Treasury's New Executive Compensation Standards—A Preview of Things to Come?

Responding to the recent unprecedented crisis in the financial markets, the Emergency Economic Stabilization Act of 2008 (the "Act") was passed by Congress and signed into law by President Bush on October 3, 2008. The Act grants the Treasury Department, acting through the newly-created Office of Financial Stability, broad authority to purchase (either directly or through an auction process) mortgages and mortgage-backed securities through a Troubled Assets Relief Program ("TARP").

A key provision of the Act requires financial institutions that participate in the TARP to comply with certain executive compensation and corporate governance standards as well as special rules for the tax treatment of certain compensation paid to their senior executive officers. Recently, the Treasury Department issued guidance that explains how these compensation and governance standards and tax rules will be applied to participating financial institutions. The applicable standards and rules differ depending on the method used to acquire financial assets from the financial institutions (either a direct or auction purchase).

While the new standards and rules are expressly applicable solely to financial institutions, we believe that they have relevance to most U.S. businesses. First, Congressional leaders have suggested that they may push next year to apply the standards to a broader group of companies. In addition, both of the major party Presidential candidates have publicly called for executive compensation reform and appear to be intent on making that a high priority in their Administration. Finally, the rescue plan announced by the Treasury Department earlier this month, which involves the purchase of senior preferred stock from nine major U.S. banks, may eventually extend to hundreds, if not thousands, of financial institutions throughout the country; thereby increasing the pressure from investors that the executive compensation standards be applied beyond the financial sector.

This article summarizes the executive compensation-related provisions of the Act to help familiarize you with the new standards and their potential implications for executive pay practices generally.

Troubled Assets Relief Program

The centerpiece of the Act is the Troubled Assets Relief Program ("TARP"), which provides the Treasury Department with up to $700 billion to purchase so-called "troubled assets" (that is, residential and commercial mortgage loans and mortgage-backed securities or other related obligations) from a broad group of "financial institutions" (a term that is defined to include banks, savings associations, credit unions, broker-dealers or insurance companies established and regulated under the state or federal laws of the United States or its territories or possessions, and having significant operations in the United States).

On October 14, 2008, the Treasury Department announced its initial action under the Act – a program intended to stabilize the United States financial system through a series of direct equity investments in a broad group of U.S. banks, savings associations, and certain bank and savings and loan holding companies. While this program does not involve the purchase of troubled assets, additional programs which do so are currently being finalized.

As provides under the Act, financial institutions participating in each of these programs will be subject to

Treasury's New Executive Compensation Standards—A Preview of Things to Come? (continued)

specified executive compensation and corporate governance standards and rules.

Capital Purchase Program ("CPP")

Overview of Program

Under this program, the federal government will take an equity position, in the form of senior preferred stock and warrants, in each participating bank and savings association (a "direct purchase" under the Act). Financial institutions have until November 14th to apply to participate in this program. As has been widely reported, nine healthy financial institutions (including Bank of America, Citigroup, and Wells Fargo) have already agreed to participate. Sometime after mid-November, the Treasury Department will select the institutions that will be permitted to sell their preferred shares to the federal government.

Financial Institutions Covered

Under the CPP, the executive compensation standards apply both to a participating financial institution (as defined above), whether publicly-traded or non-publicly-traded, and to any other entity within its controlled group. As a practical matter, this would appear to mean that, in the case of bank holding companies, the standards may apply to the senior executive officers of multiple entities within the organization.

Conditions of Participation

As a condition of participating in the CPP, a financial institution and its senior executive officers must agree to modify or terminate its existing benefit plans, arrangements, and agreements (including golden parachute agreements) to the extent necessary to be in compliance with the applicable executive compensation and corporate governance standards, and, for so long as the federal government holds any equity or debt securities of the institution, agree to be bound by the standards and any related regulations and guidance.

Interestingly, a financial institution and its senior executive officers must also agree to a waiver releasing the Treasury Department from any claims that it and its executives may otherwise have as a result of having to modify or terminate existing compensatory arrangements to comply with the new standards.

Senior Executive Officers

For purposes of the CPP, the term "senior executive officer" means an individual who is "one of the top 5 highly paid executives of a public company whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934." This includes a "named executive officer" for purposes of the SEC's executive compensation disclosure rules who is employed by a participating financial institution while the federal government holds an equity or debt position acquired under the CPP and is:

- the principal executive officer of the institution (the "CEO"),
- the principal financial officer of the institution (the "CFO"), or
- one of the three mostly highly-compensated executive officers of the institution (other than the CEO or CFO).

A financial institution's three most highly-compensated executive officers are to be determined as provided under the SEC's executive compensation disclosure rules by reference to the total compensation for the last completed fiscal year (without regard to whether the compensation is includible in the executive officer's gross income). Until the end of the first fiscal year in which a financial institution becomes a participant in the CPP, the institution should make its best efforts to identify its three most highly-compensated executive officers for the current fiscal year.

In the case of the executive officers of privately-held financial institutions, analogous concepts for determining the institution's senior executive officers are to apply. Consequently, these institutions will need to apply the SEC's executive compensation disclosure rules for determining "total compensation" to

determine which of its executive officers are the most highly-compensated for purposes of the standards.

Executive Compensation Standards

A financial institution participating in the CPP and its senior executive officers must comply with four separate executive compensation standards for the duration of the period that the federal government holds an equity or debt position in the institution. These standards are as follows:

INCENTIVE COMPENSATION

A participating financial institution must structure its executive compensation program to exclude incentives for its senior executive officers to take unnecessary and excessive risks that threaten the value of the institution.

Compliance with this standard is based on a self-policing mechanism that must include the following steps:

- Within 90 days of the first purchase under the CPP, the compensation committee of the board of directors of the financial institution must meet with the institution's senior risk officers (or persons acting in a similar capacity) to discuss and identify the features in the institution's senior executive officer incentive compensation arrangements that could lead the executives to take unnecessary and excessive risks that could threaten the institution's value. Because each institution faces different material risks given the unique nature of its business and the markets in which it operates, the compensation committee should discuss with these officials both the short-term and long-term risks that the institution faces that could threaten its value, identify the features in its incentive compensation arrangements that could lead its senior executive officers to take risks that are unnecessary or excessive, and "limit" (or change) these features to ensure that the executives are not encouraged to take such risks.
- Thereafter, the compensation committee must meet at least annually with the financial institution's senior risk officers (or persons acting in a similar capacity) to discuss and review the relationship between the institution's risk management policies and practices and its senior executive incentive compensation arrangements.
- The compensation committee must certify each year that it has completed the appropriate review of the financial institution's incentive compensation arrangements for its senior executive officers. In the case of financial institutions that are publicly-traded, the certification must be included in the institution's Compensation Discussion and Analysis. Non-publicly-traded financial institutions are required to provide the certification to their primary regulatory agency.

COMPENSATION RECOVERY

A participating financial institution must implement a policy for the recovery (or "clawback") of any bonus or incentive compensation paid to a senior executive officer if the payments were based on materially inaccurate financial statements and any other materially inaccurate performance metric criteria

This standard appears to contemplate a policy that is comparable to the compensation recovery provision found in Section 304 of the Sarbanes-Oxley Act of 2002. However, it differs from Section 304 in several notable respects:

- it applies to all senior executive officers, not just the institution's CEO and CFO,
- it applies whether the financial institution is publicly-traded or non-publicly-traded,
- it is not exclusively triggered by a financial restatement,
- it does not limit the recovery period (Section 304 is limited to the recovery of amounts received during the 12-month following a financial restatement), and
- it covers not only material inaccuracies relating to financial reporting, but also material inaccura-

cies relating to other performance metrics used to award bonuses and incentive compensation.

GOLDEN PARACHUTES

A participating financial institution must not make any golden parachute payment to its senior executive officers.

For this purpose, a "golden parachute payment" is defined in a manner that is comparable to the definition of an "excess parachute payment" under Section 280G(e) of the Internal Revenue Code. Thus, a golden parachute payment generally means any payment in the nature of compensation to (or for the benefit of) a senior executive officer 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 executive's base amount (generally, the five-year average of the executive's Form W-2 compensation).

The events that trigger this prohibition (called an "applicable severance from employment") include:

- an involuntary termination of employment with the institution (or with an entity that is treated as the same employer as the financial institution under the controlled group rules) or
- in connection with any bankruptcy filing, insolvency, or receivership of the institution (or of an entity that is treated as the same employer as the financial institution under the controlled group rules).

Further, an "involuntary termination of employment" is defined to include:

- an institution's unilateral decision to terminate a senior executive officer (but not where the executive implicitly or explicitly requested to be terminated) where the executive was willing and able to continue performing services,
- an institution's failure to renew a contract at expiration provided that the executive was willing and able to execute a new contract on similar terms and conditions and to continue providing services,
- an executive's voluntary termination from employment if the termination constitutes a termination for "good reason" due to a material negative change in the executive's employment relationship, and
- an executive's voluntary termination from employment in any case where the facts and circumstances indicate that absent such voluntary termination the institution would have terminated the executive's employment and the executive had knowledge that he or she would be terminated.

Finally, the payments that are included in determining whether any amounts are prohibited include any payment that would not have been payable if the severance from employment had occurred (including amounts that would otherwise have been forfeited) and amounts that are accelerated on account of the applicable severance from employment. Generally, the standards applicable under Section 280G are to apply here. Thus, any severance payments and additional benefits, as well as the accelerated vesting of outstanding equity awards, which are triggered by a covered termination of employment are included for purposes of applying the standard.

DEDUCTION LIMIT

A participating financial institution must agree that, for purposes of its federal income taxes, it will not deduct any remuneration paid to its senior executive officers in excess of $500,000 per year. This condition effectively applies new Section 162(m)(5), which reduces the deduction threshold for the remuneration paid to senior executive officers during any taxable year from $1 million to $500,000 and was added by the Act as a limitation for institutions participating in any auction program established by the Treasury Department, to institutions that participate in direct purchase programs as well.

Treasury's New Executive Compensation Standards—A Preview of Things to Come? (continued)

Several of the exceptions that generally apply to amounts subject to the Section 162(m) deduction limit are not available in the case of this $500,000 limitation. Most significantly, the exception for "performance-based compensation" is not available. Consequently, this limitation will have an actual economic effect on the remuneration paid to many, if not all, of the senior executive officers of participating financial institutions.

Other notable features of the $500,000 deduction limit are as follows:

- This standard applies even though the financial institution is not otherwise subject to Section 162(m)
- The dollar limitation and the remuneration for the taxable year are to be prorated for the portion of the taxable year that the federal government holds an equity or debt position in the financial institution acquired under the CPP
- The deduction limit is to be applied to payments made to a senior executive officer in a year following the year in which the remuneration was earned, even though the federal government no longer holds an equity or debt position in the institution and the individual is no longer a senior executive officer (this, effectively, prevents a senior executive officer from deferring compensation to a later year to avoid the restriction).

Program for Systematically Significant Failed Institutions ("PSSFI")

The Treasury Department is currently developing an additional "direct purchase" program to potentially provide assistance to financial institutions that are identified as "systematically significant failing institutions." While the details about this program have not yet been issued, the terms of these purchases will be negotiated on a case-by-case basis.

As a "direct purchase" program, the standards that generally apply to the senior executive officers of financial institutions participating in the CPP also apply to the senior executive officers of institutions participating in this program, with one notable exception – the prohibition on golden parachute payments is more stringent under this program.

Under the PSSFI, the term "golden parachute payment" means any payment in the nature of compensation to (or for the benefit of) a senior executive officer made on account of an applicable severance from employment. Consequently, no severance payment of any kind may be made to a senior executive officer of a financial institution participating in the PSSFI in the event of an involuntary termination of employment or in connection with any bankruptcy, insolvency, or receivership for the duration of the period that the federal government holds an equity or debt position in the institution. In contrast, such payments are prohibited under the CPP only to the extent that they exceed the "three times base amount" threshold.

Troubled Asset Auction Program ("TAAP")

As contemplated by the Act, the Treasury Department is also developing a program under which it may purchase troubled mortgage-related assets from financial institutions through an auction process.

FINANCIAL INSTITUTIONS COVERED

Under the TAAP, the applicable executive compensation standards rules apply both to a participating financial institution (as defined above), whether publicly-traded or non-publicly-traded, and to any other entity within its controlled group, but only to the extent that such purchases (when aggregated with any other assets that are acquired by the Treasury Department under the Troubled Assets Relief Program) exceed $300,000,000. For this purpose, the "controlled group" rules of Section 414(b) and (c) of the Internal Revenue Code apply (these tax rules generally base control on an 80% ownership basis). However, only parent-subsidiary relationships, not brother-sister relationships, are taken into account.

GOLDEN PARACHUTE PROHIBITION

A financial institution participating in the TAAP is prohibited from entering into any new employment contracts with its senior executive officers that provide for golden parachute payments in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership. For these purposes, a "golden parachute" is defined in the same manner as under the CPP.

This prohibition applies from the date of the first purchase under the TAAP through December 31, 2009 (the date the Act expires) or, if the Act is extended, October 3, 2010. Further, the prohibition applies without regard to whether the federal government ceases to hold an equity or debt position in the financial institution.

SENIOR EXECUTIVE OFFICERS

For purposes of the TAAP, the senior executive officers subject to the prohibition are the same group as under the CPP. Whether an individual is a senior executive officer is to be determined at the time the individual enters into the arrangement.

NEW EMPLOYMENT CONTRACT

For purposes of the TAAP, a "new employment contract" is defined to mean any material compensatory contract (including any plan, agreement, or arrangement, whether or not written) entered into on or after the date when troubled assets are purchased from the financial institution through an auction process.

Thus, the prohibition will apply to written agreements or oral understandings and would appear to apply to arrangements called for under a broad-based or executive severance plan, as well as individually-negotiated agreements. In addition, a contract that is renewed is treated as entered into on the date of the renewal and if a contract is materially modified, it is to be treated as a new contract entered into as of the date of the material modification. For these purposes, a contract is considered materially modified if it is amended to increase the amount of compensation payable to the executive, to accelerate the date on which vesting occurs, or to accelerate the payment under the contract.

ADDITIONAL CONDITIONS

Financial institutions that sell troubled assets to the federal government through the TAAP are also subject to the following tax provisions (which apply from the date of the first purchase under the TAAP through December 31, 2009 (the date the Act expires) or, if the Act is extended, October 3, 2010):

- A participating financial institution may not deduct any remuneration paid to its senior executive officers in excess of $500,000 per year. The conditions of this limit are the same as those described above for participation in the CPP
- A participating financial institution may not deduct any severance payment made to a senior executive officer in excess of three times the executive's average taxable compensation during the previous five year. In addition, the senior executive officer is subject to a 20% excise tax on this excess severance amount.

Final Observations

Even though the executive compensation-related provisions of the Emergency Economic Stabilization Act of 2008 were enacted solely to ensure that the senior executives of financial institutions receiving public funds did not personally benefit from their prior poor decisions, in the months ahead their impact is likely to reverberate well beyond the financial sector.

Proponents of executive compensation reform will likely cite their widespread application as raising the bar for "best practice" in the executive compensation area. As such, we would not be surprised to see companies begin to voluntarily incorporate some or all of these standards into their own programs. In addition, the standards may well form the basis for several new shareholder proposals for the 2009 proxy season.

Treasury's New Executive Compensation Standards—A Preview of Things to Come? (continued)

Perhaps most significantly, it's obvious that Congress is not finished taking action in this area. Given its past attempts to address excessive executive compensation and with public sentiment for curbs on executive pay running at an all-time high, we expect that one or more legislative initiatives to be introduced early in 2009 to capitalize on the momentum that has been built as a result of recent events.

With this in mind, companies should consider comparing their existing policies and practices against these standards. In many instances, you already may have one or more comparable policies or practices in place. If so, you should consider addressing this subject in your next Compensation Discussion and Analysis as a means of reassuring your shareholders of the soundness and stability of your executive compensation program. ■

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