

MEMORANDUM TO CLIENTS

September 30, 2008

RE: **Financial Bailout Bill: Pension Plan and Executive Compensation Implications**

The fate of the \$700 billion financial bailout package – and the financial markets themselves – are in great flux as we prepare this report.

The latest version of the \$700 billion financial bailout legislation being negotiated by Congress and the Administration (H.R. 3997, the Emergency Economic Stabilization Act of 2008 or "EESA") would authorize the Secretary of Treasury to establish a new "troubled asset relief program" (or "TARP") to buy "troubled assets" from any "financial institution," subject to various conditions, limits and requirements. EESA would impose executive compensation limits and corporate governance requirements on any financial institution from which assets are purchased. In addition, it would generally require the Secretary to obtain from financial institutions, as part of the purchase transaction, warrants or a long-term note to help provide potential "upside" for taxpayers.

EESA failed to gather enough votes to win approval by the United States House of Representatives on Monday, September 29. We understand, however, that supporters of the bill may try to put EESA, or a modified version of EESA, to a Senate or another House vote later this week.

In the meantime, some in the retirement services industry are asking whether EESA, if enacted, would enable pension plans to sell troubled assets through TARP. As explained in section A below, the answer to that question is "maybe."

Others are asking how EESA would change the legal landscape for executive compensation in financial institutions selling assets through TARP. The executive compensation restrictions currently in the bill are summarized in section B below.

A. What's in it for Pension Plans?

Technically, the answer turns primarily on EESA's definitions of "troubled assets" and "financial institution[s]."

Subject to certain limitations, EESA defines the term "troubled assets" generally to mean "residential or commercial mortgages and any securities, obligations or other instruments that are based upon such mortgages." The quoted language – especially "any securities . . . based upon such mortgages" – seems broad enough to cover most types of mortgage-based investments traditionally held by or on behalf of pension plans.

Similarly, EESA broadly defines the term "financial institution" to mean "any institution, including but not limited to, any bank, savings association, credit union, security broker or dealer, or insurance company" that is "established and regulated" under the laws of the United States or any State, territory, or possession of the United States, . . . , but excluding any central bank of, or institution owned by, a foreign government." Nothing in this language specifically excludes pension plans.

Other provisions of EESA more specifically reflect an intent to extend the TARP program to pension plans. Section 103 of EESA, for example, lists nine specific factors that the Secretary "shall take into consideration" in exercising the authorities granted under the Act. Two of those factors specifically mention pensions or retirement. In particular, the Secretary "shall" take into consideration:

- (2) providing stability and preventing disruption to financial markets in order to limit the impact on the economy and *protect* American jobs, savings and *retirement security*; [and]

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- (8) protecting the retirement security of Americans by purchasing troubled assets held *by or on behalf of an eligible retirement plan* [defined, by reference to the tax Code, to include section 401(a) and 403(a), 403(b) and governmental 457(b) plans, but excluding IRAs]. . .

EESA § 103 (emphasis added). Consistent with these factors, the general statement of the statute's purposes, set forth in EESA section 2, includes a specific reference to protecting "retirement accounts." Additionally, another of the listed factors specifically requires that "all financial institutions are eligible to participate in the program, *without discrimination based on size, geography, form of organization*, or the size, type and number of assets eligible for purchase under this Act." EESA § 103(5)(emphasis added). Another provision requires the Secretary to use his authority under the Act in a manner that will "minimize any potential long-term negative impact on the taxpayer, taking into account . . . *the impact on the savings and pensions of individuals*, . . ." EESA § 113(a)(1) (emphasis added). Taken together with the broad definitions of "troubled assets" and "financial institution," these excerpts strongly suggest that the Secretary may buy assets held by or on behalf of pension plans.

That said, the extent to which the Secretary, in fact, buys assets held "by or on behalf of" pension plan investors could depend greatly on how some key provisions of EESA are interpreted. To put these interpretive issues in context, it is useful to begin by considering the structures through which pension plans typically hold mortgage-based investments.

Pension plans can hold interests in mortgage-related investments directly or indirectly through investments in collective or pooled investment vehicles. Some common types of indirect ownership arrangements include interests held by pension plans in bank collective investment funds, insurance company pooled separate accounts, mutual funds, and private equity funds and hedge funds which often take the form of limited partnerships or limited liability companies. For purposes of ERISA, the underlying investments of some of these types of

vehicles are considered to be owned by the pension plans that invest in them, but that treatment does not necessarily conform to official legal ownership (e.g., insurance company separate accounts are the insurance company's assets, but generally are ERISA plan assets). Pension plans also own mortgage related securities directly, in accounts managed by professional investment managers and held by trustees or custodians.

One important caveat to the application of EESA to this wide variety of direct and beneficial pension ownership arrangements may be a proviso that limits the bill's definition of "troubled assets" to those assets "the purchase of which the Secretary determines promotes financial market stability." This proviso implies that certain assets that might otherwise fit within the general definitional language quoted above might nonetheless *not* constitute "troubled assets" if the Secretary does not conclude that they are fueling market instability. For example, the Secretary arguably could determine that a mortgage-backed security or pool of securities owned by a long-term investor like a pension plan is not a "troubled asset," but that the same asset held directly by a bank for its own account is a troubled asset. This is because the bank, in contrast to the pension plan, is engaged in the business of lending money, and the Secretary might decide that focusing relief efforts on entities directly engaged in the lending business is the most efficient way to stabilize the financial markets.

In addition, the Secretary could conclude that he is "protect[ing] ... retirement security" (as required by the EESA section 103 factors) by stabilizing the securities markets in which pension plans are major investors, and by shoring up the banks and other traditional financial intermediaries that manage and hold huge amounts of pension fund assets. In other words, the Secretary could conclude that direct purchases of troubled securities from pension plans are permitted but not required.

Additional factors complicating the application of EESA to pension plans are two sets of EESA provisions that impose additional conditions on TARP purchases. The first set of provisions imposes executive compensation limits (summarized below) and corporate governance requirements on any financial institution from which assets are purchased. See EESA §§ 111, 302. The second set of provisions generally requires the Secretary to obtain from financial institutions, as part of the purchase transaction, warrants or a long-term note to help provide potential "upside" for taxpayers. See EESA § 113.

Applying these provisions to pension plans creates still more interpretive problems. As noted, a pension plan may invest in mortgage-based assets either directly (e.g., through an account managed by an investment manager) or indirectly (e.g., through ownership of units in a collective investment trust, limited partnership or insurance company pooled separate account). If one considers the pension plan itself to be the "financial institution" from which a TARP purchase is made, EESA's restrictions on executive compensation and requirements for upside warrants or notes seem out of place. For example, most types of plans typically do not have "executives." Indeed, in the single employer plan context, plans are often "administered" by the "company" sponsoring the plan.

One also might view a plan's trustee or investment manager, or the entity that manages a collective investment vehicle, as the "financial institution" subject to the EESA restrictions. But applying EESA's executive compensation limits and warrant requirements to these entities would

seem inconsistent with ERISA and with trust law generally. For example, it would make no sense for Congress to burden an institutional trustee (who might be a non-discretionary directed trustee) with executive compensation restrictions simply because that institution happened to hold troubled assets at the direction of the investing plans' fiduciaries.

Certain de minimis purchases would be exempt from some of the general executive compensation restrictions and warrant/long-term note requirements. Although this could moot some of the troublesome issues regarding EESA's application to pension plan investors, it does not answer the fundamental question of how such investors are intended to fit within the TARP purchasing scheme.

Importantly, EESA section 101(d) contemplates the prompt publication by Treasury of program guidelines for TARP purchases. It is possible that such guidelines would establish mechanisms, methods, procedures or criteria that tend to favor, or to disfavor, the purchase of certain kinds of assets or the purchase from certain types of financial institutions, such as pension plans.

B. Executive Compensation Restrictions

EESA would impose new restrictions on the executive compensation that may be paid by financial institutions that participate in TARP. The nature and extent of the restrictions depend on whether troubled assets are acquired from the financial institution through a "direct purchase" or, instead, through an "auction sale."

1. Direct Purchases

When Treasury buys assets directly from the financial institution without going through a bidding process and receives a meaningful equity or debt position in the financial institution as a result of the transaction, the Secretary must require the financial institution to meet "appropriate standards for executive compensation and corporate governance," including:

- limits on compensation that exclude incentives for executive officers of the financial institution to take unnecessary and excessive risks that threaten the value of the institution;
- recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on financial statements that are later proven to be materially inaccurate (i.e., a "clawback" provision); and
- prohibitions on the financial institution making any golden parachute payment to its senior executive officers.

The term "senior executive officer" is defined as an individual who is one of the top 5 executives of a public company whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934 and counterparts in non-public companies. These restrictions would apply for the duration of the period during which Treasury holds the equity or debt position in the financial institution.

2. Auction Sales

A financial institution participating in the TARP auction program that sells \$300 million or more in assets (including any sales through direct purchases) would be subject to the following restrictions:

- Code section 162(m) would be amended to impose a new \$500,000 per year limit (instead of \$1 million) on the deduction permitted for the compensation of the CEO, CFO and top 3 highly compensated officers at the company (as determined on the basis of the shareholder disclosure rules under the Securities Exchange Act of 1934, whether or not such rules apply to the company). Moreover, this provision would not be limited to public companies, and would not contain any exception for "performance-based compensation." Further, companies could not defer non-deductible compensation into future years and take a deduction at that time (i.e., once an employee is covered, he remains covered).
- The Code section 280G golden parachute rules would be amended to subject to the golden parachute rules any payments made upon the severance from employment of a top 5 officer (as defined in section 162(m)) by reason of an involuntary termination or in connection with a bankruptcy, liquidation or receivership. The golden parachute rules generally provide that if an executive receives payments in excess of three times the executive's annual pay, the amount in excess of one times annual pay is not deductible and is subject to a 20% excise tax payable by the executive (Code sec. 4999).
- Under guidance to be issued by Treasury, any new employment contract with a senior executive officer would be prohibited from providing a "golden parachute" in the event of involuntary termination, bankruptcy, insolvency, or receivership.

Whether assets a financial institution holds for pension plan clients would count toward the \$300 million threshold that triggers these limits is unclear – along with many other issues.

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Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about these matters.

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