AIGFP Employee Retention Plan

Executive Summary

AIG is contractually obligated to pay a total of about $165 million of previously awarded retention pay to AIGFP employees (in respect of 2008). This amount is due pursuant to a retention plan entered into in early 2008. About $55 million of retention pay was previously paid around December, and about $93 million of additional retention pay will be eliminated because of losses at AIGFP (in accordance with the terms of the plan). AIG is also obligated to pay about $6 million of guaranteed pay to AIGFP employees under contractual obligations outside of the retention plan.

AIG is required to make these payments on or before March 15 by the terms of the retention plan or individual contract guarantees, all of which pre-date TARP and AIG's current Chief Executive Officer. Outside counsel has advised that AIG is legally obligated to pay and, under applicable law, risks a doubling of the amount owed as a penalty. In addition to this and other legal obstacles, business requirements necessitate payment.

AIG has also attempted to develop acceptable alternatives to restructure guaranteed amounts owed. However, efforts have not been successful for payments in respect of 2008 in light of the employees' contractual rights to receive these payments combined with new tax limits under Section 409A of the Internal Revenue Code that limit the ability of employers and employees to alter payment dates for deferred compensation. However, AIG has committed to use its best efforts to reduce the amounts AIG owes in respect of 2009. This will be accomplished through voluntary acts such as salary reductions, through negotiations when we sell businesses and through other arrangements over time. We believe that guaranteed payments at AIGFP for 2009 can be reduced by at least 30%.

Details Regarding Retention Plan

In the first quarter of 2008, AIGFP adopted a retention plan for about 400 employees that provided guaranteed payments to employees if they worked through specified payment dates (or either resigned for good reason or was terminated without cause before the relevant dates). At the time, AIGFP was expected to have a valuable, on-going role at AIG. The plan was implemented because there was a significant risk of departures among employees at AIGFP, and given the $2.7 trillion of derivative positions at AIGFP at that time, retention incentives appeared to be in the best interest of all of AIG's stakeholders. The program was evidenced by a written plan distributed to employees and by individual agreements executed by them.

For senior management the plan provides that 2008 and 2009 compensation will be 75% of 2007 expected compensation levels. Other participants are set at the full 2007 level. This resulted in a $313 million total for 2008 and a $327 million total for 2009 (because some employees who had other guaranteed compensation for 2008 were excluded for that year). The 2008 awards range from $1,000 to slightly less than $6.5 million. Only seven employees will receive more than $3 million.

The total for each year is divided into two components. The first is required to be paid on or before March 15 of the following year (this is $220 million for 2008), and the second is retained by AIGFP, serves as part of AIGFP's capital structure and is at risk for losses (this is about $93 million for 2008). The division between current pay and at-risk pay is

highest for the most senior employees – up to almost half. This is how AIGFP has traditionally structured its compensation.

Of the $220 million, about $165 million is required to be paid on or prior to March 15, 2009 and about $55 million was previously paid. In light of the large losses incurred last year, current and former employees will see their deferred compensation accounts reduced to the point where they will have negative balances. As a consequence there is no immediate prospect that employees will receive any payout of the at-risk piece for 2008 (about $93 million) or the remaining approximately $582 million in at risk pay earned from prior years.[1] A senior AIGFP manager therefore worked in 2008 for about 43% of his 2007 expected level.

An additional $6 million is guaranteed to employees for 2008 pursuant to contractual arrangements outside of the retention plan. To avoid any confusion, the information in this section is specific to the retention plan.

Details Regarding Legal Obligation to Pay

AIG has been advised by outside counsel that a breach of the retention plan would subject it to claims for not only the contractually owed payments, but also penalties and fees under the Connecticut Wage Act.[2] The Wage Act provides for the recovery of double damages and attorneys' fees when wages are improperly withheld and the employer's refusal to pay wages lacks a good faith basis. (Conn. Gen. Stat. §31-72.)[3] In addition, individual managers who decide to withhold wages that are due are individually liable for violation of the Wage Act.[4]

"Wages" are defined as "compensation for labor or services rendered by an employee, whether the amount is determined on a time, task, piece, commission or other basis of calculation." (Conn. Gen. Stat. §31-71a.) The courts have concluded that guaranteed bonuses constitute wages under the statute when "the payment is premised upon work or services the employee has performed as opposed to the general success of the company or

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1 Over the longer-term, AIGFP's deferred compensation plans provide for the adoption of a plan for restoring reductions to at risk pay, but only after all creditors (including the Federal Reserve and Treasury) have been repaid.

2 The retention plan is governed by Connecticut law. (Section 4.04) Because the plan mandates the application of Connecticut law, it is likely that Connecticut substantive law will apply to claims related to the plan brought in the United States, the UK, France, Hong Kong or Japan. Under Connecticut law, the payments are legally enforceable contractual obligations of AIGFP. In addition, the payments are guaranteed by AIG. (Section 3.03)

3 *Schoonmaker v. Lawrence Brunoli, Inc.*, 828 A.2d 64 (Conn. 2003)(double damages appropriate for "bad faith, arbitrariness or unreasonableness").

4 *Butler v. Hartford Technical Inst., Inc.*, 704 A.2d 222 (Conn. 1997).

the whim of management."[5] Here, the retention payments are fixed payments that compensate for services rendered in 2008 and 2009.

In addition to claims for breach of contract and violation of the Wage Act, employees denied their contractually guaranteed payments could likely claim constructive discharge, allowing them to resign immediately and sue to recover the guaranteed payments for 2008 and 2009. We have also been advised that AIGFP employees in foreign jurisdictions, including France, Japan, the United Kingdom and Hong Kong, could bring valid claims for unfair constructive dismissal in those jurisdictions.

We have been advised that the bonus provisions of the American Recovery and Reinvestment Act of 2009 prohibiting certain bonuses specifically exclude bonuses paid pursuant to pre-February 11, 2009 employment contracts.

Details Regarding Business Impact of Failure to Pay

AIGFP's derivatives portfolio stands at about $1.6 trillion and remains a significant risk. Failure to pay the required retention payments therefore could have very significant business ramifications.

For example, AIGFP is a party to derivative and structured transactions, guaranteed by AIG, that allow counterparties to terminate in the event of a "cross default" by AIGFP or AIG. A cross default in many of these transactions is defined as a failure by AIGFP to make one or more payments in an amount that exceeds a threshold of $25 million.

In the event a counterparty elects to terminate a transaction early, such transaction will be terminated at its replacement value, less any previously posted collateral. Due to current market conditions, it is not possible to reliably estimate the replacement cost of these transactions. However, the size of the portfolio with these types of provisions is in the several hundreds of billions of dollars and a cross-default in this portfolio could trigger other cross-defaults over the entire portfolio of AIGFP.

There are also substantial risks related to the hedging of AIGFP's various books. Although we view the large-market risk books at AIGFP as generally well hedged, the hedging is dynamic – that is, it must be monitored and adjusted continuously. To the extent that AIGFP were to lose traders who currently oversee complicated though familiar positions and know how to hedge the book, gaps in hedging could result in significant losses. This is driven to some extent by the size of the portfolios. In the interest rate book, for example, a move in market interest rates of just one basis point – that is 0.01% or one-100th of one percent – could result in a change in value of $700 million dollars if the book were not hedged. It has virtually no impact on the hedged book. There are similar exposures in the foreign exchange, commodities and equity derivatives books.

AIGFP's books also contain a significant number of complex – so-called bespoke – transactions that are difficult to understand and manage. This is one reason replacing key traders and risk managers would not be practical on a large scale. Personal

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5 *See, e.g.*, *Feilbogen v. AIG Trading Group, Inc.,* No. 3:03CV1624 (DJS), 2006 U.S. Dist. LEXIS 29184 at *26-27 (D. Conn. May 15, 2006) (holding that whether guaranteed retention bonus payments were wages was an issue of fact).

knowledge of the trades and the unique systems at AIGFP will be critical to an effective unwind of AIGFP's businesses and portfolios.

In this current environment, any perceived disruption in AIGFP's ability to conduct business, such as one that would result from the departure of a number of key employees, could also cause parties to limit or cease trading with AIGFP. Obviously, this would adversely affect its ability to continue to cost-effectively hedge its positions.

Departures also have regulatory ramifications. As an example, the resignation of the senior managers of AIGFP's Banque AIG subsidiary would allow the Commission Bancaire, the French banking regulator, to appoint its own designee to step in and manage Banque AIG. Such an appointment would constitute an event of default under Banque AIG's derivative and structured transactions, including the regulatory capital CDS book ($234 billion notional amount as of December 31, 2008), and potentially cost tens of billions of dollars in unwind costs. Although it is difficult to assess the likelihood of such regulatory action, at a minimum the disruption associated with significant departures related to a failure to honor contractual obligations would require intensive interactions with regulators and other constituents (rating agencies, counterparties, etc.) to assure them of the ongoing viability of AIGFP as well its commitment to honoring counterparty contracts and claims.

Details Regarding Progress of Wind-down

The team that remains at AIGFP has made significant progress in bringing down the risks and winding down the portfolio. Since October of 2008, they have reduced the number of trades by over 25% and AIG believes they have reduced most risks commensurately. They have focused initially on reducing complex and difficult to manage positions, so several risk measurements have been disproportionately reduced.

From another perspective, late last year AIG divided the risks at AIGFP into 22 separate risk businesses or "books". Progress has been made on assessing and managing the risk in all books, and five books are almost completely wound down.

From the personnel side, AIGFP has gone from about 450 employees in five locations in early 2008 to about 370 employees today. AIGFP is scheduled to close two locations, Tokyo and Hong Kong, this year.

Details Regarding 2009 Fiscal Year

Under the retention plan, $327 million is due for 2009. Of that, $97 million constitutes at risk pay that will be eliminated by AIGFP's losses. An additional $7.6 million is guaranteed to employees for 2009 pursuant to contractual arrangements outside of the retention plan.

AIG has taken significant steps to limit overall compensation at AIGFP where it can and has committed to doing more. The 25 highest paid active contract employees have agreed to reduce their remaining 2009 salaries to $1. Salaries for this group ranged up to $500,000, and the average salary was in excess of $270,000. (There are apparently legal limits that may complicate the implementation of this and AIG will likely implement the lowest salary levels we can equitably put in place across the relevant jurisdictions.) The remaining 2009 salary of all other officers – anyone with a title of associate vice president

or higher – is being reduced by 10% (subject to compliance with local law requirements). In addition, other forms of non-cash compensation will be reduced or eliminated.

We also believe that there will be considerably greater flexibility to reduce contractual payments in respect of 2009, and AIG intends to use its best efforts to do so. AIGFP intends to sell some of its books of business during the year. The employees related to these books will go with the sold businesses, and we intend to require the buyer to assume going-forward compensation payments. It is also expected that, over the course of the year, employees will leave voluntarily or be terminated for cause and will therefore no longer be entitled to retention amounts from AIG. Because the plan was designed to provide security for employees, including protection against terminations without cause, AIG is required to pay the amounts owed to employees who are downsized. However, if a downsized employee finds new employment, retention amounts will be reduced by the earnings from the other employer. In addition, for employees in foreign jurisdictions who are not U.S. taxpayers, to whom the limits of Section 409A do not apply, AIG will have the ability to negotiate with employees who are downsized. With all of these actions and other creative restructuring solutions, AIG hereby commits to use best efforts to reduce expected 2009 retention payments by at least 30%.

Plans Complex

The preceding constitutes only a summary of the terms and operation of the AIGFP retention plan. It is necessarily incomplete and was produced quickly, in light of applicable time constraints. AIG has provided additional, more detailed information that is relevant to an understanding of, and should be considered with, the summary information in this document.