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LEGAL ALERT

Legal Alert: Executive Compensation under the Emergency Economic Stabilization Act of 2008 - Executive Summary

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Financial institutions electing to participate in Congress's recently enacted efforts to stabilize this industry, the Troubled Asset Relief Program (TARP), must agree to four specific restrictions on executive compensation:

1. No incentives that involve "unnecessary and excessive risks."

2. "Claw back" provisions to recoup compensation paid.

3. No "golden parachutes" in certain severances of employment.

4. New $500,000 limit on amount of deductible compensation. IRS Notice 2008-94, issued on October 14, 2008, addresses and clarifies certain issues and definitions presented by the TARP, under which eligible financial institutions may sell or obtain insurance from the Treasury Department on troubled assets they own. Treasury Department Notice 2008-TAAP and Notice 2008-PSSFI, issued October 16, 2008, each relate to particular aspects of the TARP, and the Interim Final Regulations, published October 20, 2008, relate to the executive compensation rules for institutions involved in the TARP.

Background of the TARP

On October 3, 2008 President Bush signed the Emergency Economic Stabilization Act of 2008 (the Act), which created the Troubled Asset Relief Program (TARP). Under the TARP, there are two methods by which a financial institution may sell assets to the Treasury Department – through a "Direct Purchase," in which there are direct negotiations between the Treasury Department and the institution, or through an "Auction Purchase," where financial institutions submit "bids" offering their troubled assets for sale. In the case of a Direct Purchase, if the Treasury Department also receives a "meaningful" equity or debt interest in the selling financial institution, then while that equity or debt interest is outstanding, the institution is subject to numerous restrictions on the compensation that it may pay to certain executives

1. Limitations on Executive Compensation for Certain Institutions that Sell Assets to the Treasury Department

Financial institutions that sell assets through the TARP – not those that merely insure assets – are subject to certain controls on executive compensation:

(i) They cannot make any "golden parachute" payments (not defined in the Act) to Senior Executive Officers ("SEOs") (see definition below);

(ii) They cannot pay or offer incentives that could induce or encourage SEOs to engage in actions that present an "unnecessary and excessive risk" to the institution (as determined annually by the institution's compensation committee and certified to the Treasury Department); and

(iii) They cannot pay any bonus or other incentive payment to any SEO, unless the payment is subject to recovery ("claw back") by the institution if made on the basis of financial statements or other criteria that later turn out to have been materially inaccurate.

2. Limitations on Executive Compensation for Certain Institutions that Participate in an Auction Purchase with the Treasury Department

Financial institutions that participate in an Auction Purchase (i.e., the financial institution has submitted one or more successful "bids" to the Treasury Department), are subject to a different, but potentially more stringent, control on executive compensation. They cannot enter into any *new* employment contract, or renew or materially modify an existing contract, with an SEO that provides for the payment of a "golden parachute" (again, not defined in the Act, but see below) upon an involuntary termination of the SEO's employment or upon the bankruptcy, insolvency, or receivership of the financial institution, if the aggregate of all of Treasury's purchases (including both Auction and Direct) of that institution's assets exceeds $300 million. This restriction continues at least through the end of 2009, and possibly through the end of 2010, if extended by the Secretary of the Treasury.

For these purposes, "Senior Executive Officer" (or "SEO") means, in the case of a public company, the five executive officers whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, i.e., the CEO (or comparable position), the CFO (or comparable position) and the three highest-paid other executive officers. In the case of a private company, the term refers to the five executives who are comparable to the five reportable executives of a public company.

3. Income Tax Deduction for Executive Compensation to Senior Executive Officers is Capped at $500,000

In addition to imposing the above controls on executive compensation, the Act also amends Code §162(m) to limit the deduction that is available to financial institutions that sell in excess of $300 million of assets to the Treasury Department *and* make at least one sale through an Auction Purchase.

Section 162(m) of the Code generally prohibits a public corporation from deducting compensation in excess of $1 million that is paid to certain of its executives. Deductions for performance-based compensation, however, are not subject to this $1 million cap. For any year in which the Act applies (i.e., though December 31, 2009, unless extended until December 31, 2010 by the Secretary of the Treasury), the Act amends §162(m) to (i) apply to both public and private companies (including companies other than corporations), (ii) prohibit deductions for compensation paid to each of the institution's SEOs in excess of $500,000 (as opposed to $1 million), (iii) eliminate the exemption of performance-based compensation from this limit, and (iv) apply to deductions – whenever taken – for deferred compensation earned (but not paid) in a year in which the Act applies.

4. "Parachute Payments" to Senior Executive Officers are Curtailed

Section 280G of the Code generally provides that an "excess parachute payment" is not deductible by an employer, and Section 4999 of the Code provides that an "excess parachute payment" under §280G is subject to a 20% excise tax payable by the executive receiving the payment. An individual's "excess parachute payment" generally is the amount by which the total of all "parachute payments" made on the individual's behalf exceeds the individual's "base amount." A "parachute payment" is any compensatory payment (other than "reasonable compensation" for services rendered) that is made on account of a change of control of a corporation, where the aggregate present value of all such payments on an individual's behalf is at least three times the individual's "base amount." The "base amount," in turn, is the average of the individual's taxable compensation over the five years preceding the year of the change of control.

The amendment made by the Act expands the application of Code §280G and the excise tax of Code §4999 to treat as "parachute payments" all compensatory payments (including "reasonable compensation") to an SEO that are made on account of any involuntary termination of the SEO's employment (including any "good reason" resignation) or in connection with the institution's bankruptcy, liquidation, or receivership, if the total present value of such payments is at least three times the executive's "base amount." Also, the amendment treats as an "excess parachute payment" the amount by which an SEO's "parachute payments" exceed his or her "base amount." (In these situations, the period for determining the "base amount" is the period preceding the involuntary termination, or the institution's bankruptcy, etc., as the case may be.)

Payments that constitute "parachute payments" or "excess parachute payments" under the current "change in control" provisions of §280G of the Code remain subject to those rules, and the provisions added by the Act do not apply.

One related matter that still requires attention by the Treasury Department is the definition of "golden parachute" for purposes of the Act. Section 280G of the Code refers to "golden parachutes" only in its title; nowhere does the term appear in substantive provisions. Treasury Department and the IRS seem to agree that the Act is intended to apply to an "excess parachute payment," and both agencies refer to the definition of that term that is already prescribed by §280G of the Code (as described above). However, the authorities issued by the Treasury Department (i.e., Notices 2008-TAAP and 2008-PSSFI, and the Interim Final Regulation) all mis-state that definition. Notice 2008-TAAP and the Regulation both define "golden parachute payment" as "any payment in the nature of compensation made to . . . a SEO on account of an applicable severance from employment *to the extent* the aggregate present value of such payments *equals or exceeds an amount equal to three times the SEO's base amount"* (emphasis added). Notice 2008-PSSFI defines it as "any payment in the nature of compensation made to . . . a SEO on account of an applicable severance from employment," without reference to any threshold amount. Neither of these definitions reflects the definition of "excess parachute payment" in §280G of the Code. The IRS Notice, on the other hand, does conform to the statutory definition, i.e., "any parachute payment . . . in excess of the base amount. . .", with "parachute payment" correctly defined, including the "three times" threshhold.

5. Taxation of Offshore Deferred Compensation

In addition to instituting the TARP and its related limitations on executive compensation, the Act adds new §457A to the Code, which generally provides unfavorable tax treatment for individuals participating in certain nonqualified deferred compensation plans maintained outside of the United States. Under §457A of the Code, compensation earned after December 31, 2008 that purports to be deferred under a nonqualified deferred compensation plan of an offshore entity, the income of which is neither subject to the Code nor subject to a "comprehensive foreign income tax scheme," is taxable to the service provider when earned. Generally, a "comprehensive foreign income tax scheme" exists if the U.S. has an income tax treaty with the country whose tax scheme applies to the offshore entity in question. If an item of compensation cannot be valued at the time it is required to be included in the taxpayer's gross income, the compensation is instead included in the taxpayer's gross income in the year in which its value becomes determinable but, in such a case, the amount of compensation will be subject to an interest charge and there is an additional 20% tax penalty.

Deferred compensation earned prior to 2009 that would otherwise be subject to §457A of the Code but for the effective date provision is generally "grandfathered," and need not be taken into income until it vests, or, if later, the last year beginning before 2018.

If you have any questions regarding the executive compensation provisions of the Act or other compensation or benefits issues, please contact Jeffrey Ashendorf, 212-453-5926, jashendorf@fordharrison.com, or Stephen Zweig 212-453-5906, szweig@fordharrison.com, or any member of Ford & Harrison's Employee Benefits practice group.