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## Change-in-Control Compensation Agreements

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Imagine the following scenario: your bank has just announced an agreement to be acquired by a larger institution that is entering your market for the first time. Two months into the process your CEO, CFO and chief lender tell the board that they have decided to accept offers from local competitors because (a) they will make more money, (b) they have a built-in customer following and (c) despite good relations with the buyer they are uncertain as to their future and have families to consider. The board is then notified by the buyer that they (i) have discovered that they are unlikely to receive regulatory approval for the transaction and/or (ii) they have taken the position that the loss of the executives constitutes a "material adverse change" and they are electing to terminate the merger. Customers and other employees are already leaving, shareholders are upset and the regulators are extremely nervous. The bank is now "damaged goods" and you still have to run it.

This is not an unheard of scenario. With the increase in M&A activity in the banking industry has come a resurgence of interest in change-in-control (CIC) agreements intended not to thwart or to deter acquisitions, but rather to reduce the management anxiety and uncertainty that tends to accompany such activity and to retain critical and valued members of management through the transition.

CIC agreements are not necessarily "employment" agreements for management (unless purposefully structured that way), but are agreements that help provide a certain level of financial protection for management to compensate for the stress, additional work and uncertainty that comes with participating in a CIC. Terms of CIC agreements can vary widely, however certain terms have become relatively "standard" in the banking industry over the years and appear in many CIC agreements.

Likewise, CIC agreements can serve to increase the value of a target institution to a potential acquirer and to help assure that the transaction goes forward as negotiated by providing an incentive for retention when uncertainty – and competitors – can distract and perhaps even lure away some of the very management that has provided an important part of the value of the target. Loss of important management personnel during negotiations or, perhaps worse yet, during the pendency of an announced transaction, can adversely impact the value proposition for a buyer and jeopardize the deal and the overall value of the franchise. Maintaining the attention and focus of management through consummation of the transaction is critical, and a CIC agreement can help to alleviate some of the fear and uncertainty of what can be an emotionally draining time.

## Timing and "Triggers"

CIC agreements typically are instituted long before a transaction is contemplated. Common CIC agreements are either "single trigger" or "double trigger" agreements. In a single trigger CIC agreement, the CIC benefits are paid upon consummation of the CIC, regardless of whether the executive is retained by the acquirer. In a double trigger CIC agreement, the CIC benefits are paid only if there is a CIC ***and*** there is a termination of the executive during a "protected period." The protected period usually runs for up to two years after the CIC, and often begins up to six months prior to the CIC. Typically, the second "trigger" requires either termination of the executive by the company OR the executive's resignation after the company makes certain adverse changes to the terms of the executive's employment. CIC agreements that provide protection against certain adverse employment actions before the CIC occurs, however, typically do not pay benefits until the CIC has actually occurred.

Some CIC agreements also provide for a post-CIC "window" during which the executive can resign for any reason, or for no reason, and preserve his or her right to the CIC severance payment. This "window" is intended to provide a "getting to know you" time for both the executive and the acquirer, and to alleviate the "take it or lose it" situation that can otherwise force an early decision by the parties.

## CIC Severance Pay

Once the events have occurred which entitle the executive to payment, the benefits under a CIC agreement typically consist of a payment equal to a multiple of the executive's base salary and bonus. The CIC payment is typically paid in a lump-sum within a stated period following the triggering events and is subject to customary tax withholding and reporting.

## Limitations and Basic Tax Considerations

Internal Revenue Code Sections 280G and 4999 impose adverse consequences on both the executive and the company if the executive receives an "excess parachute payment." If the executive receives payments based on the CIC equal to or greater than three times a "base amount," the company loses the tax deduction on all payments in excess of 1 times the base amount and the executive is subject to a 20% excise tax on the payments in excess of one times the base amount.

The base amount is the average box 1 wages reported on IRS Form W-2 for the executive for the five years preceding the year in which the transaction occurs (so the average box 1 wages for 2010-2014 for a transaction that occurs in 2015).

Not all payments count against the limit in the same way. Some payments (like the CIC severance pay described above) count fully against the 280G limit. In contrast, only the present value of accelerated vesting and accelerated payment count against the limits for benefits that would have vested later or been paid over a longer period of time.

Most CIC agreements provide that the total benefits payable to the executive in connection with a CIC will be “cut back” to the maximum amount that could be payable without triggering these adverse consequences. Although institutional shareholders and regulators dislike it, other CIC agreements provide a gross-up to the executive to cover the 20% excise tax (and the taxes on that gross-up). This has a high cost to the company, especially since each additional dollar of gross-up is also subject to the 20% excise tax and is not deductible by the company. Finally, some CIC agreements provide that the executive will receive either the full amount (without a cut-back or gross up), or the cut back benefit, depending on which produces the higher net of tax amount for the executive.

Internal Revenue Code Section 409A also restricts CIC agreement design. In general, 409A imposes immediate income taxation and a 20% excise tax on deferred compensation arrangements that fail to meet a number of detailed rules. This means that all agreements must be in writing and you cannot change the time and form of payment of amounts due under the agreement without carefully parsing these rules.

## Board Considerations

CIC agreements are relatively common in the banking industry and, if structured correctly, can and do provide for an enhanced ability to attract and to retain management especially in an era when M&A activity may be prevalent. Boards, in considering CIC agreements for their executives, can look at the standards in the industry and evaluate how these agreements have helped in prior transactions. CIC agreements are not intended to deter transactions. In fact, some acquirers prefer that they be in place because the “control” issues and liability that arise in intervention with a target prior to consummation of a transaction deter use of “loaned” executives.

Signing a transaction document is just the beginning of a long process in the banking industry, and sometimes transactions are not consummated, whether because of material adverse changes to the business of one of the parties, through the failure to secure necessary shareholder and regulatory approvals or for a variety of other reasons. The board retains an obligation to the institution and its constituencies to keep the institution running until the transaction is in fact consummated, and the loss of key management during the transition can be devastating to the value of the franchise especially once a deal has been announced. Competitors will be calling, and a large portion of the intrinsic value of the franchise is its people and its relationships. Losing those, especially in the middle of a pending announced transaction, can have a significant adverse impact on the institution and can also cause shareholder and regulatory concern.

CIC agreements provide management with comfort in knowing that they will have some level of financial protection in the event that they are faced with a transaction as a target institution. Having an incentive to remain through completion of a transaction can provide comfort to both the executive and the board that the institution will remain viable through consummation of the transaction and even in the event that the transaction may for some reason be abandoned. That in itself has a significant value to the shareholders.

## Conclusions

Structured properly, CIC agreements can and do provide important and valid protections for an institution to help enhance its ability to engage in CIC activities while attracting and retaining valuable executive management. Such agreements are not typically intended to deter or discourage appropriate transactions, but rather provide incentives for management to remain in place despite the uncertainties of a transaction and the very real likelihood that competitors will be trying to “cherry pick” potentially vulnerable executives away. CIC agreements can help to ensure the attention of management to the transaction and encourage management openness with the board in dealing with transaction issues, from negotiation through consummation.

It is important to remember that target institutions need to continue to operate as independent organizations until transactions are consummated. Losing important management in the midst of a transaction can have an adverse impact on the viability and franchise value of the institution as a target and the viability and franchise value of the institution in the event that it remains independent.

Either way, CIC agreements are important tools for serious consideration by institutions, particularly in the current environment.