

The Treasury Issues Guidance on Executive Compensation and Corporate Governance Applicable to Financial Institutions Participating in the Capital Purchase Program

On October 20, 2008, the Department of the Treasury (the “Treasury”) issued interim final rules (the “Rules”)¹ providing guidance on the executive compensation and corporate governance provisions of Section 111(b) of the Emergency Economic Stabilization Act of 2008 (“EESA”). Under the EESA, enacted on October 3, 2008, the Treasury has established the Troubled Assets Relief Program Capital Purchase Program (“CPP”) to “purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary.” In the case of direct purchases by the Treasury,² the EESA requires that the participating financial institutions meet appropriate standards for executive compensation and corporate governance as set forth by the Secretary of the Treasury. At the very least, the EESA requires that the following three criteria be satisfied by participating financial institutions for so long as the Treasury holds a meaningful equity or debt position:

1. compensation of senior executive officers (“SEOs”) must exclude incentives to take unnecessary and excessive risks that threaten the value of the financial institution;
2. any bonus or incentive compensation paid to an SEO must be recoverable if based on financial data that is later proven to be materially inaccurate; and
3. golden parachute payments to SEOs are prohibited.

The Rules provide financial institutions which are considering participation in the CPP with specific information with respect to the three criteria above. The Treasury has solicited comments on the Rules which are due by November 19, 2008. This memorandum summarizes the key aspects of the Rules.

Applicability of the Rules

The Rules apply to any financial institution that participates in the CPP and continue to apply for so long as the Treasury holds a meaningful equity or debt position. The Rules apply to financial institutions regardless of whether they have securities registered with the Securities and Exchange Commission (“SEC”) pursuant to the federal securities laws.

An SEO means a “named executive officer” as defined in Item 402 of Regulation S-K under the federal securities laws and includes the principal executive officer (“PEO”), the principal financial officer (“PFO”), and the three other most highly compensated executive officers.³

¹ Tarp Capital Purchase Program, Interim Final Rule, 31 CFR Part 30 (the “Rules”), 73 Fed. Reg. at 62205 (October 20, 2008), available at <http://edocket.access.gpo.gov/2008/pdf/E8-24781.pdf>.

² For purchases conducted by the Treasury at auction, the Treasury has provided separate guidance relating to executive compensation in Treasury Notice 2008 - TAAP available at <http://www.treas.gov/initiatives/eesa/docs/Exec%20Comp%20TAAP%20Notice.pdf> (providing guidance on certain executive compensation provisions applicable to the Treasury’s Troubled Asset Auction Program) and IRS Notice 2008-94 available at <http://www.treas.gov/initiatives/eesa/docs/N-08-94.pdf> (providing guidance on certain executive compensation provisions of the EESA which added new sections 162(m)(5) and 280G(e) to the Code).

³ Compensation is determined as it is in Item 402 of Regulation S-K to include total compensation for the last completed fiscal year, without regard to whether compensation is includible in the executive officer’s gross income.

Avoiding Incentives to take Unnecessary and Excessive Risks

Promptly, and in no case more than 90 days, after a purchase by the Treasury under the CPP, the selling financial institution's compensation committee must review its SEO incentive compensation arrangements with the financial institution's senior risk officers to ensure that such arrangements do not encourage unnecessary and excessive risks that threaten the value of the financial institution. Thereafter, the compensation committee must meet at least annually with senior risk officers to discuss and review the relationship between the financial institution's risk management policies and practices and the SEO incentive compensation arrangements. In conducting such reviews, the committee should identify and limit the features in the financial institution's SEO incentive compensation arrangements that could lead SEOs to take unnecessary or excessive risks (including long-term as well as short-term risks), keeping in mind the specific nature of the financial institution's business and the markets in which it operates.

The committee must provide a certification that such reviews have been completed. A statement similar to the following would satisfy this requirement: "The compensation committee certifies that it has reviewed with senior risk officers the SEO incentive compensation arrangements and has made reasonable efforts to ensure that such arrangements do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the financial institution."

For financial institutions with securities registered with the SEC pursuant to the federal securities laws, the certification must be included in the Compensation Discussion and Analysis section of their periodic filings. For private financial institutions, the certification must be filed with their primary regulatory agency.

Recovering Bonuses or Incentives based on Inaccurate Financial Data

Any bonus or incentive compensation paid to an SEO during the period that the Treasury holds an equity or debt position acquired under the CPP must be subject to recovery by the financial institution if the payments were based on materially inaccurate financial statements or other performance metrics. This requirement is similar to that of Section 304 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").⁴ However, unlike Sarbanes-Oxley, this requirement (1) applies to the three most highly compensated officers and not just the CEO and CFO, (2) applies to both public and private financial institutions, (3) is not exclusively triggered by an accounting restatement, (4) does not limit the recovery period to 12 months following the materially non-compliant financial report, and (5) covers any material inaccuracy of criteria used to award bonuses or incentive payments.

⁴ Pub. Law. No. 107-204. Section 304(a) of Sarbanes-Oxley provides:

If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—

- (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
- (2) any profits realized from the sale of securities of the issuer during that 12-month period.

Id. at § 304(a).

Prohibiting Golden Parachute Payments

Financial institutions must prohibit golden parachute payments to an SEO during the period the Treasury holds an equity or debt position acquired under the CPP.⁵ A golden parachute payment is any payment in the nature of compensation to an SEO made on account of severance from employment by reason of an involuntary termination by, or in connection with the bankruptcy, insolvency or receivership of, the financial institution to the extent the aggregate present value of such payments equals or exceeds an amount equal to three times the SEO's base amount.⁶ An involuntary termination includes any termination due to the independent exercise of unilateral authority of the employer to terminate the SEO's services. This can include the financial institution's failure to renew a contract. An involuntary termination also includes a voluntary termination for good reason due to a material negative change in the SEO's employment relationship. A payment is only considered a golden parachute payment if the payment would have not been payable or accelerated if no applicable severance from employment had occurred.⁷

Other Conditions of the CPP relating to Executive Compensation and Corporate Governance

- Financial institutions must agree not to take any deduction that would be disallowed by Section 162(m) of the Code as excessive remuneration, regardless of the actual applicability of that section.
- A controlled group will be treated as a single financial institution for the purpose of the Rules in accordance with Section 414(b) and (c) of the Code. However, brother-sister controlled groups and combined groups are disregarded.
- A financial institution will not become subject to the Rules by reason of an acquisition in any form of a financial institution (the "target") which is subject to the Rules by virtue of having sold troubled assets to the Treasury and which is not related to the acquirer prior to such transaction. For purposes of this rule, an acquirer is "related" to a target if stock or other interests of the target are treated (under Section 318(a) of the Code other than paragraph (4) thereof) as owned by the acquirer. The target financial institution's SEOs will remain subject to the Rules until after the first anniversary following such acquisition.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Michael Macris at 212.701.3409 or mmacris@cahill.com; or Banks Bruce at 212.701.3052 or bbruce@cahill.com.

⁵ The Rules borrow extensively from Section 280G of the Internal Revenue Code (the "Code") for its definition of golden parachute payments.

⁶ "Base Amount" means the individual's annualized includible compensation for the base period. Section 280G(b)(3) of the Code.

⁷ See 26 CFR 1.280G-1.