



UPDATE:

Treasury Publishes Rules Regarding Executive Compensation Limits and Awards More Contracts

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On October 14, 2008, the U.S. Department of the Treasury published much-awaited details concerning the executive compensation limits and corporate governance standards that will apply to participants in each of the three programs created under the Troubled Assets Relief Program (“TARP”). And on October 20, 2008, Treasury announced the award of contracts to Ernst & Young and to Pricewaterhouse Coopers for professional services to assist Treasury in implementing TARP. Both contracts were awarded pursuant to existing General Services Administration Federal Supply Schedule contracts.

Following is a detailed discussion of these two actions.

Executive Compensation Limits

The executive compensation rules published by Treasury flesh out the executive compensation limits set forth in the Emergency Economic Stabilization Act of 2008 (“EESA”), Pub. L. No. 110-343, Div. A, § 111 (2008) that apply to financial institutions participating in TARP. The compensation limits differ depending on which TARP program a financial institution participates in: the Troubled Assets Auction Program (“TAAP”), Capital Purchase Program (“CPP”), or Program for Systematically Significant Failing Institutions (“PSSFI”). Separate Treasury Notices were issued for each program, and each notice requests comment from the public concerning the topics addressed therein. Treasury has advised that further guidance will be issued for any additional programs it develops under TARP.

Treasury also issued I.R.S. Notice 2008-94 setting forth guidance concerning corresponding revisions to the Internal Revenue Code, which should be consulted for more details regarding these tax code changes. Please [click here](#) to view Notice 2008-94.

At the outset, it should be noted that certain aspects of the executive compensation rules for all three TARP programs are the same:

- *Definition of “senior executive officer”* – A senior executive officer is a “named executive officer” as defined in Item 402 of Regulation S-K under the federal securities laws who is employed by the TAAP participant and is (i) the principal executive officer (PEO) (or person acting in a similar capacity) of the financial institution (or, in the case of a controlled group, of the parent entity); (ii) the principal financial officer (PFO) (or person acting in a similar capacity) of the financial institution (or, in the case of a controlled group, of the parent entity); or (iii) one of the three most highly compensated executive officers of the financial institution (or the financial institution’s controlled group) other than the PEO or the PFO. Privately-owned companies are directed to use analogous guidelines.
- *Determining who are the three most highly compensated executive officers other than the PEO and PFO* – Public companies are to use the requirements in Item 402 of Regulation S-K under the federal securities laws. “Compensation” is also defined by reference to Item 402 of Regulation S-K. Privately-owned companies are directed to use analogous guidelines.

- *Effect of the limits on corporate affiliates of TAAP participants* – The limitations imposed on TARP participants apply not only to the financial institution that participates in the TARP, but also to any other entity in its controlled group. For this purpose, the controlled group rules in sections 414(b) and (c) of the Internal Revenue Code (26 U.S.C. 414(b) and (c)) apply, but only taking into account parent-subsidiary relationships, not brother-sister relationships. Treasury advises that these tax rules generally base control on an 80-percent ownership basis.

The unique aspects of the executive compensation limits for each individual program are discussed below.

1. Executive Compensation Limits for TAAP (“Auction Purchase”)

Participants in the Troubled Assets Auction Program may sell “troubled” mortgage-related assets to Treasury through a yet-to-be-developed auction format. The compensation limits for TAAP participants, as set forth in Section 111(c) of EESA, are the least strict among the TARP initiatives. TAAP compensation limits apply only to financial institutions that sell assets to the Treasury in an amount that exceeds \$300 million in the aggregate (including direct purchases) and:

- prohibit these financial institutions from entering into any new employment contract that provides a golden parachute to a senior executive officer (“SEO”) in the event of the SEO’s involuntary termination, or in connection with the financial institution’s bankruptcy filing, insolvency, or receivership; and
- subject TAAP participants to the following tax-related limitations:
 1. the financial institution may not deduct for tax purposes executive compensation in excess of \$500,000 for each senior executive;
 2. the financial institution may not deduct certain golden parachute payments to its senior executives; and
 3. a 20-percent excise tax will be imposed on senior executives for parachute payments.

(See I.R.S. Notice 2008-94 regarding these new tax rules).

In Treasury Notice 2008-TAAP, more detailed guidance is provided concerning the executive compensation limits applicable to TAAP, including definitions and hypothetical examples to help explain how the limits will work in common fact patterns. Among the significant questions addressed by Notice 2008-TAAP are:

- *What is a “new” employment contract?* This term means any material compensatory contract (including any plan, agreement, or arrangement, whether or not written) entered into on or after the date the financial institution enters the TAAP program. A renewed or materially modified contract will be treated as a new contract entered into on the date of renewal or modification. Material modification includes amendment to increase the amount of compensation payable to the employee, to accelerate the date on which vesting occurs, or to accelerate the payment under the contract. The rules in existing § 1.162-27(h)(1)(iii)(A) and (B) of the Treasury Regulations apply for purposes of determining what constitutes a material modification.
- *How is “golden parachute” defined?* For purposes of EESA, a golden parachute is any payment in the nature of compensation to (or for the benefit of) a SEO made on account of an “applicable severance from employment” to the extent the aggregate present value of such payments equals or exceeds an amount equal to three times the SEO’s base amount. (Note that because the statute was unclear, until the guidance was issued, it was not clear whether the current “three times base” rule for golden parachutes would apply). The term “base amount” has the meaning set forth in 280G(b)(3) of the Internal Revenue Code and section 1.280G-1, Q&A-34, of the existing Treasury Regulations. An “applicable severance” means severance (1) by involuntary termination; or (2) in connection with any bankruptcy filing, insolvency, or receivership of the financial institution. The Notice contains detailed descriptions of situations that constitute involuntary

termination, including situations where a SEO is terminated “voluntarily” but “the facts and circumstances indicate that absent such voluntary termination the financial institution would have terminated the SEO’s employment and the SEO had knowledge that he or she would be so terminated.”

- *What are the aggregation rules for determining whether an affiliated group of financial institutions have exceeded the \$300 million threshold for application of the executive compensation limits?* Two or more financial institutions that are treated as a single employer under section 414(b) of the Internal Revenue Code (employees of a controlled group of corporations) and section 414(c) of the Internal Revenue Code (employees of partnerships, proprietorships, etc., that are under common control) are treated as a single financial institution, but only taking into account parent-subsidiary relationships, not brother-sister relationships. Treasury advises that these tax rules generally base control on an 80-percent ownership basis. For entities involved in mergers, reorganizations, or acquisitions, the assets sold to Treasury by the target entity will not be aggregated with those of any assets sold to Treasury by an unrelated acquiring entity prior to the acquisition, although aggregation will apply after the acquisition. An acquirer-entity not previously participating in TAAP will not become subject to the TAAP compensation limits merely as a result of having acquired a TAAP participant.
- *How long will the limits apply?* The executive compensation limits apply from the time a financial institution enters the TAAP program until the TARP expires, which is December 31, 2009, or October 3, 2010 if Treasury requests additional time for the program. The limits apply to any compensation arrangements entered with a SEO during that time. Whether an employee is an SEO is determined at the time the employee enters the arrangement. The limits will apply to a TAAP participant regardless of whether Treasury takes or ceases to hold an equity or debt position in the institution through the direct capital purchase program.

To view the Treasury Notice 2008-TAAP, please click [here](#).

2. Executive Compensation Limits for CPP (“Direct Purchase”)

Financial institutions participating in the Capital Purchase Program may obtain capital from the federal government through a direct sale to Treasury of equity or debt in the financial institution. The compensation limits for CPP participants set forth in Section 111(b) of EESA are more stringent than those applicable to TAAP, and require Treasury to impose limits that:

- ensure that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution;
- require clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and
- prohibit the financial institution from making any golden parachute payment to a senior executive. Note that this limitation applies even for current agreements that provide a contractual right to a golden parachute payment.
- although not set forth in the statute, Treasury has exercised its authority under the statute to require that financial institutions must agree, as a condition of participation in the CPP, that no tax deduction will be claimed for compensation in excess of \$500,000 each senior executive. In essence, this requirement applies the same limitation to the CPP as applies to the TAAP.

Treasury reports that to date, nine large financial institutions have accepted direct investment by Treasury through the CPP. Thus, these financial institutions apparently have already accepted the executive compensation limits applicable to the CPP.

The executive compensation limits for CPP participants are contained in an Interim Final Rule published in the Federal Register on October 20, 2008 (see 73 Fed. Reg. 62,205 (2008)) that will be codified at 31 C.F.R. Part 30, please click [here](#) for more information. Important questions answered by the Interim Final Rule are:

- *What actions are necessary by a financial institution to “ensure that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution”?* No more than ninety days after the purchase under the CPP, and then at least annually thereafter, the financial institution’s compensation committee, or a committee acting in a similar capacity, must “review” the SEO incentive compensation arrangements with the financial institution’s senior risk officers, or other personnel acting in a similar capacity, to ensure that those arrangements do not “encourage SEOs to take unnecessary and excessive risks that threaten the value of the financial institution.” The rule does not offer much concrete guidance concerning what the “reviews” must entail, so there appears to be some discretion in this regard. The rule merely states that because each institution faces different material risks given the unique nature of its business and the markets in which it operates, the risks (long- and short-term) that the financial institution faces that could threaten the value of the financial institution should be discussed, and any features in incentive compensation arrangements that could lead SEOs to take unnecessary and excessive risks should be “identified and limited.” Finally, the reviewing committee must certify that it has completed the required reviews of the SEO incentive. For public companies, the certification must be provided along with other compensation related information pursuant to Item 402(b) of Regulation S-K under the federal securities laws; private companies must provide the certification to their “primary regulatory agency.”
- *What actions are necessary to comply with the clawback requirement?* A financial institution must require that SEO bonus and incentive compensation paid during the period that the Treasury holds an equity or debt position acquired under the CPP are subject to recovery or “clawback” by the financial institution if the payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.
- *How does the CPP clawback requirement differ from Section 304 of the Sarbanes-Oxley Act of 2002?* Section 304 of Sarbanes-Oxley requires the forfeiture by a public company’s chief executive officer and the chief financial officer of any bonus, incentive-based compensation, or equity-based compensation received and any profits from sales of the company’s securities during the twelve-month period following a materially non-compliant financial report. Treasury advises that the clawback limitation for CPP participants differs from section 304 of Sarbanes-Oxley in several ways: it applies to the three most highly compensated executive officers in addition to the CEO and the CFO; applies to both public and private financial institutions; is not exclusively triggered by an accounting restatement; does not limit the recovery period; and covers not only material inaccuracies relating to financial reporting but also material inaccuracies relating to other performance metrics used to award bonuses and incentive compensation.
- *How is “golden parachute” defined?* This term is defined in the same way as for the TAAP program.
- *How long will the CPP executive compensation limits apply?* These limits apply during the period of time that Treasury holds an equity or debt position in the financial institution acquired under the CPP.

3. Executive Compensation Limits for the PSSFI

Treasury is currently developing a third program to provide, on a case-by-case basis, direct assistance to certain “systematically significant” firms in danger of failing, an initiative dubbed the Program for Systematically Significant Failing Institutions. The executive compensation limits for the PSSFI, described in Treasury Notice 2008-PSSFI, are described by Treasury as “similar in all respects” to the restrictions for the CPP except that that golden parachutes are defined more narrowly to prohibit any payments to departing senior executives. Although there is no specific guidance on this point, it is our understanding that the authorities believe that the program will be structured to prohibit all severance-type payments made to the departing SEOs; i.e., there will not be a “three times base” test as applies under the other programs and other exemptions from the golden parachute provisions that currently apply may also be limited. To view the Treasury Notice 2008-PSSFI, please click [here](#).

Although the Treasury Notices concerning executive compensation limits provide some much needed detail on how these limits will operate, important questions remain, such as exactly how participants in the CPP are to ensure that they limit incentives for excessive risk-taking by senior executives. Implementation may also prove to be a complicated matter, as the compensation limits could apply to other members of a participating financial institution's corporate family, and those that desire to participate attempt to apply the aggregation rules to determine whether, and when, the executive compensation limits apply to them.

Award of contracts to Ernst & Young and to Pricewaterhouse Coopers

On Monday, October 20, 2008 Treasury announced the award of task orders (TO) to Ernst & Young (E&Y) and Pricewaterhouse Coopers (PWC) for professional services to assist Treasury in implementing TARP. See <http://www.treasury.gov/press/releases/hp1225.htm>. The TO awarded to E&Y was for accounting support services and expert accounting advice, and that awarded to PWC was for internal controls support services. The TOs were awarded pursuant to Blanket Purchase Agreements (BPAs) entered into with each firm pursuant pre-existing General Services Administration (GSA) Federal Supply Schedule (FSS) contracts.

FSS contracts are multiple award contracts for supplies and/or services entered into by GSA which other agencies, such as Treasury, are permitted to use. GSA FSS contracts for services, like those held by E&Y and PWC, typically have pre-established labor categories and negotiated prices (labor rates), usually reflecting a discount from the contractor's commercial rates or prices. A BPA is a type of master ordering agreement that an agency may establish when it anticipates recurring requirements for particular supplies or services. See FAR 13.303; see also FAR Subpart 16.7 - Agreements. They are subject to the terms and conditions of the underlying FSS contract, but can also include additional terms and conditions. Use of GSA schedule contracts and related BPAs can expedite the acquisition of supplies and services as compared with conducting a new procurement.

E&Y's GSA contract was awarded under GSA's Financial and Business Solutions schedule, to view the schedule, please [click here](#); while PWC's contract was awarded under GSA's Mission, Organization and Business Improvement Services schedule. Please [click here](#) for further information.

Further information about E&Y's and PWC's GSA contracts, including labor categories and labor rates, please [click here](#) for information on E&Y's GSA contract and [here](#) for further information on PWC's GSA contract.

To view copies of the BPAs with Treasury, please [click here](#) (E&Y) or [here](#) (PWC).

Treasury indicated that it issued two Requests for Quotations (RFQ) to 12 FSS contract holders on October 8 and received six responses to each RFQ and then selected PWC on Thursday, October 16, and E&Y on Saturday, October 18. The BPAs have three year terms (to September 2011) and the initial TOs have values of approximately \$191,000,000 (PWC) and (\$492,000) (E&Y), respectively. Each BPA includes four attachments – the offeror's price quotation, its technical quotation, a statement of work (SOW), and Treasury's conflict of interest and non-disclosure requirements. However, all attachments except the SOW for the E&Y BPA are redacted in the copies of the BPAs available on the Treasury web site. In addition, key personnel and labor rates have also been redacted, the latter possibly because the contractors offered additional discounts off of their GSA contract rates.

The E&Y SOW indicates that the anticipated work includes Credit Reform Accounting, accounting for equity investments in financial institutions and government sponsored entities, various types of modeling, assistance in reporting, advice on accounting treatment by financial institutions of ownership and sales of mortgage backed securities and whole mortgage loans, and accounting advice on mortgage backed securities and whole loan

transactions. Both BPAs incorporate conflict of interest mitigation plans, which were apparently included in the offerors' technical quotations. E&Y and Treasury seem to have different views on the ability of E&Y to decline to accept a TO in the event of an actual or potential conflict of interest, with Treasury rejecting the position that E&Y has a unilateral right to decline to accept a TO in the event of such a conflict and noting that Treasury can elect to waive an actual or potential conflict and require performance.

If you have questions regarding the TARP executive compensation rules or Treasury's contract awards under TARP, please contact Anne Moran (executive compensation), Tom Barletta (government contracts), or your Steptoe & Johnson LLP relationship attorney.

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