

New Executive Compensation Restrictions Under the Emergency Economic Stabilization Act of 2008

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On February 4, 2009, the U.S. Department of Treasury (“Treasury”) announced guidelines (the “Guidelines”) for executive compensation paid by financial institutions that receive government assistance. The Guidelines are “designed to ensure that the compensation of top executives in the financial community is closely aligned not only with the interests of shareholders and financial institutions, but with the taxpayers providing assistance to those companies.”

Many have observed that the Obama administration chose to announce the new Guidelines in an attempt to quell criticism in advance of any new programs or assistance to the financial industry that it is widely expected to announce in the coming days. The Guidelines include provisions relating to the payment of annual compensation, golden parachute payments, the clawback of previously paid compensation, the disclosure and submission of compensation to non-binding “say on pay” shareholder votes, the certification that compensation does not encourage excessive risk taking and the adoption and disclosure of policies on “luxury” expenditures. The Guidelines also outline potential long-term regulatory reforms intended to align compensation strategies with proper risk management and long-term value creation and growth.

On a separate track, the restrictions under the Guidelines have been added to the stimulus bill under consideration in the Senate. While Treasury had given itself considerable latitude to interpret and apply its Guidelines, if similar restrictions are enacted as law by Congress, Treasury may have less latitude in its interpretation and application of the restrictions. In addition, the Guidelines appear to apply only to financial institutions that receive future assistance, but legislative initiatives thus far appear to apply the restrictions retroactively as well. It remains to be seen how any legislative initiatives will turn out.

The Guidelines apply only to financial institutions that receive assistance, but their potential effect could be broader than that. As discussed in this memorandum, some of the requirements, such as say on pay, might put pressure on non-participating companies to adopt similar measures or might pave the way for legislative or regulatory initiatives imposing similar requirements.

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Overview

The Emergency Economic Stabilization Act of 2008 (the “Act”), which was signed into law by former President Bush on October 3, 2008, authorizes Treasury to access up to \$700 billion to protect the U.S. economy and restore confidence and stability to the financial markets. To date funds have been allocated to institutions under Treasury’s Capital Purchase Program and, in exceptional circumstances, through individually negotiated agreements with Treasury (*e.g.*, AIG, Bank of America and Citi). The Act authorizes Treasury to impose executive compensation restrictions on participating institutions. Institutions participating in the Capital Purchase Program have agreed to standardized restrictions adopted by Treasury,¹ while the institutions entering into additional funding arrangements with Treasury have agreed to more onerous, individually negotiated restrictions.

The new Guidelines continue this two-tier approach, imposing new executive compensation restrictions on institutions that accept new or additional funding under a generally available capital access program and even more stringent restrictions on institutions that require exceptional financial recovery assistance. The Guidelines do not offer any gloss on what new types of programs or assistance might be offered and which types might fall into the exceptional financial recovery assistance category. It is anticipated that the category of generally available capital access programs might include a “bad asset” or “bad bank” program or a capital infusion program entailing requirements for on-lending the capital. The guidelines applicable to these programs appear to provide for standardized compensation restrictions and requirements that will be applied uniformly to all participating institutions. Treasury intends to issue proposed guidance, subject to public comment, on the executive compensation restrictions applicable to generally available capital access program participants.

Exceptional financial recovery assistance might include individually negotiated support for certain regional banks or other institutions with deteriorating balance sheets. The compensation restrictions announced for these situations do not call for additional Treasury guidance, as it appears that Treasury has reserved latitude to refine the scope and application of the restrictions, perhaps on a case-by-case basis.

¹ A comprehensive review of the Capital Purchase Program executive compensation rules can be found in our client memorandum “[Executive Compensation Rules Under the Emergency Economic Stabilization Act of 2008](#)” dated October 23, 2008.

Limits on Compensation

- » **Capital Purchase Program – Annual deduction for compensation of top 5 executives limited to \$500,000 per executive**
- » **Generally Available Capital Access Program and Exceptional Financial Recovery Assistance – Prohibition on paying annual compensation above \$500,000 to senior executives; exception for restricted stock and similar long-term incentives**

Limits on Compensation

Existing Capital Purchase Program. Institutions participating in the Capital Purchase Program are required to limit their annual deduction under Internal Revenue Code Section 162(m) for compensation paid to their top five senior executives (*i.e.*, their chief executive officer, chief financial officer and next three most highly compensated executive officers) to \$500,000 per executive. The annual deduction limit applies to both public and private institutions, there is no exception for performance-based compensation, and the deferral of compensation does not avoid the deduction limit (*i.e.*, deferred compensation in excess of the limit will be non-deductible when paid).

Generally Available Capital Access Program. Institutions participating in a generally available capital access program will be prohibited from paying annual compensation in excess of \$500,000 to senior executives, with an exception for compensation granted in the form of restricted stock or a similar long-term incentive. It appears that this restriction is limited to the top five senior executives of a participating institution, but Treasury could broaden the target group. The restricted stock or similar long-term incentive may only be cashed in either after the government has been repaid or after a specified period according to conditions that consider, among other factors: the degree to which the institution has satisfied repayment obligations, protected taxpayer interests or met lending and stability standards. It appears that “cash in” refers to the executive’s ability to monetize the restricted stock or other incentive. Accordingly, it seems that a senior executive could vest in an award on a reasonable schedule fixed by the institution, but must be prohibited from selling or otherwise receiving cash in respect of the award during the period above.

Compensation that does not comply with the restriction above may be permitted if it is disclosed and submitted to a non-binding say on pay shareholder vote. It is unclear whether an institution will have to first request permission from Treasury to pursue this exception or will be permitted to go directly to a say on pay vote, if it decides to grant compensation which does not conform with the limits above.

Exceptional Financial Recovery Assistance. Institutions receiving exceptional financial recovery assistance are also subject to the compensation restrictions above, except that the Guidelines do not explicitly offer an exception for non-complying compensation that is subject to a say on pay vote. As described under “Say on Pay” below, institutions receiving exceptional financial recovery

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Golden Parachutes

- » **Capital Purchase Program – Severance paid to top 5 executives limited to less than 3 times average annual taxable compensation**
- » **Generally Available Capital Access Program – Severance paid to top 5 executives limited to 1 times average annual taxable compensation**
- » **Exceptional Financial Recovery Assistance – Ban on severance to top 10 executives; severance paid to next 25 executives limited to 1 times average annual taxable compensation**

assistance will be required to put their compensation to a non-binding say on pay shareholder vote, but this will be a basic requirement, not a means for avoiding the restrictions above. It is unclear whether Treasury will permit variances from the pay restrictions above pursuant to some other standard or process or on a case-by-case basis.

The Guidelines' emphasis on less annual compensation and more long-term compensation is responsive to recent criticism. However, while certain constituents object to cash-based and short-term awards, others will object to any sizable restricted stock awards, requiring compensation committees to be thoughtful and proactive in designing and defending compensation arrangements that sensibly respond to concerns and requirements of the Guidelines.

Golden Parachutes

Existing Capital Purchase Program. Institutions participating in the Capital Purchase Program were required to agree to limit the severance benefits payable to each of their top five senior executives upon a severance due to an involuntary termination of employment or in connection with a bankruptcy, insolvency or receivership to less than three times the executive's average annual taxable compensation over the five-year period preceding the severance from employment.

Generally Available Capital Access Program. Institutions participating in a generally available capital access program will be required to agree to limit the severance benefits payable to each of their top five senior executives upon an applicable severance from employment to not more than one times the executive's average annual taxable compensation over the five-year period preceding the severance from employment.

Exceptional Financial Recovery Assistance. An institution receiving exceptional financial recovery assistance will be subject to an absolute prohibition on paying to its top ten senior executives any severance benefits triggered by an applicable severance from employment. In addition, and at a minimum, the institution's next 25 executives will be prohibited from receiving any severance benefits upon an applicable severance from employment in an amount that exceeds one times the executive's average annual taxable compensation over the five-year period preceding the severance from employment.

Clawback

- » All programs – Bonus and incentive compensation paid to top 5 executives subject to clawback if based on materially inaccurate financial statements or performance metrics
- » Generally Available Capital Access Program and Exceptional Financial Recovery Assistance – Clawback also applies to next 20 executives if knowingly provided inaccurate information relating to financial statements or performance metrics used to calculate own incentive pay

“Say on Pay”

- » Capital Purchase Program – No say on pay requirement
- » Generally Available Capital Access Program – Say on pay only to avoid limits on senior executive compensation
- » Exceptional Financial Recovery Assistance – Say on pay on all senior executive compensation

Clawback

Existing Capital Purchase Program. Institutions participating in the Capital Purchase Program must require that any bonus and incentive compensation paid to its top five senior executives is subject to clawback by the institution if the compensation was based on financial statements or performance metrics later determined to be materially inaccurate.

Exceptional Financial Recovery Assistance and Generally Available Capital Access Program. The above clawback provision will apply to the top five senior executives of any institution that receives assistance under a generally available capital access program or an exceptional financial recovery assistance arrangement. In addition, this clawback provision will be required to apply to the next 20 senior executives of each exceptional financial recovery assistance and generally available capital access program participant if they are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay.

Say on Pay

Existing Capital Purchase Program. No say on pay requirements apply to Capital Purchase Program participants.

Generally Available Capital Access Program. Institutions participating in a generally available capital access program will be required to submit their compensation to non-binding say on pay shareholder resolutions if they wish to avoid the restrictions described above under “Limits on Compensation.”

Exceptional Financial Recovery Assistance. Institutions receiving exceptional financial recovery assistance will be required to disclose the structure and rationale for how their senior executive compensation is tied to sound risk management and will be required to submit the compensation to non-binding say on pay shareholder resolutions. It is not clear whether the say on pay vote will be an annual requirement or will be required only when there is a significant change in a compensation element or practice, but since many institutions make compensation awards and refinements annually, this question might be moot.

The Guidelines’ embrace of non-binding say on pay votes could provide a push for legislative or shareholder action to require this for public companies across the board. While many observers expect say on pay votes to show strong

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Risk Avoidance and Certification

- » **Capital Purchase Program – Compensation committee annual review and certification of compensation of top 5 executives**
- » **Generally Available Capital Access Program – Compensation committee annual review and certification of compensation of all employees**
- » **Exceptional Financial Recovery Assistance – No requirement specified but likely to apply**

majority support for the compensation practices at most companies, the current climate clearly presents increased uncertainties on many fronts. In any event, an increase in say on pay proposals will, again, increase the stakes on proper design of the amounts and forms of compensation.

Risk Avoidance

Existing Capital Purchase Program. Each institution participating in the Capital Purchase Program must eliminate incentives for its top five senior executives to take unnecessary and excessive risks that threaten the value of the institution. To that end, the institution's compensation committee must:

- » promptly (within 90 days after receiving assistance under the program) review its top five senior executives' compensation arrangements with its senior risk officer or other personnel acting in like capacity to ensure that their compensation arrangements do not encourage them to take unnecessary and excessive risks;
- » meet at least annually with the senior risk officer to discuss and review the relationship between the institution's risk management policies and practices and the incentive compensation arrangements of its top five senior executives; and
- » certify annually that it has complied with the above.

Public institutions must include such an annual certification in the compensation committee report in their annual proxy statements. Private institutions must file such an annual certification with their primary regulatory agency.

Generally Available Capital Access Program. The risk analysis and certification procedures above will apply also to any institution participating in a generally available capital access program, except that the procedures will apply with respect to each of the institution's senior executives and other employees and not only to its top five senior executives.

Exceptional Financial Recovery Assistance. The Guidelines do not specify that these risk analysis and certification procedures will apply to institutions receiving exceptional financial recovery assistance; presumably, however, they will be included in the agreements that the institutions individually negotiate with Treasury.

Expenditures Policy

- » **Capital Purchase Program – No expenditures policy requirement**
- » **Generally Available Capital Access Program and Exceptional Financial Recovery Assistance – Board must adopt company-wide expenditures policy and post on institution’s web site; CEO must certify excess and luxury items**

Expenditures Policy

Existing Capital Purchase Program. No mandatory expenditure policies apply with respect to institutions participating in the Capital Purchase Program.

Exceptional Financial Recovery Assistance and Generally Available Capital Access Program. The board of directors of each institution participating in a generally available capital access program or receiving exceptional financial recovery assistance must adopt a company-wide policy on expenditures related to aviation services, office and facility renovations, entertainment and holiday parties and conferences and events. The policy must require the chief executive officer to certify any expenses that could be viewed as excess or luxury expenditures. The policy should be posted on the institution’s Web site.

The Guidelines note that the policy is not intended to cover reasonable expenditures for sales conferences, staff development, reasonable performance incentives and other measures tied to an institution’s normal business operations.

Certification Requirement

Existing Capital Purchase Program. No additional certification requirement.

Exceptional Financial Recovery Assistance and Generally Available Capital Access Program. In addition to the certification requirement discussed above, chief executive officers of all institutions which receive government assistance must initially certify, and re-certify annually, that they are in strict compliance with all statutory, Treasury and contractual executive compensation restrictions.

Long-Term Regulatory Reform

The Guidelines include a general section which encourages Treasury and the SEC to work together on potential regulatory reforms for company-wide compensation at financial institutions, which are designed to discourage excessive risk-taking and develop model compensation policies for the future. This section suggests for consideration:

- » Requiring compensation committees of all public financial institutions—not just those receiving government assistance—to review and disclose compensation arrangements of executives and certain employees and explain how those arrangements are consistent

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with risk management and creating long-term value for the institutions and their shareholders.

- » Requiring the compensation of top executives at financial institutions to encourage a long-term perspective on creating economic value, such as stock awards with holding requirements.
- » Allowing shareholders to have a say on pay by providing them with a non-binding resolution on the levels and structure of executive compensation.

The Guidelines conclude by noting that Treasury will host a conference on executive pay reform at financial institutions and will seek input on best practices and guidelines for executive compensation in the form of testimony, comment and white papers. This exercise will invite input from shareholder advocates, pension plans and other institutional investors, academics and executives.

For the Treasury announcement, click here: [Treasury Announcement](#)

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This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that the discussion of U.S. federal tax issues contained in this memorandum is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. If you have questions about Treasury's recent initiatives or the executive compensation rules described above, please feel free to call your Davis Polk contact.



This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

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Summary Comparison of Capital Purchase Program, Exceptional Financial Recovery Assistance and Generally Available Capital Access Programs

	Capital Purchase Program	Exceptional Financial Recovery Assistance	Generally Available Capital Access Programs
Limits on Compensation	<p>Annual deduction for compensation paid to top five senior executives limited to \$500,000 per executive.</p> <p>Limit applies to both public and private institutions.</p> <p>No exception for performance-based compensation.</p> <p>Deferral does not avoid deduction limit—deferred compensation in excess of limit will be non-deductible when paid.</p>	<p>Annual compensation in excess of \$500,000 paid to any senior executive must be paid in restricted stock or similar long-term incentive that may only be cashed in after (i) government has been repaid or (ii) a specified period according to conditions that consider factors such as: degree institution has satisfied repayment obligations, protected taxpayer interests or met lending and stability standards.</p> <p>Though not entirely clear, limit appears to apply only to top five senior executives.</p>	<p>Same \$500,000 limit on payment of annual compensation paid to any senior executive as applies to institutions receiving Exceptional Financial Recovery Assistance, but institutions may avoid limit by disclosing compensation and, if requested, submitting to non-binding say on pay shareholder vote.</p>
Golden Parachutes	<p>Severance benefits payable to top five senior executives limited to less than three times executives' average annual taxable compensation over five-year period preceding severance from employment.</p> <p>Applies to any severance benefits triggered by severance from employment (i) due to involuntary termination of employment or (ii) in connection with bankruptcy, insolvency or receivership.</p>	<p>Absolute ban on paying to top ten senior executives any severance benefits triggered by applicable severance from employment.</p> <p>Severance benefits payable to next 25 executives on applicable severance from employment limited to one times executives' average annual taxable compensation over five-year period preceding severance from employment.</p>	<p>Severance benefits payable to top five senior executives on applicable severance from employment limited to one times executives' average annual taxable compensation over five-year period preceding severance from employment.</p>

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	Capital Purchase Program	Exceptional Financial Recovery Assistance	Generally Available Capital Access Programs
<i>Clawback</i>	Any bonus and incentive compensation paid to top five senior executives must be subject to clawback by institution if compensation was based on financial statements or performance metrics later determined to be materially inaccurate.	Same clawback requirement for top five senior executives as under Capital Purchase Program. In addition, same clawback requirement applies to next 20 senior executives if they are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay.	
<i>Say on Pay</i>	No requirement to submit compensation to non-binding shareholder vote.	Senior executive compensation structure and rationale for how compensation is tied to sound risk management must be submitted to non-binding shareholder vote.	Submission of compensation to non-binding shareholder vote only required if institution is requested to do so following waiver of \$500,000 limit on payment of annual compensation.
<i>Expenditures Policy</i>	No policy required.	Boards of directors must adopt company-wide policy on expenditures related to aviation services, office and facility renovations, entertainment and holiday parties and conferences and events. Does not apply to reasonable expenditures for sales conferences, staff development, reasonable performance incentives and other measures tied to institutions' normal business operations. CEOs must certify expenditures that could be viewed as excess or luxury items. Institutions should post text of expenditures policy on their Web sites.	

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	Capital Purchase Program	Exceptional Financial Recovery Assistance	Generally Available Capital Access Programs
<i>Risk Avoidance</i>	<p>Institutions must eliminate incentives for top five senior executives to take unnecessary and excessive risks that threaten value of institution. Compensation committee must:</p> <ul style="list-style-type: none"> » promptly (within 90 days) review its top five senior executives' compensation arrangements with senior risk officer or other personnel acting in like capacity to ensure that compensation arrangements do not encourage executives to take unnecessary and excessive risks; » meet at least annually with senior risk officer to discuss and review relationship between institution's risk management policies and practices and top five senior executives' compensation arrangements; and » certify annually that it has complied with the above. <p>Public institutions must include annual certification in compensation committee report in annual proxy statements. Private institutions must file annual certifications with their primary regulatory agency.</p>	<p>No risk avoidance and certification procedures specified, but likely to be included in agreements that institutions individually negotiate with Treasury.</p>	<p>Same risk avoidance and certification procedures as under Capital Purchase Program, but apply to compensation arrangements of all senior executives and other employees, not just those of top five senior executives.</p>