FINANCIAL INSTITUTIONS
UPDATE
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Audit Committee Self-assessments:

How Are We Doing?

By Christopher J. Zinski

Audit committees have new responsibilities since the passage of the Sarbanes-Oxley Act of 2002. Many committees are measuring their performance against the new audit committee governance standards by using a formal self-assessment protocol whereby the committee evaluates the quality of its own work. All financial institutions, whether public reporting or privately-held companies, should evaluate the benefits and disadvantages of an annual self-assessment. If the bank's board of directors determines that a self-assessment is valuable, provision for the annual evaluation should be included in the company's audit committee charter.

What is a Self-assessment?

An audit committee self-assessment typically involves each member of the committee evaluating the past performance of the committee as a whole. But others on the board of directors as well as certain officers should evaluate the committee's performance, too. For instance, consideration should be given to having the CEO, chairman of the board, CFO, internal auditor, and general counsel complete an evaluation of the committee's performance from their perspective. In other words, those individuals who regularly interact with the audit committee should be polled to determine their views on the committee's strengths and weaknesses and overall performance. Each member of the audit committee as well as any officers or other directors involved in the evaluation process are given the opportunity to complete a written questionnaire that sets forth assessment criteria. The results of the questionnaires are reported to the full board and to the audit committee for their consideration.

Are Self-assessments Legally Mandated?

No. Neither the Sarbanes-Oxley Act nor the Securities and Exchange Commission requires an audit committee to undertake an annual self-assessment. But, if a financial institution holding company's stock is listed on the New York Stock Exchange, an annual self-assessment by the audit committee is required in order for the company to retain its status as a listed company. Companies with stock quoted on Nasdaq have no self-assessment obligation under the Nasdaq listing standards.

A Back Door Mandate

On October 7, 2003, the Public Company Accounting Oversight Board ("PCAOB") issued proposed Release No. 2003-017, which proposes an auditing standard for an auditor's review of corporate internal controls over financial reporting. Under Section 404 of the Sarbanes-Oxley Act, a public company's external auditor will be required to evaluate the assessment management makes of its company's internal controls. A very similar process is mandated under FDICIA for financial institutions with $500 million or more in assets.

Under 404, a public company financial institution will need to include in its annual report to stockholders management's assessment of the effectiveness of the company's internal controls. The PCAOB standard implies that it is important for audit committees to step back and undertake a self-evaluation and to benchmark their performance against their peers. Indeed the new PCAOB

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standard, if adopted as proposed, requires a frequent evaluation by the external auditor of the audit committee's performance. An external auditor may wish to see the results of the self-assessment performed by the audit committee, as a basis for its opinion on the audit committee's effectiveness. Given the emphasis the external auditor may be required to place on audit committee functionality, audit committees may be well served to voluntarily assess their own performance and make necessary modifications in their activities. This all is in an effort to avoid criticism from the external auditor if the PCAOB standard is adopted in a form that includes the requirement that the auditor evaluate the audit committee's performance.

Bank Examiners Jump In

Beginning in early 2003 the various federal banking agencies issued a number of pronouncements requiring or encouraging all financial institutions, including those that are privately-held, to comply with certain corporate governance standards embodied in the Sarbanes-Oxley Act, the new SEC corporate governance rules; or the new listing standards of the securities exchanges or associations. Moreover, bank examiners have been giving special attention to corporate governance and audit committee activities during recent examinations. So far, the bank regulators have not imposed a self-assessment requirement on bank audit committees. Nevertheless, examiners are gradually pushing down some of the Sarbanes-Oxley requirements, such as requiring small community banks to adopt whistle-blower policy statements and improve the financial literacy of their audit committees. Annual self-assessments may become a best practice in the future even if not legally mandated. Indeed, it is conceivable that examiners may require, on a case-by-case basis, banks with poorly functioning audit committees to follow an audit committee self-assessment protocol.

The purpose of a self-assessment is to improve the performance of an audit committee through a process of reflection, self-diagnosis and self-motivated remedial action.

Advantages of Self-assessment

Most financial institution audit committees will not be legally required to conduct an annual self-assessment. Nevertheless, there are advantages to conducting voluntary reviews.

The purpose of a self-assessment is to improve the performance of an audit committee through a process of reflection, self-diagnosis and self-motivated remedial action. Furthermore, by conducting self-evaluations an audit committee will appear proactive when under scrutiny by the bank examiners, which may deter examiner criticism of the committee's functionality. Finally, confirming to shareholders that the audit committee, guardian of the shareholders' financial interests, regularly evaluates its own performance may prove beneficial in the context of investor relations.

Drawbacks of Self-assessment

Self-assessment does have disadvantages. For instance, the results of an audit committee self-assessment, some of which may not be flattering, may be used against the audit committee or the full board of

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Bank on Non-Compete Agreements for Your Protectable Information Assets

By Linda K. Stevens

Consider protecting your financial institution's trade secrets by requiring officers, executives, and other staff who have access to that information to sign restrictive covenants, sometimes referred to as "non-competes." The following are some general questions and answers regarding non-competes and the circumstances under which they will be enforced.

Q: Isn't it true that non-competes are generally unenforceable?
A: Not true. A well drafted limitation on competition stands a good chance of being enforced, depending on the circumstances.

Q: That's a typical lawyer's answer! When are they enforced, and when are they not?
A: While the laws regarding non-competes vary somewhat from state to state, and while the outcome of litigation regarding non-competes will very much depend on the particular facts of each situation, the general rule followed in most jurisdictions is that a non-compete will be enforced (1) if its purpose is to safeguard a legitimate protectable interest of the employer but (2) only if the covenant is drafted no more restrictively than is necessary to protect that interest.

Q: What is a "Legitimate Protectable Interest" such as would support a non-compete?
A: The short answer is either (1) confidential information or (2) "long term" customer relationships, or, in some states, investment in training or the like.

The longer answer is this: Historically, non-competition agreements have been viewed with disfavor by the courts because they are anti-competitive. If reducing competition is the only purpose behind a non-compete, it won't be enforced. Simply put, to the extent that an agreement seeks simply to reduce the competition faced by an employer, that agreement is invalid. However, the courts of most states have recognized that there are situations in which an employer does not seek to restrict appropriate and fair competition, but rather wishes to prevent the employee from exploiting some unfair advantage in post-employment competition. In such cases, the employer has a legitimate reason for wanting to restrict the post-employment competition of its employee, which reason is known in Illinois as a "legitimate protectable interest."

Most states recognize at least these two possible legitimate protectable interests that would justify and support the use of a non-competition agreement: (1) long term customer relationships (sometimes referred to as a company's "good will"), and (2) confidential or trade secret information that is in danger. The first step in determining whether an employer may enforce a non-competition agreement therefore is to ask whether the employer has either of these interests that would be imperiled if the employee were allowed to compete with the employer upon the termination of his employment. If the employer cannot show a legitimate protectable interest, a court will not enforce a non-competition covenant, regardless of how narrowly and reasonably it is drafted. (There is a substantial body of case law defining what constitutes a legitimate protectable interest, *e.g.*, when customer relationships are significant

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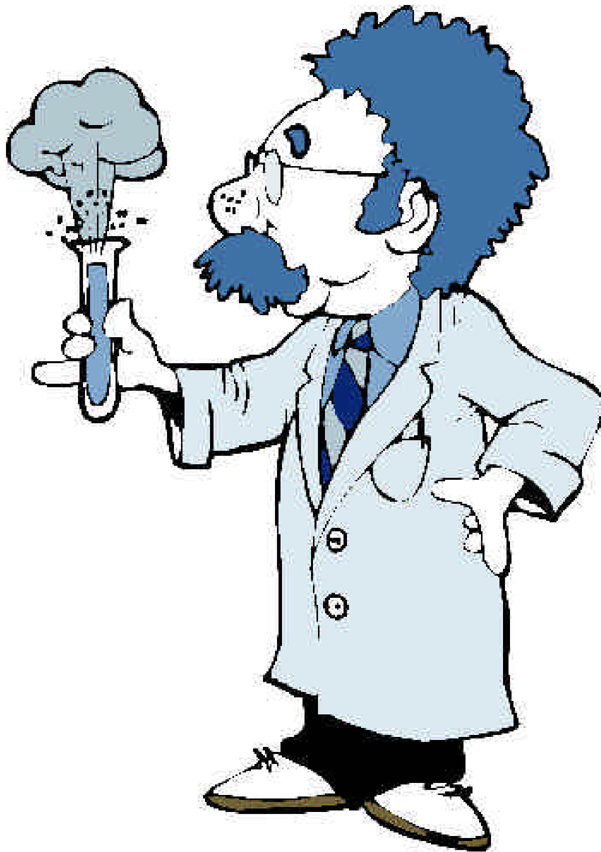
Financial Institutions Can Patent What They Do Best

From Lab Coats to Bankers' Suits

By Mark Bergner

At one time, patents were considered to be in the exclusive domain of rocket scientist inventors, whether they were working alone in their garage tinkering with the next successor to the personal computer or employed by a mega-technology giant like NASA. The image of the inventor as a techie carrying a pocket protector full of pencils surrounded by sketches on napkins and half-finished models strewn about the work area is still the image likely to come to mind when one mentions the word "patent" to a lay person.

That image, however, may not be accurate for a new breed of inventors and the patents that they are getting for business methods – especially with respect to financial institutions. In fact, it was the financial industry that helped evolve this type of intellectual property protection.



Now the Way Financial Institutions Do Business Can Be a Protectable and Valuable Asset

Prior to 1998, it was generally understood that patents were required to be related to science and technology, and business methods were considered *per se* not patentable. However, the Federal Circuit Court of Appeals ruled in its landmark 1998 *State Street Bank v. Signature Financial Group*, a business method involving a data processing system for a hub and spoke financial services configuration could be patented. Since that time, the United States Patent & Trademark Office has seen explosive growth in the business methods field.

What a Business Method Patent Does, and Why It Is Valuable

A business method patent permits its owner to exclude others from practicing method steps for a particular business function, such as developing a new and innovative type of financial service process or financial reporting system. In essence, it is a government sanctioned monopoly for a limited period of time (currently twenty years from the date a patent application is filed). The ability to exclude competition in the marketplace for innovative procedures can have a significant impact on the bottom line for a financial institution because competitors may be forced to engage in costly design-arounds or operate less efficiently or less competitively. Additionally, a patent or patent portfolio covering key technologies can often be successfully licensed to other financial institutions for substantial dollar amounts. It might also be a valuable asset in terms of a financial institution's mergers, acquisitions, or dispositions strategy. Finally, a well-developed patent portfolio can often be used defensively in the face of a patent infringement threat by a competitor (such threats are likely to become more common in the years to come) permitting cross-licensing opportunities that can benefit both financial institutions.

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enough, and when information is sufficiently “confidential,” to support a non-compete agreement, but that case law is too voluminous to address here. If you have questions about these issues, you should discuss them with a lawyer who is knowledgeable in this area.)

Q: What type of non-compete restrictions are considered reasonable by the courts?
A: Once a court has determined that the employer has a legitimate protectable interest that would support the enforcement of a non-compete agreement, it then will evaluate the reasonableness of the restrictions contained in that agreement. Generally speaking, an agreement should be no more restrictive than necessary to protect the legitimate interest claimed by the employer. So, whether a particular provision is reasonable depends on the facts of each particular case: what is the interest sought to be protected, and what is the least restrictive prohibition that would protect that interest?

Q: Time limits: for how long can a non-compete restrict an employee and still be enforceable?
A: A court evaluating the time period contained in a non-compete would ask the question, “What is the shortest period of time that would protect the legitimate interest claimed by the employer?” If the legitimate interest is confidential information, the court is likely to ask how long it would take a competitor to develop the information independently, how long the information will remain “fresh,” *i.e.*, current and useful, and how long before the information goes “stale.” If the legitimate interest claimed by the employer is customer relationships, the court will ask how long it would take the employer to put a new employee in place and allow him to become familiar with those customers. Time limits of one year are generally considered to be defensible, depending on the circumstances. Time periods of two years are sometimes upheld, again depending on the circumstances. Time periods of three years and longer, while sometimes warranted, are generally considered to be on the outside edge of enforceability.

Q: Territory: what geographic scope is generally considered reasonable?
A: A court evaluating the geographic restriction in a non-compete would ask the question, “What is the most limited geographic restriction that would adequately protect the interest claimed by the employer?” Often, employers want to include a nationwide prohibition, which will be upheld only if the interest sought to be protected requires it. Thus, where the employer’s business is national in scope and where the departing employee had duties which also were national in scope, was privy to confidential information of a national nature, and/or had relationships with a national customer base, a court might well uphold a nationwide restriction. Otherwise, the territorial restriction should be limited to the area as to which the employee performed his duties, if possible. Caution: in cases where the interest sought to be protected is customer relationships, some courts are increasingly questioning the appropriateness of geographic restrictions and preferring a customer-based restriction.

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Zinski Speaks

Christopher J. Zinski, a partner in Schiff's Financial Institution Group, will be speaking at the following events in 2004 on corporate governance, enforcement actions and succession planning:

RSM McGladrey 2004 Bank Director's Conference
Scottsdale, Arizona,
March 4, 2004

America's Community Bankers Mutual Community Bank Conference
Washington, D.C., March 8, 2004

Independent Community Bankers Association of America
San Diego, California, March 15, 2004

Indiana Bankers Association, 2004 IBA Mega Conference
Indianapolis, Indiana, May 11, 2004

Illinois Bankers Association, Annual Conference
Las Vegas, Nevada, June 9, 2004

Baird, Kurtz & Dobson Financial Institutions Conference
St. Louis, Missouri, June 17, 2004

Financial Managers Society, Finance and Accounting Forum
Washington, D.C., June 21, 2004

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directors in litigation, should litigation or other claims materialize, where a plaintiff's lawyer tries to prove a breach of fiduciary duty or securities fraud claim. Shielding the survey results from a discovery action may be difficult.

In litigation, as a general matter, the courts take the view that any information that is material and germane to the subject of the claim should be made available and should be discoverable by the claimant, with the exception of privileged information. One way to shield the survey results from discovery is to assert attorney/client privilege. That is, if properly conducted it may be possible for a financial institution to argue to a judge that the survey results in the self-assessment process should not be disclosed to a plaintiff in a claim or admitted as evidence in court on the theory that the survey results are protected under attorney/client privilege. If the institution's lawyer prepares the survey, interviews the audit committee members and other individuals who are asked to participate in the survey, and compiles the survey results, the institution may have a legitimate argument later on that the survey results should be protected as attorney/client communication. In other words, the company's lawyer would be communicating with the audit committee about the self-evaluation process, including reporting to the committee the results of the lawyer's work in distilling the results of the survey.

The argument would be that the communication between the lawyer and the audit committee is legal in nature and strictly confidential. The lawyer's role would need to be carefully considered so as to effectively rebut an argument by the claimants' lawyer that the privilege does not apply because the lawyer is merely collecting data from the committee, thereby acting merely as a repository of the survey results solely for the purpose of trying to protect them from discovery.

What a Privilege

In addition to the attorney/client privilege, some states recognize a self-evaluation privilege, which, if available, would give a financial institution more protection from the risk of discovery of the audit committees' self-assessment report. Some courts have concluded that there is a public interest served by companies and their board of directors and committees in evaluating their performance. At the risk of chilling self-evaluation and subsequent remedial action, some courts protect the self-critical analysis from discovery. The courts that do recognize the privilege limit it to the subjective elements of the self-evaluation, such as opinions of the persons undertaking the self-evaluation; however, the underlying statistics are not protected.

Conclusion

Boards of directors and audit committees of all sizes should at least consider the merits of an annual audit committee self-assessment. Choosing the self-assessment course may pre-empt criticism from bank examiners concerning a weak audit committee function and satisfy shareholders that the audit committee is serious about improving through self-policing. Yet the discovery risk is quite real and an institution that performs a self-assessment should do so in such a way as to shield the survey results, to the maximum extent legally possible, from discovery. Taking steps to secure the attorney/client and self-assessment privileges will mitigate the liability risks of the self-examination process, a process intended to enhance the effectiveness of the audit committee. ■

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Q: My business is becoming global, and my employees don't really have a set geographic "territory." What if a geographic restriction makes no sense?

A: If an employer's business has no clear geographic borders, or if its employees' duties consist of customer interaction, that employer should consider a customer-based restriction, *i.e.*, restricting the employee with respect to particular customers as opposed to a particular geographic area. The most narrowly drafted customer-based restriction would prohibit the employee from doing business with those customers with whom he had contact and/or as to whom he had access to confidential information during his tenure. Anything broader (*e.g.*, prohibiting the employee from calling on all of the employer's customers) runs the risk of being rejected as overly broad.

Q: Many of my employees do not deal with customers. What if a customer-based restriction makes no sense?

A: A court may be reluctant to enforce an agreement that keeps an employee out of the field of his or her expertise altogether. Consequently, if a geographic limitation makes no sense and a customer-based restriction is not appropriate, an employer should consider other ways to "tailor" the non-compete. For example, some agreements describe a specific type of product or specific areas of technology in which the employee will be prohibited from working. Any such description or list should correlate to the legitimate interest that the employer is seeking to protect. For example, the listed products or technology should be products or technology that the employee worked with (or had confidential information about) while working for the employer.

Q: What can an employer do to increase the chances that its non-compete will be enforced?

A: Three things: (1) identify the "protectable interest" that underlies the non-compete or, in other words, identify what unfair advantage a departing employee would be able to use against the employer, (2) draft the non-compete to prohibit only those activities that would imperil that interest in line with the concepts discussed above, and (3) make sure that adequate "consideration" is given to the employee in exchange for his or her signing of the agreement.

Q: I understand the first two points, based on the answers given above, but what is "consideration" and how do I make sure I've given enough?

A: "Consideration" is the thing that the employer gives the employee in exchange for signing the agreement. In general, all contracts require consideration. In the non-compete context, the best and easiest way to satisfy the consideration requirement in most jurisdictions is to have the employee sign the agreement before starting work. That way, the "consideration" exchanged for the employee's signature on the agreement is the job itself. If the employee signs the agreement after starting work, a court is likely to find that the job itself was not the consideration given for signing the agreement. Some states (including Illinois) may recognize "continued employment" as sufficient consideration for the signing of a non-compete, but other states do not. It is important to know which state's law will apply to your agreement. ■

Audit Committees Engage Independent Legal Counsel

The Sarbanes-Oxley Act of 2002 provides that an audit committee shall have authority to engage independent legal counsel as it determines necessary to carry out its duties. The audit committee may find that separate, independent legal counsel helps give committee members comfort in understanding and discharging their enhanced duties, and helps reinforce the committee's independent perspective.

Schiff Hardin is Chicago's oldest large law firm and is well-prepared to represent audit committees of financial institutions and their holding companies as independent, special legal counsel. We can counsel the chair of an audit committee as to his or her special responsibilities in this new era of corporate governance and can assist in training other members of the audit committee as to their duties. We are available for audit committee meetings and serve as a sounding board for the serious determinations that an audit committee needs to make.

If your institution would like to receive written information about our services to audit committees or to discuss our capabilities in this area, please contact: Christopher J. Zinski, phone: 312.258.5548 or czinski@schiffhardin.com. ■

Losing Your Head-Count: Keeping a Private Affair from Becoming Public

By Andrew Christensen

Financial institution holding companies with fewer than 500 shareholders[1] know that they lead a charmed existence. Their peers with more shareholders must navigate a morass of SEC regulatory and reporting obligations as well as the stringent mandates of the Sarbanes-Oxley Act. Being privately-held has never looked so good. But fortunes can change overnight, literally, and the private affair can turn public. That is, if a company loses control of its shareholder headcount, public company status can be thrust upon an unsuspecting privately-held bank or savings institution. Thus, officers of community bank holding companies should keep a watchful eye on the size and characteristics of their institution's shareholder base so as to avoid an unintended consequence.

. . . good monitoring and management of the size of a financial institution's shareholder base comes down to a reasonable amount of diligence and a proper perspective. . . it requires that the shareholder headcount become a priority issue in managing the organization

Much has been said and written about publicly-held financial institutions "going private." Less has been said about how privately-held banks can assure their continued private status.

Public Burdens

Crossing the 500 shareholder threshold and becoming an SEC reporting company involves significant increases in costs and liabilities. The preparation and presentation of SEC filings can consume significant internal resources of the institution from time to time throughout the reporting year, and actual costs and expenditures in connection with these reporting obligations can be significant as well. Meanwhile, the benefits to the reporting institution may not in all cases be meaningful, especially for reporting companies whose securities are not likely to be actively traded. In fact, because the SEC reporting process requires public disclosure of a fairly wide array of financial and even operational details about the reporting institution, including, for example, executive compensation and business plans, the reporting process can encumber the institution's ability to conduct business, by arming competitors and potential critics of the institution with such otherwise private information.

Moreover, becoming a reporting company carries with it many of the extensive requirements of the Sarbanes-Oxley Act and its regulatory aftermath, which for the most part do not apply to non-reporting financial institution holding companies (except, by mandate of the federal banking regulators, those with total assets of $500 million or more). The costs and potential liabilities associated with Sarbanes-Oxley have further inspired management of many community bank holding companies to use a "belt and suspenders" approach to keeping the institution's shareholder headcount under control.

Responsible oversight and management of the shareholder headcount can be viewed as consisting of three elements: the initial assessment, ongoing monitoring, and periodic maintenance.

Initial Assessment - How to Count Heads

The initial assessment consists of carefully evaluating the institution's shareholder base to determine the shareholder headcount with precision. Nearly all financial institution holding companies maintain, either themselves or through a transfer agent, fairly good records of the institution's shareholders. Management should have (or be able to readily obtain), at any given time, a precise list showing exactly how many shareholders of record the institution has. If the list is reliable and shows a total shareholder headcount of not much more than 400, then

[1] In some cases, a 300 shareholder threshold applies. This is generally only the case where the issuer previously conducted a registered offering of its securities. Consult your securities law counsel if you are uncertain. For purposes of simplicity, this article focuses on the 500 shareholder threshold, although the concepts discussed herein generally apply equally to either threshold.

management can consider the institution to be on reasonably comfortable footing vis-à-vis the reporting company threshold. On the other hand, if the headcount is very much in excess of 400, the ongoing monitoring and periodic maintenance elements described below are of even greater importance.

When management of some financial institution holding companies really begin to examine their shareholder list, they often find that questions arise when trying to understand precisely how to count "shareholders of record". In truth, there can be some subtleties to the process. For example, if a partnership or trust holds some shares of the institution's stock, must the shareholder headcount include individual partners or beneficiaries of the trust? How is an ESOP treated or company shares held by the company's 401(k) plan? If a husband and wife, or a parent and child, hold shares jointly, are they counted as one or two shareholders? Management should consult the SEC's rules and guidance on this topic, or consult their securities law counsel, if there is doubt about how to treat a particular shareholding scenario. In fact, this initial assessment is valuable not only in giving the institution's management a reliable sense of how close the institution is to the reporting company threshold, but also in educating management about how to count the number of shareholders the right way on an ongoing basis. This exercise is critical preparation for the monitoring and maintenance phases.

The initial assessment should also include an evaluation of likely or potential fluctuations in the number of shareholders in the short-term and long-term. Management should have a clear sense of the potential for significant changes, some of which may be driven by the institution itself, such as grants of options or planned issuances of equity to raise capital, and others may be purely in the control of the existing shareholders. The age of the shareholder base matters, too. In theory at least, an institution's management could wake up one morning to discover that over the course of the last month, ten shareholders were overcome by the desire to give each of their ten grandchildren (apiece) a few token shares of Bright Future Bancorp, which, accordingly, now has 100 more shareholders than it did previously. In addition, constituencies other than the existing shareholder base, such as option holders or holders of convertible debt, may be able to influence the shareholder headcount at any given time. Benefit plans may also be relevant if stock or stock options are potential awards under such plans.

Ongoing Monitoring - Moving Close to the Line

In the monitoring phase, management's role is to keep track of developments that impact the shareholder headcount. The shareholder list must of course be promptly updated to reflect the occurrence of transactions that change the ownership of the institution's stock, and management should evaluate the overall impact of such transactions on the total number of shareholders in relation to the reporting company threshold. Similarly, as the landscape of plans or potential for changes emerges, such as if it were to become clear that the institution will need to raise more capital shortly, management should take stock of such changes and evaluate and plan for their impact on the size of the shareholder base. This will allow management to spot shareholder headcount problems in advance, and take steps to eliminate or limit the adverse consequences of new developments. For example, management might realize that a planned capital raising episode should be done without issuing new equity, such as through a trust preferred securities structure or a debt offering, or, if the capital must be raised through a sale of equity, that the offering should be limited to sales to pre-existing shareholders, rather than a battery of new investors, so as not to increase the shareholder headcount.

Periodic Maintenance - Establishing a Deliberate Protocol

Maintenance of the size of the shareholder base should be comprised of passive and active measures. Examples of passive measures may include provisions in shareholder agreements, the holding company's articles of incorporation or bylaws, and buy/sell agreements designed to prevent the transfer of the institution's securities to new holders without some form of consent requirement or other opportunity for intervention by the institution. Such measures can be critical in preventing sudden unexpected developments like the hypothetical gift giving described above. These measures can also double as valuable anti-takeover mechanisms.

Active maintenance measures are specific, more proactive steps that management may determine are necessary in order to avert an impending increase that might put the institution across the reporting company threshold. For example, management may determine that a reverse stock split is necessary, on terms that would have the effect of cashing out shareholders with fewer than a certain minimum number of shares. This would require a certain amount of available capital. If even more capital is available, management may prefer to undertake a self-tender offer to repurchase shares from the shareholder base, with an emphasis on cashing out shareholders in their entirety, not merely reducing a given shareholder's holdings. A simpler approach may involve establishing a share repurchase program whereby the company makes it known to shareholders that it stands ready, willing and able to repurchase shares when and if a shareholder needs a liquidity event, such as when an estate of a former shareholder wishes to dispose of stock.

Ultimately, good monitoring and management of the size of a financial institution's shareholder base comes down to a reasonable amount of diligence and a proper perspective. Most importantly, it requires that the shareholder headcount become a priority issue in managing the organization. To make it a priority requires know-how. ■

Financial Institutions Can Patent continued from page 4

How Do You Know If Your Business Method Is Patentable?

In order to obtain a patent, an invention must meet three primary criteria: it must be useful (a generally easy criteria to meet in the business world, but may require a technical effect), novel (new – not previously publicly used or described), and non-obvious (not just a mere variation or combination of known technology that could easily be created by anyone with some knowledge in the applicable field). There is no simple answer as to whether a particular business method is patentable. However, if you believe that you have an idea for a business method or have developed an innovative procedure that may give you an edge over your competitors, it may be worth the effort to explore the idea of patent protection with an attorney who practices and is properly credentialed in patent law. ■

ESOPs for Banks: Enhancing Control and Independence, Tax Savings and Morale

Co-Authored by Ed Spacapan and David Williams

ESOP is an acronym for "employee stock ownership plan." An ESOP is not a stock option plan. Rather, it is like a broad-based 401(k) or profit sharing plan, with one important difference. An ESOP's primary asset is the stock of your financial institution or financial institution holding company.

ESOPs are present among *Fortune 1000* companies and many private companies have them, too. Yet, ESOP's are often misunderstood and dismissed because of their perceived complexity. They should not be.

Financial institutions face control and independence issues, both of which can be effectively addressed by use of an ESOP. For example, the ESOP of a typical financial institution whose shares are publicly traded would own between 10 and 20 percent of the stock of the institution, and in the event of a significant corporate transaction requiring shareholders' approval, employees participating in the ESOP would vote the publicly-traded stock that the ESOP holds. Such a large stock ownership in presumably friendly hands — *i.e.*, the employees — may enhance the independence of the institution by giving the ESOP a degree of "blocking" power in a contest for control. Similar advantages may be available to institutions whose shares are privately held.

When a family or several large stockholders hold a large block of stock, a sale of the financial institution can cause these stockholders to incur large tax liabilities. An ESOP can provide solutions to this problem. If the stock of the institution is privately-held, shareholders can sell their stock to the ESOP, receive cash in return and reinvest the cash proceeds in marketable securities, all without incurring a current tax liability. Then, through creative but simple financing techniques, the selling shareholders can "monetize" such marketable securities without selling them. This tax deferral is available in a so-called "1042 transaction" where the ESOP ends up owning at least 30 percent of the institution after the stockholders sell their stock to the ESOP. For stockholders, taking advantage of these 1042 tax benefits can mean huge tax savings.

The control/independence and shareholder tax benefits of an ESOP are significant. But the tax benefits to the financial institution that are associated with the ESOP are equally attractive. The institution that sponsors a leveraged ESOP, that is an ESOP that borrows funds from a third-party lender to purchase stock of the institution, can generally deduct for federal and state income tax purposes the institution's contributions to the ESOP to fund the principal and interest on the ESOP's debt that it incurred to buy the financial institution's stock. Thus, the U.S. government through the tax system subsidizes a significant percentage of the cost of the ESOP. That subsidy benefits the institution, its stockholders and employees. Comparable tax benefits are even available to non-leveraged ESOPs.

The stock that a leveraged ESOP owns is typically allocated to participating employees' accounts in the ESOP over a long period of time, ten years for instance. Once the stock is allocated and after a vesting period is reached, the participating employees have a stake in the success of the financial institution because, as the institution's fortunes improve, so too does the participating employees' financial standing under the ESOP. Thus, ESOPs motivate the participating employees to think like owners and work for the success of the institution. ■

Northern's Former Chief Counsel Rejoins Schiff Hardin

In March, Peter L. Rossiter rejoined Schiff Hardin LLP after spending 11 years in high-level legal and executive positions at Northern Trust Corporation. In 1992, Rossiter left our firm to become Executive Vice President, General Counsel, Corporate Secretary and member of the Management Committee of Northern Trust Corporation. During a seven-year term as G.C., Rossiter led a 30+ lawyer legal department and also supervised the work of numerous outside law firms engaged by Northern, including Schiff Hardin. As a member of the Management Committee, he also participated in virtually all high-level policy and business decisions that helped to propel Northern to its status as one of the world's premiere private banking, personal and institutional trust and investment management institutions. In 2000, Rossiter became President of Corporate and Institutional Services - the institutional side of Northern's business, which accounts for about half of Northern's revenues and income. In 2003, with the pendency of the new Basel Capital Accord and the attendant requirements for allocating capital to operational risks, Rossiter was appointed Head of Corporate Risk Management, with responsibility for developing a corporate-wide regulatory compliant risk management and measurement systems.

During the time Peter was at Northern, total assets of Northern grew from $16.9 billion to $41.5 billion, and assets under administration grew from $412 billion to $2.2 trillion. However, always a lawyer at heart, Peter yearned to return to the practice of law, and Schiff Hardin was eager to welcome him back to our firm.

Peter enjoyed a distinguished career with our firm prior to joining Northern. He began with our firm in 1976 after serving for a year as clerk to the Honorable Warren Burger, Chief Justice of the United States. Previously, he had clerked for Judge Alvin B. Rubin in the U.S. District Court for the Eastern District of Louisiana, a position he had accepted following his graduation from Yale Law School in 1973.

From his early years as an associate, Peter focused his activities on our firm's burgeoning corporate and securities practice and participated in numerous acquisitions and securities matters for both public and privately owned clients. His work included acquisitions, financings, securities regulation and general corporate matters for such clients as Newell Rubbermaid, Illinois Consolidated Telephone Co., Northern Indiana Public Service, and Palmer Tube Mills Ltd.

In 1980, Peter was part of the acquisition team that Schiff Hardin assembled to represent Northern Trust in acquisitions following the adoption of new legislation in Illinois permitting bank holding companies to acquire additional banks. He worked on Northern's acquisition of O'Hare International Corp. in 1982, which was the first major bank acquisition under the new legislation. A number of other acquisitions followed in the Chicago area and Peter also assumed responsibility for all of Northern's securities offerings and securities regulatory and reporting matters.

Peter's outside activities include long involvement as a director and active supporter of CARPLS, the Coordinated Advice and Referral Program for Legal Services (Cook County's legal aid hotline). He is a past President and Director of the Lawyers Club of Chicago. He also served as an advisory director for the Chicago Volunteer Legal Services Foundation, has chaired the Northwestern Corporate Counsel Institute, and taught at the University of Chicago Law School. From 1989-1994, he served as Chancellor of the Episcopal Diocese of Chicago. He presently serves as a Director and Secretary of Inroads, Inc., a national minority-internship program, and is a member of the Executive Committee of the Yale Law School Alumni Association. Peter has participated in many banking industry programs and activities and will be active our firm's financial institutions practice as well as its general corporate and securities practice.

Rossiter lives in Glencoe, Illinois, with his wife Kay. They have two children, Elizabeth and John. ■

Who We Are

Schiff Hardin LLP was founded in 1864, and we are Chicago's oldest large law firm. In the past 140 years we have grown to more than 300 attorneys, with additional offices in Washington, D.C.; New York, New York; Atlanta, Georgia; Lake Forest, Illinois; and Dublin, Ireland. As a general practice firm with local, regional, national, and international clients, Schiff Hardin has significant experience in most areas of the law.

Throughout our firm's history, we have continued to serve the special needs of financial institutions of all sizes and charters. Our Financial Institutions Group attorneys work with international and domestic banking organizations that look to us for representation in routine matters and the not so routine. Whether it is negotiating a bank merger or branch acquisition or rolling out an e-commerce banking strategy, we think hard, we put client needs first, and we draw on our diverse experience to fashion solutions that help our clients meet their business goals. Our lawyers are experienced in many different disciplines besides financial institutions, such as securities and corporate, commercial litigation, lending, employee benefits, and labor law. We integrate these disciplines so that our financial institution clients experience seamless representation that serves all of their legal needs.

Our deep experience in the highly regulated banking industry and the diversity of our clients present a solid platform for us to solve the problems of any financial institution — bank, savings institution, or trust company. Depository institution holding companies, whether a bank, thrift, or financial holding company, have special legal needs, too; counseling these companies is central to our practice. ■

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We are Chicago's oldest large law firm with a strong tradition of professional service to savings institutions and commercial banks.

We offer our clients the benefit of a comprehensive law firm coupled with industry experience.

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