



**Addressing Key Succession Issues:
Management, Board and Ownership
Succession**

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PRACTICES
Financial Institutions Corporate and Regulatory
Banking and Finance
Mergers and Acquisitions
Transactional ESOP

EDUCATION
JD, Southern Methodist University, 2001
BS, Texas A&M University, 1992

BAR ADMISSIONS
Texas

Robert's practice focuses on corporate and regulatory representation of small to large regional and national financial institution franchises. He has counseled institutions on M&A transactions, as well as provided representation on securities offerings and capital planning.

Relevant Experience

Strategic business planning

- Structuring and raising equity and debt through public or private offerings.
- Shareholder matters including share repurchases/tender offers, responses to activist investors and related corporate governance planning.
- Structure changes and expansionary activities such as de novo formations, charter conversions, holding company formations, expansion of existing lines of business (trust, insurance, securities and non-banking activities).
- Management planning, compensation planning, corporate succession matters and board advisory services.

Acquisition transactions

- Advises clients on all matters related to the acquisition or sale of existing financial institutions and the acquisition, sale, establishment and relocation of branch offices..
- Awarded a top legal ranking in the U.S. for the 10th year in a row in SNL Financial's league tables for bank and thrift legal advisers. (2016)

Regulatory Compliance:

- Advises clients on a broad variety of bank regulatory and compliance matters, including consumer compliance, third party risk, compliance management systems, incentive compensation, high risk customers, transactions with affiliates and other regulatory and compliance matters.
- Response to formal and informal administrative actions and supervisory issues.

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What Will We Talk About Today?

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- Succession Planning in General
- Board Best Practices
- Compensation and Succession Planning
- Shareholder Succession (Liquidity)



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Management Succession

Management Succession

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Community bank CEOs are now, on average, in their middle 60's. One of the more important part of a board's fiduciary duty concerns picking talent and succession planning.

The National Association of Corporate Directors ("NACD") has noted:

Good or bad, there is a direct correlation between CEO leadership and corporate performance. The identification and selection of such significant individuals cannot be left to chance, corporate politics or personal friendships, but should be the result of thorough and just process orchestrated by the corporate board of directors in partnership with the incumbent CEO. Directors need to ensure that the appropriate individual is running the corporation at all times. Therefore, the board of which the CEO is generally a member, is not only accountable for the selection of the CEO, but also for recognizing when new leadership is needed and for spearheading the succession process. Too often, boards ignore this responsibility and allow the current CEO to determine how and when s/he will be replaced.

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Management Succession

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- **Why Bother?**

- The Baby Boomer generation now at or approaching retirement age – directly impacts aging CEO and directors
- Banks are not only losing CEOs to retirement, but entire teams to competitors
- **Regulators are asking for it**
 - The regulators are talking about succession planning, especially for the CEO, but also for directors
 - They want banks to take a serious approach
 - They want it in writing
- Opens the bank to a takeover as the age of the selling CEO recently has been rising

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Management Succession

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- **Levels and Types of Succession Planning**
 - Three levels of succession planning :
 - CEO/Management Succession
 - Board Succession
 - Ownership Succession
 - Two common types of succession planning
 - Emergency
 - Death
 - Disability
 - Resignation
 - Planned
 - Retirement

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Management Succession

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- **Developing a Good Succession Plan**
 - Begin with the end in mind – where do we want to be?
 - Determine the bank's Strategic Plan
 - Be able to communicate the Strategic Plan to anyone who asks – regulators, management, directors and potential succession candidates
 - Identify responsible parties for oversight
 - Identify position(s) covered in the plan
 - Identify triggering events (including longer-term and “emergency” strategies)
 - Create a process for identifying suitable candidates, both internal and external

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Management Succession

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- **Developing a Good Succession Plan (cont.)**
 - Develop readiness/training program for candidates
 - Identify suitable executive search firms if they are to be used
 - Have a list of interim candidates (if necessary)
 - Develop transition plan(s)
 - Have a general compensation package, but also one that is candidate-specific for identified target candidates
 - Incumbent's compensation package
 - SERP
 - Liquidity for equity
 - Consulting role/board seat
 - Successor's compensation package (more on this later)
 - Periodically review and revise the succession plan, including discussing with regulators

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Management Succession

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- **The bottom line....**
 - "Succession planning is a means for an organization to ensure its continued effective performance through leadership continuity"
 - *Society for Human Resource Management*
 - Start discussion of a succession plan with Board of Directors
 - Set a firm timeline
 - Identify key components that align with Strategic Plan
 - Develop succession plan and continually update it
 - Boards of Directors and CEOs need to work closely, but Boards of Directors have the fiduciary responsibility to ensure capable successors for the CEO and other key bank roles
 - CEO shares the same responsibilities for succession planning of remaining key roles and positions (including directors) throughout the bank
 - Communicate succession plan with key management

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Director Succession

Director Succession

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The National Association of Corporate Directors has stated that:

[A]n effective board is far more than the sum of its parts: it should bring together a variety of skill sets, experiences, and viewpoints in an environment conducive to reaching consensus decisions after a full and vigorous discussion from diverse perspectives...Typically, a board will want some persons with specialized knowledge of relevant businesses and industries and the business environment in which the company functions who can provide insight regarding strategy and risk. Director qualifications and criteria should be designed to position the board to provide oversight of the business.

Director Succession

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Where do you find director candidates?

- Local community
- Customer base
- Investor base
- Former bankers (spun off from increased M&A activity)
- Former regulators
- Family members of current directors

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Director Succession

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What are the qualifies of ideal directors?

- Balance
 - Reflect the community as best as possible
 - Understand the market
 - Understand the strategic vision for the bank
 - Diversity among directors
 - Age, race, sex
 - Occupation and business experience
 - Geography (if multiple locations)
 - Independence of Directors
 - Majority of directors should be non-management and independent
 - Independent directors should meet in regular executive sessions (i.e., non-bankers)

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Director Succession

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What are the qualifies of ideal directors?

- Competence
 - Directors should be of notable integrity with character that is above reproach
 - Conduct interviews of director candidates
 - Consider background checks or investigations
 - Directors should have strong reputations within the community
Consensus builders
 - Well-regarded by investors (if future capital raising is likely)
 - Directors should have strong business experience
 - Financial acumen
 - Legal expertise
 - Risk management
 - IT background/understanding
 - Accounting background/understanding

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Director Succession

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What are the qualifies of ideal directors?

- Competence
 - Directors should have strategic planning experience
 - Prior quality banking experience is a plus
 - Background in and knowledge of key business lines of the bank
 - Prior non-profit or for-profit board experience is a plus
- Commitment
 - Directors should be committed to the task
 - Be a team player
 - Work to build consensus
 - The board should function as a team

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Director Succession

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What are the qualifies of ideal directors?

- Commitment
 - Be dedicated
 - Time commitment can be burdensome
 - Regular and special meetings
 - Committee meetings
 - Education and training
 - Get educated, stay educated – training is important

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Director Succession

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Director Core Competencies:

- Accounting knowledge
- Audit committee experience
- Board of director experience
- Brand marketing experience
- Corporate governance experience
- Executive compensation experience
- Financial officer experience
- Governmental knowledge
- Industry knowledge
- International or global knowledge
- Investment knowledge
- Merger & acquisition experience
- Operations experience
- Public relations experience
- Sales distribution experience

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Shareholder Succession (Liquidity)

Stock Repurchase/Shareholder Liquidity

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- **Tender offers**

- Typical structure
- Bifurcated tender offers
 - ❖ Installment Sale
- “Test the Waters” letters
- Basic tender offer rules
- 20 days minimum
- Extensions

company
Common
stock
repurchased
company's
Treasury
held

Stock Repurchase/Shareholder Liquidity

Overview of KSOP Transaction

- Create ESOP/KSOP
- Fund ESOP/KSOP
 - One-time election right
 - Rollover IRAs
 - Match or discretionary contribution by BHC or Bank
 - Leveraged ESOPs

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Stock Repurchase/Shareholder Liquidity

Existing 401(k) Plan

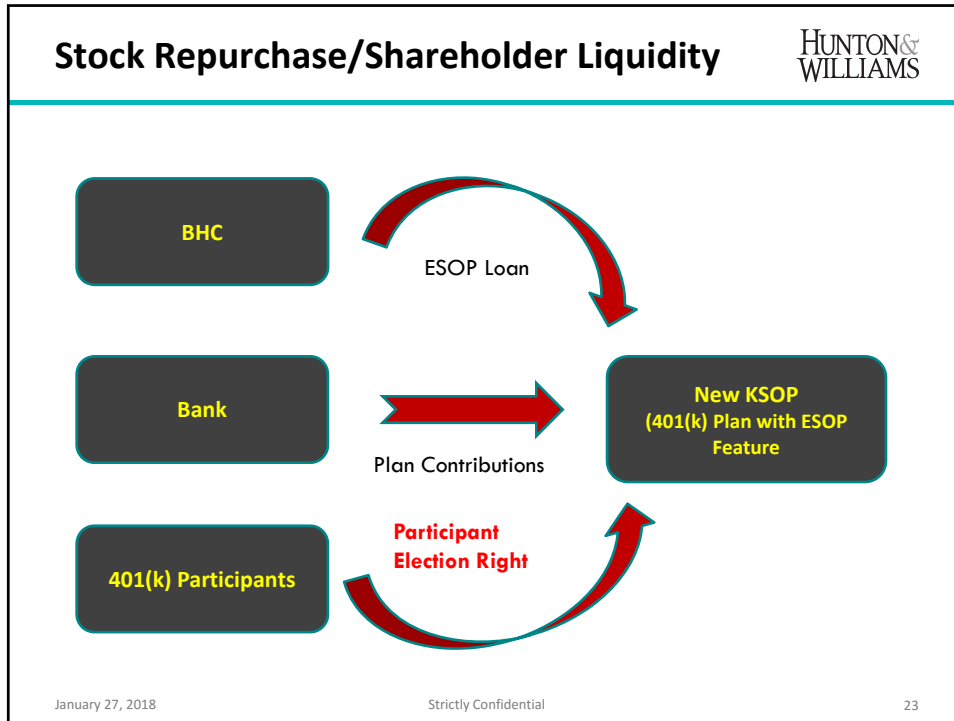
Amendment and Restatement to
add ESOP Feature

New KSOP
(401(k) Plan with ESOP Feature)

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- ### Stock Repurchase/Shareholder Liquidity
-
- Plan design
 - Appraisal requirements
 - Benefits of a Sub S ESOP
 - ERISA issues
 - Fiduciary duties
 - Inside/outside trustees
 - Third-party administrators
 - Bank Holding Company Act issues
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Compensation Planning and Succession

Compensation Planning and Succession

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- The “Compensation Stack”
- Annual Incentive Bonus
- Qualified Retirement Plans
 - 401(k) plan
 - Employee Stock Ownership Plan
- Equity-Based Plans
 - Stock Options
 - Stock Appreciation Rights
 - Phantom Stock Units
 - Restricted Stock
- Non-Qualified Plans
 - Deferred Bonus Agreements
 - Salary Continuation Plans/SERPs
- Other Benefits
 - Perks



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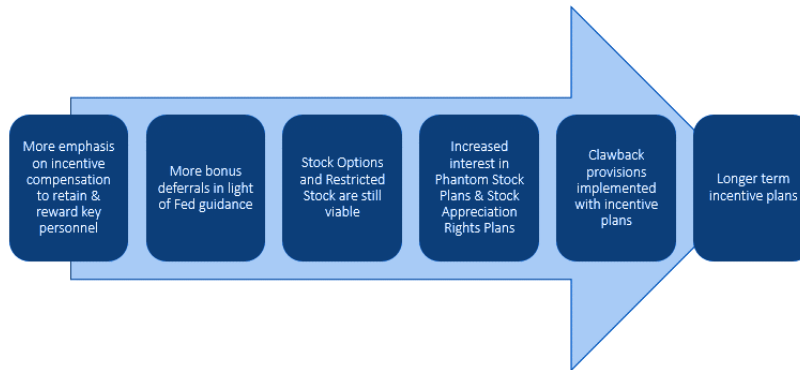
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Compensation Planning and Succession

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Compensation Trends in Banking



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Restricted Stock

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- **What is it?**
 - An outright grant of stock
 - Typically no out-of-pocket required from director
 - Contains transfer restrictions until vested
- **What are the requirements?**
 - Restricted stock grants need not be granted pursuant to a formal written plan (but typically are)
 - Shareholder approval of restricted stock grant is not required
 - Board approval of restricted stock grant is required
- **Who is eligible?**
 - Employees and directors

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Restricted Stock

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- **What are the typical features?**
 - Vesting
 - Usually 3 to 5 year vesting, graded or cliff vesting, most often is service-based
 - May vary from one grant to another and one employee to another
 - Vesting often accelerates on a change of control (and sometimes on death or disability)
 - Forfeit restricted stock if vesting requirement not satisfied
 - Recipient is a “restricted” shareholder
 - No transfers until vested, otherwise forfeited
 - Additional features
 - Repurchase Right
 - Rights of First Refusal

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Restricted Stock

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- **How is restricted stock taxed?**
 - Without Section 83(b) election
 - Director may make an “83(b) election” at date of grant
 - Moves taxation event to date of grant, rather than as restrictions lapse
 - Difference between FMV on the date any restrictions lapse and the amount paid, if any, for the restricted stock taxed as ordinary income
 - Subsequent sale of stock results in capital gain taxation
 - Compensation deduction for the bank equal to recipient compensation income when recognized

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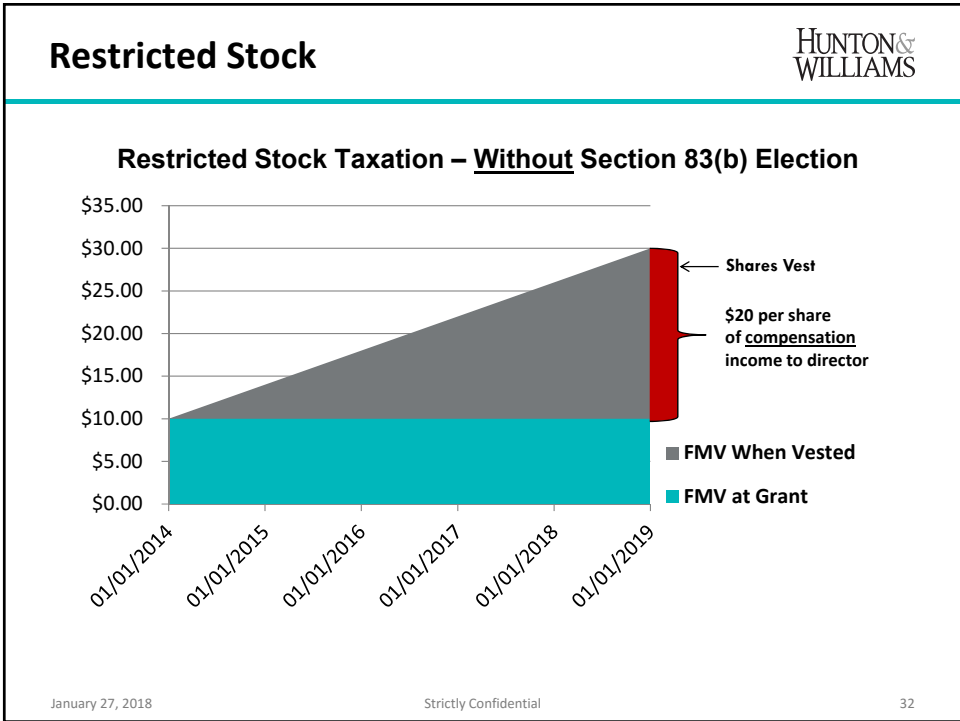
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Restricted Stock

- **How is restricted stock taxed?**
 - With Section 83(b) election)
 - Director may make an “83(b) election” at date of grant
 - Moves taxation event to date of grant, rather than as restrictions lapse
 - Difference between FMV on the date of grant and the amount paid, if any, for the restricted stock taxed as ordinary income
 - ❖ Advantages if stock price expected to increase over time
 - Subsequent sale of stock results in capital gain taxation
 - Compensation deduction for the bank equal to recipient compensation income when recognized

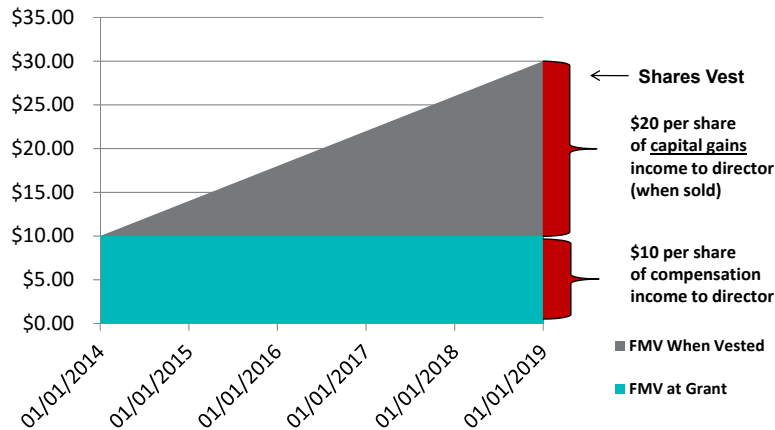
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Restricted Stock

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Restricted Stock Taxation – With Section 83(b) Election



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Restricted Stock

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- **Advantages**
 - Director has “skin in the game”
 - Gain to director tied to share value increase
 - Compensation deduction to bank when director recognizes income (with or without Section 83(b) election)
- **Disadvantages**
 - Grant of restricted stock is dilutive to share ownership and earnings per share
 - Thinly traded market may cause difficulty in later sale of stock
 - Director recognizes compensation income when restrictions lapse or upon Section 83(b) election
 - The “gamblers choice” with respect to 83(b) elections
 - FAS 123(R) accounting requirements and financial statements

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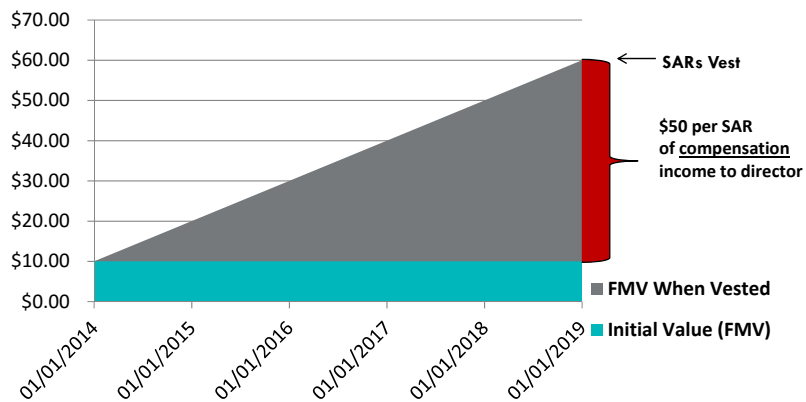
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Stock Appreciation Rights

- **How does it work?**
 - Bank grants director a stock appreciation right (or “SAR”)
 - SAR has an “initial value”
 - SAR is a right to a cash payment equal to increase in FMV over “initial value” over time
- **Stock Appreciation Rights Example**
 - 1,000 SARs granted
 - Initial value is \$10.00
 - FMV at “exercise/payment” is \$60.00
 - Cash payment of \$50,000 at “exercise/payment”
 - Payment is compensation income

Stock Appreciation Rights

Stock Appreciation Right Example



Phantom Stock Units



- **How does it work?**
 - A Phantom Stock Unit (PSU) is the right to a cash payment equal to the number of PSUs multiplied by the then-current FMV of the stock
 - Bank grants director a (or “PSU”)
 - PSU has no “initial value,” rather it is a hypothetical share of stock
 - Often Includes cash dividends and stock dividends paid on stock
 - Includes stock splits applicable to stock
- **Phantom Stock Units Example**
 - 1,000 PSUs granted to director
 - Bank pays \$2.50 per share cash dividend on stock
 - FMV at “exercise/payment” of PSU is \$60.00
 - Director receives \$60,000 cash payment at “exercise/payment” plus the \$2,500 dividend

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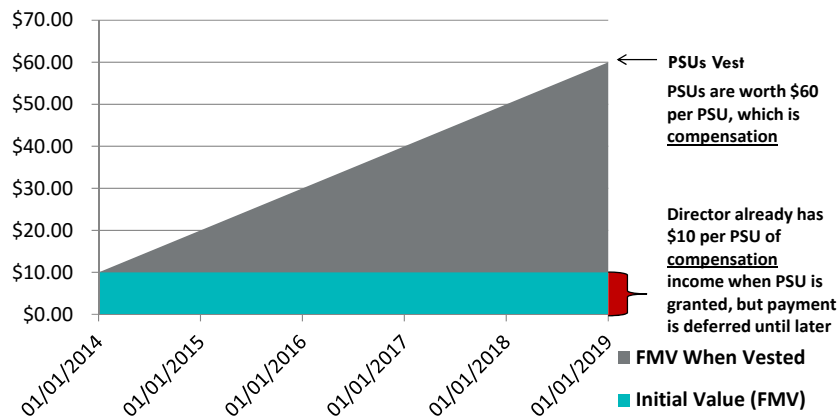
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Phantom Stock Units



Phantom Stock Unit Example



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Director Deferred Compensation Arrangements



- **Voluntary Deferral Plan**

- Each director chooses to participate on an annual basis
- Each director determines how much of their fees he or she wants to defer
- Bank credits an interest rate on the deferred fees
- Flat rate
- Floating rate
- Can be tied to ROE or a percentage of ROE
- Can be tied to prime rate or some other index
- Bank can make discretionary “matching” grants to the plan

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Director Deferred Compensation Arrangements



- **Director Fee Continuation Plan**

- Provides continued director fees upon “retirement” from the board
- Fees can continue for any number of years that the bank so chooses (typically five to ten years)
- The plan is totally funded by the bank (similar to a defined benefit plan)
- Bank accrues the liability over time
- Often BOLI-based or supported and includes a death benefit
- Allows directors to “retire” and still have benefits from the bank for past service
- Less common, but may increase in popularity in the future

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Compensation Laws, Rules and Regulations

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- Internal Revenue Code
 - 409A (deferred compensation)
 - 280G (parachute payments)
 - 422 (stock options)
 - 162(m) (executive compensation)
- 2010 Incentive Compensation Guidance
- 2016 Proposed Rules on Incentive Compensation
- Say on Pay (public companies)
- Reg Z (mortgage lenders)
- Others.....



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Questions?