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Executive Compensation under the Emergency Economic Stabilization Act of 2008

The Emergency Economic Stabilization Act of 2008, which President Bush signed into law on October 3, 2008, includes restrictive provisions affecting the compensation of top executives at financial institutions that sell troubled assets pursuant to the relief program authorized by the Act. The executive compensation features of the Act fall into two categories:

- Section 111 of the Act directs the Secretary of the Treasury to establish two sets of substantive standards for executive compensation. Section 111(b) mandates "applicable standards" of compensation for certain institutions from which Treasury acquires troubled assets in direct purchases, while Section 111(c) prohibits new "golden parachute" arrangements for senior executive officers of certain institutions that sell troubled assets through auctions.
- Section 302 of the Act amends Sections 162(m) and 280G of the Internal Revenue Code to create special rules that limit the deductibility of compensation and parachute amounts paid to covered executives at institutions participating in the troubled assets relief program under the Act.

The executive compensation provisions of the Act, particularly Section 111, are replete with ambiguity, and their application will raise a myriad of legal and interpretive issues. In this client alert, we present our preliminary reactions to the new legislation.

Section 111: Direct Federal Regulation of Compensation

In Section 111 of the Act, Congress directs the Secretary of the Treasury to regulate certain compensation practices at financial institutions that participate in the troubled assets relief program. The rules differ for institutions from which the Secretary authorizes direct purchases of troubled assets and for institutions from which the Secretary purchases troubled assets through an auction process.

<u>Direct Purchases</u>. Section 111(b) provides the directive for rules that will apply where the Secretary makes <u>direct purchases</u> of troubled assets from a financial institution where no bidding process or market prices are available <u>and</u> the government receives a "meaningful equity or debt position" in the institution as a result of the transaction. Whether an equity or debt position is "meaningful" is left for future determination, presumably by rulemaking. Section 111(b) is not triggered in situations where the government does not acquire an equity or debt position, or where it acts to guarantee troubled assets pursuant to the authority granted under Section 102 of the Act.

Where Section 111(b) is triggered, the Secretary is directed to require the financial institution to meet "appropriate standards for executive compensation and corporate governance". These standards must follow the following three principles:

- Compensation must include limits that "exclude incentives for executive officers to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the Secretary holds an equity or debt position in the financial institution". What constitutes "unnecessary and excessive risks", and which compensation strategies might incentivize executives to incur those risks, are left unspecified and presumably will need to be addressed in rulemaking.

- Appropriate standards must also require "recovery by the financial institution 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". While evocative of Section 304 of the Sarbanes-Oxley Act, Section 111(b) potentially sweeps more broadly, as it is not limited (as is Section 304 of Sarbanes-Oxley) to situations involving an accounting restatement, has no requirement that the inaccuracy be the result of misconduct and applies to compensation paid to any "senior executive officer" rather than only the chief executive officer or chief financial officer.
- Finally, appropriate standards must include a "prohibition on the financial institution making any golden parachute payment to its senior executive officer[s] during the period that the Secretary holds an equity or debt position in the financial institution". Somewhat surprisingly, the Act does not define "golden parachute payment", and we are left with uncertainty about the circumstances under which a payment should be characterized as a golden parachute and about any dollar thresholds that might determine whether a payment falls within the prohibition. "Golden parachute" is hardly a term of art with a standard meaning, and the interpretive possibilities are almost endless. One possibility is that Congress intended "golden parachute" to mean a "parachute payment" to which the amendments to Section 280G effected by Section 302 of the Act apply.[1] But that is only one possible interpretation.

The required standards will apply to an affected financial institution's "senior executive officers". A "senior executive officer" is defined for this purpose as an individual who is "one of the top 5 highly paid executives of a public company whose compensation is required to be disclosed" pursuant to the executive compensation disclosure rules under the Securities Exchange Act of 1934 and non-public company counterparts. This standard will require elaboration for both public and private companies. For public companies, the question arises of when the "top 5" executives are determined and for how long that determination remains in effect. Similar issues have arisen in other contexts (disclosure of executive compensation arrangements on Form 8-K, for instance) and have been addressed by resort to the SEC's standards for determining who is a "named executive officer".[2] A similar approach might make sense in the Section 111(b) context. For private companies that are not required to disclose their executive compensation arrangements, Section 111(b) may require compensation calculations similar to those already required of public companies.

In addition to the interpretive issues noted above, a few additional points deserve mention.

- The three categories discussed above are apparently <u>minimum</u> requirements for what constitutes "appropriate standards". The Secretary could, it appears, impose additional limitations.
- Although the statutory text refers to appropriate standards for executive compensation "and corporate governance", proposals relating to say-on-pay and director nominations that figured in earlier versions of the bill are not included in the Act as adopted by Congress. As adopted, the standards relate uniquely to executive compensation.
- The open-ended duration of the standards is noteworthy: they will continue in effect for so long as the Secretary holds equity or debt in the institution. The qualifier "meaningful", which

[1] That §302(b) of the Act, which amends I.R.C. §280G, bears the heading "Golden Parachute Rule" might lend support to this interpretation.

[2] A company's chief financial officer is a "named executive officer" for SEC purposes whether or not the individual is one of the five most highly paid executives, and the CFO's compensation must be disclosed in accordance with the SEC rules. It is an open question whether the CFO would in all cases be considered a "senior executive officer" under §111(b).

defines the threshold for application of Section 111(b), is conspicuous by its absence in the sentence defining the period during which the limitations will apply. Thus, while the required standards will apply only if Treasury acquires a "meaningful" equity or debt position in the relevant institution, it is a plausible reading that they will continue to apply for so long as Treasury holds a single share or single dollar of debt.

- The prohibition on incentives "to take unnecessary and excessive risks that threaten the value of the financial institution" opens the door to a federal common law of employee compensation, as some decision maker – whether Treasury through rulemaking or the courts through litigation – will need to determine what risks are unnecessary and excessive and whether they threaten the value of the institution. Depending on how this cryptic language is interpreted, Section 111(b) could severely restrict an institution's ability to pay competitive salaries or cash bonuses or to provide equity incentives. (Section 302's expansion of the limitations on tax deductibility, moreover, may further constrain compensation strategy. See below.) Ironically, Section 111(b) could direct financial institutions away from performance-based incentives and toward incentives that are earned based exclusively on continued service; we suspect it will be easier to argue that an award that vests based on continued service does not give executives incentives to take excessive risks than it will be to argue in favor of an equivalent award with a vesting schedule based on attainment of a financial target – and the more ambitious the target, the greater may be the perceived risk. For affected institutions, Section 111(b) may have the unintended consequence of setting back efforts to link compensation to performance.

Auction Purchases. Section 111(c) applies where the Secretary determines that the purposes of the Act are best met by auction purchases of troubled assets, and the purchases from a financial institution, in the aggregate, exceed $300 million (including direct purchases). Under Section 111(c), the Secretary is directed to prohibit any new employment agreement contract with a senior executive officer that provides a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency or receivership. The Secretary is directed to issue guidance to carry out Section 111(c) within two months after the date of enactment of the Act. The guidance will be effective upon issuance.

A few observations:

- Section 111(c) presents similar ambiguities as Section 111(b) over what constitutes a "golden parachute", but limits the circumstances to which the prohibition applies to involuntary termination, bankruptcy, insolvency or receivership. The absence of a similar limitation in Section 111(b) might be argued to imply that the Section 111(b) prohibition is intended to be broader.
- Section 111(c) applies only to "new" employment contracts. Existing contractual arrangements, even if they contain golden parachute provisions, should not be affected.
- The prohibition applies to golden parachutes payable upon involuntary termination, bankruptcy filing, insolvency or receivership. We suspect – although it is not free from doubt – that "involuntary termination" will be construed broadly enough to encompass constructive terminations or resignations for "good reason". It is more doubtful that the statutory language could plausibly be construed to reach cases of retirement or unprompted resignation.
- Section 111(c) contains a "sunset" provision under which the prohibition applies only to arrangements entered into while Treasury's authority under Section 101(a) to purchase troubled assets remains in effect. This authority is slated to expire on December 31, 2009, but can be extended until no later than the second anniversary of enactment.
- A given financial institution could be subject to both paragraphs (b) and (c) of Section 111 if it sells certain troubled assets to Treasury directly and sells others by auction. As a general matter, for

institutions in this situation, only Section 111(b) would be relevant, as the prohibition in Section 111(c) is effectively contained within Section 111(b).

Foreign Institutions. Whether foreign financial institutions will be affected by Section 111 may depend on whether they are permitted to participate in the troubled assets relief program. The Secretary's authority under Section 101(a) extends to purchases and funding of commitments to purchase troubled assets from "any financial institution", defined to include designated types of institution (banks, broker-dealers, insurance companies, etc.) that are "established and regulated under the laws of the United States or any State, territory or possession" of the United States (including the District of Columbia, Puerto Rico and certain other designated jurisdictions). Although the Act includes, at Section 112, authority for Treasury to purchase troubled assets that are held by foreign financial authorities and central banks, the universe of financial institutions with which Treasury can transact pursuant to Section 101(a), and which can potentially become subject to Section 111(b) or Section 111(c), appears to exclude institutions organized outside the United States. If the program is understood, or expanded, to permit participation by non-U.S. institutions, the extraterritorial application of Section 111 to compensation programs of these institutions would raise additional troubling issues.

General Observations. Section 111 constitutes a bold intrusion by Congress into an area – executive compensation – that historically has been regulated under state law, with decisions entrusted to a corporation's board of directors. While Congress and federal regulators have in the past sought to influence compensation strategies through the use of tax incentives (and penalties) and public company disclosure requirements, Section 111 constitutes an unprecedented venture into direct, substantive regulation of executive compensation. The good news for those concerned with a transfer of regulatory authority from the state to the federal level is that Section 111 will apply to only a limited range of business enterprises: financial institutions that participate in the troubled assets relief program – and not even all of them, given the thresholds to applicability.

To some extent, Congress pioneered a broader role for federal regulation in areas previously left to state law when it adopted the Sarbanes-Oxley Act. Section 402 of Sarbanes-Oxley, for instance, prohibits personal loans to executive officers and directors of public companies, thereby introducing a federal limitation on activity that traditionally was regulated, if at all, by the states. Section 111 of the Stabilization Act continues this trajectory and sweeps more broadly than Sarbanes-Oxley by imposing limitations on designing executive incentives and termination packages and requiring clawbacks in a greater range of circumstances. The consequences of this shift in the locus of regulatory authority remain to be determined.

Section 302: Amendments to the Internal Revenue Code

Section 302 of the Act amends Sections 162(m) and 280G of the Internal Revenue Code. In both cases, the amendments add new statutory provisions that are likely to have a significant influence on compensation packages for executives of the relevant financial institutions.

The amendments to Sections 162(m) and 280G apply to any employer from whom the amount of troubled assets acquired by Treasury for all taxable years exceeds $300 million. However, if the only sales of troubled assets are through one or more direct purchases by Treasury, these assets are not taken into account to determine whether the $300 million threshold has been crossed. The new provisions will thus apply only to institutions from which troubled assets are purchased using market mechanisms such as auctions and reverse auctions, or from which troubled assets are purchased through a combination of direct sales and market mechanisms.

The amendments follow a coordinated approach on which executives are covered. Under both new tax rules, a "covered executive" is any employee who, during any portion of a taxable year while Treasury's purchase authority under Section 101(a) of the Act is in effect, serves as the institution's chief executive officer or chief financial officer or is one of the three highest compensated other officers determined on the basis of the

SEC's executive compensation disclosure rules. Any employee who has terminated employment before the purchase authority of Treasury under the Act goes into effect is not covered.

Section 162(m). Since 1994, public companies have been unable to claim a deduction for compensation in excess of $1 million paid to their "covered employees" (the individual serving as CEO at the end of the taxable year and, under current regulations, the three other executive officers serving at the end of the taxable year whose compensation is required to be disclosed under the SEC rules).[3] The limitation on deductibility nevertheless has not applied to "qualified performance-based compensation", which, generally speaking, has been defined as compensation that is earned upon the attainment of objective performance criteria established when their satisfaction remained substantially uncertain, as well as gains realized upon exercise of stock options and stock appreciation rights with an exercise price no less than the fair market value of the underlying stock on the date of grant.

Section 302 of the Act significantly alters the Section 162(m) limitation on deductibility for affected financial institutions:

- The threshold for non-deductible compensation for covered executives is lowered from $1 million to $500,000.
- There is no exception for qualified performance-based compensation. Even if based on the attainment of objective performance goals, compensation in excess of $500,000 will not be deductible. Similarly, income realized upon exercise of nonqualified stock options will count against the $500,000 threshold. $500,000, in other words, means $500,000.
- An employee who is a covered executive for any "applicable taxable year" will be treated as a covered executive for all subsequent applicable taxable years and for all subsequent taxable years to which non-deductible amounts earned while a covered executive are deferred. Both prongs of this new rule demand attention.

  Under the first prong, if an individual is a covered executive during a given year, he or she will be treated as a covered executive for all future "applicable taxable years" of the employer whether or not the individual would otherwise be considered a covered executive for that future year based on his or her position or compensation. An "applicable taxable year" is defined as the first taxable year of the employer that includes any portion of the period during which Treasury's purchase authority under the Act is in effect and the amount of troubled assets acquired from the institution since inception of the relief program exceeds $300 million. For example, if X is a covered executive of FI for FI's taxable year ending December 31, 2008, and Treasury acquires more than $300 million in troubled assets from FI before December 31, 2008, X will be treated as one of FI's covered executives for 2008 and each future taxable year of FI during which Treasury's purchase authority remains in effect.

  The second prong of the new covered executive standard effectively denies the employer a deduction for any amount for which the deduction would have been denied if payment had occurred in the year it was earned. This provision chokes off what has been a standard strategy under Section 162(m): to delay payment of an amount subject to the Section 162(m) limit on deductibility until compensation paid to the individual is no longer subject to the limit (for example, because the individual is no longer an employee). Under Section 162(m) as modified by Section 302 of the Act, there is no point to delaying compensation, as the amount will never be deductible.

The supplemental provisions added to Section 162(m) will require covered institutions to bear the financial costs of a loss of deduction for compensation over $500,000 paid to their covered executives. It seems to us highly

[3] A public company's CFO is not a "covered employee" for purposes of §162(m) generally, but will be a "covered executive" for purposes of the new provisions added by the Act.

questionable that a total compensation package of $500,000 will be adequate to recruit or retain the quality of executive talent needed to lead a major financial institution, especially one in crisis. Institutions that feel the need to pay more than $500,000 per year to top executives, yet wish to avoid (or at least minimize) loss of deduction for tax purposes, will be compelled to develop strategies to mitigate the consequences of the new statutory provisions. These strategies will likely take advantage of the fact that the new provisions will continue in effect only while the Treasury's purchase authority under Section 101(a) of the Act remains in effect. Some possibilities:

- Multi-year performance plans that will pay out only after Treasury's purchase authority has expired and are designed so that payment under the plan will qualify for the performance-based compensation exemption that will again be available to the institution.
- Stock options that may not be exercised until after Treasury's purchase authority has expired.

Section 280G. The amendments to Section 280G treat as a "parachute payment" any payment made to a person considered a covered executive (determined under the new standard introduced for Section 162(m)) during an applicable tax year (as defined for purposes of Section 162(m)) on account of a separation from employment with a financial institution by reason of involuntary termination or in connection with any bankruptcy, liquidation or receivership of the employer.

- The amendments to Section 280G parallel, and raise many of the same interpretive questions, as the amendments to Section 162(m) discussed above. For example, the same uncertainty surrounds the reference to "involuntary termination" in the two sections.
- Amended Section 280G does not deny deductibility to all termination payments made to covered executives during the period that the amendment is in effect. Termination payments, like parachute payments contingent on a change in ownership or effective control of a corporation, will be subject to the limitation on deductibility only if the aggregate amount of payments equals or exceeds three times the individual's "base amount". The same principle applies to the imposition of excise tax under Section 4999 of the Internal Revenue Code. Companies will nevertheless need to consider the application of Sections 111(b) and 111(c) of the Act to determine whether a given termination payment, whether or not deductible, is permitted.
- As is the case with the Act's amendments to Section 162(m), the amendments to Section 280G remove an important exception that otherwise would be available. Section 280G generally does not apply to parachute payments made to employees of companies whose equity securities are not publicly traded, provided that certain shareholder approval requirements are satisfied. This exception is not available to private financial institutions under the amendments introduced by the Act, with the result that public or private company status should be irrelevant under the new provisions.[4]
- The amendments will apply to payments with respect to separations occurring while Treasury's repurchase authority under Section 101(a) remains in effect. Deferring payment until after the authority expires thus will not avoid application of the new standards.

Coverage

As explained above, not all financial institutions that participate in the troubled assets relief program will become subject to the compensation rules of the Act. In addition, the rules are of limited duration. The following chart summarizes the application thresholds and duration of each provision.

[4] We note, though, that the definition of "covered executive" from Section 162(m) that is imported into Section 280G relies on the SEC's disclosure rules applicable to public companies, and Section 302 of the Stabilization Act, unlike Section 111, does not include a directive to adapt the definition to accommodate non-public company counterparts. On a strict reading, private companies would not be subject to the new provisions of Section 280G – because they have no "covered executives".

Provision	Application Thresholds	Period of Application
§111(b): "applicable standards" of executive compensation	· Treasury makes any direct purchases from the institution; and · Treasury acquires a "meaningful" equity or debt position in the institution	Standards apply for so long as Treasury holds any equity or debt position in the institution
§111(c): prohibition on new golden parachutes	· Auction sales of at least $300 million of troubled assets	· Applies to arrangements entered into while Treasury's authority to repurchase troubled assets is in effect (December 31, 2009, unless extended)
Amendments to I.R.C. §162(m)	· Sales of at least $300 million of troubled assets	· Any taxable year of the employer that includes any portion of the period during which Treasury's authority to repurchase troubled assets is in effect · Loss of deductibility continues indefinitely for compensation earned by covered executives during any year for which the amendment is in effect
Amendments to I.R.C. §280G	· Sales of at least $300 million of troubled assets	· Applies to separations occurring while Treasury's authority to repurchase troubled assets is in effect

The adoption of Sections 111 and 302 of the Stabilization Act will present manifold challenges for financial institutions that participate in the troubled assets relief program and that meet the thresholds for applicability. All such financial institutions will need to review their existing executive compensation programs; many will need to revise programs to avoid infringing Section 111; still others will need to give meaningful consideration to how to address the expanded limits on deductibility introduced by Section 302's additions to Sections 162(m) and 280G of the Internal Revenue Code. These challenges will be made greater by the ambiguities and internal inconsistencies that permeate Sections 111 and 302 – although these faults were perhaps inevitable in legislation drafted in the extraordinary climate that has prevailed in Congress and the nation during the last several weeks. The consequences of the new legislation are only now starting to be felt, but will likely continue to reverberate for years to come.

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