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Executive Compensation Rules Under EESA

The Emergency Economic Stabilization Act of 2008 includes important requirements with respect to the executive compensation and corporate governance practices of participating financial institutions. The U.S. Department of the Treasury issued additional guidance with respect to these requirements. We have included links in the summary below to the newly issued Treasury guidance.

If a financial institution participates in the program, will its executives be subject to new restrictions on their compensation?

Perhaps. Participation in the Troubled Assets Relief Program ("TARP") under the Emergency Economic Stabilization Act ("EESA") may trigger several new restrictions on executive compensation and/or the tax treatment of such compensation. The restrictions will primarily depend on (a) the value of the assets sold by the institution to the Treasury and (b) the method by which the Treasury acquires those assets (directly or via auction). Institutions that do not sell any assets directly to the Treasury, and do not sell more than $300 million of assets via auction, will not be subject to any new executive compensation restrictions.

The restrictions are only in effect so long as the Treasury holds "a meaningful equity or debt position" in the institution or as long as the EESA authorities remain in effect. Additional guidance was provided by the Treasury and IRS on October 15, 2008 (this guidance will be summarized in future E*Zines). The basic framework is summarized below.

(1) *Outright Limitations on Executive Compensation.*

If a financial institution sells any assets directly to the Treasury (including sales of the financial institution's own equity) and the Treasury obtains a "significant equity or debt position" in the institution, the Secretary must require that the institution "meet appropriate standards for executive compensation and corporate governance." Such standards shall include, at a minimum, prohibitions on senior executive officer compensation structures that encourage unnecessary risk-taking, claw-back of bonuses paid to senior executive officers that are based on materially inaccurate earnings statements, and a ban on golden parachutes. "Senior executive officers" are defined as the top five highly-paid executives of the selling institution (whether public or private).

(2) *Golden Parachutes – Broadened Applicability of Penalty Taxation and Limits on New Senior Executive Contracts.*

Generally speaking, existing golden parachute rules impose an excise tax if, in connection with a change of control of the employer, an executive receives a payment that exceeds three times his/her average annual compensation over the previous five years. The excise tax is 20% of the amount in excess of his/her average annual compensation.

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Under EESA, financial institutions selling in excess of $300 million in aggregate assets to the Treasury (at least one of which is sold through the auction process) are subject to the golden parachute rules in certain additional circumstances, even if there is no change of control. An "applicable severance from employment" now includes any severance by reason of involuntary termination, bankruptcy, liquidation, or receivership. Further, these institutions are expressly prohibited from entering into any new employment contracts with senior executive officers that would provide a golden parachute under those additional circumstances.

(3) Limitations on Corporate Tax Deductions for Executive Compensation.

For financial institutions selling in excess of $300 million in aggregate assets to the Treasury (at least one of which is sold through the auction process), the corporate tax deduction for executive compensation will be limited to $500,000 per covered employee (rather than the current $1 million for companies that do not participate). Further, there is no exception for commission- or performance-based compensation. This limitation applies regardless of corporate form, and once a "covered employee" is designated as such, the individual remains a covered employee for the duration of the institution's participation in the program.

Click here for the Treasury interim final rule regarding the application of the standards imposed on financial institutions in which the government obtains a substantial equity or debt position.

Click here for the Treasury Notice 2008-TAAP, providing guidance regarding the golden parachute restrictions applicable to financial institutions that sell troubled assets to the government through an auction sale.

Click here for the Treasury Notice 2008-PSSFI, providing guidance on the standards imposed on failing financial institutions to which the government provides assistance on a case-by-case basis.

Click here for the IRS Notice 2008-94, providing guidance on changes to the taxation of payments to executives of financial institutions under Code Sections 162(m) and 280G, when the institution participates in sales of troubled assets to the government through auction sale.

We have prepared a related E*Zine on the Treasury's TARP Capital Purchase Program & FDIC's Temporary Liquidity Program that is available at www.joneswalker.com/assets/attachments/1323.pdf.

Visit our Fiscal Recovery Resource Center at www.joneswalker.com/practices-103.html for copies of federal guidelines and documents related to the Emergency Economic Stabilization Act of 2008. We will be updating this resource page as new information becomes available.

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Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact:

Blackman, IV, John C.
Brechtel, Timothy P.
Chambers, Susan K.
Curran, Anita B.
Martin, Edward F.
Murphy, Margaret F.
Ramelli, Rudolph R.
Rebarchak, James
Simoneaux, Kelly C.
Spencer, Hope M.

201 St. Charles Avenue
New Orleans, LA 70170
504.582.8000

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