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The Impact of the Bailout Legislation on Bank Executive Compensation: CPP Participants

The Emergency Economic Stabilization Act of 2008 (the "Act") contains many provisions and law changes that directly affect financial institutions. Among other provisions, the Act would (i) establish a Financial Stability Oversight Board to review and make recommendations regarding the exercise of authority under the Act, (ii) authorize a study on and restate the Securities and Exchange Commission's authority to suspend application of mark-to-market accounting standards and (iii) temporarily increase FDIC deposit insurance coverage from $100,000 per account to $250,000 per account (until December 31, 2009).

One of the major provisions of the Act is the ability of financial institutions to raise additional capital through the sale of preferred stock to the Department of the Treasury (referred to as the Capital Purchase Program ["CPP"])." To participate in the CPP and sell preferred stock to the Treasury, publicly traded financial institutions were required to apply by November 14, 2008, and privately held financial institutions must apply by December 8, 2008. The specific terms of the CPP are outside the scope of this article, but can be found at http://www.treas.gov/press/releases/hp1207.htm.

One of the key concepts in the Act relates to limitations on executive compensation imposed upon financial institutions that participate in the CPP. The purpose of this article is to briefly summarize the executive compensation limitations of which banks who have elected, or who are contemplating electing, to participate in the CPP must be mindful.

To participate in the CPP, among other requirements, the financial institution must abide by certain restrictions or agreements with respect to executive compensation. These restrictions were described in an interim final rule (the "Interim Rule") issued by the Treasury on October 14, 2008. These restrictions or agreements are:

- a limitation on compensation to exclude incentives for senior executive officers (an "SEO") of the financial institution to take unnecessary and excessive risks (an undefined term) that threaten the value of the financial institution ("No Risks Limitation");
- a provision for the recovery by the financial institution of any bonus amount(s) or incentive compensation paid to an SEO that is based upon earnings, gains or other criteria that are later proven to be materially inaccurate ("Clawback Requirement");
- a prohibition on the financial institution making any golden parachute payments to a SEO ("Golden Parachute Limitation"); and

- an agreement by the financial institution to limit to $500,000 federal income tax deductions for certain executive compensation ("Deduction Limitation").

These restrictions and conditions apply during the period that the Treasury holds any equity or debt of the financial institution (the "Treasury Investment Period") (including the warrants). For purposes of these restrictions, "SEO" essentially means (i) the principal executive officer of the financial institution, (ii) the principal financial officer of the financial institution and (iii) the next three most highly compensated executive officers of the financial institution.

This article focuses on the Interim Rule, which provides guidance on how to implement, monitor and/or address the four executive compensation limitations listed above that apply to CPP participants. Certain of the limitations require corporate governance measures that must be taken and certified to the financial institution's primary regulator (or to the Securities and Exchange Commission ["SEC"] if the financial institution has registered securities). Because most financial institutions do not have securities registered with the SEC, this article will focus on the CPP requirements applicable to non-SEC-registered financial institutions, and will discuss in more detail each of the four limitations listed above.

Implementing the No Risks Limitation

The Interim Rule requires financial institutions participating in the CPP to exclude from executive compensation incentives that encourage a SEO to take unnecessary and excessive risks that threaten the value of the financial institution. The term "unnecessary and excessive risk" is not defined in the Act or the Interim Rule, which of course leaves this particular limitation open to tremendous interpretation. An unnecessary and excessive risk for one financial institution located in one region of the country may be very different from a risk for another financial institution. Similarly, rural versus urban financial institutions face different types of risks. While guidelines would be helpful, there are none provided.

Nevertheless, the Interim Rule requires that, in order to comply with the No Risks Limitation, financial institutions participating in the CPP must adhere to the following rules during the Treasury Investment Period (this would include the terms of the warrants):

(i) promptly, but not more than 90 days after a sale of preferred stock under the CPP, the financial institution's compensation committee, or similar committee, must review the SEO(s) incentive compensation arrangements with the financial institution's senior risk officer (or other similar officer) to ensure that the arrangement does not encourage the SEO to take unnecessary and excessive risks that would threaten the value of the financial institution (again, an undefined concept);

(ii) at least annually, the compensation committee must meet with the financial institution's senior risk officer to discuss and review the relationship between the financial institution's risk management policies and practices and the SEO(s) incentive compensation arrangement; and

(iii) the compensation committee must certify (to the SEC if securities are registered and otherwise to the financial institution's primary regulator) that it has completed the reviews required under (i) and (ii) above.

The incentive compensation arrangements that should be reviewed include, but are not limited to, employment agreements, bonus compensation programs, deferred compensation arrangements, severance arrangements, change in control arrangements, retention and similar agreements, stock option or other equity-based compensation agreements, and other arrangements that provide some form of incentive compensation to SEOs. Based upon our experience, these types of arrangements often have incentive-based components. If the review identifies such incentives, the arrangement must be carefully analyzed to determine if it encourages the taking of unnecessary or excessive risks, and, if so, it must be amended or revised appropriately to temper or eliminate the incentives. As previously stated, examples of what constitutes an incentive that encourages the taking of unnecessary or excessive risks are not provided, but such incentives would likely include incentives based upon "loan growth," or "earnings,"' or even the attainment of stated bank performance levels. The Treasury is looking for "quality" loan growth, and incentives related to management of the financial institution that encourage healthy, low-risk growth. Incentives based upon "earnings" or general bank performance would likely need to be revised to ensure that this fairly broad incentive would not lead an SEO to be aggressive in attaining the stated goals.

Implementing the Clawback Requirement

The Interim Rule requires financial institutions that participate in the CPP to recover any bonus amount(s) or incentive compensation paid to a SEO during the Treasury Investment Period that was based upon earnings, gains or other criteria that are later proven to be materially inaccurate. This limitation likely would require that any arrangements that provide for bonus amounts based upon earnings, gains or other similar criteria be reviewed and amended to add provisions to implement, or make such payment subject to, the Clawback Requirement. Administrative procedures will also need to be implemented to continue to assess the attainment of the criteria. Participating institutions should also be aware that this limitation appears to have no expiration date; therefore, bonus amounts paid today that are determined ten years from now to have been based upon "cooked books" would be subject to the Clawback Requirement.

Implementing the Golden Parachute Limitation

The Interim Rule requires financial institutions that participate in the CPP to prohibit the financial institution from making any "golden parachute" payments to a SEO during the Treasury Investment Period. The Act adds a new provision to Section 280G of the Internal Revenue Code of 1986, as amended, to define "golden parachute" payment for purposes of the Golden Parachute Limitation.

Specifically, under Code Section 280G(e), a "golden parachute" payment is any payment in the nature of compensation to (or for the benefit of) an SEO made on account of applicable severance from employment to the extent that the aggregate value of such payment(s) equals or exceeds three times the SEO's "base amount." "Base amount" is the SEO's average compensation (Form W-2 wages) over the five years prior to the year in which the severance payment is made.

An "applicable severance from employment" means the SEO's severance from employment with the financial institution (i) by reason of involuntary termination or (ii) in connection with any bankruptcy filing, insolvency or receivership of the financial institution. "Involuntary termination" includes a voluntary termination for "good reason" due to a material change in the SEO's employment relationship (what this means is uncertain, but presumably refers to a traditional "good reason" definition including compensation or benefit restrictions, relocation, title change, duty changes, etc.). "Involuntary termination" also includes situations in which the SEO "resigns" before the involuntary termination, when it is certain that the financial institution was going to terminate the SEO.

A payment is on account of an "applicable severance from employment" if it is a payment that would not have been payable if there were no applicable severance from employment (including amounts that would have been forfeited if no applicable severance from employment had occurred) and amounts that are accelerated on account of applicable severance from employment (such as stock options or vesting in deferred compensation amounts).

Unlike the traditional application of Code Section 280G, which applies to payments in the nature of compensation made on account of or contingent upon a change of control of the paying corporation, the Golden Parachute Limitation essentially applies to severance payments resulting from involuntary termination of employment during the Limitation Period, if the severance payment(s) exceed three times the "base amount." There is no additional requirement of a change of control. It would appear, therefore, that the more uncommon "single-trigger" change of control payment is not a "golden parachute" payment for purposes of the Golden Parachute Limitation, and thus could be made, subject of course to Code Section 280G, and, more importantly for this discussion, subject to the application of the Deduction Limitation (described below).

Also unlike the traditional application of Code Section 280G, under the Golden Parachute Limitation, there is no exception for payments made by "small business corporations." Finally, and most important, unlike the traditional application of Code Section 280G, which permits the golden parachute payment but applies excise taxes and limits the deductibility of the "excess parachute payments," the Act prohibits the payment of a "golden parachute" payment completely. This raises a number of interesting issues, including how a participating institution deals with existing contractual obligations with SEOs.

The Deduction Limitation

In addition to the above prohibitions, and likely more important than the other limitations, a financial institution that participates in the CPP must agree, as a condition to participation, that no deduction for federal income tax purposes will be claimed by the financial institution for

compensation that would not be deductible if Section 162(m)(5) applied to the financial institution.

Section 162(m) of the Code generally limits the allowable deduction for compensation paid to a "covered executive" of a publicly held corporation to no more than $1,000,000, unless the compensation is performance-based compensation. New Section 162(m)(5) of the Code added as part of the Act provides that in the case of an "applicable employer," the deduction limitation of Code Section 162(m) with respect to a "covered executive" is reduced to $500,000. An "applicable employer" includes a financial institution that participates in the CPP, while "covered executives" are SEOs. These rules apply during the Treasury Investment Period. Each year during the Treasury Investment Period is referred to as an "applicable tax year."

Additionally, under Code Section 162(m)(5), there is no exception for performance-based compensation. Thus all compensation payable to a SEO during the Limitation Period is subject to this limitation. Finally, for purposes of Code Section 162(m)(5), compensation includes current compensation as well as the portion of "deferred deduction" compensation for services that was taken into account in a preceding taxable year. "Deferred deduction" compensation is compensation that would be current compensation for services performed but for a deduction for such compensation being allowable in a subsequent year.

The application of Section 162(m)(5) can be broad. If an SEO is a covered executive at any time during an applicable tax year, that SEO is considered a covered executive for that tax year. Furthermore, if the SEO is a covered executive for any applicable tax year, that SEO is considered a covered executive with respect to the applicable employer for all subsequent applicable tax years and for all subsequent tax years in which deferred deduction compensation with respect to services performed in all applicable tax years would be deductible. In addition, if a financial institution that participated in the CPP is acquired by a financial institution, the acquiring financial institution does not become an applicable employer solely by reason of the acquisition. But, any SEO that is a covered executive of the selling financial institution will continue to be a covered executive if the SEO is employed by the acquiring financial institution's controlled group of which the selling financial institution becomes member, regardless of whether the acquiror is an applicable employer and regardless of whether the SEO is a covered executive of the acquiror.

Under the Deduction Limitation, during the Limitation Period, although the financial institution may pay compensation greater than $500,000 (subject to the Golden Parachute Limitation) to an SEO, for federal income tax purposes the financial institution must agree that it will claim only $500,000 of that compensation as a federal income tax deduction. Thus, as is mentioned in the Golden Parachute Limitation discussion, above, a "double-trigger" change of control payment can be changed to a single-trigger payment to avoid application of the Golden Parachute Limitation; however, the single-trigger payment is still subject to the Deduction Limitation. It is our belief the Deduction Limitation will be the tougher limitation to overcome, as most severance payments, whether in connection with a change of control or otherwise, are less than three times base amount, but very often exceed $500,000.

What does it all mean?

If a financial institution has elected to participate or is considering participation in the CPP, it needs to be aware of the executive compensation limitations. Participation in the CPP will very likely require amendments to the compensation arrangements maintained for the financial institution's SEOs, to address the executive compensation limitations. At a minimum, the financial institution should review its compensation arrangements for compliance with the No Risks Limitation and to determine how the Golden Parachute Limitation and Deduction Limitation would impact SEOs, both in the ordinary course of business and if the financial institution were to sell during the period that the Treasury holds the debt or equity position in the financial institution. That review should include both the financial institution's counsel and its compensation consultants, if any.

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