LUSE GORMAN POMERENK & SCHICK

A PROFESSIONAL CORPORATION

ATTORNEYS AT LAW

5335 WISCONSIN AVENUE, N.W., SUITE 400 ■ WASHINGTON, D.C. 20015 ■ 202.274.2000 T ■ 202.362.2902 F ■ WWW.LUSELAW.COM

Volume 14, Number 6 **October 22, 2008**

EXECUTIVE COMPENSATION RULES UNDER THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

The United States Treasury Department ("Treasury") has announced a capital purchase program ("CPP") pursuant to the Emergency Economic Stabilization Act of 2008 ("EESA") whereby it will invest directly in the preferred stock of qualifying financial institutions ("QFIs"). This newsletter discusses the compensation restrictions that will be imposed on participating financial institutions and their executives under the CPP. There are additional restrictions pertaining to executive compensation that apply to institutions that sell troubled assets to the Treasury through the Direct Auction Program or the Troubled Asset Auction Program. These will be addressed in a subsequent newsletter.

For a more detailed description of the CPP, please see our newsletter dated October 17, 2008, which is available on our web site at www.luselaw.com.

Compensation Restrictions

QFIs (including their holding companies and any subsidiaries) and certain of their executive officers are required to accept four types of compensation restrictions, as described below. These restrictions will generally apply to the chief executive officer, the chief financial officer, and the next three most highly compensated senior executive officers ("SEOs").

The compensation restrictions will continue for as long as Treasury owns any equity (including warrants) or debt position in a QFI.

A QFI and its SEOs must also grant Treasury a waiver releasing Treasury from claims that the QFI and the SEOs may have as a result of any modifications to the terms of benefit plans, arrangements, and agreements between the SEO and the QFI to bring them into compliance with the new compensation requirements.

The compensation restrictions are as follows:

- **Prohibition of Incentives That Involve Unnecessary and Excessive Risks.** Incentive compensation must not encourage "unnecessary and excessive risks" that threaten the value of the QFI.

  Treasury has not clarified what constitutes such a risk.

  Nonetheless, a QFI's compensation committee is required to: (i) review the incentive compensation arrangements with senior risk officers within 90 days after the QFI participates in the CPP to determine if such risks exist; (ii) meet at least annually with senior risk officers to discuss and review the relationship between the QFI's risk management policies and practices and the incentive compensation arrangements; and (iii) certify that it has completed the review of the incentive compensation arrangements as outlined above. A QFI with securities registered with the Securities and Exchange Commission ("SEC") must disclose its certification in the Compensation Discussion and Analysis portion of its annual meeting proxy statement. A QFI that does not have securities registered with the SEC must provide the certification to its primary regulatory agency.

- **Clawback Provisions.** Any incentive compensation paid to an SEO will be subject to "clawback" (recovery) by the QFI if the payments were based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate. This standard is more rigorous than the standards under the Sarbanes-Oxley Act, which require only the chief executive officer and chief financial officer to disgorge certain incentive pay and stock profits if there is a restatement of financial statements due to corporate misconduct.

- **No Golden Parachute Payments.** "Golden parachute payments" are prohibited. The definition of a "golden parachute payment" has been expanded for purposes of EESA to include payments to a SEO by reason of an involuntary termination (defined to include certain "good reason" terminations), or in connection with a bankruptcy, liquidation or receivership (whether or not involving a change in control), the present value of which equals or exceeds 3x the "base amount" as defined in Internal Revenue Code ("Code") Section 280G (referred to as "280G").

- **New $500,000 Limit on Tax Deductibility.** Under new Code Section 162(m)(5), a QFI may not deduct for tax purposes executive compensation earned in excess of $500,000 for each SEO per applicable tax year. For these purposes, executive compensation includes performance-based compensation, commissions, and "deferred deduction executive remuneration" (e.g., deferred compensation) that is promised in the applicable tax year but paid in a later tax year. (*Note, this is different than the general rules that disallow deductions in excess of $1 million for named executive officers under Code Section 162(m), which exempts performance based compensation commissions and compensation deferred to a later year.)*

  Example: In 2009 (an applicable tax year), the CFO of a QFI is paid $400,000 in salary and is promised deferred compensation of $250,000, payable in 2015. The full $400,000 in salary is deductible in 2009. The deferred compensation counts against the deductible compensation limit for 2009, however it will be deductible, to the extent permitted, in 2015, when it is paid to the CFO. In 2015, the QFI is entitled to a tax deduction of $100,000 for the deferred compensation distributed and will not be able to deduct the remaining $150,000 because this exceeds the unused portion of the $500,000 limit for 2009.

Special Rules for Mergers, Acquisitions or Reorganizations There are special rules with respect to QFIs that are acquired. If a QFI participates in the CPP is acquired, the acquiror will not be subject to the CPP's executive compensation and corporate governance standards, as a result of the acquisition. SEOs of target that previously participated in the CPP will be subject to the CPP's executive compensation and corporate governance standards until the first anniversary following the acquisition.

Observations

The Treasury Department has not yet issued the rules implementing many of the compensation provisions, including: (1) what constitutes "unnecessary and excessive risk," (2) whether "incentive compensation" includes compensation that is not performance based, such as a supplemental retirement plan, or (3) whether claw-backs apply even if a SEO engaged in no misconduct that led to the inaccurate financial statements? Further, QFIs will need to address what to do if a SEO does not consent to amending his or her compensation agreement to conform to the new rules.

The new tax deduction rules are effective immediately without any transition relief for QFIs that elect to participate in the program. It is unclear how the rules will apply in 2008, if for example, a QFI sells preferred stock to the Treasury Department on December 1, 2008. The regulations suggests the $500,000 limit will be prorated, but it is unclear what the deduction limit is for the portion of the calendar year not covered by the new limit (e.g., the period before December 1).

Steps To Take A QFI should determine how the new compensation rules will affect its SEOs as part of its decision making process to participate in the CPP. A review of an SEO's compensation agreements would be prudent in order to determine what changes may be appropriate. An important component of this process is to effectively communicate the compensation restrictions and to quantify its effect on each SEO.

If you have questions, please contact any of the attorneys listed below.

Beverly J. White:
202-274-2005 ■ bwhite@luselaw.com

Norma M. Sharara:
202-274-2035 ■ nsharara@luselaw.com

D. Max Seltzer:
202-274-2038 ■ mseltzer@luselaw.com