Financial Bailout Legislation Restricts Executive Compensation

Emergency Economic Stabilization Act Limits Executive Compensation at Participating Institutions

SUMMARY

President Bush on Friday signed into law the Emergency Economic Stabilization Act of 2008 (the “Act”) shortly after its passage by Congress. The Act seeks to restore stability and liquidity to the financial markets by addressing some of the major stresses currently affecting the U.S. financial system, particularly in the mortgage and credit markets.

The Act authorizes the Secretary of the Treasury (the “Secretary”) to establish a $700 billion troubled asset relief program (the “TARP”), under which the U.S. Department of the Treasury (the “Treasury Department” or “Treasury”) will have broad authority to purchase troubled assets from a wide range of financial institutions. The Act also:

- prescribes new rules governing executive compensation for financial institutions that participate in the TARP; and
- provides for the current taxation of offshore nonqualified deferred compensation (without regard to the TARP).

These executive compensation provisions are summarized below.

I. IN GENERAL

Under the TARP, the Treasury Department is authorized to purchase mortgages, mortgage-related securities, and certain other troubled assets from any financial institution “on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary.” This authority lasts until December 31, 2009, unless
extended. The Act also authorizes a guaranty program for troubled assets, to be funded by premiums paid by participating financial institutions. The Act is immediately effective.

For more information about the TARP and the guaranty program, see our memorandum entitled “Emergency Economic Stabilization Act” dated October 7, 2008.

The Act also contains two new special regimes governing executive compensation provided by financial institutions participating in the TARP. According to congressional explanations, these are intended to prevent “government subsidies of excessive compensation” to executives of those institutions. Two new tax provisions impose more stringent versions of the preexisting million dollar cap on deductibility of executive compensation and extend the golden parachute rules to ordinary severance, in each case applicable only to institutions participating in the TARP. Congress, however, could later decide to apply these tighter provisions more broadly, beyond the scope of the TARP.

The new rules applicable to an institution and its executives depend on whether the Treasury Department is acquiring troubled assets from the institution directly or by auction:

- If by direct purchase only, the Act grants the Treasury Department broad discretion to prescribe new standards limiting specified kinds of compensation to executives. These provisions originated with the congressional financial services committees and, accordingly, are not framed, for the most part, as amendments to the Internal Revenue Code.
- If by auction purchase, the Act imposes separate limitations that were developed largely by the tax-writing committees. These provisions amend the Internal Revenue Code to subject institutions that sell the Treasury Department more than $300 million worth of troubled assets in TARP auctions (or in both TARP auctions and direct sales) to significantly tighter versions of the existing million dollar cap on deductible executive compensation (Section 162(m)\textsuperscript{1}) and the golden parachute rules (Sections 280G and 4999) as well as a new prohibition on certain golden parachutes.

If the Treasury Department makes both direct and auction purchases of troubled assets from an institution in an aggregate amount exceeding $300 million, the institution appears to be subject to both regimes. Financial institutions that do not participate in either the direct purchases or the auctions under the TARP are not subject to the Act's new executive compensation provisions relating to the TARP.\textsuperscript{2} (The Act also contains provisions that apply to offshore deferred compensation, and those are wholly unrelated to the TARP.)

\textsuperscript{1} References to Sections refer to Sections of the Internal Revenue Code of 1986, as amended.
\textsuperscript{2} Under the Act, the troubled assets the Treasury Department is authorized to purchase also include assets held by or on behalf of tax-qualified retirement plans such as 401(k) plans, other defined contribution plans, or defined benefit plans (but not plans or arrangements that are subject to Section 409A or IRAs) in order to “[protect] the retirement security of Americans.”

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II. RESTRICTIONS THAT APPLY TO INSTITUTIONS PARTICIPATING ONLY IN DIRECT PURCHASE PROGRAM

Under the Act, financial institutions that make direct sales of troubled assets to the Treasury Department ("where no bidding process or market prices are available") will be subject to new standards if Treasury’s purchase gives it a "meaningful equity or debt position" in the financial institution. (The Act does not define "meaningful" for this purpose.) The Act requires Treasury to hold such institutions to "appropriate standards" for executive compensation and corporate governance, effective for as long as it holds an equity or debt position in the institution. The Treasury Department standards will apply to the compensation of the top five highly paid executives of a public company, whose compensation is required to be disclosed under the proxy rules, and non-public company counterparts (the “top executives”).

Under the Act, the standards must include –

- Limits on compensation for the top executives that exclude incentives to “take unnecessary and excessive risks that threaten the value of the financial institution”;
- A “clawback” providing for the financial institution to recover any bonus or incentive compensation paid to a top executive based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and
- A ban on golden parachute payments from the institution to its top executives.\(^3\)

The Act does not make clear how “golden parachute payments” are to be defined in this context (e.g., whether based on the generally applicable Section 280G golden parachute tax provisions, the newly enacted Section 280G golden parachute tax provisions that apply only to employers that participate in the TARP auctions, as described below, or some other definition).

III. RESTRICTIONS THAT APPLY TO INSTITUTIONS PARTICIPATING IN TARP AUCTIONS

The Act prescribes special, more stringent versions of the golden parachute rules and the million dollar cap on tax deductible compensation for certain employers (the tax provisions of the Act use the term “employer” while the nontax provisions, summarized above, use the term “institution”) that participate in the TARP.

- The special rules apply to employers that sell the Treasury Department more than $300 million worth of troubled assets in TARP auctions (or in a combination of TARP auctions and direct sales).

\(^3\) Incidentally, the Act does not expressly state that the three specified standards are the only ones the Treasury Department has authority to require institutions to meet, although the Act does not specifically refer to the possibility of other standards.
• The $300 million threshold is a cumulative, aggregate amount of assets acquired over time from all affiliated entities that are treated as a single employer under a modified version of the Internal Revenue Code’s 80% controlled group aggregation rules.

A. PROHIBITION ON NEW GOLDEN PARACHUTES

If the $300 million threshold is exceeded, the Act directs the Treasury Department to prohibit the institution from entering into any “new employment contract with a senior executive officer” (i.e., one of the five “top executives”, as defined earlier for purposes of the executive compensation standards under the TARP direct purchase program) “that provides a golden parachute” in the event of an involuntary termination or a corporate bankruptcy filing, insolvency, or receivership.

The Act does not define the terms “new”, “employment contract”, “golden parachute” or “involuntary termination”, and the Treasury Department is directed to issue guidance to carry out this provision within two months after enactment, to be effective upon issuance. (The Act does not expressly state, but seems to imply, that this new golden parachute provision would not take effect before the Treasury Department issues its guidance.) This prohibition on new golden parachutes applies only to arrangements entered into during the Treasury Department’s asset purchase authority under the TARP which is scheduled to last until December 31, 2009, but could be extended by Treasury up to October 3, 2010 (referred to here as the “TARP authority period”).

B. NEW GOLDEN PARACHUTE RESTRICTIONS UNDER SECTION 280G

The Act extends the existing golden parachute tax regime in Section 280G to apply (during the TARP authority period) to payments to a “covered executive” of an employer that has exceeded the $300 million threshold if the payments are made on account of a severance from employment whether or not a change in control has occurred. Accordingly, in general terms, if the applicable severance payments equal or exceed three times the executive’s base pay (essentially average annual pay over the preceding five years), then the excess of those payments over base pay will be nondeductible to the employer and subject to a 20% excise tax imposed on the covered executive.

A “covered executive” is any employee who, at any time during the TARP authority period, is the employer’s CEO or CFO or one of the employer’s other three most highly compensated officers for the tax year.

• The three most highly compensated officers other than the CEO and CFO are generally determined based on the proxy disclosure rules (whether or not those rules apply to the employer) and counting only employees employed during the portion of the tax year that overlaps with the TARP authority period.4

4 For further information on certain aspects of the proxy disclosure rules that are inconsistent with the “covered executive” definition in the Act, see Joint Committee on Taxation, Technical Explanation of (footnote continued on next page)
This group – not necessarily the same as the five “top executives” who are subject to the direct purchase standards – may not be limited to the named executive officers actually disclosed in the proxy.

The rules apply only if the severance occurs

- by reason of an “involuntary termination” of the executive by the employer (since “involuntary termination” is not defined, it is unclear to what extent it, unlike Section 409A, would include voluntary terminations for so-called “hair trigger” “good reason” events), or
- in connection with any bankruptcy, liquidation, or receivership of the employer.

Unlike the existing general golden parachute provisions under Section 280G, no change of control or ownership is needed to trigger the new provisions. In fact, the new severance payment regime will not apply to any payment that is also a parachute payment under the general provisions of Section 280G. In addition, the new severance payment rules do not incorporate or adapt certain existing golden parachute rules, such as the

- presumption that payments pursuant to agreements entered into within a year before the change in control are contingent on the change,
- exception for “reasonable compensation for personal services”,
- exception for small business corporations, or
- exception for certain payments approved by a supermajority of shareholders of corporations that do not have publicly traded stock.

The Act authorizes Treasury to issue regulations or other guidance to carry out the purposes of these provisions and the Act as a whole, including the extent to which these golden parachute provisions apply in the case of a merger, acquisition or reorganization of an employer that participates in the TARP. This regulatory authority also extends to

- coordination of the new and the preexisting golden parachute rules (where some payments with respect to an individual are treated as parachute payments under the new rules while others are treated as parachute payments under the preexisting rules), and
- preventing avoidance of the new rules by mischaracterizing a severance from employment that actually occurred by reason of an involuntary termination or in connection with a bankruptcy, liquidation, or receivership of the employer.

The new golden parachute severance provisions apply to payments with respect to severances that occur during the TARP authority period.

(footnote continued)

C. NEW $500,000 CAP ON DEDUCTIBLE COMPENSATION UNDER SECTION 162(M)

For employers that surpass the $300 million threshold, the million dollar deduction cap under Section 162(m) is tightened in several ways:

- **Not Limited to Public Corporations.** All employers participating in the auction purchase program are subject to the new Section 162(m) limitations, not only publicly held corporations.

- **Cap Reduced to $500,000.** Employers will not be allowed a deduction for executive remuneration to the extent it exceeds $500,000 (rather than $1 million) a year, and to the extent attributable to services performed by a “covered executive” for the employer during a tax year of the employer if, by the end of the tax year, it had sold more than $300 million of assets under the TARP.

- **No Grandfathering.** There is no exception for compensation paid under existing binding contracts.

- **Covered Executives.** For purposes of the $500,000 cap, a “covered executive” is defined in the same way as under the new Section 280G golden parachute provisions described above.

- **No Performance-Based Exception.** For purposes of applying the $500,000 cap, the Act eliminates the existing statutory exception otherwise available under Section 162(m) for performance-based compensation (evidently including stock options).

- **Deferred Compensation Swept In.** Deferred compensation paid by these employers to covered executives will no longer escape the deduction cap. Compensation deductible in a year later than the one in which the services were performed (where the services were performed during a tax year described in the preceding bullet point titled “Cap Reduced to $500,000”) will count against the $500,000 cap.

- **Top Five “Alumni” Covered.** The $500,000 cap (unlike the Section 162(m) million dollar cap) generally applies to covered executives even after they no longer occupy those positions.
  - In general, this applies only for tax years of the employer that include any portion of the TARP authority period.
  - Therefore, it appears that an individual who is no longer one of the top five executives after the TARP authority period expires generally will then be out from under the $500,000 cap.
  - However, the Act appears to make an exception for deferred compensation earned by a top-five executive during the TARP authority period: it seems to provide that such deferred compensation will be subject to the $500,000 cap when paid, even if after the TARP authority period and after the individual has fallen out of the top five.

- **Years Covered.** The $500,000 cap provisions apply to tax years of the employer ending on or after October 3, 2008 (the date of enactment of the Act) that include any portion of the TARP authority period, beginning with the tax year in which the employer first exceeded the $300 million threshold. For example, the $500,000 cap would apply to the calendar 2008 tax year of an employer that has a calendar tax year if the employer sold troubled assets in a TARP auction in 2008 and exceeded the $300 million threshold in 2008.

The Act provides that a covered employee’s $500,000 cap will be reduced by any disallowed golden parachute payments with respect to the employee (under Section 280G, as expanded by the Act) and by any excise tax payments with respect to the covered employee under Section 4985 (relating to stock options).
compensation of insiders in expatriated corporations) – in each case under rules similar to those that apply to the million dollar cap under Section 162(m).

The Act authorizes the Treasury Department to issue regulations or other guidance to carry out the purposes of these provisions and the Act as a whole, including the extent to which the $500,000 cap applies in the case of a merger, acquisition or reorganization of an employer that participates in the TARP.

IV. TAXATION OF OFFSHORE NONQUALIFIED DEFERRED COMPENSATION

The tax extenders legislation added to the bill by the Senate includes a provision intended, as described by its authors, to require “hedge fund managers to report and pay taxes on their compensation as they receive it, rather than storing it offshore to avoid taxes.” The provision would have a larger impact as it essentially taxes deferred compensation currently if paid by any “tax indifferent” employer.

The stated rationale is that “tax indifferent” employers are not subject to the tax tension that theoretically limits – or offsets the fiscal cost of – deferred compensation by postponing the company’s tax deduction even as it postpones the tax on the executive. Such “tax indifferent” employers do not claim a tax deduction because they are, for example, offshore corporations in tax haven jurisdictions. This provision is a major revenue raiser, scored as raising an estimated $25.161 billion in tax revenues over 10 years.

A. SPECIFIC PROVISIONS

The provision generally requires that compensation deferred under a nonqualified deferred compensation plan of a “nonqualified entity” be includible in income by a U.S. citizen or resident (or other U.S. cash basis taxpayer) when there is no longer a “substantial risk of forfeiture” of the compensation. This would apply in addition to the regular Section 409A provisions.

For this purpose, a “nonqualified entity” is defined essentially based on “tax indifference” as

- any foreign corporation unless substantially all of the foreign corporation’s income is (a) effectively connected with the conduct of a U.S. trade or business or (b) subject to a “comprehensive foreign income tax” and
- any partnership (foreign or domestic) unless substantially all of the partnership’s income is allocated to persons other than (a) foreign persons not subject to a comprehensive foreign income tax⁵ and (b) tax-exempt organizations.

⁵ For this purpose, a comprehensive foreign income tax is defined, with respect to any foreign person, as the income tax of a foreign country if the person is eligible for the benefits of a comprehensive income tax treaty between the foreign country and the United States, or the person demonstrates to the satisfaction of the Treasury Department that the foreign country has a comprehensive income tax.
For this purpose, compensation is subject to a “substantial risk of forfeiture” generally only if a recipient’s rights to the compensation are conditioned on the future performance of substantial services.

This definition is significantly narrower than the definition of “substantial risk of forfeiture” for purposes of Section 409A, which also treats compensation as subject to a substantial risk of forfeiture when it is subject to the occurrence of a condition related to the purpose of the compensation, e.g., the achievement of a performance goal. Subject to a grandfather rule for existing compensation arrangements, this narrowing of the exceptions could trigger taxation of many performance-based fees that are now exempt from Section 409A, including fees from so-called “side-pocket” investments of foreign hedge funds.

The Act provides an exception under which compensation determined solely by reference to the amount of gain recognized on the disposition of an investment asset is treated as subject to a substantial risk of forfeiture until the disposition. An “investment asset” is defined as any single asset (other than an investment fund or similar entity) acquired directly by an investment fund or similar entity, with respect to which the entity does not (nor does any person related to the entity) participate in the active management of the asset (or, if the asset is an interest in an entity, in the active management of the entity’s activities), and substantially all of any gain on the disposition of the asset (other than such deferred compensation) is allocated to investors in the entity.

The Act provides that, for these purposes,

- nonqualified deferred compensation has the meaning ascribed to it under Section 409A, except that it includes a plan that provides for compensation based on the appreciation in value of a specified number of equity units of the employer or other service recipient, and
- compensation will not be treated as deferred if the employee or other service provider receives payment within 12 months after the end of the service recipient’s tax year during which the right to the payment is no longer subject to a substantial risk of forfeiture.

Under the Act, if the amount of any compensation is not determinable when it is otherwise includible in income, it will be includible when determinable, and the tax imposed in that year will be increased by 20% of the compensation plus interest at the underpayment rate plus 1%, determined as under Section 409A.

The Act provides another exception that applies to foreign corporations with effectively connected income taxable under Section 882. Compensation will not be taxable upon lapse of the substantial risk of forfeiture if, had the compensation been paid in cash when no longer subject to a substantial risk of forfeiture, it would have been deductible by the foreign corporation against that income.

For purposes of these provisions, the controlled group aggregation rules apply, and references to deferred compensation are treated as including income (actual or notional) attributable to the deferred compensation – in each case, as under Section 409A.
B. REGULATIONS AND EFFECTIVE DATES

The Treasury Department is required to issue regulations to carry out the purposes of this section, including regulations that disregard a substantial risk of forfeiture in cases where that is necessary to carry out those purposes.

The proposal would generally apply to amounts deferred that are attributable to services performed after December 31, 2008. However, existing deferrals – amounts deferred that are attributable to services performed before 2009 – that are not includible in income in a tax year beginning before 2018 will be includible in the later of the last tax year beginning before 2018 or the tax year in which there is no substantial risk of forfeiture of the rights to the compensation (determined in the same manner as for purposes of the provisions just described relating to tax indiff erent entities).

The Treasury Department is required to issue guidance within 120 days of the enactment of the Act, providing a limited period of time during which a nonqualified deferred compensation arrangement attributable to pre-2009 services may be amended, without running afoul of the requirements of Section 409A, to conform the date of distribution to the date the amounts are required to be included in income. Similarly, in the case of back-to-back arrangements where the service provider is also a service recipient vis-à-vis other service providers, and maintains nonqualified deferred compensation arrangements for its service providers under which any amount is attributable to pre-2009 services, the Treasury Department guidance is to permit this arrangement also to be amended to conform the dates of distribution under the arrangement to the date the amounts are required to be included in income. The Act provides that none of these accelerated payments will constitute a material modification of the arrangement under Section 409A.

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Navigating the “Parachute” Maze After the Act

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6 This table provides only a brief, general outline; the memorandum provides more specifics on the Act’s provisions.