

Client Alert

Employee Benefits Department

November 19, 2008

Emergency Economic Stabilization Act of 2008 (“Act”) Affects Certain Executive Compensation

I. TARP

The Act authorizes the Treasury Department to establish a Troubled Assets Relief Program or TARP. The Act includes several provisions that are designed to limit and discourage financial institutions that participate in the TARP from paying excessive compensation, particularly severance, to senior executives. For these purposes, a senior executive officer (“SEO”) is an 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 their non-public company counterparts. The interim final rule on executive compensation for firms involved in TARP provides additional guidance for determining SEOs.

Under the Act, there are two general categories of TARP participants, direct purchase (referred to as the Capital Purchase Program or “CPP”) and auction purchase.

Direct Purchase

If the Treasury Department makes a direct purchase of troubled assets from a financial institution and receives a “meaningful” (undefined) debt or equity position, the Treasury Secretary must require the institution to meet appropriate standards for executive compensation and corporate governance that will apply so long as Treasury holds a debt or equity position in the financial institution. These standards will include:

- limits on compensation to exclude incentives for SEOs to take “unnecessary and excessive risk” that threaten the financial institution’s value during the period that Treasury holds an equity or debt position;
- recovery (“clawbacks”) of any bonus or incentive compensation paid to a SEO based upon 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 SEOs during the period that Treasury holds an equity or debt position. With respect to existing contracts, bifurcation may be required, i.e., prohibiting golden parachutes during the TARP period and permitting them thereafter.

The IRS has issued interim final regulations which:

- require the compensation committee of a financial institution to identify the features in the institution’s SEO incentive compensation arrangements that could lead SEOs to take “unnecessary and excessive risks” that could threaten the value of the financial institution. While “unnecessary and excessive risks” is not defined, because, in the IRS’ view, “each financial institution faces different material risks given the unique nature of its business and the markets in which it operates,” the compensation committee is required to review the SEO incentive compensation arrangements with the financial institution’s senior risk officers, to ensure that

SEOs are not encouraged to take such risks. Such review must occur promptly, and not more than 90 days, after the direct purchase by Treasury. The compensation committee must also meet annually with the institution's senior risk officers to discuss the issue, and certify that it has completed this review;

- discuss the relationship between the Act's clawback and the clawback under the Sarbanes-Oxley Act, and indicate the difference between them.

The Secretary also has authority under the Act to impose additional standards of corporate governance. In the interim final regulations, the IRS requires that a financial institution must agree, as a condition of participation in the CPP, that no deduction will be claimed for federal income tax purposes for remuneration, that would not be deductible if the Code Section 162(m) rules capping deductions on certain payments to CEOs, discussed below, were to apply to the financial institution. This rule only applies for taxable years that include the period that the Treasury holds an equity or debt position in the financial institution.

Auction Purchase

With respect to auction purchases, the following rules apply:*

- The financial institution is barred from entering into a new employment contract with a CEO that provides a "golden parachute payment" to the executive in the event of the executive's "involuntary termination of employment" or in connection with the bankruptcy, liquidation or receivership of the institution. In Notice 2008-TARP, the IRS provided the following guidance with respect to this requirement:
 - For purposes of determining whether the aggregate amount of assets acquired from a financial institution exceeds \$300 million, two or more employers that are treated as a single employer under Code Sections 414(b) and 414(c) are treated as a single financial institution except that the rules for applying brother-sister combined groups and controlled groups are disregarded.
 - "golden parachute" means any payment in the nature of compensation to or for the benefit of a CEO on account of an applicable severance from employment to the extent the aggregate present value of such payment equals or exceeds three times the base amount. An "applicable severance from employment" is one by reason of the involuntary termination of employment by, or in connection with, the bankruptcy filing, insolvency or receivership of the financial institution.
 - "Involuntary termination of employment" means a termination from employment due to the independent exercise of the unilateral authority of the employer to terminate the CEO's services, other than due to the CEO's requesting termination of employment. It also can include failure to renew a CEO's contract, a "good reason" termination under the Code Section 409A regulations or a voluntary termination of employment where, had the CEO not agreed to a voluntary termination of employment, the financial institution would involuntarily have terminated his or her employment.
 - Payments on account of an applicable severance from employment do not include distributions from a tax qualified retirement plan.
 - A "new employment contract" means any material compensatory contract entered into on or after the date when the Act applies to an institution. A contract that is renewed is treated as entered into on the date of renewal.

Similarly, if a contract is materially modified, it is treated as a new employment contract on the date of the material modification. For these purposes, a contract is materially modified if it is amended to increase the amount of compensation payable to the employee, to accelerate the date on which vesting occurs, or to accelerate the payment under the contract.

- If a financial institution that had sold troubled assets to Treasury under TARP is acquired by an entity that is not related to such entity, then the troubled assets sold to Treasury under TARP by the target are not aggregated with any assets sold by the acquirer either prior to or after the acquisition.
- The \$1,000,000 cap on deductible compensation under Code Section 162(m) is modified in a number of respects for any taxable year that the TARP is in effect. First, the amount of compensation that a covered executive may receive that may be deducted in any taxable year that the TARP is in effect is restricted to \$500,000, with no exception for performance based compensation, including stock options. For these purposes, a “covered executive” means (i) anyone serving as CEO or CFO during any portion of the taxable year that the TARP is in effect and (ii) the three most highly compensated officers (other than the CEO or CFO) for the taxable year, determined under the rules for proxy disclosure of executive compensation. Additionally, a covered executive in any applicable year will continue to be treated as such in any year that the TARP is still in effect. This \$500,000 limitation applies to public and private corporations, as well as partnerships. Finally, the \$500,000 limitation also applies to “deferred deduction executive remuneration,” i.e., compensation for an applicable year that is paid in a subsequent taxable year, even after the TARP has ended. The TARP is scheduled to end on December 31, 2009, but subject to possible extension by Treasury to end not later than October 3, 2010.
- The golden parachute rules under Code Section 280G, which currently apply to payments to certain persons in connection with a change in control, would be amended to subject to these rules, any payment upon the severance from employment of a top five officer (as defined under Code Section 162(m)), by reason of an involuntary termination or in connection with a bankruptcy, liquidation, or receivership. Under the golden parachute rules, if an executive receives payment in excess of three times the executive’s annual pay over a five year base period, then the amount in excess of one times annual pay is not deductible and is subject to a 20% excise tax payable by the executive.
- Additionally, Treasury is currently developing a third program to potentially provide direct assistance to certain failing firms on terms negotiated on a case-by-case basis - “Program for Systemically Significant Failing Institutions.” These standards are similar in all respects to the direct purchase executive compensation standards under CPP, except that golden parachutes will be defined more strictly to prohibit any payments to departing CEOs.

II. Incentive Stock Option (“ISO”) Alternative Minimum Tax (“AMT”) Relief

Any tax underpayment, interest and penalties outstanding on October 3, 2008 for pre-2008 tax years and attributable to the AMT treatment of ISOs is immediately abated, and for 2008 and 2009 there is an increase in the AMT refundable tax credit and minimum tax credit.

While these provisions have a significant effect, the TARP provisions apply only for a limited period of time and to a limited number of institutions. However, a new administration with a filibuster-proof majority in the Senate could enact more extensive reforms with respect to executive compensation. Similarly, a proposal to tax carried interests as ordinary income could be enacted.

Manes M. Merrit
mmerrit@olshanlaw.com

Nina B. Krauthamer
nkrauthamer@olshanlaw.com

Barry L. Salkin
bsalkin@olshanlaw.com

Annette E. Messano
amessano@olshanlaw.com