DOMESTIC COMPENSATION LIMITATIONS UNDER THE EMERGENCY ECONOMIC STABILIZATION ACT

The Emergency Economic Stabilization Act of 2008 (the "***Act***") includes new tax limits on both domestic and offshore compensation. This memorandum discusses the relatively narrow domestic compensation limitations, which will generally affect only the most senior executives of financial institutions from which troubled assets are purchased by the Secretary of the Treasury. For a discussion of the new limits on offshore deferred compensation and deferred compensation payable by certain partnerships with tax-indifferent parties, please see our memorandum "New Tax on Nonqualified Deferred Compensation from Certain Tax-Indifferent Parties" dated October 3, 2008. For a complete discussion of the non-compensation-related provisions of the Act, please see our memorandum "U.S. Bailout Plan" dated October 4, 2008.

In General

The Act creates three new sets of limitations on domestic compensation paid by financial institutions from which the Treasury purchases troubled assets, whose application depends on whether the Treasury has purchased the assets directly or at auction. First, if assets are purchased directly, and as a result of the purchase the Treasury receives a "meaningful" equity or debt position in the troubled institution, the Treasury may require the institution to meet appropriate standards for executive compensation and corporate governance for as long as it holds such equity or debt position ("***Direct Purchase Limitations***"). No such standards may be imposed on institutions whose assets are purchased at auction.

The Act provides that if assets are purchased at auction from a financial institution, new employment contracts entered into by any of the financial institution's "senior executive officers" during the period from October 3, 2008, to a date not later than October 3, 2010 (the "***Restricted Period***"), may not provide a "golden parachute." This prohibition does not apply to employment or other compensation agreements entered into prior to October 3, 2008, or to any contracts with executives of institutions whose assets are purchased directly. For purposes of the Act, the term "senior executive officers" refers to the "top five highly paid" executives of a public company who are classified as "named executive officers" and to their non-public-company counterparts.

Finally, if any of an institution's assets are purchased by the Treasury at auction, but not if the assets are acquired entirely through direct purchases, two other limitations are applicable:

- Deductions are disallowed for "senior executive officers" whose annual compensation exceeds $500,000, whether or not performance-based, but only if the compensation was awarded during any taxable year that ends or begins during the Restricted Period (an "***Applicable Taxable Year***"). This would not affect compensation awarded during taxable years ended prior to October 3, 2008.

- To the extent that severance paid to a "senior executive officer" upon an involuntary termination or in connection with a bankruptcy, liquidation, or receivership during the Restricted Period exceeds three times the executive's "base amount" for purposes of determining the existing golden parachute threshold (generally, the executive's five-year average W-2 compensation from his employer), no deductions will be allowed for any portion of such severance exceeding the one times the executive's base amount, and the executive will be subject to an additional 20% excise tax on such excess, without regard to whether a change in control has occurred.

A more detailed examination of these standards follows:

Direct Purchase Limitations

Where troubled assets are purchased directly from a financial institution and no bidding process or market prices are available, such financial institution will be required to meet certain executive compensation standards during all periods in which the federal government holds a "meaningful" equity or debt position in the financial institution, including (i) prohibiting incentive compensation for "senior executive officers" of the financial institution that encourages taking unnecessary and excessive risks that threaten the value of the financial institution, (ii) implementing policies requiring "senior executive officers" of the financial institution to disgorge incentive compensation that is based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate, and (iii) prohibiting the payment of any "golden parachute" payments to "senior executive officers" of the financial institution.

Auction Purchase Limitations

1. Golden Parachutes Prohibited

Where troubled assets are purchased at auction from a financial institution and such purchases in the aggregate exceed $300 million (including direct purchases), such financial institution will be prohibited from entering into any new employment contract with a "senior executive officer" that provides a "golden parachute" in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership. Further guidance will be needed with respect to the meaning of these terms and their application to good-reason terminations and retirements.

2. Deduction Limitations Under IRC Section 162(m)

The Act amends IRC Section 162(m) (which currently limits a publicly held employer's deduction to $1 million for non-performance-based compensation paid to each "covered employee") to further limit the deductibility of compensation paid to certain executives of financial institutions participating in the troubled assets relief program. Under IRC Section 162(m) as amended by the Act, to the extent a financial institution sells any troubled assets to the federal government at auction and the aggregate value of all troubled assets sold by such institution to the federal government (including through direct sales) exceeds $300 million, such financial institution (an "***Applicable Employer***") may not claim a deduction for (i) *any* compensation (whether or not performance-based) in excess of $500,000 paid to a "covered executive" during any Applicable Taxable Year or (ii) *any* compensation (whether or not performance-based) for services performed by a "covered executive" in any Applicable Taxable Year that is deferred to a later year and that exceeds $500,000 *minus* amounts previously paid to the executive in respect of such year of service.

The term "covered executive" is slightly different from the term "covered employee" used elsewhere in IRC Section 162(m). It includes any executive of an Applicable Employer who, at any time during the Restricted Period, is (i) the chief executive officer or the chief financial officer, or any individual acting in either such capacity, or (ii) one of the three most highly compensated officers (other than an executive described in clause (i)) determined on the basis of the executive compensation disclosure rules under the Securities Exchange Act of 1934, as amended (without regard to whether such rules apply to the Applicable Employer). An executive, once classified as a "covered executive," will remain a "covered executive" throughout the Restricted Period and for all subsequent taxable years in which compensation deferred during the Restricted Period is paid to the executive.

3. Parachute Payment Limitations

The Act amends IRC Section 280G (which currently limits an employer's deduction for "excess parachute payments" paid in connection with a change in control of a corporation) to add a new subsection extending the limitation on deductions thereunder to apply with respect to "excess parachute payments" paid by an Applicable Employer during an Applicable Taxable Year upon a termination of employment of a "covered executive" under IRC Section 162(m) (as amended by the Act) either (i) by reason of an involuntary termination by the employer or (ii) in connection with a bankruptcy, liquidation, or receivership of the employer (regardless of whether a change in control of the employer occurs for the general purposes of IRC Section 280G). In addition, the standard exemptions from the non-deductibility of "excess parachute payments" under IRC Section 280G will not apply in the case of the subsection added by the Act, including those with respect to (i) amounts that the employer establishes as reasonable compensation for personal services, (ii) amounts paid by a private corporation whose shareholders approved the payment of such amounts, and (iii) amounts paid by non-corporate entities. Furthermore, as is the case with all payments with respect to which an employer loses a deduction under IRC Section 280G, IRC Section 4999 imposes a 20% excise tax on the "covered executive" with respect to the amount of any such "excess parachute payment."

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