Are Your Bank's "Parachutes" In Shreds?

By Margaret Black and Dan Wetzel

With excise tax gross-ups on the decline, Boards of Directors and executives of Banks that are considering transactions can face unexpected issues when the golden parachute tax rules are applied to severance and change-in-control (CIC) arrangements.

Current provisions within a bank's contracts such as scaleback provisions, or potential golden parachute excise taxes, can significantly erode intended economic benefits. At the same time, the difference between expected and actual economic benefits for publicly-traded Banks may not be apparent to either the executive or the Board, because there is no requirement to perform golden parachute calculations as part of the annual proxy disclosure requirements (unless the Bank employment arrangements provide excise tax gross-ups). Finally, once a real transaction is in motion, the opportunity to modify CIC programs is more limited.

As a result, when an actual CIC occurs, many Banks and their executives are often shocked that their compensation programs will trigger golden parachute liabilities or a significant reduction of benefits. To avoid significant headaches, Banks and their Boards should undertake a thorough review of their CIC and severance arrangements well in advance of a real transaction. Digging into the Bank's CIC provisions and running financial scenarios can help avert surprises that could derail a prospective deal.

What Are the Golden Parachute Tax Rules?

The golden parachute rules under Internal Revenue Code (IRC) Sections 280G and 4999 are intended to discourage excessive compensation to executives in the event of a CIC by imposing negative tax consequences to both the company and the executive. Under the rules, if the present value of the CIC payments to an executive exceeds his/her "safe harbor" – meaning three times the executive's average taxable compensation over the five most recent calendar years preceding the CIC (or "base amount"), less $1 – the company loses tax deductions for the amounts considered "excess parachute payments." Additionally, the executive is required to pay a 20 percent excise tax on excess payments.

What Types of Compensation Are Considered Parachute Payments?

The rules generally apply to all forms of compensation made to executives that are "contingent upon the CIC" of a company. Typical parachute payments include severance payments, accelerated vesting of equity and other long-term incentive plans. However, annual bonus payments, Supplemental Executive Retirement Plan (SERP) benefits, nonqualified deferred compensation plan payouts, and split dollar benefits may also be trapped in the wide net of what may be considered parachute payments.

What Executive Benefit Programs at Banks Most Often Create Golden Parachute Issues?

Many Banks have implemented multiple executive pay programs that have CIC-related benefits. For example, a number of Banks have CIC severance plans alongside SERPs (or salary continuation programs) and split dollar benefits that vest or provide enhanced benefits upon a CIC or termination following a CIC. Layering all of these potential CIC benefits on top of one another will increase the likelihood that at least one executive at the Bank will have CIC payments that are significantly affected.

Why Does 280G Pose a Problem for Many Banks Today?

Banks that have received funds from the Troubled Asset Relief Program in the recent past will have faced special restrictions on a variety of common executive pay practices, including the use of bonuses, stock options and restricted stock. In addition, the economic environment resulted in compensation that was often below target compensation for several years. As a result, the amount of CIC payments which might be subject to excise taxes or a scaleback may be significantly higher than in prior years.

Which Banks Are Most At Risk of Running Into 280G Problems?

For Banks which might be acquired, a combination of lower actual compensation over the past several years, newly issued equity awards, and multiple compensation arrangements triggered upon a CIC increases the likelihood that golden parachutes issues will present problems. While not often considered, these problems are compounded with Banks that have SERPs, salary continuation and/or split dollar benefits in addition to severance protections. Also, Banks that have long-term performance-based awards that will vest or accelerate upon termination or at the CIC are at a heightened risk of triggering 280G problems, since values for these awards can be so significant.

How Can a Bank More Accurately Assess its Golden Parachute Exposures?

Since quantification is driven by complex tax rules, Bank Boards and executives cannot rely on sheer logic to get through the process. Involving experienced advisors can be helpful in getting an accurate picture of company costs, lost tax deductions and executive excise taxes. While the golden parachute limitations may appear relatively straightforward, there are numerous complexities inherent in most 280G calculations. Issues can emerge when least expected – but solutions may be available with the right set of facts.

What Strategies Can Reduce Potential Golden Parachute Excise Taxes?

If golden parachute issues are uncovered, there are a number of actions that a Bank can consider to reduce the sting of golden parachute rules. These include:

- <u>Adding contractual terms covering excise taxes or reductions in benefits.</u>

  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.

- 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.

- Accelerating taxable income to increase Base Amounts and Safe Harbors.

  If a CIC is likely, a Bank can consider accelerating income into the year prior to the CIC to increase executive base amounts and golden parachute safe harbors. This is most often done by exercising stock options, accelerating the vesting of taxable awards (restricted stock awards and RSUs that settle at vesting), and accelerating earned bonuses. However, before taking any such action, Banks must carefully navigate a myriad of other tax rules, including the deferred compensation rules IRC Section 409A and the $1 million deduction limits on compensation for certain officers under IRC Section 162(m).

- 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.

What Immediate Steps Can Banks Take to Ensure CIC and Golden Parachute Exposures Do Not Go Unnoticed?

Banks with the particular circumstances outlined in this article should consider putting a formal review and quantification of their CIC programs on their Compensation Committee agenda for 2014. Experienced advisors should be enlisted to assist with identified exposures. Taking these types of actions now can help avoid significant headaches when a deal is on the table.

About the Authors

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