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CLIENT ALERT

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Effect of Emergency Economic Stabilization Act of 2008 on Executive Compensation

Congress recently passed the Emergency Economic Stabilization Act of 2008 (the "EESA"). This legislation authorizes the Treasury Department to purchase "troubled assets" from financial institutions under a new Troubled Asset Relief Program. Included in the EESA are a number of important provisions affecting executive compensation arrangements of participating financial institutions. These provisions include limits on the ability of participating financial institutions to deduct compensation paid to certain executives, excise taxes, mandatory "clawback" provisions for certain types of executive bonus arrangements, and absolute prohibitions on certain compensation. The Treasury Department's guidance provides for three primary programs in which financial institutions may, depending on their circumstances, participate — the Capital Purchase Program, the Troubled Asset Auction Program and the Program for Systemically Significant Failing Institutions. The specific applicable executive compensation provisions/limitations will depend on the program under which the financial institution participates. This alert gives an overview of the methods of participation provided in the legislation and the applicable executive compensation provisions. Implementation of, and guidance regarding, the legislation is rapidly evolving. We understand, for example, that the government may limit direct asset purchasing under these programs.

Method of Participation

Financial institutions may participate in several programs under the Troubled Asset Relief Program, including (1) the Capital Purchase Program, (2) the Troubled Asset Auction Program and (3) the Program for Systemically Significant Failing Institutions.

Under the Capital Purchase Program, the Treasury Department may directly acquire assets from, and take a debt or equity position in, the participating financial institution.

Under the Troubled Asset Auction Program, the Treasury Department will purchase assets by auction. The selling financial institution will be subject to executive compensation restrictions if more than $300 million in assets are sold to the Treasury Department if any of those assets are purchased under auction.

Under the Program for Systemically Significant Failing Institutions, the Treasury Department will provide assistance on a case-by-case basis to certain failing financial institutions.

Capital Purchase Program

Financial institutions that participate in the Capital Purchase Program will be subject to various restrictions for their senior executive officers. Senior executive officers include the CEO, CFO and the three most highly compensated officers (other than the CEO and CFO). Executive compensation limitations for these financial institutions include:

- **Prohibited Incentives**: During the period that the Treasury Department holds an interest in the financial institution, the institution must conduct reviews of compensation policies to ensure that such policies do not encourage senior executive officers to make unnecessary or excessively risky decisions that threaten the value of the financial institution. Financial institutions must conduct this review within 90 days of initial participation in the program and annually thereafter.

- **Clawbacks**: Incentive and bonus arrangements of participating financial institutions must provide the right to recover incentive or bonus compensation paid to a senior executive officer during the period that the Treasury Department holds an interest in the financial institution, if that compensation was paid based on reported institution performance that later proves to be materially inaccurate. This clawback provision is broader than the clawback established by the Sarbanes-Oxley Act, in that it applies to a larger group of entities and may be triggered more easily.

- **Golden Parachute Restrictions**: Participating financial institutions are prohibited from making certain golden parachute payments to senior executive officers during the period that the Treasury Department holds an interest in the financial institution. For this purpose, a golden parachute payment includes amounts payable to a senior executive officer because of an "applicable termination" from employment, when such compensation exceeds three times the senior executive officer's base amount. The base amount generally equals the officer's average annual compensation for the five preceding years. An applicable termination from employment includes an involuntary termination, certain "good reason" voluntary terminations, and a termination in connection with any bankruptcy, insolvency or receivership of the financial institution.

- **Limit on Deductible Compensation**: Participating financial institutions (including both public and private companies) are not permitted to take a deduction in excess of $500,000 for compensation paid to senior executive officers. Generally, this would prevent an institution from taking a deduction for compensation paid in excess of $500,000 per year to a senior executive officer. These rules also provide that amounts deferred to a subsequent year will be considered in calculating the $500,000 limit.

Troubled Asset Auction Program

Financial institutions that participate in the Troubled Asset Auction Program will be subject to certain restrictions if they sell more than $300 million in assets to the Treasury Department. For purposes of determining whether a financial institution participating in the auction program has surpassed the $300 million limit, assets sold directly to the Treasury Department under the direct purchase program will also be considered. Executive compensation limitations for these financial institutions include:

- **Prohibition on Golden Parachute Agreements**: Participating financial institutions will be prohibited from entering into any new compensation agreements that would provide a senior executive officer with a golden parachute payment (as defined above). For this purpose, a renewal of an existing agreement will generally be treated as a new agreement.

- **Golden Parachute Excise Tax and Deduction Limitation**: Amounts paid in excess of the golden parachute limits described above will not be deductible to the participating financial institution and will subject the receiving senior executive officer to a 20 percent excise tax.

- **Limit on Deductible Compensation**: As with companies participating in the Capital Purchase Program, financial institutions participating in the Troubled Asset Auction Program will not be permitted to take a deduction in excess of $500,000 for each senior executive officer.

Program for Systemically Significant Failing Institutions

The Treasury is also issuing guidance for the executive compensation limitations that will apply to the financial institutions participating in this program. These rules will be similar to the rules for the Capital Purchase Program. However, the prohibition on golden parachute payments is more restrictive and prohibits any severance payments to senior executive officers on an "applicable termination" (i.e., even if such severance is less than three times the senior executive officer's base amount).

Offshore Deferred Compensation

In addition to the executive compensation restrictions for financial institutions participating in the Troubled Asset Relief Program, the EESA also created more widely applicable restrictions on payments of offshore deferred compensation. These provisions are codified in Section 457A of the Internal Revenue Code and generally prohibit U.S. taxpayers from deferring U.S. income tax on compensation for services performed for offshore employers located in low-tax jurisdictions.

Conclusion

The executive compensation consequences of the various programs under the EESA are significant, and many questions remain unanswered (e.g., how do affected companies deal with existing contractual obligations to executives in light of the restrictions). Participating companies should carefully review their executive compensation programs to avoid unintended violations. Additionally, the reach of these new executive compensation limitations and prohibitions may spread as the Treasury Department issues new guidance, and they may foreshadow more generally applicable executive compensation legislation under the new administration. Finally, even companies that do not participate directly in the EESA may find themselves subject to the rules in the event that an affiliate participates in the program or if they enter into mergers or acquisitions with entities that have received EESA benefits.

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