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Treasury Department Issues Executive Compensation Rules under the Capital Purchase Program for U.S. Financial Institutions

Executive Summary

The Treasury Department has rapidly moved forward to implement the recently enacted Emergency Economic Stabilization Act of 2008 (commonly referred to as the "Financial Rescue Plan" and referred to in this alert letter as "the Act"). Instead of implementing the Act through the direct or auction purchase of financial institution assets, initial implementation is occurring through the purchase of preferred stock in participating financial institutions, referred to by Treasury as the Capital Purchase Program ("CPP"). In order to participate in the program, the financial institutions must agree to four sets of compensation restrictions described in Interim Final Regulations ("Interim Regulations)" promulgated by the Treasury Department on October 14 that apply to senior executive officers ("SEOs") of participating institutions. The four compensation curbs are:

- Prohibition of incentives that involve "unnecessary and excessive risks,"
- Enhanced "clawback" provisions to recoup compensation,
- Prohibition of golden parachute payments in the case of certain severances of employment, and
- New $500,000 limit on tax deductibility of compensation.

The remainder of this letter discusses in more detail the compensation restrictions and how they apply to CPP participants. The discussion below under "Rule 3—Golden Parachute Limits" will also describe the provisions of an additional notice issued by the Treasury Department that will apply to any direct purchases of troubled assets by the Department of the Treasury through "programs for systemically significant failing institutions."

Participation in the CPP

While it has been widely reported that nine leading financial institutions have agreed to participate in the CPP, it is less widely understood that the CPP is, according to the

Treasury Department, potentially available to all "qualifying U.S. controlled banks, savings associations, and certain bank and savings and loan holding companies" that elect to participate by November 14, 2008. This is potentially thousands of organizations. The details as to which institutions will qualify have not been announced, but we expect many financial institutions to apply for participation in the CPP.

Under the CPP, the bank or other financial institution (this letter will refer to the participant as a "bank") may apply by November 14 to sell senior preferred stock to the Treasury Department. The Treasury Department will then, according to its press release, "determine eligibility and allocations after consultation with the appropriate federal agency." Many banks will find the terms of the preferred stock attractive--the preferred stock pays a 5% dividend for the first five years, resetting at 9% after year five if still outstanding. The Treasury Department website, http://www.treas.gov/initiatives/eesa/, contains a standardized summary term sheet of the preferred stock terms and other conditions that a bank must agree to in order to participate in the CPP. The website also contains references to the other relevant rules that govern the program.

To participate in the CPP, the bank must agree to the applicable executive compensation and corporate governance standards of the Act. This agreement continues during the period the Treasury Department owns any equity or debt securities of the bank (the "CPP Period"). As an additional condition to the issuance of the Treasury's purchase of the preferred stock, both the bank and the SEOs must agree to any necessary modifications to benefit plans that are required for compliance with the Act and to a waiver of any claims that the bank and the SEOs may have against the Treasury Department on account of such modifications.

Definition of SEOs

Generally, an SEO is (1) the principal executive officer (PEO) of the bank (or, if applicable the bank's parent), (2) the principal financial officer (PFO) of the bank (or, if applicable the bank's parent), and (3) the three most highly compensated executive officers of the bank, excluding the PEO and the PFO. In determining compensation levels, the SEC rules used for determining the most highly compensated executive officers for proxy statement purposes will apply.

While public issuers are now familiar with the SEC's methodology for determining compensation levels among executive officers, there are issues related to implementing the SEO definition. For example,

- The Interim Regulations do not clarify how the PEO and PFO rules apply when more than one person occupies that position during the year.

- The Interim Regulations state that all parent-subsidiary controlled entities are aggregated for the purposes of the regulations.

- The rules appear to indicate that the SEO determination for a current year is based on the compensation for that year and state that the bank "should make its best efforts" to determine who will be the three most highly compensated persons for the year. This "best efforts" test could be problematic in the case of golden parachute payments--the executive may be entitled to immediate payment, but the amount that can be paid will be limited if the executive is an SEO, which apparently cannot be finally determined until the year is over.

- The SEO rules apply to all banks, including those that are not subject to the SEC proxy statement rules, requiring these banks to now learn and apply the complex SEC rules for measuring compensation.

The Interim Regulations also contain guidance with respect to how the SEO rules apply in the event of an acquisition, merger, or other reorganization. If the target company participated in the CPP but the acquirer did not (and was not related to the target company), the general rule is that the acquirer will not become subject to the Interim Regulations as a result of the acquisition. In addition, any SEOs of the target will only retain that status until the first anniversary date of the acquisition.

Rule 1—Limits on Incentive Compensation That Encourages Excessive Risk Taking

The Act requires SEO compensation to exclude incentives to encourage excessive risk-taking during the period that the Treasury holds preferred stock. This rule has not been implemented with substantive standards, but through the imposition of a series of procedural requirements that apply to a bank's compensation committee (self-policing):

- Within 90 days after the stock is issued, the compensation committee must meet with the bank's "senior risk officers, or other personnel acting in a similar capacity" to review the SEOs' incentive compensation arrangements and identify any features in the SEO's compensation arrangement that would lead the SEO to take "unnecessary and excessive risks that could threaten the value of the financial institution." Then, presumably, the committee must act to change the incentive arrangements to remove the incentive for excessive risk-taking;

- Thereafter, the compensation committee must meet annually with senior risk officers to "discuss and review the relationship between the financial institution's risk management policies and practices and the SEO incentive compensation arrangements;" and

- The compensation committee must certify that it has completed these reviews and that it "has made reasonable efforts to ensure that such arrangements do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the financial institution." This statement must be part of the Compensation Discussion and Analysis ("CD&A") of a bank that files a proxy statement, or in other regulatory filings for non-public entities.

Rule 2—Clawback Rules

Under the second rule, any incentive compensation paid to the SEO while the Treasury Department owns the preferred stock must be repaid to the bank if the payment was "based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria."

The Interim Regulations note that this repayment rule is significantly broader than a similar rule found under the Sarbanes-Oxley Act of 2002 ("SOX") because:

- It applies to the SEOs while SOX only applies to the PEO and PFO;
- SOX is exclusively limited to an accounting restatement while the Interim Regulations apply to any inaccurate performance criteria;
- Unlike SOX, the Interim Regulations do not limit the recovery period for payments subject to clawback.

Rule 3—Golden Parachute Limits

The Interim Regulations significantly clarify the rule in the Act that "golden parachute payments" cannot be paid to SEOs during the period that the Treasury holds the preferred stock. An initial concern was that no severance payment could be made to SEOs. The Interim Regulations clarify that severance payments can be made if they are below the amounts that would trigger an excise tax under the golden parachute rules in the Internal Revenue Code (described below).

Two important threshold aspects of the rule should be noted:

- The rule is intended to override existing contractual provisions and, as previously indicated, a condition to participation in the CPP is the agreement of the bank and the SEOs to any necessary modifications; and
- The prohibition literally only applies to payments to the SEO during the period that the Treasury Department holds the preferred stock. For example, if the SEO terminated during the holding period, it appears that the Golden Parachute Limits do not apply to payments after the end of the holding period.

One of the most important clarifications in the Interim Rules is the definition of golden parachute payments to only include payments that are large enough to trigger the loss of deduction/20% excise tax penalties of the golden parachute rules in sections 280G and 4999 of the Internal Revenue Code (the "280G rules"). The 280G Rules are only triggered when severance payments equal 300% or more of an executive's "base amount." The base amount is equal to the average of an executive's W-2 pay over the five years preceding the severance. For example, if the average annual W-2 pay for those

five years was $600,000, the Golden Parachute Limits in the Interim Regulations would allow severance payments of up to $1,799,999.

The Interim Regulations also clarify the circumstances under which the Golden Parachute Limits apply. They are the SEO's severance from employment (1) by reason of involuntary termination of employment or (2) in connection with any bankruptcy filing, insolvency, or receivership of the bank (or any entity aggregated with the bank).

The Interim Regulations contain several operating rules for determining when a severance is an involuntary termination. An involuntary termination will include:

- The SEO's termination because of failure to renew an employment agreement if the SEO was willing to execute a new contract with substantially similar terms and conditions;

- The SEO's quitting voluntarily if the termination would constitute a termination for good reason due to a material negative change in the SEO's employment relationship, as defined in the regulations under 409A of the Code. These regulations contain a lengthy list of circumstances that would constitute such a material negative change including, for example, a material diminution in the SEO's base pay, authorities, duties, or responsibilities, or a material change in the SEO's job location; and

- A voluntary termination where the SEO was aware of the fact that the bank would have otherwise terminated the SEO.

The rules also state that an involuntary termination will not be deemed to occur if the bank fires the SEO at the SEO's request when the SEO was willing to continue working. (This is an unusual fact pattern and we are unsure what situation the Treasury Department was concerned about.)

The determination of what amounts are being paid on account of the termination will follow the rules of 280G. For example, if payment of amounts is accelerated or amounts are vested earlier than otherwise would occur, the Interim Regulations refer to the 280G rules for calculating the value of the acceleration and vesting.

Modified Golden Parachute Rules for Direct Purchases of Troubled Assets. On the same day that the Interim Regulations were issued the Treasury Department also issued a notice containing executive compensation rules for banks that sell troubled assets to the Treasury Department (the "Direct Purchase Provisions"). Since no program yet exists to buy such assets and the notice states that "further guidance will be issued for any additional programs," additional executive compensation rules may be issued when such programs are actually initiated.

The Direct Purchase Provisions are identical to the Interim Regulations with the major exception of the required ban on golden parachute payments. Unlike the Interim

Regulations, the Direct Purchase Provisions disallow ***all*** parachute payments. This would not only include additional payments conditioned on a covered severance, but any accelerations of payments or additional vesting in benefits conditioned on the severance. The Direct Purchase Provisions indicate that they only apply to payments “that would not have been payable if no applicable severance from employment had occurred.” This suggests that, if the payment would have been made in the event of a voluntary termination (such as, for example, unused vacation pay), it could still be paid in the event of an involuntary severance.

Rule 4—$500,000 Deduction Limit on SEO Compensation

One of the surprises in the Act was that, while it amended 162(m) of the Code to limit deductible compensation to $500,000, this statutory change only applied to entities that sold securities to the Treasury Department through an auction process. Some commentators speculated that the Treasury would extend a similar rule to direct purchases of assets under its authority to prescribe “appropriate standards for executive compensation” in the case of direct asset purchases. This is, in fact, what has happened. As a condition to participating in the CPP, the bank must agree to not claim any deduction that would be disallowed if new section 162(m)(5) applied to the bank. The IRS recently issued Notice 2008-94, which contains guidance with respect to the interpretation of the new 162(m)(5) rules, including confirmation that there is no performance-based compensation exception to this deduction limitation.

The new deduction limit applies to the SEOs throughout the CPP Period. It also appears that SEO status is permanent (that is, once a person is an SEO, he or she remains an SEO throughout the CPP Period) and that, if someone becomes an SEO during the year, he or she is treated as an SEO throughout the year.

It is easiest to understand the operation of the Deduction Limit by first focusing on the situation where the executive is an SEO throughout the year and the entire year is during the CPP Period. In this case the deduction for compensation for that SEO is limited to $500,000.

The rules become more complicated if the SEO earns compensation in one year but it is paid in another year. Assume that the Deduction Limits apply in 2009, the SEO is paid $400,000 in 2009 and receives an additional $200,000 in 2011 for services in 2009. In this case, only $100,000 of the $200,000 deferred payment may be deducted in 2011. This is because the $400,000 payment in 2009 used up all but $100,000 of the deduction limit for 2009, so the additional $200,000 is only deductible up to $100,000. Moreover, it does not matter whether 2011 is within the CPP Period.

The Deduction Limit Rules contain guidance with respect to how the deduction limit applies when payments cover services over multiple years or consist of equity compensation. The basic rule is that the compensation is prorated over the different years in which it was earned. For this purpose, compensation is determined with reference to the amount that the bank would otherwise deduct. For example, if a stock option were

issued January 1, 2009 during the CPP Period and cliff vested at the end of four years, one-quarter of the compensation attributable to the option would be treated as allocated to each of the years 2009 through 2012. The amount of the compensation could only be determined when the option was exercised. For example, if the option were exercised in 2015 at a profit of $900,000 (potentially entitling the bank to a $900,000 deduction), $225,000 of the deduction would be considered allocated to each of the years 2009 through 2012 for the purpose of applying the Deduction Limit. The amount of the deduction for 2015 would be determined by first ascertaining which of the years 2009 through 2012 were in the CPP Period and how much of the $500,000 deduction limit had previously been utilized.

One important issue that may warrant further guidance is the application of the Deduction Limits when the CPP Period is less than a full taxable year. This issue is of immediate relevance since 2008 preferred stock purchases for 2008 will be occurring only in the last quarter of this year. The Interim Regulations state that the "dollar limitation and the remuneration for the taxable year are prorated for the portion of the year" that is within the CPP Period. Assume a preferred stock purchase occurs December 1, 2008. Does this mean that the deduction limit for 2008 for an SEO is $41,666 (1/12th of $500,000) and that this applies to 1/12th of the compensation of that SEO for 2008, regardless of when it is paid?

Issues and Observations

While many questions remain to be answered with regard to the executive compensation limits applicable to CPP participants, the initial guidance represents a substantial accomplishment given how quickly the Treasury Department has responded.

An important issue for a compensation committee to consider in structuring the scope of its review of incentive compensation arrangements is that the certification in the CD&A that it has made reasonable efforts to ensure that incentive compensation arrangements do not lead to excessive risk potentially creates liabilities under both the Exchange Act and the Securities Act.

Also, as part of the CPP, the Treasury Department must receive a warrant to purchase stock from any participating bank--another important question is whether the Treasury regulations on executive compensation extend during the period the Treasury no longer holds preferred stock but still owns a warrant to purchase the institution's common stock.

While some significant questions thus remain, the current guidance appears sufficient to enable a bank adequately to evaluate the executive compensation requirements that will apply if it determines to participate in the CPP.

The Treasury's Interim Regulations only apply to organizations that participate in the Treasury's Rescue Plan. We expect, however, that the compensation committees of other companies will begin asking whether they should not voluntarily consider applying the risk assessments, recoupment policies, and separation caps to their own organizations. In

addition, it is possible that Congress may legislate adoption of some or all of the standards in the Interim Regulations.

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