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# Treasury/IRS Issue Rules Implementing EESA Restrictions on Executive Compensation on Institutions Participating in the Troubled Asset Relief Program

As highlighted in our various alerts, the recently enacted legislative and regulatory responses to the financial crisis in the United States include important provisions affecting executive compensation at participating institutions. These provisions prohibit certain types of compensation arrangements altogether, deny employer tax deductions for certain kinds and amounts of payments and, in certain circumstances, impose penalty taxes on the executives who themselves receive certain payments. These provisions prohibit certain types of compensation arrangements altogether, deny employer tax deductions for certain kinds and amounts of payments and, in certain circumstances, impose penalty taxes on the executives who themselves receive certain payments. Last week, the U.S. Department of the Treasury and the Internal Revenue Service issued guidance under these rules. This memorandum highlights some of the important provisions of this recent guidance.

**New Program Guidance**

Treasury issued an interim final rule and two official Treasury Notices, and the IRS issued one Notice, in each case, prescribing rules and regulations on executive compensation applicable to institutions participating in three specific programs established under the Emergency Economic Stabilization Act of 2008 ("EESA) that established the Troubled Asset Relief Program ("TARP"):

- the troubled asset auction purchase program ("Auctions Program");
- the program for systemically significant failing institutions ("Failing Institutions Program"); and
- the Capital Purchase Program ("CPP").

The Treasury's authority under TARP is for the period from October 3, 2008 until December 31, 2009. It may be extended, but only until October 3, 2010. As a general matter, the restrictions under the Auctions Program last for the duration of TARP's authority, without regard to whether the Treasury ceases to hold an equity or debt position in the institution (though tax deduction limits and penalty taxes may extend beyond this period), and the restrictions under the Failing Institutions Program and CPP last for so long as the Treasury holds an equity or debt position acquired under the programs.

**Affected Executives and Employers; Key Concepts**

*Senior Executive Officer*. The executive compensation rules are aimed at the top five executive officers of participating institutions; however, there are several EESA statutory rules, and the definitions of the applicable officer groups differ slightly among the rules. These differences were not completely eliminated in the recent guidance, but the differences will likely not affect the determination of who is in the applicable officer group.

For purposes of this memorandum and the guidance under EESA's corporate governance rules, senior executive officer ("SEO") means a "named executive officer" as defined in Item 402 of Regulation S-K under the Securities Exchange Act of 1934 (the "Exchange Act") who is employed by a financial institution that is participating in a TARP program and is the principal executive officer, principal financial officer, or one of the next three most highly compensated executive officers of such financial institution.

For publicly traded institutions or institutions that have listed securities, the executive compensation amount is determined according to Item 402 of Regulation S-K, meaning that the total compensation for the last completed fiscal year is considered without regard to whether the compensation is includible in the executive officer's gross income. The term "executive officer" has the meaning as defined under Rule 3b-7 of the Exchange Act. For a *controlled group*, the parent entity's officers are the SEOs. If the compensation data is not yet available, the institutions "should" use "best efforts" to identify the three most highly paid executives for the current fiscal year. For private institutions, analogous rules apply.

*Controlled Group*. The applicability of the executive compensation rules is in many cases determined by looking to the financial institution that is selling assets under TARP and entities affiliated with the institution. Affiliation is tested under existing rules under the U.S. Employee Retirement Income Security Act of 1974, as amended ("ERISA"), with some variations. Under the ERISA rules, two or more institutions that are treated as a single employer under Sections 414(b) and (c) of the Internal Revenue Code (IRC) are treated as a single financial institution. These rules are adopted by EESA and the recent guidance. However, the rules for brother-sister *controlled group*s and combined groups are disregarded for this purpose (including under Sections 1563(a)(2) and (3) of the IRC and Treasury Regulations 1.414(c)-2(c)).

*Applicable Severance from Employment.* Some of the executive compensation restrictions will be triggered only if compensation is payable in connection with an executive's "applicable severance from employment." Under the guidance, "applicable severance from employment" means any SEO's severance from employment with the institution by reason of *involuntary termination* of employment with the institution, or in connection with any bankruptcy filing, insolvency or receivership of the institution. The rules are aimed at applying to the institution and members of its *controlled group*.

*Involuntary Termination*. *Involuntary termination* means termination from employment due to the independent exercise of the unilateral authority of the employer to terminate the SEO's services, where the SEO was willing and able to continue performing services (other than due to the SEO's implicit or explicit request to terminate employment). It may include the failure by the employer to renew an expiring contract (assuming that the SEO was willing and able to perform and the new contract had substantially similar terms). Also, voluntary termination constitutes an *involuntary termination* if the termination constitutes a termination for good reason due to a material negative change in the SEO's employment relationship. This guidance parallels rules under IRC Section 409A, which regulates deferred compensation. Further, if the SEO terminates employment voluntarily, the termination is nonetheless an *involuntary termination* where the facts and circumstances indicate that absent voluntary termination, the SEO would have been fired, and SEO knew that he or she would have been fired.

*Payment on Account of an Applicable Severance from Employment*. Any payment that would not have been payable if no *applicable severance from employment* had occurred, including amounts that would otherwise have been forfeited and amounts that were accelerated. This does not include amounts paid to an SEO under a tax qualified retirement plan.

**Governance Restrictions under Auctions Program**

An institution selling assets to Treasury under TARP of more than $300 million (calculated including any direct sales to Treasury) through auctions will be prohibited from entering into any new employment contract that provides a golden parachute to an SEO in the event of the SEO's *applicable severance from employment.* If acquisitions by Treasury occur solely through direct purchases, the institution will not be subject to this rule. For purposes of counting the assets, any assets sold by the *controlled group* are also included.

For this purpose, golden parachute is defined as any payment in the nature of compensation to an SEO made 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. "Base amount" has the meaning set forth in Section 280G(b)(3) of the IRC and Section 1.280G-1, Q&A-34 of the Treasury Regulations.

A new employment contract means any material compensatory contract entered into on or after the date that the institution sells more than $300 million to the Treasury. A contract that is renewed or materially modified is treated as a new contract. Material modifications include acceleration of payments and/or vesting, and increase in the amount of compensation. The rules in Section 1.162-27(h)(1)(iii)(A) and (B) of the Treasury Regulations will be applied to determine the materiality of a modification, and the rules in Section 1.162-27(h)(1)(i) of the Treasury Regulations apply to determine what constitutes a renewal of a compensatory contract that is treated as a new contract.

**Governance Restrictions under the CPP and Failing Institutions Program**

An institution selling assets to Treasury directly, including through the CPP and the Failing Institutions Program established by Treasury last week, must comply with executive compensation standards imposed by Treasury, including three restrictions required under EESA and any other standards imposed at Treasury's discretion. The Treasury notices issued last week provide for institutions participating in the CPP and the Failing Institutions Program important guidance regarding the meaning of the restrictions required under EESA, and imposed one additional standard. Under the guidance to date, the standards for the CPP and the Failing Institutions Program are substantially similar, with one notable difference identified below.

The four restrictions that will apply to institutions participating in the CPP and Failing Institutions Program are:

- a prohibition on incentives for SEOs to take "unnecessary and excessive risks that threaten the value of the financial institution";
- recoupment of bonus or incentive compensation paid based on earnings, gains or other criteria that are materially inaccurate;
- no "golden parachute" termination payments; and
- a new $500,000 annual employer compensation tax deduction limit.

In connection with the requirement that no incentives include "unnecessary or excessive risks," the guidance provides that the compensation committee of any institution participating in the Failing Institutions Program and CPP must undertake a review of SEO incentive compensation arrangements with such institution's senior risk officers (or other personnel acting in a similar capacity) within 90 days after the Treasury's purchase under the program. The purpose of the review is to ensure the arrangements do not encourage the SEOs to take unnecessary and excessive risks that threaten the value of the financial institution. At least annually thereafter, the compensation committee must meet with the risk officers to discuss and review the relationship between the institution's risk management policies and practices and the SEO incentive compensation arrangements. Further, the compensation committee must certify that it has completed both the initial and the annual reviews of the SEO incentive compensation arrangements.

Treasury has not identified a bright-line list of risks that automatically fall within the category of "unnecessary and excessive that threaten the value of the financial institution" and its guidance characterizes risks as varying by institution. The guidance provides that the compensation committee should identify the risks, both long and short-term, that threaten the value of the institution with the help of risk officers. The features in the SEO incentive compensation arrangements that could lead SEOs to take such risks should be identified and then limited to ensure that the SEOs are not encouraged to take risks that are unnecessary or excessive.

The certification requirement may be met by making the following statement: "The compensation committee certifies that it has reviewed with senior risk officers the SEO incentive compensation arrangements and has made reasonable efforts to ensure that such arrangements do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the financial institution." For publicly traded institutions or for institutions that have listed securities, this certification must be provided in the Compensation Discussion and Analysis required pursuant to Item 402(b) of Regulation S-K. Non-public institutions need to file this certification with their primary regulatory agency.

With respect to the requirement that all compensation be subject to a "clawback" by the institution under certain circumstances, clients should note that the circumstances requiring clawback are more broad than under existing Sarbanes Oxley rules, expanding the officers whose compensation may be reclaimed, the recovery period and the circumstances triggering the right to recovery.

With respect to the prohibition on golden parachute payments to SEOs, the definition of a prohibited golden parachute payment differs between the CPP and the Failing Institutions Program. The Failing Institutions Program definition covers any payment in the nature of compensation to an SEO made on account of *an applicable severance from employment*, while under the CPP such payment is only prohibited to the extent the aggregate present value of the payments equals or exceeds three times the *SEO*'s base amount. "Base amount" has the meaning set forth in Section 280G(b)(3) of the IRC and Section 1.280G-1, Q&A-34 of the Treasury Regulations.

The new $500,000 annual employer tax deduction limit requires institutions participating in the CPP and Failing Institutions Programs to comply with the new IRS Section 162(m)(5) rules added by EESA and applicable under EESA for institutions selling assets in auction. These rules are described below. The dollar limitation and remuneration for the taxable years are prorated for the portion of the year when Treasury holds equity or debt of the institution.

**Tax Deduction Limitations and Executive Penalty Taxes for Institutions Participating in Auctions Program**

The newly added Sections 162(m)(5) and 280G(e) of the IRC provide additional limitations on the deductibility of compensation paid to SEOs of institutions who participate in the Auctions Program and exceed the $300 million threshold, counting the *controlled group*'s sales. (If the acquisitions are solely via direct purchase, these deduction limitations do not apply.) Public and private employers, and employers that are not corporations are subject to these limitations. If a selling entity is a partnership, trust or similar entity and has no employees who are executive officers, then the owner of the entity that manages the selling entity's assets is the entity that may be the applicable employer for purposes of these rules – along with other members of that owner's controlled group.

Section 162(m)(5) reduces the deduction limit to $500,000 in the case of executive remuneration and deferred deduction executive remuneration. It applies to any taxable year during which the $300 million threshold is exceeded and to any subsequent taxable years ("*applicable taxable year*"). (For *controlled group*, the relevant taxable year is that of the parent entity.) For deferred deduction executive remuneration, the limit will apply until the remuneration has been completely paid.

Executive remuneration means SEO remuneration as determined under Section 162(m)(4) of the IRC without regard to sections B,C or D of the same. The $500,000 limit applies only to remuneration attributable to services performed during an *applicable taxable year*, not for services performed in prior years but deducted in the *applicable taxable year*. The $500,000 limit is carried forward until the year in which the deferred deduction executive remuneration allocable to the *applicable taxable year* is otherwise deductible.

Section 280G(e) disallows any deduction for an excess parachute payment and levies a tax equal to 20% of the excess parachute payment on the SEO who receives it. The prohibition on the deduction and the tax apply to remuneration paid in the *applicable taxable year*. An excess parachute payment is any parachute payment in excess of the base amount allocated to the payment. The parachute here means any payment in the nature of compensation to an SEO made on account of *an applicable severance from employment* to the extent the aggregate present value of such payments equal or exceeds an amount equal to three times the SEO's base amount. "Base amount" has the meaning set forth in Section 280G(b)(3) of the IRC and Section 1.280G-1, Q&A-34 of the Treasury Regulations.

If a payment treated as a parachute payment under IRC Section 280G(e) is a parachute payment under Section 280G on account of a change in control without regard to Section 280G(3), then Section 280G(e) does not apply to the payment.

**Special Rules for Acquisitions, Mergers or Reorganizations**

For the purposes of the Auctions Program, assets sold by a target institution to Treasury prior to an acquisition are not aggregated with the acquirer's sales both prior and after the acquisition unless the acquirer is related to the target. An acquirer is related to a target if stock or other interests of target are treated as owned by acquirer under Section 318(a) of the IRC. However, if after an acquisition, the target's assets are sold by the acquirer's *controlled group* (including target), those assets must be aggregated with any assets sold by acquirer, whether prior to or after the acquisition. The acquirer will not become subject to the pre-existing restrictions imposed on the target merely because it acquired the target.

For purposes of Failing Institution Program and CPP, an acquirer of a target subject to the restrictions will not itself become subject to the restrictions merely because of the acquisition unless the target and the acquirer are related. An acquirer is related to a target if stock or other interests of target are treated as owned by acquirer under Section 318(a) of the IRC. Employees of the target who are SEOs prior to the acquisition will be subject to the golden parachute restriction until after the first anniversary following the acquisition.

For the purposes of the tax deduction limitations, the assets sold by target prior to the acquisition are not aggregated with any assets sold by acquirer prior to or after the acquisition unless the target and acquirer are related. An acquirer is related to a target if stock or other interests of target are treated as owned by acquirer under Section 318(a) of the IRC. However, if after an acquisition, the target's assets are sold by the acquirer's *controlled group* (including target), those assets must be aggregated with any assets sold by acquirer, whether prior to or after the acquisition. If the target was restricted prior to the acquisition, the acquirer will not become restricted merely because of the acquisition. Any SEO of the target, if they remain employed with the acquirer or its controlled group will remain SEO regardless of whether the acquirer is subject to the restriction or whether the executive is a SEO of the acquirer. However, if after an acquisition, a target SEO ceases to be employed by the controlled group of which target is a member, no new executive of the target will become a SEO merely because of such termination, unless such executive is a SEO of acquirer.

**Effective Dates**

The Notices setting out the Auctions Program and Failing Institutions Programs restrictions are effective as of October 3, 2008. The CPP restrictions will become effective on the date of their publication in the *Federal Register*, which is expected October 20, 2008.

**Related Developments**

Notably, separate Treasury guidance, also issued last week, addressing terms of equity interests to be purchased by Treasury under the CPP included two executive compensation rules.

First, as a condition to the closing of Treasury's purchase of its equity stakes described in the guidance, the institution and its SEOs are required to modify or terminate all compensation arrangements to the extent necessary to comply with EESA's and Treasury's corporate governance guidance. Also, SEOs and participating financial institutions must release Treasury from claims they may otherwise have as a result of the issuance of any regulations which modify the terms of compensation arrangements to eliminate provisions that would not comply with such guidance.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning the foregoing may be directed to:


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