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TRENDS & ISSUES

Bank Compensation: Should You Award a Transaction or Retention Bonus?

AUTHOR

Margaret Black
Managing Director

When a bank suddenly finds itself in the midst of a sale, merger, or other strategic transaction, retaining key talent and senior leadership becomes critical. Without proper incentives, executives can be left to wonder whether impending changes align with their own economic interests and long-term career goals. Banks need their key players to remain sharply focused on maintaining and growing the existing business, while simultaneously handling the increased responsibilities of working through a potential transaction.

While banks typically have change-in-control (CIC) severance and equity arrangements in place for senior executives, retention bonuses—and in special cases "transaction bonuses"—may be implemented as a deal is contemplated.

> *"Banks will be under a heightened level of scrutiny to demonstrate the prudence of their decisions."*

When establishing awards, banks should be mindful of the total retention opportunities for the group, including potential severance and equity vesting upon termination or CIC. Awards approved should be reasonable on a standalone basis, in the aggregate when considering all CIC-related costs, and relative to deal size. When current severance, equity, and other CIC related benefits are sufficient, there may be no need for additional transaction compensation.

Used less frequently than other retention vehicles, transaction bonuses can be used to motivate executives throughout the business sale process. They are usually paid in cash upon or shortly following a deal closing, although some awards are in shares. Terms vary based on the role a key executive will play.

- For the deal makers, the select group of executives that are responsible for driving deal terms and value, a transaction bonus can be fairly significant and often is determined as a fixed dollar value, a percentage of the equity transaction value, or fixed number of

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shares. Some awards are hinged on the attainment of strategic performance goals or metrics such as negotiating a threshold transaction price.

- For key administrators, those senior level executives critical to managing the due diligence and sale process, transaction bonuses are typically used to compensate for the additional work required. These awards tend to be smaller, taking the form of fixed cash bonuses determined based on a percentage of an executive's base salary with amounts increasing as desired retention periods lengthen.

To understand how banks are using this incentive, we examined public disclosures over the last five years for the acquisitions of 88 public banks.

- Of those, just a small number (17 percent) disclosed paying transaction bonuses to their named executive officers (NEOs). In contrast, about a third (31 percent) of the banks reported paying retention bonuses with service periods extending beyond closing. When transaction bonuses were paid, over half of the banks (53 percent) disclosed that there would be no further cash severance benefit provided.

- Transaction award amounts were extremely varied based on the specific circumstances and size of each transaction and each individual's contribution. When paid, aggregate awards to all NEOs ranged between $55,000 to over $10 million (on an absolute basis). Aggregate awards as a percentage of transaction values ranged from 0.15 percent at the 25th percentile to 1.36 percent at the 75th percentile with a midpoint of 0.78 percent. Percentages in relation to deal size tended to decrease as the deal size increased.

When considered on the eve of deal, legal and compensation advisors should be actively involved in the design and approval process; banks will be under a heightened level of scrutiny to demonstrate the prudence of their decisions. Also, banks should be mindful of institutional shareholder and shareholder advisory services concerns and a number of tax, legal, and accounting potholes. For example, Internal Revenue Code Section 280G applies when the present value of all payments related to a CIC equals or exceeds three times the individual's base amount (i.e., an individual's five-year average W-2 earnings). When 280G is triggered, punitive excise tax penalties apply and intended CIC benefits can be significantly eroded.

In practice, transaction bonuses for senior executives are paid much less frequently than compared to standard retention awards and tend to cover a smaller, more senior group of executives. However, for deal makers, these awards can be a significant incentive and worth considering since they are meant to reward value realization. For key administrators, transaction awards are sized to effectively compensate for the additional time and effort needed to bring a transaction to close. Transaction awards may provide the right retention hold and motivation when severance and equity benefits are insufficient to retain senior level executives through or shortly following close and may help your institution get a deal over the finish line.

About the Author

Margaret Black is a managing director in the Los Angeles office and a member of the firm's Technical Services team. She has consulted for over 25 years in the field of tax and over 20 years on all aspects of compensation and benefits matters. Margaret has extensive experience in issues related to corporate acquisitions, divestitures and restructurings, as well as with change-in-control provisions, IRC Sections 280G, 409A, and 162(m) compliance.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

Pearl Meyer

NEW YORK
570 Lexington Avenue, 7th Floor
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, NE, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
93 Worcester Street, Suite 100
Wellesley, MA 02481
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
123 N. Wacker Drive, Suite 860
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LONDON
3rd Floor
58 Grosvenor Street
London W1K 3JB
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

SAN FRANCISCO
595 Market Street, Suite 1340
San Francisco, CA 94105
(415) 651-4560
sanfrancisco@pearlmeyer.com

For more information on Pearl Meyer, visit us at www.pearlmeyer.com or contact us at (212) 644-2300.