

21st Century Money, Banking & Commerce Alert[®]



Please [click here](#) to view our archives

Treasury Department Issues Guidance on Implementation of Executive Compensation Provisions of the Emergency Economic Stabilization Act of 2008

I. Introduction

On October 14, 2008, the US Department of the Treasury (the "Treasury") announced the development of three programs under the Troubled Asset Relief Program ("TARP") authorized by the Emergency Economic Stabilization Act of 2008 (the "EESA"). Through the issuance of an interim final rule and notices, the Treasury set forth regulations for each of the new programs to implement the new executive compensation rules under Sections 111(b) and (c) of the EESA. For an explanation of the executive compensation provisions of the EESA (*i.e.*, a general description of TARP), please see Fried Frank's alerts "[Executive Compensation Provisions in the Emergency Economic Stabilization Act of 2008](#)" dated October 6, 2008, and "[Emergency Economic Stabilization Act Offers Opportunities for Sellers, Contractors, and Purchasers](#)" dated October 6, 2008. This alert serves as an update to the previous alerts based on the recent Treasury guidance.

The three new programs to date developed to implement TARP include:

- the Capital Purchase Program (the "CPP"),
- the Troubled Asset Auction Program (the "TAAP") and
- Programs for Systemically Significant Failing Institutions (the "PSSFI").

Also see the chart at the end of this alert for a very brief overview and comparison of executive compensation requirements applicable to each program, as well as a list of relevant Treasury Notices and other rules with their comment periods.

The CPP, which is the only program currently active, is designed to provide equity capital under standardized terms directly to certain financial institutions in order to strengthen their capital structures and facilitate continued lending. The recent proposed purchase of up to \$250 billion in preferred stock from nine large financial institutions, as well as from other institutions, will be conducted under this program. The TAAP, which is still being developed, is designed to purchase troubled mortgage-related assets through an auction format. The PSSFI, also currently under

development, is designed to provide direct assistance to certain failing institutions on terms negotiated on a case-by-case basis.

II. Capital Purchase Program

The Treasury has released an interim final rule for the CPP. In its current form, under the CPP, the Treasury will purchase up to \$250 billion of senior preferred shares on standardized terms from institutions that elect to participate before November 14, 2008. Institutions qualified to participate include US controlled banks, savings associations, bank holding companies and savings and loan holding companies engaged only in financial activities and those entities which are generally within a parent-subsidiary controlled group with such institutions. See "[TARP Takes a New Turn; FDIC Takes On a New Role](#)" dated October 14, 2008, for a fuller description of the general program.

The CPP's interim final rule release implements four executive compensation requirements that participating institutions must follow as part of the program and provides guidance on the operation of these rules, all of which is detailed below. These executive compensation requirements apply to "senior executive officers" ("SEOs") of financial institutions that are participating in the CPP generally during the period the Treasury holds an equity or debt position acquired under the CPP. SEOs are generally (1) the principal executive officer, (2) the principal financial officer and (3) the three most highly compensated executive officers other than the principal executive and financial officers as determined under the SEC's executive compensation disclosure requirements, or the equivalent counterparts in a non-public company. However, while disclosure under the SEC considers compensation of the most recently completed fiscal year for purposes of determining the next three highest paid officers, for purposes of the CPP, the interim final rule provides that until compensation data for the current fiscal year is available, the institution should make its best effort in determining the three most highly compensated officers for the current fiscal year.

1. Unnecessary and Excessive Risk

The EESA requires certain financial institutions to place limits on compensation to prevent incentivizing SEOs from taking unnecessary and excessive risks that threaten the value of the financial institution during the period the Treasury holds an equity or debt position in the institution. The interim final rule clarifies the process institutions participating in the CPP should undertake to satisfy this requirement. First, the financial institution's compensation committee (or an equivalent committee) must promptly, and in any event, within 90 days after the purchase under the CPP, review the SEOs' incentive and bonus compensation arrangements with senior risk officers (or other personnel that act in a similar capacity) to ensure that the SEO incentive arrangements do not encourage SEOs to take unnecessary and excessive risks. Any features of the SEOs' incentive arrangements that would lead the SEO to take unnecessary and excessive risks should be limited. Second, the compensation committee must meet at least annually with the senior risk officers to review the relationship between the institution's risk management policies and the SEO incentive arrangements. Finally, the compensation committee must certify that it has completed the reviews explained above, either in the institution's Compensation

Discussion and Analysis section of its proxy statement (or other applicable filing with the SEC) or, if it is private company, in a filing with its primary regulatory agency.

2. Clawbacks

The EESA also requires financial institutions to provide for the recovery of any bonus or incentive compensation paid to an SEO if the financial criteria it was based on was later proven to be materially inaccurate. The interim final rule clarifies that any such incentive or bonus payments paid during the period that the Treasury holds an equity or debt position in the financial institution acquired under the CPP must be subject to a “clawback” if the payments were based on materially inaccurate financial statements or any other materially inaccurate financial performance metric criteria.

The standard under the EESA differs from a similar provision in Section 304 of Sarbanes-Oxley in several ways. The standard under the EESA: applies to the three most highly compensated executive officers in addition to the principal executive and financial officers; applies to both public and private financial institutions; is not exclusively triggered by an accounting restatement; does not limit the recovery period; and covers not only material inaccuracies relating to financial reporting but also material inaccuracies relating to other performance metrics used to award bonuses and incentive compensation.

3. Golden Parachute Payment Prohibition

The EESA prohibits financial institutions from making any “golden parachute payments” to SEOs during the period the Treasury holds an equity or debt position acquired under the CPP. Under the interim final rule, “golden parachute payment,” for purposes of this requirement, is defined under the new Section 280G(e) of the Internal Revenue Code of 1986, as amended (the “Code”), which was added to the Code by the EESA. Generally under the new amendment, a golden parachute payment is any payment in the nature of compensation to an SEO made on account of an “applicable severance from employment” to the extent that the aggregate present value of such payments equals or exceeds an amount equal to three times the SEO’s base amount (where base amount is defined under the current Section 280G regulations generally as the average compensation over the five years prior to the severance from employment).

This provision extends the definition of “applicable severance from employment” by distinguishing it from the prior definition of golden parachute payment, which was based on a change in control or ownership. An “applicable severance from employment” is defined as any SEO severance from employment with the financial institution (1) by reason of involuntary termination of employment or (2) in connection with any bankruptcy filing, insolvency or receivership of the financial institution.

4. Deduction Limitations

The EESA also amends Section 162(m) of the Code, which limited the deductibility of compensation to certain covered employees of publicly-traded companies. The interim final rule applies this amendment to financial institutions that are participating in the CPP during the period the Treasury holds a debt or equity interest in the financial institution. Under this new deduction

limitation, the deduction limit for remuneration paid to SEOs during any taxable years was reduced from \$1 million to \$500,000. The \$500,000 deduction limit is computed without regard to “performance-based compensation” and certain deferrals of income.

Also of note is that the interim final rule provides guidance on how the executive compensation requirements operate in connection with an acquisition, merger or reorganization. Generally, if a financial institution which is a target and has sold troubled assets to the Treasury through the CPP is acquired by an entity that is not related to the target in an acquisition of any form, the acquirer does not become subject to these requirements. Any employees of the target who are SEOs prior to the acquisition will be subject to the golden parachute payment prohibition until after the first anniversary following the acquisition.

III. Programs for Systemically Significant Failing Institutions

Treasury also issued a Notice to provide guidance on executive compensation requirements for those institutions which would participate in the PSSFI. The PSSFI is currently being developed by the Treasury and no institutions are participating in it to date. The executive compensation requirements are the same as the requirements under the interim final rule of the CPP (as described above, including the operation of the requirements in connection with an acquisition, merger or reorganization), except the prohibition on golden parachute payments are more stringent.

For purposes of the PSSFI, the definition of “golden parachute payment” means any payment in the nature of compensation to an SEO made on account of an “applicable severance from employment.” This means that any payment (including “typical” severance payments) to an SEO resulting from an involuntary termination of employment or in connection with any bankruptcy filing, insolvency or receivership is prohibited.

IV. Troubled Asset Auction Program

The Treasury also issued a Notice providing guidance under the EESA with respect to the executive compensation requirements that will apply to institutions participating in the TAAP. The Notice is currently being developed by the Treasury and no institutions are participating in it to date. The Notice applies to any financial institution that is participating in the TAAP and from which the Treasury has acquired, at least partially through auction purchases (rather than solely through direct purchases), an aggregate amount of troubled assets that exceeds \$300 million. A financial institution that meets these two requirements remains subject to the TAAP through the TARP authorities period, regardless of whether the Treasury ceases to hold an equity or debt position in the financial institution. The TARP authorities period expires December 31, 2009, but the Secretary has the authority to extend the period, but no later than two years after enactment of the EESA (October 3, 2010).

The executive compensation requirements under the TAAP for participating institutions, and any entities generally in a parent-subsidiary controlled group, with respect to the SEOs (as described above), include: (1) the application of the deduction limitation and new golden parachute payment rules established by amendments to Sections 162(m) and 280G of the Code under the EESA and (2) the prohibition on entering into new employment contracts with SEOs that provide for a golden

parachute payment in the event of an involuntary termination of employment, bankruptcy filing, insolvency or receivership. For this purpose, “new” contracts may include contracts renewed or materially modified while the financial institution is a participant in the TAAP.

* * *

IRS Circular 230 Disclosure: Any US tax advice herein (or in any attachments hereto) was not intended or written to be used, and cannot be used, by any taxpayer to avoid US tax penalties. Any such tax advice that is used or referred to by others to promote, market or recommend any entity, plan or arrangement should be construed as written in connection with that promotion, marketing or recommendation, and the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Authors and Contributors

For more information regarding this client alert, please contact your usual Fried Frank attorney or any of the attorneys listed below:

New York

[Laraine S. Rothenberg](#)

+1.212.859.8745

[Amy L. Blackman](#)

+1.212.859.8620

[Todd McCafferty](#)

+1.212.859.8546

Washington, DC

[Thomas P. Vartanian](#)

+1.202.639.7200

[Robert H. Ledig](#)

+1.202.639.7016

[David L. Ansell](#)

+1.202.639.7011

[Gordon L. Miller](#)

+1.202.639.7173

Fried, Frank, Harris, Shriver & Jacobson LLP

New York

One New York Plaza
New York, NY 10004-1980
Tel: +1.212.859.8000
Fax: +1.212.859.4000

Washington, DC

1001 Pennsylvania Avenue, NW
Washington, DC 20004-2505
Tel: +1.202.639.7000
Fax: +1.202.639.7003

Frankfurt

Taunusanlage 18
60325 Frankfurt am Main
Tel: +49.69.870.030.00
Fax: +49.69.870.030.555

Hong Kong

in association with
Huen Wong & Co.
9th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
Tel: +852.3760.3600
Fax: +852.3760.3611

Shanghai

40th Floor, Park Place
1601 Nanjing Road West
Shanghai 200040
Tel: +86.21.6122.5500
Fax: +86.21.6122.5588

Fried, Frank, Harris, Shriver & Jacobson (London) LLP

London

99 City Road
London EC1Y 1AX
Tel: +44.20.7972.9600
Fax: +44.20.7972.9602

Fried, Frank, Harris, Shriver & Jacobson (Europe)

Paris

65-67, avenue des Champs Elysées
75008 Paris
Tel: +33.140.62.22.00
Fax: +33.140.62.22.29

A Delaware Limited Liability Partnership

The information and materials offered in this publication are for general informational purposes only; it does not constitute legal advice and is presented without any representation or warranty whatsoever, including as to the accuracy or completeness of the information.

21st Century Money, Banking & Commerce Alert® is published by, and is a registered trademark and servicemark of Fried, Frank, Harris, Shriver & Jacobson LLP.

21st Century Money, Banking & Commerce Alert® is provided free of charge to subscribers. If you would like to subscribe to this E-mail service, please send an E-mail message to 21stCen@friedfrank.com and include your name, title, organization or company, mail address, telephone and fax numbers, and E-mail address.

To view copies of previous 21st Century Money, Banking & Commerce Alerts®, please visit our [archives](#) on the Fried Frank website.

Treasury Department Issues Guidance on Implementation of Executive Compensation Provisions of the Emergency Economic Stabilization Act of 2008



BREAKDOWN OF EXECUTIVE COMPENSATION REQUIREMENTS UNDER NEW TREASURY PROGRAM GUIDANCE (as of October 16, 2008)

Item	CPP Interim Final Rule (31 CFR Part 30)	PSSFI Notice 2008-PSSFI	TAAP Notice 2008-TAAP
<p>Limiting incentive compensation arrangements that could lead SEOs to take unnecessary and excessive risks</p> <p>EESA § 111(b)(2)(A)</p>	<p>Q-3, 4 & 5: Procedure to comply with § 111(b)(2)(A)</p> <p>Within 90 days, after purchase under CPP, compensation committee must review incentive arrangements of SEOs with senior risk officers and limit any features that could lead to taking unnecessary and excessive risks.</p> <p>Compensation committee must meet at least annually with senior risk officers to review relationship between risk management policies and SEO comp arrangements.</p> <p>Compensation committee must certify it has completed such reviews in CD&A or applicable filing.</p>	<p>Q-3, 4 & 5: Same as CPP.</p>	<p>Does not apply.</p>
<p>Implementation of clawbacks</p> <p>EESA § 111(b)(2)(B)</p>	<p>Q-6: SEO bonus and incentive compensation paid during the period Treasury holds an equity or debt position must be subject to clawbacks if the payments were made based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.</p>	<p>Q-6: Same as CPP.</p>	<p>Does not apply.</p>

**Treasury Department Issues Guidance on Implementation of Executive Compensation Provisions
of the Emergency Economic Stabilization Act of 2008**



Item	CPP Interim Final Rule (31 CFR Part 30)	PSSFI Notice 2008-PSSFI	TAAP Notice 2008-TAAP
<p>Prohibition on golden parachute payments</p> <p>EESA § 111(b)(2)(C) for CCP & PSSFI</p> <p>EESA § 111(c) for TAAP</p> <p>EESA § 302 for all programs</p>	<p>Q-8 and 9: Prohibition on golden parachute payments which include payments made to an SEO on account of an “applicable severance from employment” where the aggregate present value of such payments equals or exceeds three times the SEO’s base amount during the period Treasury holds a debt or equity position.</p> <p>See also new Internal Revenue Code Section 280G(e).</p>	<p>Q-8 and 9: Same as CPP, except that “golden parachute payment” means <u>any</u> payment in the nature of compensation to a SEO made on account of an “applicable severance from employment.” There is <u>no</u> requirement that the aggregate present value of such payment equal or exceed an amount three times the SEO’s base amount.</p> <p>See also new Internal Revenue Code Section 280G(e).</p>	<p>Q-3: When purchases exceed \$300M in aggregate and at least one is an auction purchase, there is a prohibition on entering into <u>new</u> employment contracts that provide for golden parachutes to SEOs in the event of an involuntary termination and in connection with a bankruptcy filing, insolvency or receivership. The definition of golden parachute is the same as under the CCP and the new Internal Revenue Code Section 280G(e).</p>
<p>162(m)(5) Deduction Limitations</p> <p>EESA § 302</p>	<p>Q-10: New Section 162(m)(5) (EESA § 302), as applied to the CCP, limits deduction for compensation that exceeds \$500,000 and applies to SEOs during period Treasury holds a debt or equity position.</p>	<p>Q-10: Same as CPP.</p>	<p>Under EESA § 302, when purchases exceed \$300M in aggregate and at least one is an auction purchase, deduction is limited to \$500,000 for “covered employees” (as defined in EESA § 302).</p>

Treasury Department Issues Guidance on Implementation of Executive Compensation Provisions of the Emergency Economic Stabilization Act of 2008



LIST OF PUBLICATIONS

Emergency Economic Stabilization Act of 2008 (Pub. L. No. 110-343).

Department of the Treasury Interim Final Rule, 31 C.F.R. Part 30, *pending publication in the Federal Register on October 20, 2008*, (guidance on the executive compensation requirements as applied to financial institutions that are part of the Capital Purchase Program). Comments have been requested and may be submitted to the Department of the Treasury by November 19, 2008.

Treasury Notice 2008-TAAP (explanation of the new golden parachute rules as applied to the Troubled Asset Auction Program). Comments have been requested and may be submitted to the Department of the Treasury.

Treasury Notice 2008-PSSFI (explanation of executive compensation standards and more restrictive golden parachute payment rules that will be applicable to those institutions that become part of the Programs for Systemically Significant Failing Institutions, as may be negotiated with the government). Comments have been requested and may be submitted to the Department of the Treasury.

IRS Notice 2008-94 (guidance on the changes to Sections 162(m) and 280G of the Internal Revenue Code). Comments have been requested and may be submitted to the Internal Revenue Service.