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TRENDS & ISSUES

Add a Change-in-Control Review to the Year-End Agenda

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Merger and acquisition (M&A) activity is alive and well in the community bank marketplace, increasing the chances for unexpected changes-in-control (CICs).

The best time to address compensation issues related to a potential CIC is when you don't need to: that is, when there's *not* an imminent likelihood of being acquired.

When triggered, CIC agreements can provide unexpected surprises that can, in some cases, result in liabilities so substantial that the deal can unwind. Further, executives are often shocked to find their expected CIC payments will be significantly eroded by automatic cut-backs or golden parachute excise taxes.

But fixing programs is much more difficult on the eve of a deal. Boards will be under a heightened level of scrutiny to demonstrate the prudence of their decisions and there is a presumption in the golden parachute regulations that provides that payments made under agreements entered into or modified within one year of a CIC are presumed to be made as a result of the CIC.

> *"Fixing problems is much more difficult on the eve of a deal."*

That's why banks that are potential acquisition candidates should seriously consider a thorough review of their CIC agreements and Internal Revenue Code (IRC) Section 280G exposures before the end of this year. Quantifying CIC packages and 280G exposures on a regular basis can help to identify the trouble spots far enough in advance for boards to take appropriate action.

IRC Section 280G applies when the present value of all payments related to the CIC totals more than 2.99 times the individual's base amount (i.e., an individual's five year average W-2 earnings). When this safe harbor is exceeded, punitive excise tax penalties apply for executives and what's referred to as "excess parachute payments" are not deductible for the bank.

Without proper planning, banks are especially at risk for golden parachute troubles for a number of reasons.

- First, during the financial crisis, compensation for many bank executives dropped significantly as a result of lower (or zero) bonuses and reduced realized equity values. This has resulted in lower base amounts from which golden parachute excise taxes are calculated.
- Banks often have multiple compensation programs with CIC related benefits and payouts. We commonly see severance plans; supplemental executive retirement plans (SERPs) or other salary continuation programs; split dollar benefits; and equity plans with varying payment triggers, definitions, and provisions for accelerated vesting.
- In addition, a number of banks have recently moved to performance-based equity programs. While these types of awards seek to drive performance and address shareholder and institutional advisory concerns, accelerations increase the level and payout of CIC benefits potentially subject to 280G.

Layering multiple CIC benefits on top of one another and/or increased CIC payouts, in combination with the lower base amounts, has increased the probability that at least one executive at a bank undergoing a M&A will be adversely impacted by IRC Section 280G.

If addressed far enough in advance of a potential M&A, banks may be able to make adjustments to existing CIC provisions to ensure that a much greater portion of the intended benefits is delivered in a tax-efficient manner for all parties. Some of the more common planning actions considered by boards of directors include:

- **Accelerating taxable income to increase base amounts and safe harbors**
  The higher an individual's base amount, the higher the golden parachute safe harbor. Since the base amount is simply an average of the taxable earnings for the five years preceding the CIC, taking steps to increase taxable earnings in a year prior to the CIC is often considered. For example, in a year prior to the CIC, an executive can exercise stock options. Similarly, a bank can accelerate the vesting of taxable awards (restricted stock awards and restricted stock units that settle at vesting) and/or the payout of earned bonuses. Taking these types of actions requires careful navigation of a myriad of technical rules, including the deferred compensation rules under IRC Section 409A and the $1 million deduction limits on compensation for certain officers under IRC Section 162(m).
- **Subjecting CIC payments to a valid and enforceable non-compete**
  Amounts that can be allocated to a non-compete covenant are not considered CIC payments and are not included in the 280G calculations.
- **Accelerating the vesting of potential CIC payments in advance of a transaction**
  Vested benefits are generally excluded from the 280G calculations. As a result, accelerating benefits a year or more in advance of a transaction can reduce potential parachute payments.

- **Adding contractual terms covering excise taxes or reductions in benefits**
  Defining what happens to potential payments in the event there are potential excise tax liabilities can significantly improve the after-tax benefits to executives if the current arrangements are silent.

- **Other approaches**
  With the right set of facts, there may be other more technical solutions available to mitigate or eliminate a bank's golden parachute exposure.

Given the inherent complexity of CIC arrangements and the myriad of technical issues that are likely to arise, reviewing your CIC agreements and performing a few scenario-based calculations may protect you from being caught by surprise if an actual deal comes knocking on your door in 2017.

About the Authors

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About Pearl Meyer

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