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October 17, 2008

Executive Compensation Restrictions Under the Emergency Economic Stabilization Act of 2008

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The U.S. Treasury Department has issued three Notices implementing the provisions of the Emergency Economic Stabilization Act of 2008 (EESA) that relate to compensation for executives. While these do not answer all of the uncertainties of the law and its implementing rules and guidelines, they are helpful in many respects.

The Notices address three programs, which theoretically are only three out of any number of others that might in the future be created within the overall statutory framework.

I. Capital Purchase Program

This is the Treasury's equity purchase program. Nine major financial institutions have already agreed to participate. A large number of additional financial institutions are going to be eligible for it.

In order to participate in this program, the financial institution is being required to contractually agree with the government that it will change its compensation arrangements to conform to the following restrictions. This is true notwithstanding that the Act did not require that its compensation restrictions would apply in this situation. Treasury is also requiring that each participating company grant to the government a release against any claim arising from any third party based on making these changes to its compensation program.

These rules apply not only to the executives of the financial institution itself, but also to holding companies and other

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control persons.

These changes to the compensation program must continue for as long as the government owns the equity position in the financial institution.

The compensation restrictions apply to a defined group of "senior officers": the CEO, CFO and the 3 other most highly compensated officers. They are generally determined in accordance with the rules in Item 402 of Regulation S-K (even for companies that are not SEC registered). This is done based on the last completed fiscal year, or in the case of the first year in which the restrictions apply, based on a best effort to identify the highest compensated officers. If there is more than one CEO or CFO during the fiscal year, there could be more than 5 officers who are considered "senior officers," and to whom the restrictions apply.

These are the specific standards that apply to these senior officers for financial institutions that participate in the Capital Purchase Program:

- **Avoidance of Risk** - The first principle in the Act is to limit the employer's ability to have a compensation arrangement that creates incentives to take excessive or unnecessary risk. The rule states that the extent to which a particular arrangement creates such incentives is to be determined based on a conversation between the Compensation Committee and the officer. That conversation is to be held within 90 days after the government invests in the equity. The analysis is going to be done on a case-by-case basis, considering the incentives and their relationship to risks of different types. After this initial discussion, the Compensation Committee is to meet at least annually with the financial institution's chief risk officer about how the incentives are working out in relation to risk. Then the Compensation Committee must sign a certification, in a prescribed form, to the effect that it has taken reasonable steps to assure that the compensation program is in compliance. Public companies file this with the SEC. Private companies file it with their principal regulator.

- **Clawback** – The Act calls for a broad policy to recover compensation that is paid to senior officers based on either a material misstatement in the financial statements or an error in calculating the measure to which incentive compensation is pegged. The requirement is based on Section 304 of the Sarbanes-Oxley Act, but goes a bit further. It applies to all of the senior officers. It applies to private as well as public companies. And it is not limited by a one-year look-

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back period.

- **Golden Parachutes** – Senior officers are prohibited from receiving parachute payments, as defined in Section 280G of the Internal Revenue Code. This definition uses the measure of 3 times the "base amount" of the individual's compensation. An individual's "base amount" is generally the average compensation paid to such individual during the 5 year period (or while employed if less than 5 years) prior to termination of employment. Parachute payments below this threshold will be permitted. The prohibition applies to payments that would be made in the event of any involuntary termination of employment of the individual, or to a bankruptcy, insolvency or receivership of the company.

- **Deductibility of Compensation Paid** – The limit on deductibility of compensation paid to senior officers, under section 162(m) of the Internal Revenue Code is $500,000 (rather than the normal $1,000,000).

II. Program for Systemically Significant Failing Institutions

A second program of the Treasury Department, under the authority of the EESA, is to provide relief to financial institutions that are significantly distressed. The terms of the Treasury's investment will be negotiated on a case-by-case basis. The companies that participate in this program will have the same compensation restrictions as described above, with respect to the Capital Purchase Program, plus the following:

- **Prohibition on Golden Parachute Payments** – Parachute payments upon severance of any of the senior offices is absolutely prohibited (i.e., no amount of severance may be paid). The prohibition applies to severance that occurs in the context of an involuntary termination of employment of the individual, or to a bankruptcy, insolvency or receivership of the company.

III. Sales of Troubled Assets

The third program is actually the one for which the EESA was originally designed, and that is the sale (by financial institutions and potentially other companies) of assets, both directly and through an auction process. If an institution sells more than $300 million of troubled assets through this program, the following restrictions on executive compensation apply, in addition to those identified under the Capital Purchase Program:

- **Prohibition from "New" Parachute Agreement** –

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The institution is prohibited from making "golden parachute payments" under any new employment agreement or arrangement that is adopted from the date of participation in the program at the $300 million level, and continuing until the expiration of the Act. (The Act is currently set to expire on December 31, 2009, but may be extended until October 3, 2010.) As with the Capital Purchase Program, described above, this prohibition relates to payments in excess of 3 times the "base amount," determined under Section 280G of the Internal Revenue Code. The prohibition includes oral as well as written agreements. It includes renewal of a preexisting agreement that expires. It also includes any modification of an existing agreement.

- **Sanctions on "Excess Parachute Payments"** – To the extent that any covered individual receives a "golden parachute payment" (as determined under Section 280G of the Internal Revenue Code) as a result of any agreement entered into prior to October 3, 2010, deductions for the amount that represents an "excess parachute payment" will not be permitted. In addition, the individual receiving the "golden parachute payment" will be subject to a 20 percent excise tax on the amount of the "excess parachute payment." The "excess parachute payment" is the amount that exceeds 1 times the individual's "base amount." These sanctions apply for any severance payment occurring during the period beginning October 3, 2008 through December 31, 2009, but may be extended until October 3, 2010.

The rules and regulations that are summarized above, as well as numerous questions and answers elucidating their application and interpretation, can be found in Notice 2008-94, Notice 2008-TAAP and Notice 2008-PSSFI, all issued by the Treasury Department. Copies of these Notices are available by clicking on the name of the Notice.

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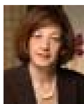

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