



Client Alert

Financial Markets Developments

The New Recovery Legislation: The TARP Covers Executive Compensation

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 ("EESA") was signed into law. EESA generally provides the US Department of the Treasury ("Treasury") with sweeping authority to purchase up to US\$700 billion of unsound financial assets held by banks and other financial institutions that played a part in disrupting the global credit and other financial markets.

Under the Troubled Asset Recovery Program (the "TARP") created by EESA, Treasury is authorized to buy certain troubled mortgage-related instruments from affected institutions at the lowest possible price through an auction. Where no bidding or market prices are available, Treasury may purchase the troubled assets directly from a financial institution that, in turn, provides the government with an equity or debt position in the selling institution. Treasury's authority may extend in various circumstances to the assets of tax-qualified retirement plans and certain other similar arrangements. Treasury's purchasing authority terminates on December 31, 2009, unless extended by Congress to a date not later than October 3, 2010.

A number of EESA provisions intended to rein in executive compensation of financial institutions participating in the TARP were identified by key members of Congress as critical to garnering support for the law's enactment. Also included is an unrelated provision that may particularly affect the compensation arrangements of certain investment funds using offshore entities.

Summary of Executive Pay Limitations

EESA places limits on executive pay for certain financial institutions that sell troubled assets to Treasury. Various executive pay restrictions may apply to a financial institution and its top five executives officers, depending on the dollar amount of troubled assets sold to Treasury and the method of such sales.

If a financial institution sells more than US\$300 million of troubled assets to Treasury exclusively through one or more auctions, the following constraints will apply to the top five executive and the institution:

- The institution will lose a deduction for pay above US\$500,000 to each such executive for any applicable tax year
- EESA's "golden parachute" provisions (i) will impose a 20 percent excise tax on certain severance payments received by covered executives, while the institution will forfeit a deduction for such payments and (ii) provide that any new employment contract entered into between the institution and any of its top five executives must not allow for golden parachutes payable in connection with the executive's involuntary termination or the institution's financial instability.



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If a financial institution either sells troubled assets to Treasury through (i) direct sales only (without regard to any dollar amount) or (ii) a combination of direct sales and auction sales that are in the aggregate US\$300 million or less, then the following constraints will apply to the top five executives and the institution:

- The institution must eliminate any incentives that encourage such executives to take unnecessary and excessive risks that threaten the value of the financial institution
- The institution must recoup any incentive compensation that was paid to such executives based on financial reports that are later proven to be materially inaccurate

- The institution is prohibited from paying golden parachutes to such executives in connection with their involuntary termination or the institution’s financial instability.

If a financial institution sells more than US\$300 million of troubled assets to Treasury through a combination of auctions and direct sales, then all of the restrictions discussed above apply. As discussed below, the new golden parachute tax penalty provisions may effectively be moot in this situation.

If a financial institution sells US\$300 million or less of troubled assets to Treasury exclusively through one or more auction purchases, then no executive pay limitations will apply.

The following table illustrates these provisions:

	Auction Purchases Only (US\$300m or less)	Auction and Direct Purchases (US\$300m or less)	Auction Purchases Only (over US\$300m)	Auction and Direct Purchases (over US\$300m)	Direct Purchases Only
Lost deductions for pay over US\$500,000			X	X	
Golden Parachute Provisions					
■ 20 percent excise tax and lost deductions for excess parachute payments			X	X (possibly moot)	
■ No parachute payments		X		X	X
■ No parachute payment provisions in new contracts			X	X	
Limitation on Incentive Pay		X		X	X
Clawbacks		X		X	X

Lost Deductions

Existing US\$1 Million Deduction Cap. Section 162(m) of the Internal Revenue Code of 1986 (the “Code”) generally imposes a US\$1 million cap on the deductibility of compensation paid to certain executive officers by a public corporation, unless an exception applies. One important exception is for qualified “performance-based compensation.” In addition, the deduction limitation generally does not apply to deferred compensation that is paid after the executive has ceased to be covered by Section 162(m).

New US\$500,000 Deduction Cap. Under EESA, the Section 162(m) deduction limit is reduced to US\$500,000 for affected financial institutions, whether publicly or privately held, or incorporated or unincorporated, that sell over US\$300 million of troubled assets to Treasury through one or more auctions (or a combination of auctions and direct sales). The existing exceptions from Section 162(m), including the exception for qualified performance-based compensation, will not apply under the new rules. The limit applies to a taxable year in which the US\$300 million threshold is first exceeded and any subsequent taxable year in which Treasury is authorized to purchase troubled assets (“applicable taxable years”). Generally, all corporations in the same controlled group are treated as a single financial institution for purposes of determining whether an executive’s compensation received from any members of the controlled group exceeds the US\$500,000 deduction limit, and whether the troubled asset sales to Treasury exceed the US\$300 million threshold.

Persons Covered. The reduced cap on deductions is limited to “covered executives.” A covered executive is any individual who serves as the CEO or CFO at any time during the portion of the taxable year that includes Treasury’s authorized purchase period. The deductibility cap also applies to any executive who (i) is one of the three highest compensated officers (other than the CEO or CFO) determined on the basis of the executive compensation disclosure rules applicable to reporting companies (without regard to whether those rules actually apply to the financial institution) and (ii) is employed during any portion of the taxable year that includes the authorized purchase period. In a departure from existing law, a covered executive will maintain this status for all subsequent taxable years for purposes of the special rule

discussed below regarding deferred compensation.

Special Rule for Deferred Compensation. A special rule applies to compensation related to services performed by a covered executive during an applicable taxable year, which becomes deductible in a later taxable year, as in the case of nonqualified deferred compensation. Under this rule, any unused portion of the US\$500,000 limit for the applicable taxable year is carried forward until the year in which the deferred compensation is otherwise deductible and applied to such compensation. The following examples are based

Example 1: Illustrates deferred compensation earned in an applicable taxable year and paid in a later taxable year.

Assume a covered executive is paid US\$400,000 in cash salary by an applicable employer in 2008 (an applicable taxable year) and the covered executive earns US\$250,000 in nonqualified deferred compensation payable in 2015. The full US\$400,000 in cash salary is deductible under the US\$500,000 limit in 2008. In 2015, the employer’s deduction with respect to the US\$250,000 will be limited to US\$100,000, which represents the unused portion of the US\$500,000 limit from 2008 (while being denied a deduction for the remaining US\$150,000 of nonqualified deferred compensation earned in 2008).

Example 2: Illustrates deferred compensation earned in one applicable taxable year and paid in another applicable taxable year.

Assume the same facts as Example 1, except that the nonqualified deferred compensation is deferred until 2009 (also an applicable taxable year) and the covered executive is paid US\$500,000 in cash salary in 2009. As in the example above, the employer’s deduction for the US\$250,000 of nonqualified deferred compensation paid in 2009 (related to services performed in 2008) would be limited to US\$100,000. The entire US\$500,000 of cash salary earned in 2009 would also be deductible. In 2009, the employer may deduct US\$600,000 (while being denied a deduction for the remaining US\$150,000 of nonqualified deferred compensation earned in 2008).

Example 3: Illustrates deferred compensation earned in a taxable year and paid in an applicable taxable year. Assume the same facts as Example 1, except that the covered executive also receives in 2008 a payment of US\$300,000 in nonqualified deferred compensation that was attributable to services performed in 2006. Only the US\$400,000 cash salary paid in 2008 will be subject to the new US\$500,000 limit. Accordingly, the employer may deduct US\$700,000 in 2008 (consisting of US\$300,000 of nonqualified deferred compensation earned in 2006 that is not subject to the limit and US\$400,000 of base salary earned in 2008). In addition, the remaining deduction of US\$100,000 may be carried forward to a future year and applied to the nonqualified deferred compensation attributable to services performed in 2008.

on those given in EESA's legislative history:

It remains to be seen whether the deduction limitation will result in controls on executive compensation, or a loss in tax deductions which could ultimately have the effect of hurting the financial institution and its shareholders. Experience with existing Section 162(m) illustrates that either alternative is possible in any particular case. It also remains to be seen whether any of the new rules will eventually be extended by Congress under Section 162(m) generally.

Golden Parachutes

Section 280G of the Code generally provides for punitive excise taxes on executives and losses of deductions for employers in the case of certain excess "parachute payments" contingent on a change in control. For the first time, this existing golden parachute regime has been expanded in its application outside the realm of a corporate change in control.

Tax Penalty Provisions. EESA modifies Section 280G to impose limits on severance payments made to the covered executives of a financial institution on account of such executives' involuntary termination or the institution's bankruptcy filing, liquidation or receivership during an applicable taxable year. For this purpose, the terms "covered executive" and "applicable taxable year" have the same meaning as under the modifications to Section 162(m) of the Code (described above).

In situations where Treasury purchases more than US\$300 million of troubled assets through auction purchases from a financial institution, the excess parachute payment, as determined under Section 280G for these purposes, are nondeductible by such institution. In addition, an excise tax is imposed on the recipient of any excess parachute payment equal to 20 percent of the amount of such payment. These tax consequences apply to parachute payments triggered by an applicable termination of employment during Treasury's authorized purchasing period. It is not immediately clear how terminations for so-called "good reason" and other similar constructive terminations will be treated under EESA.

We note that, in a case where more than US\$300 million in troubled assets are sold under the TARP through a combination of auctions and direct purchases, the 20 percent excise tax and loss of deduction for excess parachute payments may

effectively be moot. This result arises because it is possible that the prohibitions (discussed below) on making any golden parachute payments, in the case of direct purchases under the TARP, may ultimately operate to prohibit excess parachute payments altogether.

Yet again, it is unclear whether these provisions will act to rein in executive pay or will result in additional costs for affected financial institutions and their shareholders, particularly if the institution pays a tax gross-up to the executive. In addition, Treasury is to provide further guidance regarding the interplay of a severance payment that is treated as a golden parachute under both the existing “change in control” and the new “severance” regimes of Section 280G.

Prohibited Golden Parachute Payments and Contracts.

If Treasury acquires troubled assets through direct purchases from a financial institution and obtains a meaningful equity or debt position in such institution, then Treasury is to impose several standards, one of which would prohibit the financial institution from making any golden parachute payments to its covered executives. These standards are applicable during the period Treasury holds an equity or debt position in the financial institution. The two other specific standards set forth in EESA are noted below.

As there might be constitutional or other infirmities to unilaterally imposing restrictions on an executive which are inconsistent with the institution’s contractual obligations, institutions that are considering participating in the TARP may wish to (i) review their existing contractual obligations for any provisions which could be inconsistent with EESA’s requirements and (ii) exercise care regarding the establishment of any new contractual arrangement which could run afoul of EESA.

In situations where Treasury purchases more than US\$300 million of troubled assets through auction purchases (or a combination

of auction and direct purchases) from a financial institution, EESA prohibits covered financial institutions from entering into new employment contracts with any covered executive which provide for parachute payments.

Notably, the statute does not define golden parachute payments and it remains to be seen how broadly Treasury will interpret the scope of which such payments or new contract provisions are prohibited under EESA.

Limitations on Incentive Pay

In situations where Treasury purchases troubled assets from a financial institution through direct purchases and obtains a meaningful equity or debt position in such institution, as a second standard which Treasury is to impose, such institution must eliminate any incentives that encourage its top five executive officers to take “unnecessary and excessive risks” that threaten the value of the financial institution. This restriction applies during the period Treasury holds an equity or debt position in the financial institution.

The provision is intended to prevent financial institutions from taking irresponsible risks that may fail while the government has a stake in the institution. However, EESA does not define the phrase “unnecessary and excessive risk.”

Clawbacks

If Treasury purchases troubled assets directly from a financial institution and obtains a meaningful equity or debt position in such institution, as a third standard which Treasury is to impose, any bonus or incentive awards paid to its top five executives that were based on materially inaccurate financial reports must be returned to the institution. This restriction, apparently modeled on a similar clawback provision under the Sarbanes-Oxley Act of 2002, applies during the period Treasury holds any equity position or debt in the financial institution.

Nonqualified Deferred Compensation

One of the non-TARP provisions included in EESA would tax certain offshore deferred compensation arrangements. Under existing law, Section 457 of the Code limits deferred compensation paid by certain tax-exempt entities. New Section 457A limits deferred compensation paid by certain offshore tax-indifferent entities.

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