An Update and Discussion of Compensation and Benefits Arrangements for Mutual Institutions

2023 Maximizing Mutuality Conference
May 11, 2023

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Overview of Compensation and Benefits Arrangements

- Offer Letters
- Employment Agreements
- Change in Control Agreements
- Early Retention Agreements
- Annual Incentive Plans
- Long-Term Incentive Plans
- Executive Deferred Compensation Plans
- Short-Term Supplemental Compensation Arrangements
- Supplemental Executive Retirement Plans
- Late Retention Agreements
- Life Insurance Arrangements
- Stock Benefits (public mutual holding companies)

Offer Letter

- Serves as an outline for job duties and responsibilities.
- Sets forth compensation and summarizes benefits and bonus opportunities.
- May contain non-competition and/or non-solicitation covenants.
    - ➢ Negotiate and agree to the terms prior to employment commencing.

Employment Agreement

- Sets forth job duties and responsibilities.
- Sets forth salary and other compensation items (bonus, perquisites).
- Sets forth the ability for the bank to terminate the employee's employment.
  - With cause – no severance due.
  - Without cause – severance due. Key is to define cause and provide a reasonable severance amount to make the agreement meaningful to the employee.
- Sets forth the ability for the employee to terminate the employee's employment.
  - Without good reason – no severance due.
  - With good reason – severance due. Key is to define what constitutes good reason and provide a reasonable severance amount to make the agreement meaningful to the employee.

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Employment Agreement (cont'd)

- Sets forth any compensation or benefits due upon death or disability – may refer to other arrangements.
- Sets forth payments due (or restricted) in connection with a change in control – this is important in a consolidating industry.
  - Should be coordinated with other arrangements that pay benefits and/or accelerate benefits upon a change in control (or upon a termination in connection with a change in control).
- May contain non-competition and/or non-solicitation covenants – must be reasonable in scope and need to comply with state law. A non-compete may be used to work around certain tax issues with payments made in connection with a change in control.

Change in Control Agreement

- May generally or specifically describe job duties and responsibilities.
- May describe salary and other compensation items (bonus, perquisites).
- Sets forth the ability for the bank to terminate the employee’s employment in connection with a change in control.
  - With cause – no severance due.
  - Without cause – severance due. Key is to define cause and provide a reasonable severance amount to make the agreement meaningful to the employee.

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Change in Control Agreement (cont’d)

- Sets forth the ability for the employee to terminate the employee's employment in connection with a change in control.
  - Without good reason – no severance due.
  - With good reason – severance due. Key is to define what constitutes good reason and provide a reasonable severance amount to make the agreement meaningful to the employee.
- May contain non-competition and/or non-solicitation covenants - must be reasonable in scope and need to comply with state law. A non-compete may be used to work around certain tax issues with payments made in connection with a change in control.
- Does not restrict the employer’s ability to terminate the employee outside of a change in control with no severance obligation due.

Early Retention Agreement

- Provides a method to incentivize the employee to remain employed for a period of time.
- Example –
  - ➢ If the employee remains employed on each of the first, second, and third anniversaries of their employment, they will receive a payment of $25,000.
  - ➢ The remaining benefit is forfeited if the employed is not employed on any given anniversary date.
  - ➢ The benefit can be structured in many different ways (e.g., $15,000, $15,000 and $30,000).
  - ➢ The benefit can be structured over different time periods (e.g., six month intervals, over one year, over five years).
- Benefits can vest and be deferred to a later time (if done at the time the agreement is entered into by the parties).

Annual Incentive Plan

- Normally fairly broad-based but can also cover a select group of participants.
- Benefit is based on performance for a given year – the compensation committee sets the performance metrics each year.
- Performance may be measured at the bank-level and at the employee-level.
- Payment of awards may be paid in the following year or deferred (voluntarily or mandatorily) to future years.
- Example – Employee A earns an award of $30,000 based on meeting the performance metrics in Year 1. Normally, the award is paid to Employee A by March 15th of Year 2. In this case though, $5,000 is paid by March 15th of Year 2, $5,000 is paid by March 15th of Year 3 and $20,000 is paid by March 15th of Year 3. Employee A must be employed on each of the payout dates in order to receive the payment; however, the performance metrics do not need to be met again.

Long-Term Incentive Plan

- Normally fairly broad-based but can also cover a select group of participants.
- Benefit is based on performance for a given performance cycle – e.g., 3 years.
- Performance may be measured at the bank-level and at the employee-level.
- Can compliment other incentive arrangements.

Executive Deferred Compensation Plan

- Designed to allow the employee to defer compensation (normally, salary and, possibly bonus) beyond what is deferred under a 401(k) plan.
- Since the employee defers compensation that would otherwise currently be paid to them, the deferrals are fully vested but paid in accordance with the terms of the plan (e.g., upon a separation from service, a fixed date, change in control or death).
- May allow for matching contributions (often based on the same match made under the 401(k) plan and/or other employer contributions. Other contributions can be made to provide a reward to an employee for some event on a deferred basis.

Executive Deferred Compensation Plan (cont'd)

- Matching and other employer contributions may be subject to a vesting schedule.
- Amounts contributed under the plan can earn interest at a rate set by the plan documents (or the board) or the employee may be able to "invest" the contributions in certain "deemed" investments.
- Example – Each year Employee D defers $27,000 under the 401(k) plan (the annual maximum). Employee D elects to defer an additional $20,000 under the deferred compensation plan each year. Employee D is fully vested in the benefits and will receive them upon her separation from service. In Year 5, Employee D successfully heads up a major strategic initiative of the bank. At the completion of the project, the bank contributes $50,000 to the plan on behalf of Employee, in which Employee D becomes fully vested after 5 years of service.

Short-Term Supplemental Compensation Plan

- The plan is designed to provide a supplemental benefit (i.e., a benefit beyond salary, bonus and retirement income) for select employees at some point prior to retirement.
- The benefit can vest throughout the period ending with the payment date or prior to the payment date.
- The benefit can be designed to help the employee meet certain future financial obligations.
- The benefit can be in addition to a supplemental retirement plan but all of the benefits should be considered in designing the compensation package as a whole.
- Example – Employee B is 35 years old and has one child who is 8 years old. Under the terms of the plan, Employee B will receive $15,000 in each of Years 10-13 (four years). While the plan is not contingent on attendance, it is intended to assist the employee with college payments once the child turns 18.
- Example – Employee C is 35 years old and has two children, ages 8 and 5. Under the terms of the plan, Employee C will receive $15,000 in each of Years 10-12, $30,000 in Year 13, and $15,000 in each of Years 14-16.

Supplemental Executive Retirement Plan

- Provides supplement retirement benefits to a select group of employees.
- May be structured as a defined benefit or a defined contribution plan.
- Normally, has some vesting schedule.
- Payments must meet certain requirements (e.g., separation from service, fixed date, change in control, death, disability) and can be in a lump sum or installments.
- Can be coordinated with a tax-qualified pension plan.
- Can be coordinated with split-dollar life insurance arrangements.
- Often "funded" with bank-owned life insurance.
- Sometimes funded with annuities.

Late Retention Agreement

- Works like early retention agreements but is entered into late in the individual's career.
- The benefit typically supplements any other compensation or benefits due to the individual.
- Example – Employee D will turn 65 and is contemplating retirement from the bank. Employee D is fully vested in his tax-qualified and non-tax-qualified retirement benefits. Based on her age and years of service, Employee D cannot accrue any additional benefits under the existing retirement plans (other than 401(k) plan and matching contributions). The bank would like Employee D to remain employed for two additional years for a smoother transition with his successor. The bank agrees to pay Employee D $200,000 if he remains employed on the second anniversary of agreement. The benefit will also be payable to Employee D's beneficiary should Employee D die within the two-year period. If, at the end of two years, the Bank would like Employee D to remain employed for an additional year, the retention agreement can be extended to provide an additional payment at the end of the third year.

Life Insurance Arrangements

- Death Benefit Only Plans – The bank promises to provide a death benefit (above what is available under a group-term life plan). The benefit, when paid, is taxable to the beneficiary since it is paid by the bank (as opposed to through a life insurance policy).
- Split-Dollar Life Insurance Arrangements – The bank purchases (or owns) bank-owned life insurance and enters into an agreement whereby it splits the death proceeds of the policy with the individual's beneficiaries (but not to a degree beyond recovering the premiums it paid on the policy).
  - The benefit is not taxable since it is paid under a life insurance policy.
  - The promise to pay the benefit can last while (i) the individual is employed by the bank, (ii) to a certain age or (iii) until death. The length of the promise may have an accounting impact.
  - The benefit may offset supplemental retirement benefits (e.g., if the individual dies while employed, benefits may be paid in a tax-efficient manner under the life insurance arrangement rather than under the supplemental retirement plan) or as an additional benefit.
  - Even with out the split-dollar arrangement, bank-owned life insurance is often used to "fund" supplemental retirement benefits.

Phantom Incentive Plan

- Phantom plans may be put in by mutual institutions
  - Phantom plans offer "stock option-like" or "restricted stock-like" benefits based normally on the equity of the institution as it changes from time to time
  - These plans are usually implemented not just to reward employees but to better "tie" them to growth of the organization

Stock Benefit Plans (Public Mutual Holding Companies)

- Provide stock options, restricted stock and restricted stock units to employees and non-employee directors.
- Company may reserve some portion of the plan (informally) for new hires to better compete with stock banks.
- If the company uses all of the awards available under the plan it may seek a second plan or make cash-based awards that are valued based on the price of the common stock.
- Equity plans can also be used to make grants to certain officers or directors of a target mutual bank in a mutual-to-mutual target.
  - Stock benefits may set the company apart from other mutual institutions seeking a mutual-to-mutual merger with the same target.

Stock Benefit Plans (Public Mutual Holding Companies) (cont'd)

- Example – Restricted Stock
  - Company A grants employee 5,000 shares of restricted stock that vests in five annual installments. Assume the value of the stock is $20 in Year 1, $22 in Year 2; $24 in Year 3; $27 in Year 4 and $30 in Year 5. Each year the individual vests in the stock (i.e., holds it outright with generally no restrictions worth the following amounts: Year 1 - $20,000; Year 2 - $22,000; Year 3 - $24,000; Year 4 – $27,000 and Year 5 - $30,000. The individual can continue to hold the shares after vesting and realize any future gain in the stock.
- Example – Stock Options
  - Assume the same stock value as above, but instead of restricted stock the individual holds 5,000 stock options with an exercise price of $20. After vesting in all stock options in Year 5, the individual exercises all stock options when the stock is valued at $30 and realizes $50,000 in gain (($30-$20)*5,000)
- Employees can typically buy stock in the public offering and often afterwards with funds in their 401(k) plan.
- Employees become participants in a new tax-qualified retirement plan – an employee stock ownership plan.

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