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Congress Curbs Compensation of Executives Under Financial Rescue Plan

Executive Summary

As part of the Emergency Economic Stabilization Act of 2008 (commonly referred to as the "Financial Rescue Plan" or "Bailout Bill" and referred to in this alert letter as "the Act") signed into law on October 3, various limitations have been imposed on executive compensation including:

- New limits on tax deductibility,
- Prohibition of certain golden parachute payments,
- Enhanced "clawback" provisions to recoup compensation, and
- Prohibition of incentives that involve "unnecessary and excessive risks."

The limitations apply only to financial institutions that sell assets under the Troubled Asset Relief Program ("TARP") and only to senior executive officers. The compensation limitations in the Act take various forms including some familiar regulatory mechanisms such as tax deductibility limits (IRC Sections 162(m) and 280G have been amended under the Act) and enhanced "clawback" provisions. The Act also bans "golden parachutes" (severance payments made in the case of involuntary termination or bankruptcy, irrespective of a change in control) in certain situations and introduces a new regulatory approach – preclusion of incentives to take "unnecessary and excessive risks." The tax deductibility limitations generally apply only while the TARP is in effect, which is scheduled to end on December 31, 2009, subject to possible extension by the Secretary of the Treasury for no more than two years after the Act was signed into law. The other provisions apply as long as the Treasury holds debt or equity of the financial institution. Many questions and issues regarding the provisions of the Act and its application need to be resolved.

The remainder of this letter discusses in more detail the compensation provisions and how they apply to TARP participants, as well as related provisions and issues regarding the Act.

Type and Amount of TARP Participation

The application of the various compensation limits depends on the type and amount of TARP participation by a financial institution. Under the Act, there are two general categories of TARP participants:

- Direct Purchase Only – The Secretary makes only a direct purchase of troubled assets from a financial institution where no bidding process or market prices are available, and the Treasury receives a "meaningful" equity or debt position in the financial institution.

- Auction Purchase – The Secretary makes auction purchases of troubled assets from a financial institution, and the aggregate auction purchase and any direct purchases exceed $300 million. If the aggregate purchases are $300 million or less, the provisions do not apply.

The following sections describe and contrast the compensation limits that apply to these two categories of TARP participation.

Direct Purchase Only Participants

For financial institutions that fall into the "direct purchase only" category, the Secretary must require the institution to meet appropriate standards for executive compensation and corporate governance that will apply so long as the Treasury holds an equity or debt position in the financial institution.

Under the Act, the standards will include:

- No Risky Incentives – Limits on compensation to exclude incentives for senior executive officers to take unnecessary and excessive risk that threaten the financial institution's value during the period the Treasury holds an equity or debt position;

- Clawbacks of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; and

- No golden parachute payments by the financial institution to senior executive officers during the period the Treasury holds an equity or debt position.

This section also appears to grant the Secretary authority to impose additional standards, possibly including some of the corporate governance proposals that have been mentioned in connection with the Act, such as "say-on-pay."

For purposes of this section, "senior executive officer" is defined as:

- Any individual who is one of the top five executives of a public company whose compensation is required to be disclosed under the Securities Exchange Act of 1934 and the regulations thereunder, and

- Non-public company counterparts of the individuals in the bullet above.

Auction Purchase Participants

Three different compensation provisions may apply to "auction purchase" TARP participants during the period the TARP is in effect:

- No New Golden Parachutes – The Secretary is to prohibit the financial institution from entering into a new employment contract with a senior executive officer that provides a golden parachute in the event of involuntary termination, bankruptcy filing, insolvency or receivership. (Note that "golden parachute" and "involuntary termination" are not defined.)

- New IRC Section 162(m)(5) Deduction Limitation – The amount of compensation to a covered executive that may be deducted for any taxable year the TARP is in effect ("applicable year") will be capped at $500,000, and there is no exception for performance-based compensation (including stock options). The limit applies to public and private corporations, as well as partnerships.

  The $500,000 limitation also applies to "deferred deduction executive remuneration" (DDER), i.e., compensation for an applicable year that is paid in a subsequent taxable year, even if it is after the TARP has ended. In the year the DDER is paid, it is only deductible to the extent that the $500,000 limit was not already reached due to (1) compensation paid in the year the DDER was earned and (2) prior payouts of DDER for that year.

  The definition of a "covered executive," as follows, differs from the current application of Section 162(m) by including the CFO:

  - Anyone serving as CEO or CFO during the portion of the taxable year during the period that the TARP is in effect, and

  - The three highest compensated officers (other than the CEO or CFO) for the taxable year, determined under the rules for proxy disclosure of executive compensation (only taking into account employees who are employed during the portion of the taxable year that the new $500,000 limit applies to the financial institution).

  As a further change, a covered employee in any applicable year will continue to be treated as such in any year the TARP is still in effect, even if no longer employed.

- New Section 280G(e) Golden Parachute Payment Limitation – Deductions will also be disallowed for "golden parachute payments" related to the severance from

employment of a covered executive (same meaning as in new IRC Sec. 162(m)(5)). Instead of a change in control, however, the new section applies to payments made to a covered executive due to involuntary termination, bankruptcy filing, insolvency or receivership while the TARP is in effect. Further, the Act appears to limit covered severance payments only to those made while the TARP is in effect.

Another significant effect of this provision is that the 20% excise tax under IRC 4999 (as calculated using the current "2.99x" safe harbor amount) would be applicable to the payments to the covered executive in addition to the employer being unable to deduct the payments. The Secretary has authority to issue guidance, rules or regulation to apply new 280G(e) and IRC 4999 if payments are treated as parachute payments under both 280G(e) and under 280G without regard to 280G(e).

<u>Summary of Application of Executive Compensation Provisions</u>

The application of the new compensation provisions to TARP financial institution participants is summarized in the following table:

Treasury Involvement		**Executive Compensation Provisions**				
Purchase Method	**Amount of Investment**	**No "Risky" Comp.**	**Clawback**	**No Golden Parachutes**	**New 162(m)**	**New 280G**
Direct Only	"Meaningful"	Applies Sec. 111(b)	Applies Sec. 111(b)	No payments Sec. 111(b)		
Auction	> $300 mil. including direct			No new agrmts. Sec. 111(c)	Applies Sec. 302(b)	Applies Sec. 302(b)
	< $300 mil.	*Exempt from all*				

<u>Comparison with Existing Statutory Limitations</u>

The Act's compensation provisions broadly expand existing legislative constraints on executive compensation, and include a foray into uncharted regulatory waters with the preclusion of "risky" incentives, as summarized below:

Provision	**Statutory Precedent**	**Additions in New Provision**
New 162(m)(5)	Existing IRC Sec. 162(m) (enacted in 1994)	Limit lowered to $500,000 from $1 million No performance-based exception Once a covered executive, incl. for all TARP years Includes deferred compensation Applies to private companies
New 280G(e)	Existing IRC 280G (enacted in 1984)	Not limited to change in control Applies to partnerships and private companies
Clawback	Included in Sarbanes-Oxley (enacted in 2002)	Accounting restatements not required Misconduct not required Expanded coverage (sr. exec. off. vs. CEO/CFO)
No Parachutes	Sarbanes Oxley - no loans BAPCA (2005) - no KERPs*	Extended to severance payments
No Risky Comp.	None	

* BAPCA = Bankruptcy Abuse Prevention and Consumer Protection Act; KERP = Key Executive Retention Plan

Miscellaneous Provisions

The TARP ends on December 31, 2009, unless the Secretary extends it to a period that must end by October 3, 2010. To extend, the Secretary must submit a written certification to Congress that includes a justification of why the extension is necessary to assist American families and stabilize financial markets, and the expected costs of the extension to taxpayers.

The Secretary of the Treasury is to issue guidance to carry out the prohibition on new employment contracts that provide for golden parachute payments within two months after the date of enactment of the Act.

Issues and Observations

The uncertainty associated with any new legislation will be compounded by the truncated timeframe for developing and debating the Act's provisions and the broad powers given the Secretary of the Treasury. There are many unresolved issues and questions at this point, including the following:

- How will "unnecessary and excessive risk" be defined and applied?

- How will the new $500,000 deductibility limit be applied including, for example, how stock options and multi-year performance awards made during an applicable year are to be treated?

- Are "good reason" terminations covered by the golden parachute provisions? Payments due if the executive terminates for good reason are not clearly covered, but the Senate Finance Committee's explanation of the Act suggests that the only exception is for payments on retirement.

- How will the requirements be monitored and reported, and what are the penalties for non-compliance?

- Why do some provisions apply in one situation and not another? Will the Secretary use the broad powers to apply specific provisions to other situations?

Stepping back and looking at the broader message that Congress is sending with the executive compensation provisions under the Act, there are two dominant themes:

- Direct assault on "pay for failure" by prohibiting severance payments, banning new severance agreements, enhancing clawback provisions, and extending tax penalties to certain severance payments.

- Preventing the government from subsidizing perceived excessive compensation levels by limiting or disallowing deductions and banning certain types of compensation arrangements.

As with the broader question on the ability of the Act to stabilize financial markets and the economy in general, the impact of the Act's compensation provisions is uncertain. Some observers assert that the provisions are toothless and essentially political window-dressing to gather enough votes to pass the Act. Others caution that overly onerous provisions will discourage potential participation in TARP and further hamper a broader economic recovery.

In any event, the Act is widely expected to be a harbinger of broader compensation reform and legislative activity following the November elections.

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General questions about this alert letter can be addressed to Ed Graskamp in our Chicago office at 312-332-0910 (edgraskamp@fwcook.com), Rich Alpern in our New York office at 212-986-6330 (rlalpern@fwcook.com), and David Gordon in our Los Angeles office at 310-277-5070 (degordon@fwcook.com). Specific questions should be referred to legal counsel. Copies of this letter and other published materials are available on our website at www.fwcook.com.