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BOLI-Financed Executive Compensation

by
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Executive compensation– – no topic is closer to an executive's heart than this. When it comes to making certain that an executive's existing contractual compensation entitlements are bullet proof, surprisingly many, if not most, community bank executives display an eerie passivity regarding the "what if" scenario of how an executive's contractual compensation entitlements play out in a merger. As human beings, none of us wants to die, but all of us recognize that death is inevitable. Similarly, bank executives should plan to make certain that executive compensation programs, particularly the esoteric world of BOLI-financed executive compensation programs, are ironclad in the change-in-control context when a seasoned acquiror will attempt to exploit any contractual ambiguity or loophole in an attempt to chisel or deprive an executive of his or her well-earned compensation entitlements.

A financial institution's executive compensation program can consist of up to six basic components. These include a formal base salary structure, an annual cash incentive earnings program, a long-term incentive earnings program (for mutual institutions, this program would be cash-based), qualified benefit plans, a nonqualified executive benefit program and executive perquisites. Each of these components can play a different role and function in an effective executive compensation program. By combining these components in appropriate, well-designed ways, an institution can make sure that its executive compensation program meets the bank's own broad needs and those of its executives. Not all banks, of course, will want to use all six components.

Change-in-control benefits and SERPs (the acronym by which a supplemental executive retirement plan is known) have become a staple for community banks to attract and maintain senior management talent. SERPs have become common place in the banking industry because qualified plans simply do not provide top executives with benefits that are in line with final pay or reflect the shareholder value top executives create. Caps on qualified plan contributions and distributions, as well as Social Security, often limit executives' retirement benefits to 30% to 50% of final pay, while lower-paid bank staff retire at 70% to 90% of final pay. A SERP can help your bank deliver retirement benefits commensurate with executive pay. The *2003 SNL Bank Executive Compensation Review* notes that for the 499 "public company" (SEC-reporting) banks and thrifts with assets greater than $500 million, 59.1% provide a SERP benefit for senior management. For the 475 "public company" banks and thrifts in America with assets less than $500 million, the *2003 SNL Bank Executive Compensation Review* notes 28.4% of these companies provide a SERP benefit for senior management.

As a bank adopts SERP or split dollar arrangements, it is essential that one advisor consider the "big picture" and review change-in-control issues incident to these compensation

benefit programs. Change-in-control protection is perhaps an executive's most important compensation expectation when considering a new senior level position or upward movement within a bank to senior management ranks. Banks should consider strategies (i) to lessen the impact of §280G of the Internal Revenue Code (a provision which denies deductions to corporations for the payment of any excess "parachute payments" and imposes a nondeductible 20% excise tax on the recipient of any excess "parachute payments") and (ii) to position executive SERP recipients for optimal contractual rights *vis-à-vis* any acquirer. Ensuring that senior management compensation issues are satisfactorily addressed in any merger and acquisition scenario requires foresight and planning long before any acquisition offer arrives. With a §280G assessment of executive contract rights, management will be able to make certain that a bank's SERP agreements, in conjunction with existing employment agreements and stock option plan grants, are well conceived and well informed.

A snapshot assessment of an executive's compliance posture *vis-à-vis* the limitations of Internal Revenue Code §280G is integral to executive compensation planning. SERPs can be designed to position proposed SERP recipients for optimal standing *vis-à-vis* §280G challenges. Obtaining the optimum SERP change-in-control benefit (in a tax-advantaged fashion), along with other favorable contractual provisions, is a once in a lifetime opportunity. If the proposed recipient of a SERP receives the optimum SERP change-in-control benefit, that contractual entitlement probably results in a larger monetary benefit than the severance benefit received under an employment contract, making it worthwhile from an executive's personal perspective to strive for the best SERP change-in-control benefit possible.

Adequate §280G planning is not the only matter that makes for a well-crafted SERP. An executive would wish to have the right to petition for accelerated payment of vested benefits that otherwise pay out over time. Very few SERPs provide for that. The typical executive would also desire a legal expense reimbursement provision, particularly for the context in which a successor company tries to force the executive to incur the prohibitive costs of enforcing his or her SERP agreement. Legal expense reimbursement provisions are not uncommon, but they are ordinarily not as ironclad as they could be, and perhaps should be. A typical executive would also want to be sure that changes in his or her compensation arrangements occurring after the SERP agreement is entered into are taken into account in subsequent post-retirement income planning. In many cases, SERP retirement benefits are based on compensation levels that existed when the SERP agreement was entered into, which might bear little or no relation to compensation levels that exist at the point of retirement, thus undermining the rationale for the SERP as a device to address the reverse discrimination retirement income shortfall that highly paid senior executives encounter.

BOLI or bank-owned life insurance plays a prominent role in a well-designed executive (and director) compensation program. Because BOLI is typically purchased on a single premium payment basis, a BOLI financing represents a significant balance sheet commitment for most banks. Commensurate with the significance BOLI financings have for the banking industry, bank regulatory agencies and other governmental overseers such as the IRS impose comprehensive and stringent requirements on banks' BOLI investments. Because a BOLI financing generally represents the largest single investment decision the bank will make in a given year, the bank should retain qualified advisors, including specialists in the BOLI marketplace, and counsel skilled in advising banks regarding BOLI bank regulatory compliance,

IRS compliance, state insurable interest law compliance and most importantly well-conceived executive compensation planning.

As with most decisions affecting compensation of executives, adoption of compensation arrangements is generally within the business judgement of a company's board of directors. In order for a bank to avail itself of the protection of the business judgement rule, the board of directors should have legal counsel and benefit consultants available to answer questions regarding the compensation plans under consideration. Cloaking this exercise with all the trappings of the board's informed exercise of business judgement incident to adoption of the new compensation arrangements is arguably the most important element of the entire exercise. A board of directors should be presented with relevant documentation regarding proposed compensation arrangements, including the potential costs of the arrangements.

The Delaware Court of Chancery's action on May 28, 2003, declining to dismiss a derivative shareholder lawsuit challenging Michael Ovitz's employment agreement and subsequent $140 million "non-fault termination" payment with The Walt Disney Company, is a ringing wake-up regarding the importance of documenting executive compensation decisions made by the board. The Disney case is based on factual allegations that Disney CEO Michael Eisner unilaterally made an offer of employment to his longstanding personal friend Mr. Ovitz without prior board or compensation committee consideration or approval. Although the compensation committee subsequently approved Mr. Ovitz's hire as President of Disney, reportedly the compensation committee never reviewed either a draft of the employment agreement or the final version which was agreed to by Mr. Eisner and Mr. Ovitz several months later. The meeting at which the hire decision was approved lasted for less than one hour, and a majority of the time was spent on matters other than the employment terms. Further, the Delaware Court of Chancery also considered whether Mr. Ovitz could be found liable to Disney in connection with his employment and the terms of his termination. While the court's holding is fact specific and the Disney litigation is still at an early stage, the decision highlights the scrutiny being applied to executive compensation, severance decisions and the need for maintaining a complete record of the decision making process.

About the author:

Mr. Grady, a former attorney for the Federal Deposit Insurance Corporation, is the founder of Grady & Associates, a Cleveland, Ohio law firm specializing in the representation of banks and thrifts, BOLI-financed executive compensation plans and bank merger transactions.