October 7, 2008

FINANCIAL INSTITUTIONS DEVELOPMENTS

Executive Compensation and the Emergency Economic Stabilization Act of 2008

Last Friday, the President signed into law the Emergency Economic Stabilization Act of 2008 (the "Act"), which aims to restore liquidity and stability to the financial system, to protect the value of Americans' homes and savings and to promote economic growth. The Act includes a number of provisions relating to executive compensation, which have important implications for financial institutions selling troubled assets under the Act.

Summary of Executive Compensation Provisions

The Act subjects financial institutions that sell assets to the Treasury to restrictions on executive compensation, based on the nature of the sale.

Direct Purchases. The Treasury Secretary must require a financial institution to meet "appropriate standards" for executive compensation and corporate governance where the Treasury (1) directly purchases troubled assets from a financial institution and (2) receives a meaningful equity or debt position in the seller. The restrictions apply for the duration of the period during which the Treasury holds the position and include the following provisions with respect to senior executive officers: (A) limits on compensation to exclude incentives to take unnecessary and excessive risks that threaten the value of the institution; (B) a "clawback" with respect to incentive compensation based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; and (C) a prohibition on golden parachute payments. For purposes of the Act, the term "senior executive officers" generally means the top five most highly compensated executives of a company whose compensation is required to be disclosed in the annual proxy statement (or their counterparts in a private company).

Auction Purchases. Where the Treasury makes any auction purchases of troubled assets from a financial institution and the aggregate amount of auction and direct purchases exceeds $300 million, the Act prohibits any "new" employment contract with a senior executive officer that provides a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency or receivership. The Act requires the Treasury to promulgate final regulations regarding these provisions within two months; these regulations will be effective upon issuance.

Tax Provisions. The Act amends Sections 162(m) and 280G of the Internal Revenue Code to impose tax penalties in connection with the compensation of the CEO, CFO and the three other most highly compensated executive officers of public and private financial institutions ("covered executives") that sell any troubled assets to the Treasury through the auction process if the aggregate amount of auction and direct purchases by the Treasury exceeds $300 million.

Section 162(m). The Section 162(m) amendments limit the deductibility of compensation earned by covered executives during any applicable taxable year (as defined under the Act) to $500,000 per year per executive, regardless of whether the financial institution is a

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corporation or another entity and without exception for performance-based compensation. For purposes of the amendments, "applicable taxable year" means any taxable year during which (1) the Secretary has authority under the Act (generally through December 31, 2009, but subject to extension until as late as October 3, 2010) *and* (2) the aggregate amount of troubled assets acquired at any time from such financial institution exceeds $300 million. Once an individual becomes a covered executive with respect to a financial institution under the Act, the executive forever remains a covered executive of that financial institution under the Act. As a result, no amounts earned in excess of $500,000 during an applicable taxable year, whether paid during the applicable taxable year or in any subsequent taxable year and irrespective of a covered executive's status with the financial institution at the time of payment, will be deductible.

Section 280G. The Act also amends Section 280G of the Code to provide that payments in the nature of compensation to (or for the benefit of) a covered executive (1) by reason of an involuntary termination of the executive by the employer or (2) in connection with a bankruptcy, liquidation or receivership of the employer will be subject to the dual penalties imposed under Section 280G (20 percent excise tax on the recipient executive and loss of deductibility by the paying corporation) if they equal or exceed three times the executive's average annual compensation for the five calendar years preceding the year of termination, without regard to whether such payments are made in connection with a change of control. The amendments to Section 280G do not contain any exception for reasonable compensation for services to be rendered, nor do they permit a private company to avoid imposition of the penalties by having its shareholders approve the arrangements.

Implications

Participation. The Act's compensation provisions may affect the manner and extent to which financial institutions concerned about management retention participate in the troubled assets purchase programs established by the Act. On the face of the Act, none of the executive compensation provisions apply to companies that avail themselves of the Treasury sponsored guarantee of troubled assets. Similarly, the restrictions on new golden parachute agreements and the amendments to Sections 162(m) and 280G do not apply to those companies that sell less than $300 million of troubled assets to the Treasury.

Direct Purchases. The compensation limits to deter excessive risk taking, the clawback provision and the absolute prohibition on golden parachute payments apply solely in the context of direct purchases in which the government receives a meaningful debt or equity stake in the financial institution (the Act does not define "meaningful").

- The clawback provision of the Act is consistent with similar measures under the Sarbanes-Oxley Act of 2002 that apply to CEOs and CFOs of public companies and policies that public and private companies have independently adopted on a broader basis. The clawback provision of the Act may encourage a shift from performance-based compensation to compensation that is not performance-based.

- The prohibition on golden parachute payments does not restrict companies from entering into agreements or plans that provide for golden parachutes, suggesting that

the implementation of new agreements or plans while the Treasury holds a meaningful equity or debt position is permissible so long as a company does not make prohibited payments until after the Treasury ceases to hold a company stake. The Act does not define what constitutes a prohibited "golden parachute payment."

- The provision relating to excessive risk taking also raises questions, as there is little guidance as to its meaning or intent.

It is unclear whether regulations under the Act will include additional restrictions relating to compensation matters.

Auction Purchases and Golden Parachute Agreements. As noted above, the Act prohibits any new employment contract with a senior executive officer that provides a golden parachute upon an involuntary termination, bankruptcy filing, insolvency or receivership, if a financial institution sells any troubled assets to the Treasury through auction and the aggregate amount of auction and direct purchases by the Treasury exceeds $300 million. The Act does not define "golden parachute," raising questions as to the nature and scope of the restriction. Notably, the prohibition on golden parachutes does not on its face prohibit new agreements containing payments triggered solely by virtue of a change of control, without regard to whether a subsequent termination of employment occurs. Where a financial institution has existing golden parachute arrangements in effect which are not prohibited by the Act, payments to senior executive officers under those arrangements may nevertheless be subject to the excise tax and lost deduction provisions contained in the amendments to Section 280G.

Amendments to Section 162(m). The Act amends Section 162(m) to limit the deductibility of compensation earned by covered executives during applicable taxable years to $500,000 per year, regardless of whether such compensation is performance-based. Many companies seeking to avail themselves of the Act may not have taxable income and, as a result, the loss of deduction for executive compensation may be of limited consequence. For companies that have taxable income, the reduction of the cap to $500,000 and inclusion of all forms of compensation, whether paid currently or deferred and whether or not performance-based, ensure that the majority of participating financial institutions will not be able to design their compensation programs so that compensation in excess of $500,000 during an applicable taxable year will be deductible.

It is unclear under the definition of "deferred deduction executive remuneration" whether earnings attributable to equity awards and other awards subject to vesting granted during an applicable taxable year count towards the $500,000 limit, notwithstanding the fact that vesting, settlement and/or exercise may not occur until a subsequent taxable year that is not an applicable taxable year. It does appear that taxable compensation during an applicable taxable year resulting from the vesting, settlement and/or exercise of equity awards granted prior to the initial applicable taxable year will count towards the $500,000 limit on deductibility. We hope that the regulations will provide additional guidance on the foregoing timing issue, since the loss of the deduction for awards granted prior to a financial institution's participation in the Act seems contrary to the prospective application of the other compensation related limitations imposed by the Act.

Amendments to Section 280G. The amendments to Section 280G will result in the imposition of the dual penalties of Section 280G (nondeductibility to the payor) and Section 4999 (20% excise tax on the recipient) on certain payments made in connection with covered terminations of employment, irrespective of the occurrence of a change of control. Many financial institutions provide executives with a gross-up for the Section 4999 excise tax (though many such gross-ups may not cover payments subject to the amended provision or may require technical modifications). Accordingly, the Act may lead to increased, and previously unanticipated, costs associated with executive terminations.

Mergers and Acquisitions. It is unclear whether the executive compensation and related tax provisions would apply to a financial institution not separately subject to the Act's compensation provisions that acquires an entity subject to the Act, although the Act contemplates that the Secretary may establish regulations prescribing the extent to which the changes to Sections 162(m) and 280G apply in the context of mergers and acquisitions. In recent months, stable financial institutions have rescued distressed companies, bolstering weakened financial institutions through private action. It would be helpful if the regulations under the Act would take into account the benefit of these acquisitions by excluding successors from application of the executive compensation and tax provisions of the Act. Pending further guidance, acquirors should consider the possibility that the executive compensation provisions of the Act could apply to them as successors to participating target companies, and vulnerable financial institutions should consider whether to avail themselves of the Act if doing so will disadvantage them as acquisition targets.

Action Items

Set forth below are selected action items for companies that may become subject to the executive compensation and related tax provisions of the Act.

Severance Agreements. Financial institutions that have previously determined to enter into severance agreements with senior executive officers or individuals who may become senior executive officers should execute these agreements prior to engaging in sales of troubled assets under the Act, although it is unclear whether the prohibition on new golden parachute agreements will apply retroactively to cover arrangements entered into after enactment of the Act but prior to such sales.

Golden Parachute Excise Tax Provisions. Financial institutions should understand whether existing golden parachute excise tax gross-ups apply to payments subject to the amendments to Section 280G and whether they wish to provide this protection in the non-change-of-control context. To the extent that companies do provide excise tax protection under circumstances covered by the amendments to Section 280G, they should understand the potential costs of any lost deductions and gross-ups that may apply as a result of the termination of a covered executive's employment, and reflect the gross-up cost in annual proxy statement disclosures. Similarly, companies that impose cut backs should determine whether to impose these limitations in the non-change-of-control context.

Identifying Senior Executive Officers/Covered Executives. Any financial institution (public or private) engaging in asset sales that trigger application of the Act's

executive compensation and related tax provisions will need to identify the "senior executive officers" and "covered executives" under the Act and should implement systems to track all includible compensation for executives that may fall into these categories.

Expand Internal Controls. Financial institutions subject to the compensation and tax provisions of the Act will need to implement controls to ensure that they do not take improper deductions or lose permissible deductions due to the application of the amended rules.

Reconsidering Compensation Elements and Disclosure in Light of Amended Section 162(m). Companies subject to the amendments to Section 162(m) should monitor any Treasury guidance regarding the types of compensation subject to the $500,000 limit. Once regulations are issued, financial institutions that are subject to the amendments to Section 162(m) should consider whether it makes sense to redesign compensation arrangements in light of the elimination of the exception for performance-based compensation during periods in which the Act is in effect, taking into account the fact that Section 162(m) as in effect prior to the Act will remain in effect after the amendments under the Act cease to apply. Finally, companies may need to modify Section 162(m) disclosure in their annual proxy statements to reflect the ability to take deductions in light of the amendments to Section 162(m) under the Act.

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