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The Emergency Economic Stabilization Act of 2008 legislates new executive pay practices for financial institutions that receive government guarantees.

The Emergency Economic Stabilization Act of 2008 Extensively Regulates Executive Compensation, but Leaves Many Unanswered Questions

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The Emergency Economic Stabilization Act of 2008 (the "Act"), signed into law by President Bush on October 3, 2008, contains several provisions affecting executive compensation. Ambiguities in the Act, however, create questions as to the scope of the Act's provisions and permissible avenues of compliance.

The Act regulates executive compensation in two separate ways. Under one provision of the Act, institutions that benefit from government aid are directly prohibited from providing certain types of compensation to certain executives. Under another provision, the government uses the Internal Revenue Code of 1986, as amended, to prohibit deductions by these institutions and to tax their employees in the event certain compensation practices are not followed. This legislation is significant because the federal government has rarely strayed into the arena of directly regulating what types or levels of compensation may be paid, as opposed to regulating compensation by imposing tax sanctions or penalties. In this respect, the Act may represent an unprecedented level of activism by the federal government.

Because the penalties apply only to financial institutions that are assisted by the government under the Act, the lead decision makers of a troubled financial institution may be tempted to consent to an acquisition or investment by a private financial institution that is less favorable to shareholders than a transaction that includes federal assistance under the Act. This may be so despite decision makers' fiduciary obligations to maximize shareholder returns or, in the case of an insolvent corporation, to protect the interests of creditors.

In addition, because the applicable sanctions and penalties are limited to the arrangements entered into in connection with the current financial debacle, such sanctions and penalties will not prevent problems that may occur after the current financial crisis passes.

Compensation Restrictions in the Event of Direct Purchases by the Government

Section 111 of the Act sets forth compensation standards applicable where the government purchases troubled assets directly from a financial institution where no bidding process or market prices are available, if the purchase comprises a "meaningful equity or debt position." The Act does not define what constitutes a *meaningful* position so that, prior to the issuance of further guidance, financial institutions may not be aware of whether they are subject to these rules. The sanctions or penalties that are applied are limited to the top five executive officers (the "Top Five Executives"), who are disclosed on a public company's (and non-public company's counterpart) proxy statement or Form 10-K. (Note that the current version of section 280G of the Internal Revenue Code extends to a broader group of individuals, thereby potentially creating a mismatch in these rules.)

If these rules apply, there are three separate standards that must be met.

Compensation Must Exclude Incentives for Unnecessary and Excessive Risks

First, limits must be in place so that compensation "exclude[s] incentives for executive officers to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the Secretary [of the Treasury] holds an equity or debt position in the financial institution." No definition is included that provides any clarity as to what would entail *unnecessary and excessive* risk. We believe that further guidance will be needed before this provision can be sensibly implemented by any financial institution. However, it is not inconceivable, based on the broad language contained in the Act, that many common incentive techniques are now outlawed. Financial institutions seeking to play it safe may, in fact, provide more compensation to executives as base pay without an incentive component. This may not be a policy direction that meets the goals of the Act but may, in fact, become an unfortunate byproduct. Also, it is quite conceivable that an unnecessary or excessive risk may not be clear until a financial institution has the benefit of hindsight.

Required Clawback of Certain Compensation Paid Based on Inaccurate Statements

In addition, financial institutions must now provide for recovery of any bonus or incentive paid to a Top Five Executive that was based on statements of earnings, gains or other criteria that are later proven to be inaccurate.

This provision is similar to the clawback provisions passed in 2002 under the Sarbanes-Oxley Act, under which CEOs and CFOs have been required to disgorge certain incentive payments in the event that misconduct results in the restatement of financial statements. However, under the Act, the clawback provision is broader, because it can affect more executives and can be triggered even if there no misconduct.

Prohibition of Golden Parachute Payments

There is also a provision in section 111(b)(2)(C) of the Act that prohibits financial institutions from making golden parachute payments to Top Five Executives during the period that the Secretary of the Treasury holds an equity or debt position in the institution. Interestingly, although another section of the Act, section 302, addresses parachute payments by broadening the types of payments subject to the provisions of section 280G of the Internal Revenue Code, section 111(b)(2)(C) of the Act (which provides an outright prohibition) does not define what is intended to be a golden parachute payment. Until further guidance is issued, it may not be unreasonable to assume that a "golden parachute payment" will be defined the same as an "excess parachute payment," currently defined in section 280G of the Internal Revenue Code.[1] Accordingly, in this area as well, further guidance is necessary before a financial institution can institute meaningful policies.

Compensation Restrictions in the Event of Auction Purchases by the Government

If a financial institution sells more than $300 million of troubled assets to the federal government and at least some of those assets are sold through an auction purchase, there will be a prohibition on the financial institution providing a new employment contract to a senior executive officer that provides for "a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency or receivership." The Secretary of the Treasury is charged with issuing guidance in connection with this mandate not later than two months after the date of enactment of the Act. These provisions are effective until the government's authority to purchase troubled assets expires - this is currently December 31, 2009. This effective period may be extended until no later than two years following the enactment.

This provision, like the provision applicable to "direct purchases," also inexplicably does not define what is intended to fall within the meaning of a golden parachute payment for this purpose.

Tax Provisions Related to Executive Compensation

Section 302 of the Act provides for amendments to the Internal Revenue Code in the areas of the general deductibility of compensation and the provision of excess parachute payments. First, the Act broadens the rules under section 162(m) of the Internal Revenue Code to deny income tax deductions to certain financial institutions to the extent that the remuneration for any "covered executive" for a taxable year exceeds $500,000. Second, it expands the limits under the "golden parachute" rules of Internal Revenue Code section 280G to payments made to departing executives of failing financial institutions. These new provisions will apply to financial institutions from which the government is acquiring at least $300,000,000 of troubled assets.

Deduction Limit on Employee Remuneration

The Act disallows deductions of remuneration of over $500,000 paid to covered executives of a financial institution during the first taxable year of an employer in which the aggregate amount of troubled assets acquired by the government, when added to the assets previously acquired, exceeds $300,000,000, which specifically excludes assets sold through direct purchase from an individual financial institution. Deductions will also be limited to $500,000 during any subsequent taxable year that includes any portion of such period during which the Act is in effect.

A *covered executive* for whom the deduction limits will apply will include any employee who at any time during a taxable year is the CEO, the CFO, or one of the three highest compensated officers other than the CEO or CFO. If an individual is a covered executive for any taxable year, he or she will remain a covered executive in subsequent taxable years in which either services are performed or deductions are taken by an employer with respect to such compensation. It does not matter whether the executive would otherwise be considered a "covered executive" based on the then current compensation or title.

The definition of "covered executive" is distinguished from "covered employee," as defined in Internal Revenue Code section 162(m). Current guidance excludes the CFO from the definition of "covered employee," due to Internal Revenue Code section 162(m)'s reference to the Securities Exchange Act of 1934, as amended, and the change to the proxy reporting rules. Thus, unlike the definition of "covered employee," "covered executive" includes the CFO, as well as the CEO and three highest compensated officers.

What Compensation Is Counted?

Compensation will generally include all remuneration for a particular taxable year that a company would be able to deduct as an expense. Unlike current Internal Revenue Code section 162(m), the amount of compensation included to determine remuneration in excess of $500,000 includes performance-based compensation, including commission compensation, or compensation paid under a contract in effect on February 17, 1993.

Significantly, the Act denies deductions for compensation that is deferred into a later year if such compensation would have been nondeductible in the year in which it was earned. This is a departure from the manner in which section 162(m) of the Internal Revenue Code generally treats deferrals; that is, to permit deductions up to the limit applicable in the year in which the compensation is taxable to the executive, irrespective of whether it was deferred in a prior year. This provision also captures the carry-forward of expense deductions for companies with a net operating loss in the applicable taxable years.

Golden Parachute Provisions

The rules contained in the Internal Revenue Code that prohibit employer tax deductions for payments to certain departing executives after a change in control of an organization have been expanded to prohibit deductions on account of an involuntary severance of employment of a "covered executive" in connection with any bankruptcy, liquidation or receivership of the employer. These rules generally prohibit tax deductions for severance payouts of three times annual pay or greater. Again, the prohibitions on deductions is narrowed from the current individuals defined under section 280G of the Internal Revenue Code to only "covered executives."

The golden parachute provision excludes certain portions of current Internal Revenue Code section 280G, including arrangements (or amendments to arrangements) entered into one year prior to a "change in control," amounts that the company establishes as reasonable compensation, exemptions for small businesses, and the treatment of the company as a controlled group.

The provision is also limited to covered executives whose employment is terminated either involuntarily by the company or in connection with a bankruptcy, liquidation or receivership of the company. The Secretary of the Treasury is to establish guidance so that a company cannot avoid this provision by mischaracterizing the termination of the covered executive.

Impact of These Provisions

It does not appear that the Act will have a long-lasting effect on executive compensation. The Act is limited to financial institutions currently in distress, but does not contemplate that the same issues that financial institutions currently face may in fact occur in other types of businesses. If Congress was serious about re-engineering executive compensation, it could have extended the performance period that section 162(m) affects to a longer period to ensure that long-term, rather than short-term, gains of a company are considered in tying compensation to performance. In addition, a company in distress does not necessarily consider the tax deduction expense when the company is operating at a net operating loss. Accordingly, the loss of a deduction may not have the punitive effect the Act contemplates. Furthermore, executive contracts often contain tax gross-up provisions for the 20% excise taxes imposed on executives, which would result in no punitive effect on executives who may incur a penalty tax in connection with a parachute payment. The Act could have disregarded any contract provision that provided for a tax gross-up for such penalties and/or could have levied further penalties in connection with a gross-up.

Financial institutions that are covered by the government's assistance program will need to review current compensation practices. Even without a current clear mandate from the federal government as to what changes need to be made, each institution should inventory the areas that likely will need to be changed in light of the current legislative language. Further guidance will be needed, however, before the full impact of the Act can be assessed and all appropriate changes can be implemented.

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[1] Note that although section 280G of the Internal Revenue Code is entitled "Golden Parachute Payments," that section neither mentions, nor defines, "golden parachute payments."