Executive Compensation Planning and Challenges for M&A Transactions in the New Compensation Environment

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Beverly J. White, Esq.
Luse Gorman Pomerenk & Schick, PC
5335 Wisconsin Avenue, N.W., Suite 780
Washington, DC 20015
Phone: (202) 274-2000 Fax: (202) 362-2902
www.luselaw.com

Who We Are

Luse Gorman Pomerenk & Schick is a Washington, D.C. – based law firm with a financial institutions transactional practice that specializes in mutual-to-stock conversions, mutual holding companies, mergers and acquisitions, executive compensation, regulatory and enforcement matters and general corporate and securities law.

LUSE GORMAN
POMERENK & SCHICK
attorneys at law

Our M&A Expertise

Luse Gorman Pomerenk & Schick is one of the leading law firms nationally in the area of mergers and acquisitions involving financial institutions. We are consistently ranked among the top 10 law firms nationally in total number of transactions and were ranked first in 2009. We have been counsel in more than 80 acquisitions in the past five years alone.

Executive compensation and employee benefit issues arise in every M&A transaction and give rise to tax, ERISA, accounting and securities issues.

All Companies (public and non-public)

- Parachute Payment Rules (IRC §280G)
- Deferred Compensation considerations (IRC §409A)
- TARP considerations (if applicable)
- FDIC Golden Parachute Rules (if applicable)

Public Companies

- SEC reporting requirements
  - Say on Pay Vote
  - Say on Golden Parachute Vote
  - Termination Payments Table
- Shareholder activism and shareholder advisory firms

Buyer's Priorities

- Identify liabilities and obligations
- Prepare for integration of employees/plans
- Ensure appropriate incentives are in place to motivate key management to stay through the acquisition
- Ensure Buyer is paying a fair price for incoming executives
  - Requires review of salary arrangements, employment agreements and incentive plans
  - Analyze golden parachute arrangements
- Determine whether existing arrangements can be renegotiated to Buyer's benefit

Seller's Priorities

- Protect key management, employees and plans

- Ensure appropriate incentives in place to motivate key executives to stay through transaction and facilitate smooth sale

- Limit representations and warranties

Plans and Arrangements Encountered in M&A Transactions

- Employment Agreements and Change in Control Agreements
- Severance Plans
- Nonqualified plans
  - Deferred Compensation Arrangements
  - Supplemental Retirement Plans
- Stock Plans
- Tax-qualified Plans
- Health and Welfare Plans

Employment Agreements/Change in Control Agreements

- How many?
- Single, Modified Single Trigger or Double Trigger?
- Payment Terms? (e.g., lump sum or installments)
- Subject to rules for nonqualified deferred compensation? (could affect payment timing)
- Any excess parachute payments?
- Gross-ups for excess parachute excise taxes?

Parachute Payments under IRC §280G

- Payments in the nature of compensation that are contingent on a change in control of the Company ("**Contingent Payments**")

- Made to certain persons who perform personal services for Company ("**Disqualified Individuals**")
  - Officers
  - Highly compensated individuals (who earned more than $110,000 from the Company)
  - Shareholders who own 1% or more of Seller's stock
  - Non-employee directors who are either highly compensated individuals or shareholders mentioned above

Parachute Payments under IRC §280G

- A Disqualified Individual will have a Parachute Payment if Contingent Payments equal or exceed 3 times the Base Amount
- **Base Amount** = average taxable income (Box 1, Form W-2 or Box 3, Form 1099-Misc) over last 5 calendar years ending before the change in control calendar year.
- **Safe Harbor** = the limit on Contingent Payments. The Safe Harbor is $1 less than 3 times the Base Amount.

Parachute Payments under IRC §280G

If Parachute Payment exists:

- Then Disqualified Individual has a 20% excise tax of his/her Excess Parachute Payment (e.g., amounts in excess of the Base Amount)

- Company loses tax deduction on all Contingent Payments in excess of Base Amount

Parachute Payments – What's Included

- Severance payments
- Payments or benefits that arise solely as a result of a change in control
- Payments or benefits that are "enhanced" as a result of a change in control
- Payments or benefits that vest as a result of a change in control
- Vested payments or benefits that accelerate and are paid earlier as a result of the change in control

Parachute Payment - Exclusions

- Payments from tax-qualified plans

- Payments from S corporations (or corporations that qualify)

- Payments from corporations that have no stock readily tradable on an established securities market immediately before the transaction
  - Requires approval of 75% of shares eligible to vote
  - Shareholder receiving compensation cannot vote
  - Compensation can't be paid if vote is unfavorable

- Payments of reasonable compensation for personal services or forbearance from performing services

Deferred Compensation under IRC §409A

IRC §409A sets out detailed rules with respect to (i) the timing of elections to defer compensation and (ii) the timing of payment of amounts treated as deferred.

Deferred Compensation under IRC §409A

- If these rules are not met, IRC §409A accelerates the taxation of deferred amounts and imposes an additional 20% penalty tax on the amount included in income plus interest.

- Plan aggregation – if benefits under one deferred compensation plan violate IRC §409A, the employee is taxable under IRC §409A on all benefits in other plans of the same type.

What does IRC §409A prohibit?

- Acceleration of benefit payments
- Change in Timing of distributions
- Change in Form of distributions (e.g., from installments to lump sum)
- Late elections to defer compensation

What does IRC §409A Require?

- Written plan document
- Timely written deferral elections
- Distribution only upon recognized triggering events:
  - Death
  - Disability
  - Separation from Service
  - Change in Control
  - Unforseeable Emergency
  - Specified Time or Fixed Schedule of Payments

Public Company "specified employees" under IRC §409A

- Specified employees are subject to a six-month delay for payments made on "separation from service" (which may be different than termination of employment)

- Specified employees are "key employees" under IRC §416 who are (i) officers with an annual compensation greater than $160,000 (in 2011), (ii) 5% owners of a company, or (iii) 1% owners with annual compensation of more than $150,000

IRC §409A – Exceptions

- Short term deferrals
- Certain severance pay plans
- Incentive stock options
- Restricted stock
- Nonqualified stock options and SARs (if exercise price is at least equal to fair market value of stock on the date of grant)

Deferred Compensation under IRC §409A

- Parties in a transaction should review all nonqualified deferred compensation plans to ensure compliance with IRC §409A

IRC §409A and Parachute Payment Planning

IRC §409A precludes certain actions that were previously used to avoid Excess Parachute Payments, such as --

- Termination and distribution of SERPs <u>before</u> specified triggering event (e.g., separation from service or change in control)

- Substitutions of other payments for payments under deferred compensation plan (e.g., noncompete payments paid in different form)

Troubled Asset Relief Program (TARP)

Financial institutions that took TARP or participated in the Capital Purchase Program (CPP) are prohibited from paying certain types of compensation to certain executives until after TARP is repaid.

TARP Considerations on Change in Control

- Cannot make <u>Bonus Payments</u> to certain persons (depends on amount of TARP assistance received)

- Cannot make Departure Payments or Change in Control Payments to –
  - Senior Executive Officers (SEOs)
  - Next 5 most Highly Compensated Employees (HCEs) (as determined under Reg. S-K proxy rules) based on the year prior to fiscal year of transaction

- Cannot provide tax gross-ups to SEOs or 20 next most HCEs

TARP Considerations

- Buyer will <u>not</u> be subject to executive compensation rules under TARP merely as a result of the acquisition

- If Buyer is not subject to TARP immediately after the acquisition, then Buyer’s employees (including former SEOs and HCEs of Seller) will not be subject to TARP

TARP Considerations

What this means –

- Buyer can’t pay departure payments to Seller executives who are terminated without coming to work for Buyer
- If Seller executives come to work for Buyer then leave, payments upon departure should be permitted
- Single trigger payments (that are triggered solely by change in control) are prohibited
- Enhanced SERP payments that would be triggered solely by change in control would be prohibited golden parachute payments

FDIC Golden Parachute Rules Under 12 USC §1828(k)

- Applies to institutions in “troubled condition”
  - ➢ CAMELs 4 or 5
  - ➢ Subject to Formal Order
  - ➢ Notified by regulators

FDIC Golden Parachute Rules

- Prohibits payments (or any agreement to make a payment) in the nature of compensation by any insured depository institution or affiliated holding company for the benefit of any current or former “institution affiliated party” (IAP)

- That is contingent on, or by its terms payable on or after, the termination of the IAP’s employment

- IAPs include, among other persons, any director, officer, or controlling stockholder

FDIC Golden Parachute Rules - Permitted Payments

- Payments not related to termination
- Payments under qualified retirement plans
- Payments under *bona fide* deferred compensation plans (that are vested and accrued)
- Nondiscriminatory severance plans
- Certain payments on unassisted change in control (not to exceed 12 months base salary)
- Payments for which FDIC grants permission upon institution or IAP request.

SEC Reporting Requirements – "Say on Parachute" Advisory Vote

- Requires both tabular and narrative disclosure of parachute pay;
- Smaller reporting companies are not exempt;
- Vote is required for applicable proxies filed after April 25, 2011

SEC Reporting Requirements – New Termination Payment Table

- Must include columns for the following types of compensation:
  - Cash
  - Equity
  - Pension & non-qualified deferred compensation
  - Perquisites & other personal benefits
  - Tax reimbursements and other items

- Current disclosure required by S-K rules does not satisfy requirements
- Not required if previously included in say-on-pay vote, but tabular info must also have been included

Shareholder Activism and Proxy Advisory Services

Shareholder Activism has become more pronounced in recent years, encouraged by proxy advisory firms and various legislative reforms

Institutional Shareholder Services (ISS) and Glass Lewis establish annual pay guidelines and best practices

ISS Guidelines -

In response to new “say-on-parachute payment” vote, ISS policy will be to recommend on a case-by-case basis on proposals to approve a company’s golden parachute compensation, consistent with their policies on problematic pay practices related to severance packages.

Features that may lead to an ISS AGAINST recommendation:

- Recently adopted or materially amended agreements that include:
  - excise tax gross-up provisions
  - single trigger or modified single trigger payouts

- Single trigger vesting of equity based on a definition of change in control that requires only board or shareholder approval of the transaction (rather than consummation)

- Potentially excessive severance payments

Executive Compensation and Benefits in M&A Transactions – Conclusions for Buyer

- Do careful due diligence
- Catalogue Seller's plans and quantify liabilities
- Beware the minefields, what may work to eliminate excess parachute payment may violate IRC § 409A
- Consider compensation disclosure to shareholders

Executive Compensation and Benefits in M&A Transactions – Conclusions for Seller

- Review existing arrangements for compliance with IRC § 409A, 280G, TARP or FDIC rules (where applicable)

- **Initial "review" should occur more than 1 year before the effective date of any merger**

- Review proxy disclosure and termination payments table and confirm accuracy of statements

Any Questions?

Beverly White
LUSE GORMAN POMERENK & SCHICK

A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW
5335 Wisconsin Avenue, N.W., Suite 780
Washington, D.C. 20015

TELEPHONE (202) 274-2000
FACSIMILE (202) 362-2902
www.luselaw.com