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Stress-Testing Executive Change-in-Control Agreements

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Banks identify potential value-creating deals based on attractive valuations and potential synergies. Details like executive change-in-control (CIC) agreements may not be on the radar until well into the due diligence phase.

These agreements are crucial because they determine how a transaction will financially impact individual executives. In extreme cases, problematic CIC contracts can jeopardize, or at least complicate, a transaction. Periodically stress-testing your bank's CIC agreements to identify red flags is fundamentally good governance, since it can potentially eliminate surprises and facilitate a smooth transaction.

The Critical Components

Companies use CIC agreements to help keep decision-makers neutral in the face of a transaction that may result in their job loss. While executive CIC agreements are referred to as "golden parachutes," they play a specific role in facilitating a merger or acquisition.

What constitutes a CIC? How a bank defines a change in control is critical. That definition determines whether a transaction triggers the agreement. There are typically multiple parts of the definition, and it is important to review and understand each one.

What is the trigger? Understanding what action causes the CIC agreement to become effective is key. Today, most CIC agreements have a "double trigger," meaning both a defined CIC and termination of employment after the CIC transaction are required to trigger the agreement. (Today, few CIC agreements are single trigger, only requiring a change in control, but you should know your bank's agreement terms.)

What is the cash severance? The primary benefit under a CIC agreement is usually cash severance, typically ranging from three times the annual base salary plus annual incentive at the CEO level, to one time for entry-level executives.

How will equity awards be treated? Equity award agreements typically define how a company will handle outstanding equity awards upon a CIC. The value can be significant; unvested equity awards can serve as an important "golden handcuff." At one time, most equity agreements provided for single-trigger vesting upon a defined CIC. However, in recent years, most companies have shifted to double-trigger, making them consistent with cash severance agreements.

How are supplemental executive retirement plans treated? Nonqualified retirement benefits such as supplemental executive retirement plans, or SERPs, are often an important executive benefit, especially at community banks. The SERP arrangement may provide for accelerated vesting and lump-sum cash payments upon a CIC and/or a qualifying termination.

Know Your Tax Consequences

It is imperative that any stress-test of the bank's CIC model the tax consequences of these agreements, which can be onerous for both the executive and the bank.

What is a golden parachute? Internal Revenue Code (IRC) Section 280G places a limit on golden parachute payments that are paid contingent on a CIC. The 280G calculations are complex and not intuitive. For example, parachute payments include any cash severance but will also include a value for the accelerated vesting of noncash equity and SERP benefits.

What is the excise tax? IRC Section 4999 imposes a 20% nondeductible excise tax on excess parachute payments. At one time, many banks would provide a tax gross-up for these excise taxes. Now, it is much more common to either cap such payments at the safe harbor amount or to allow an uncapped benefit if it is better for the executive on an after-tax basis.

These IRC laws are intricate, and the calculations must follow a prescribed formula. Banks should consider bringing in an expert in this field for any simulations. Private banks may be exempt from the complex tax consequences of CIC agreements if they comply with specific rules, including a binding shareholder vote.

Plan Ahead

It is best if a bank-stress tests its CIC agreements well before it is in the midst of a transaction. Once a transaction commences, management and the board are under additional scrutiny. Furthermore, the bank may be subject to legal standstill agreements, and tax laws will assume that changes within 12 months of a deal are parachute payments.

Good pay governance at banks should include periodic stress-testing of CIC agreements. Engaging a technical expert can ensure the bank's interpretation of the agreements is in line with how it would play out in the event of a real deal, creating a thorough understanding of the agreements and their implications to smooth out any future transaction discussions.

About the Author

David Seitz is a managing director at Pearl Meyer. He has over 30 years' experience in executive compensation consulting and particular expertise in long-term incentive plan design. Additional areas of concentration include total compensation strategy, incentive performance metrics, executive retirement, and global compensation, among others.

About Pearl Meyer

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