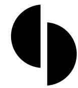
FINANCIAL INSTITUTIONS CLIENT SERVICE GROUP UPDATE



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Roadmap for a Successful Workout

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A lender once told me that a loan goes into workout as soon as it closes. Even if you are not competing for the dubious "rapid acceleration" award, every lender must be alert for the opportunity and necessity of seeking repayment in full or with the least cost or discount. Much like a long road trip, early and careful planning using the best map, experienced guides and contingency planning will yield the best experience. This brief article lays out an introduction to the mindset and roadmap to use and certain risks to avoid in workouts of troubled credits.

Starting Early. Getting the earliest possible start is essential in a workout. At that time, refinancing, restructuring or sale may be easier to accomplish and yield more because the borrower's distress is not as obvious and other parties may not have adopted set positions. The lender should be alert to the early warning signs of serious problems: management turmoil, inability to provide financial statements, loss of liquidity, stretched trade credit, increased COD or CIA terms, requests for additional credit to fund losses or requests for waivers of covenant defaults. Other early warnings include distress in or threats to the borrower's industry or customer base due to foreign competition, new technology, rising interest rates, rising prices of raw materials, energy or labor, slow down of sales and the borrower's inability to pass cost increases through to customers.

Finding Yourself on the Map. The lender's starting position will often dictate the speed and route to its destination. Assembling an experienced legal/business team will remove the bias, interests and frustration of the relationship officer in the crucial task of assessing the lender's documentation and collateral value, the depth of the borrower's managerial, financial and operational problems and the prospects and cost of recovery from them. Counsel's "re-closing" of the loan and reviewing of the correspondence file and the loan administration history will identify any documentation or potential waiver issues that must get cleaned up before strict compliance can be enforced or default remedies can be commenced without risk of lender liability or bankruptcy avoidance litigation. Counsel will advise whether obtaining a release is advisable or necessary as part of the workout arrangement. Reviewing the borrower's cash flow projections will reveal the depth of the borrower's problems as well as the operating and financial assumptions underlying its positions. A careful liquidation analysis (as a going concern and piecemeal, as appropriate) will set the benchmark for a workout if it includes appropriate discounts for soft assets (*e.g.*, licenses, goodwill, WIP or custom inventory, leasehold improvements, prepaid expenses) and projected outlays for costs of sale and attorneys' fees. The foregoing information provides the basis for the lender to plan and press its negotiating points with knowledge of the consequences of failing to make a deal.

Defining Achievable Destinations. The collateral position, managerial acumen and legal conditions (much like the age, make and

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model of car and gas level) will dictate the range of recovery objectives that can be attained. The lender must select two or three alternative objectives to which it can realistically drive the workout. These include a deferral or restructuring of the lender's debt, a refinancing, a recapitalization with additional equity or subordinate debt, a going concern sale or a shut down and liquidation.

Evaluating Alternative Routes. The lender's objectives can often be attained by several routes, which involve different potential levels of recovery, execution risk, costs, timing and speed. Engagement of a turnaround consultant to bolster management may be a precursor to refinancing or sale as a going concern. An investment banker may be needed to achieve a good sale. A deferral of interest or amortization or additional financing from the lender or others may create sufficient liquidity to get the borrower over a short term issue. However, a bankruptcy may be necessary to impose controls on the borrower, provide certainty (through the DIP financing process) of the lender's recovery of new advances, the outlay to fund outstanding payables, junior debt or legacy costs of retirees and the nullification of the "negative leverage" of junior creditors, unions and municipalities. Of particular concern is the recent emergence of the multi-billion "second lien" financing by traditional mezzanine lenders and hedge funds. Depending on the structure of the intercreditor agreement, it may be impossible to achieve certain workout alternatives without the imposition of bankruptcy rules and the pressure of the bankruptcy court.

Sorting and Motivating Fellow Travelers. Besides the lenders' own team, it must assess the position, objectives and wherewithal of the other players in the workout. These include management, shareholders, guarantors, leading trade creditors, licensors of key technology, lessors of key real estate and junior secured and unsecured creditors. Only by understanding these players' brightest hopes, worst fears, negative leverage, alternatives and staying power, can the lender most effectively isolate or motivate other's impact on the workout. The lender must separate those who "can't" contribute from those who "won't". It must smoke out the bluff from real threats that can derail the workout. Because other players are doing the same thing, the lender must bolster the credibility and staying power of its position and strategy as soon as possible. Thus, the lender must replace the unilateral concessions of the pre-workout period with bi-lateral tradeoffs. Rather than immediately threatening Armageddon (usually a suicide pact), the lender must establish a pattern of exacting small penalties for each default so that others will believe that the lender has the will to liquidate the borrower (without, in fact, pulling the plug). Since the reserves set for a credit and the "principle" of the lender cannot easily be discovered by others, such a course of action can be very effective over the course of the workout journey. Finally, the lender must obtain confirmation at the outset of negotiations and in all correspondence regarding defaults and solutions that it reserves its rights and remedies so that any workout deal only will be effective when the parties sign a written agreement.

Avoiding Fatal Accidents. While lender liability cases have waned in recent years, rapid turns by a lender still can be as fatal in a workout as on the highway. Most lenders assess their exposure in terms of the likely recovery of principal and interest (net of costs). However, ill-considered or poorly executed actions can create exposure that not only zeros out a lender's recovery, but can generate expensive litigation and create an affirmative liability to others. For example, lenders who become deeply involved in their borrower's affairs are subject to being treated as "insiders," a position that holds several key exposures. They are more likely to have their security interests and debts subordinated to the trade credit. They are exposed to a greater risk that their obligations, payments and collateral will be avoided as a preference or fraudulent transfer. Knowingly assisting management's self-dealing to the detriment of other creditors can lead to aiding and abetting liability and exposure to damages of other creditors. The law has evolved to give creditors standing to assert claims against insiders who breach duties of care and loyalty to the borrower in the "zone of insolvency" where workouts all occur. Some cases create liability for officers, directors and other persons in control (and lenders who aid and abet them) for prolonging the life of a borrower and thereby "deepening the insolvency" to the harm of creditors. Finally, statements about the borrower's financial condition to potential refinancing

lenders or other existing creditors can trigger liability for these other parties' losses. A steady hand and carefully chosen words (or silence) is essential.

Recording the Travelogue. No workout is complete without appropriate documentation. This can be a forbearance, loan modification or waiver agreement that conditions lender's forbearance on the absence of future defaults and either waives or suspends current defaults. It contains the borrower's admission to defaults and any necessary releases, loan modifications or waivers. Blocking notices under subordination agreements and agreements to obtain control over blocked accounts or bailments or the attornment of landlords may be advisable. Illinois, like many states, enacted a statute barring oral modification of loan documents, however, it is wise to recite that the only changes to the original loan documents appear in the workout documentation.

Keeping in Touch. This overview on workouts only scratches the surface of these points and will be supplemented by detailed discussions of certain topics in workouts and bankruptcy. In the meantime, please call with your questions if you are about to embark on a workout or get lost on the way! ■

Regulatory Developments — How do You Spell Relief?

By Peter L. Rossiter
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In the last few months, the federal bank regulatory agencies have taken steps in a few areas that promise to lighten — a little — the regulatory burdens bankers carry. Here are some of the more significant developments.

Small Bank Holding Companies. Since 1980, the Federal Reserve Board has allowed bank holding companies with less than $150 million in assets to carry debt levels above those permitted by the capital guidelines that otherwise would apply. The Fed's policy is designed to facilitate the transfer of ownership at small community banks.

In September, the Fed proposed to raise the size threshold for this special treatment to $500 million in assets. There are other proposed changes that will require analysis in specific situations — changes in the qualitative criteria to get this special treatment, and a proposal to treat trust preferred as debt for these purposes. The proposal, if adopted, will still help bring this policy up to date and give smaller bank holding companies additional flexibility. In the same release, the Fed also announced that it expects to propose a lightening of the financial reporting requirements for small bank holding companies.

Community Reinvestment Act. In July, three of the federal bank regulatory agencies released long-anticipated final revisions to their CRA rules, intended to reduce burdens on community banks while furthering the Act's purposes. The new Fed, OCC and FDIC rules raised the ceiling for treatment as a "small bank" from $250 million in assets to $1 billion in assets.

This will eliminate the formal CRA loan data collection and reporting requirements for banks in this "intermediate" size range. These banks will still be evaluated on lending activity in CRA exams, however, so it would be a good idea to maintain internal tracking of these loans. In addition, intermediate banks will be subject to a new community development test that looks at community development loans, investments and services in the context of the bank's community and the capacity of the bank. A satisfactory rating under both the lending and the community development text will be required for an overall rating of satisfactory.

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The new rules expand the definition of "community development" for all banks, in order to encourage activities in designated disaster areas and distressed or underserved rural areas. The rules also seek to clarify an area that has been somewhat murky — when discrimination or other illegal credit practices will affect a CRA rating.

The OTS had acted earlier, in a departure from the agencies' practice of acting in unison on CRA matters. In August 2004, the OTS raised its "small bank" ceiling to $1 billion, as the other agencies now have done. Then in February 2005, it introduced a note of flexibility for large retail banks — those with at least $1 billion in assets — by allowing them to request a different weighting for the three CRA tests that apply to them, which would otherwise be 50% for lending, 25% for services, and 25% for investments.

Preemption. The FDIC in October proposed rules that would allow state-chartered banks to take advantage of the type of preemption that national banks have long enjoyed. Host state laws would be pre-empted for out-of-state branches of state banks where the OCC or federal courts have decided that the law has been preempted for national banks. This proposal, if adopted, would help level the playing field for state-chartered banks.

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Basel I. The U.S. regulatory agencies have been struggling for some time with how to implement the New Basel Capital Accord — Basel II — developed by the Basel Committee on Banking Supervision and endorsed by the central bank governors and banking supervisors of the G10 countries. In September, they postponed again the effective date of the new capital regime in the U.S., which has not yet been spelled out in regulations. The U.S. regulators' goal is now to have final rules in place so that the new regime is fully effective January 1, 2009, rather than January 1, 2008 as previously planned.

The few large U.S. banks that must adopt Basel II or plan to elect to do so will no doubt welcome the additional time. The regulators' action, however, probably responded more to political concerns, differences among the agencies, and lingering doubts about the real effects of Basel II, than to concerns about the work involved for bankers.

Basel I-A. The great majority of U.S. banks will not adopt Basel II and they have for some time been worried that they would be at a competitive disadvantage if larger banks, under the new regime, were able to carry less capital overall or for particular lines of business. The regulators met these concerns with a promise to tune up the existing capital regime, Basel I. In October, they published an Advance Notice of Proposed Rulemaking, asking for comment on possible changes to the current capital rules that range from increasing the number of risk-weight categories to modifying the risk weights for various types of credits, including one-to-four family residential mortgages. The result would be a so-called "Basel I-A" regime.

It is too early to predict the results of this process, but the agencies made clear in their earlier Basel II release that they want the Basel II and Basel I-A rule-making processes to run in parallel.

Internal Controls. Another regulator has figured prominently in the life of publicly-held holding companies with a market capitalization in excess of $75 million during the past year: the Securities and Exchange Commission. These holding companies are the "accelerated filers" who were required to file their first management report on their internal control over financial reporting for the year ended December 31, 2004. Their auditors were also required to audit and report on internal control over financial reporting. These requirements resulted from the effective date for these companies of Section 404 of the Sarbanes-Oxley Act.

In September, after reviewing the very substantial cost and effort involved in complying with theses rules, the SEC gave "non-accelerated filers" — those with market capitalization under $75 million — an additional year's extension. The requirement for these companies now takes effect with the first fiscal year ending after July 15, 2007 —

December 31, 2007 for calendar year companies. This gives holding companies not yet subject to Section 404 some additional, welcome time to prepare. In addition, a number of groups are examining ways to ease the burden of Section 404 compliance and this extension also makes it possible that changes will be agreed upon before the new effective date.

The FDIC has in November amended the FDICIA rules that require larger banks to have independent audit committees and furnish an assessment of internal controls by management and the auditors. The amendment raises the asset threshold at which the internal control assessment requirement applies to banks and thrifts from $500 million to $1 billion, and allows institutions with between $500 million and $1 billion in assets to have an audit committee with a majority (as opposed to all) independent of management.

Regulation B. In the July 2005 edition of the *Schiff Hardin Financial Institutions Update*, we wrote about the SEC's proposed Regulation B, designed to implement parts of the Gramm-Leach-Bliley Act by replacing the blanket securities law exemption for banks acting as a broker with a narrower, activities based exemption. The proposed rule continues to be controversial, and the SEC in September again extended the effective date for Regulation B. The new effective date is September 30, 2006, and bankers are hoping for significant changes in the rule before that date arrives.

Legislation. There may also be some relief in prospect on the legislative front. A number of bills are working their way through Congress that may provide additional relief, on areas that range from deposit insurance to currency transaction report filing requirements. Of course, many bankers will remember that FDICIA started out as regulatory relief legislation — so it will be important to stay tuned to the legislative process over the coming months. ■

An Annual BOLI Check-up: A Prescription for a Healthy Bank

By Christopher J. Zinski
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Many financial institutions have purchased Bank Owned Life Insurance ("BOLI"), either recently or in the distant past, in order to finance employee benefit liabilities, such as amounts owed to executives under deferred compensation plans or supplemental executive retirement plans.

The bank regulators require financial institutions to conduct an annual review of their BOLI asset and to document that review. Unfortunately, some banks have a tendency to purchase BOLI and then either fail to vigorously review the asset's performance periodically or rely too heavily on outside consultants to perform the periodic performance assessment. Banks with this tendency act at their own peril because the bank regulators have a heightened awareness of BOLI risks and the examination process can encompass an evaluation of these risks.

To meet the regulatory compliance standards takes work but can be accomplished with focus and resources. The purpose of this article is to draw your attention to this important annual review requirement and give you some ideas regarding how the compliance review can actually lead to better financial performance for your bank's BOLI asset.

New Regulatory Guidance on December 7, 2004

The four federal banking agencies issued an interagency statement on December 7, 2004 providing general guidance for banks and savings institutions regarding supervisory expectations for the purchase and risk management for BOLI (the "Interagency Statement"). The Interagency Statement replaced old guidance in this area. Importantly, the Interagency

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Statement's guidance concerning the ongoing risk management of BOLI subsequent to its purchase applies to all holdings of life insurance regardless of when purchased. The Interagency Statement requires that an institution with BOLI on the books must have an "effective ongoing system of risk assessment, management, monitoring, and internal control processes, including appropriate internal audit and compliance frameworks."

The Board's Responsibility for Supervising BOLI Risk

BOLI is an asset of your financial institution. Like any asset, the Board of Directors has ultimate responsibility to ensure that the bank has proper internal controls, policies and procedures in place to monitor and manage the risks associated with BOLI. At least annually, management of your financial institution should review with the Board of Directors the performance of the institution's BOLI. That review should be documented in writing and prepared anticipating that the bank examiners may request to review the documentation during a regular exam. Of course, the documentation becomes even more important if the financial institution's investment in BOLI approaches or exceeds the 25 percent concentration of capital limit or if the financial performance of your institution's BOLI is below industry standards.

The Interagency Policy provides that the following areas need to be documented as part of management's and the Board's review of your institution's BOLI:

- a comprehensive assessment of liquidity risk, transaction/operational risk, tax and insurable interest implications, reputational risk, credit risk, interest rate risk, compliance/legal risk and price risk;
- identification of which employees are, or will be, insured;
- assessment of death benefit amounts relative to employee salaries;
- calculation of the percentage of insured persons still employed by the institution;
- evaluation of the material changes to BOLI risk management policies;
- assessment of the effects of policy changes;
- analysis of mortality performance and impact on income;
- evaluation of material findings from internal and external audits and independent risk management reviews;
- identification of the reason for, and tax implications of, any policy surrenders; and
- peer analysis of BOLI holdings.

The written analysis of your bank's BOLI risks and performance is essential but it is equally important that the Board, management and the appropriate committees of the Board properly process the analysis and make business decisions in response to this information.

Special Considerations

Audit Committee Issues. Audit Committees have more responsibility than ever before as a result of The Sarbanes-Oxley Act of 2002 and the new duties imposed on Audit Committees by the bank examiners. BOLI is an important financial instrument of a financial institution. This insurance product requires a high degree of legal compliance and due diligence. Indeed, if BOLI is not properly monitored the situation may rise to the level of an internal control deficiency or financial reporting issue, all of which is within the purview of a financial institution's Audit Committee. Therefore, Audit Committees should be attuned to the bank's annual review of its BOLI investment.

Merger and Acquisition Issues. Consolidation in the financial institutions industry continues and BOLI issues can arise when one bank acquires another bank. For instance, if the target bank has BOLI on the balance sheet, then the acquiring bank should perform some level of due diligence on that asset. Moreover, once the

Audit Committees Turn to Schiff Hardin for Self-Assessment Help

Schiff Hardin assists financial institution audit committees in designing and developing an annual self-assessment protocol.

- We provide assessment questionnaires, meeting agendas, and explanatory memoranda.
- Counseling on document retention and attorney client privilege is part of our program.
- We also tabulate the results from the evaluation and provide an evaluation report to the audit committee.
- We also can interview audit committee members to avoid written questionnaires.

If you chair your bank's audit committee and could benefit from some coaching on the advantages and disadvantages of audit committee self-evaluation or need a law firm with financial institution and corporate governance experience, we would be please to hear from you.

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merger is completed, the surviving bank's Board of Directors and Audit Committee must undertake an annual evaluation of the acquired BOLI as mentioned. If both the acquiring and target banks have BOLI, a special risk evaluation should be undertaken by the Board of Directors of the surviving bank before the merger closes to assess how the two BOLI assets interrelate with the employee benefit obligations of the combined institution.

Technical Know-how. BOLI raises technical tax and accounting issues that your bank's CFO should understand so that the CFO is able to explain the issues to the bank's Audit Committee and Board of Directors. Your bank's external auditors will review your BOLI asset as part of its annual audit review. Key management personnel, the Audit Committee, the Board of Directors and the external auditor should be sure each understands the tax and accounting treatment of your bank's BOLI product. If a CFO and senior management have lost touch with the characteristics of their bank's BOLI and have not kept pace with developments in the BOLI marketplace, it will be difficult for them to give a cogent explanation of the bank's BOLI investment when called upon to do so either by the external auditors, bank examiners or audit committee. It makes good business sense for management to stay attuned to its BOLI risks.

Monitoring in Relation to Balance Sheet Changes. If your bank is either growing rapidly, or shrinking, or if your bank is experiencing financial difficulties, it is important that senior management, the Audit Committee and the Board of Directors keep a watchful eye on the bank's BOLI asset. Rapid balance sheet growth may suggest that the bank should consider increasing the amount of BOLI it carries on the balance sheet to hedge employee benefit liabilities. A shrinking balance sheet may raise an issue with respect to the concentration of BOLI in relation to the bank's assets and, perhaps, capital. The concentration risk needs to be closely monitored. A bank experiencing financial difficulties will necessarily assess the risks of BOLI differently on an ongoing basis than a financially sound bank.

Policies and Procedures. The bank's Board of Directors is ultimately responsible for the bank's investment policies and procedures and the bank's compliance with these policies and procedures. Thus, periodically, the Board should review the bank's policies and procedures relative to BOLI and ensure that those policies and procedures comply with applicable law.

Good BOLI Compliance Means Good Financial Decision-making

While a strong compliance protocol is the best method for avoiding regulatory enforcement actions, if done properly it should also promote sound business decision-making. The Board, Audit Committee and senior management should not view an annual BOLI review simply as a compliance item that gets checked off and the report put in a desk drawer until the following year. Rather, management should use the annual compliance review as an opportunity to evaluate the financial performance of the bank's BOLI asset and whether it is adequately hedging the bank's employee benefit liabilities.

In some cases, it may make sense to surrender an existing BOLI asset and replace it with another, better performing product from a different carrier. In other circumstances, the review may lead to the conclusion that additional BOLI is warranted. At a minimum, senior management, the Board and the Audit Committee need to be able to talk intelligently about the nature of the BOLI product on the bank's books and its performance relative to the bank's expectations.

Finding Help

BOLI is an extremely specialized financial product. Moreover, the legal compliance issues (which include tax, banking regulation and ERISA) can be daunting for senior management and a Board of Directors. It may be advisable to retain independent consultants to assist management and the board in conducting an annual review of the bank's BOLI and prepare the necessary written documentation substantiating that a thorough review was indeed conducted under the terms of the Interagency Statement. Importantly, management and the Board need to be directly involved in the analysis even when a third-party consultant is hired to assist in the evaluation. ■

Top Ten Employment Laws Every Bank Executive Should Know

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Owners of banks and bank executive officers can do much to prevent the risk of employment claims and litigation by re-familiarizing themselves with the proscriptions of the major employment laws that govern today's workplace, and being mindful of key risk areas. Many banks do not have professional human resource directors or internal legal counsel who can proactively address employment law concerns and establish procedures to avoid costly severance disputes and discrimination claims. In a typical bank environment, therefore, it is very important that every top executive have training and sensitivity with respect to employment law issues. The following top ten list is a good first step toward awareness and claim prevention.

1 **Title VII of the Civil Rights Act of 1964 ("Title VII").** Title VII prohibits discrimination in the employment (including hiring) of individuals based on race, color, religion, sex, and national origin. Employment decisions must be free from considerations based on these factors. Sexual harassment claims also arise from Title VII; liability can arise when an employee is harassed or pressured into sexual behavior, or when the workplace is made hostile and offensive to an employee because of his or her gender.

2 **Americans with Disabilities Act ("ADA").** The ADA prohibits discrimination in the employment (including hiring) of individuals with disabilities who are otherwise qualified to perform the essential functions of the job with or without reasonable accommodation. Pre-employment inquiries that elicit information about disabilities may create risk in this area, as could certain kinds of pre-employment medical or psychological testing. The ADA also requires employers to make reasonable accommodation to otherwise qualified disabled individuals to assist them in performing their jobs.

3 **Age Discrimination in Employment Act ("ADEA").** The ADEA prohibits discrimination in the employment (including hiring) of individuals who are 40 or older because of their age. The Supreme Court recently expanded the kind of liability that can arise in this area to include "disparate impact" claims, so certain types of otherwise age-neutral policies or practices may now create risk in certain circumstances. (For example, a requirement of computer proficiency that is not job-related might give rise to claim if it has a negative effect on older workers.)

4 **Pregnancy Discrimination Act ("PDA").** The PDA, which is part of Title VII, prohibits discrimination in the employment (including hiring) of individuals based on pregnancy. This would also encompass an employee who receives adverse treatment because of her stated plan to become pregnant. Certain pre-employment inquiries about family and family plans may create risk in the area.

5 **Equal Pay Act ("EPA").** The EPA requires that women and men be paid equally for performing the same or similar job. This law looks to the substance of the job and not job title; labeling a position "administrative assistant" in the sales department would likely not justify lower compensation if the duties actually are that of a sales manager. It is generally accepted that an employer can take into account an applicant's or employee's prior salary history in determining compensation.

6

Fair Labor Standards Act ("FLSA"). The FLSA requires that employees be paid time and a half for all hours worked in excess of 40 per week. Employees in certain kinds of higher-level administrative, professional, executive or computer-related fields are exempt from the overtime requirement. The monetary penalties for misclassifying an employee as "exempt" when the duties are actually that of a non-exempt position can be severe, so a careful exempt/non-exempt analysis should be performed if there is any uncertainty. The FLSA also sets forth the prevailing minimum wage.

7

Family and Medical Leave Act ("FMLA"). The FMLA requires employers to grant up to 12 weeks of unpaid leave to qualified employees for the birth or adoption of a child, or in order to care for their own serious health condition or the serious health condition of a family member. Conditions that may not initially appear very serious such as the flu, headaches, fatigue, or stress, might qualify as a "serious health condition" if certain criteria are met, so before denying leave for such reasons a careful analysis should be performed.

8

Uniformed Services Employment and Reemployment Rights Act ("USERRA"). USERRA requires employers to grant leave to members of the uniformed service and reservists who are called to active duty and to reinstate them to their former positions on their return, including reinstatement of all benefits and promotions they would have received. These employees also have job protection for six months or one year after returning from active duty (depending on the length of active duty). Before terminating an employee who has returned from duty, a careful analysis should be performed.

9

State and Local Human Rights Laws. Many states and municipalities have their own human rights laws or ordinances that mirror Title VII, but they often have expanded categories of employees who are protected. Some examples are protection based on marital status, sexual orientation, welfare status, and, in certain California locations, "appearance." Managers should familiarize themselves with the law in their jurisdiction so they don't unintentionally run afoul of their state's prohibitions.

10

State Workers' Compensation Laws. Most states have workers' compensation laws that require employers to compensate employees who have suffered job-related injuries for medical costs, lost time from work, and pain and suffering. A corollary is that the employer cannot retaliate against a worker who has filed a workers' compensation claim. Risk can be created under the anti-retaliation provision of workers' compensation laws when an employee who has filed a workers' compensation claim is terminated or disciplined; a careful analysis should be performed in these circumstances.

The foregoing is a general overview of these laws' key provisions. Of course, each of these laws has additional and more detailed requirements, as well as guidance to help employers comply. Employers with questions about these or other employment laws, or who would like guidance on employment decisions, should consult with counsel. ■

IRS Issues Proposed Regulations for Deferred Compensation Arrangements

By Lauralyn G. Bengel
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Financial institutions often sponsor supplemental retirement or other deferred compensation plans for their officers and key employees. The American Job Creations Act, which was enacted last year as Section 409A of the Internal Revenue Code ("409A"), imposes significant restrictions on the operation of these plans beginning in 2005, and extends these restrictions to other arrangements not typically thought of as providing deferred compensation, such as severance agreements and stock-based plans.

In September, the Treasury Department issued proposed regulations under 409A. The proposed regulations supplement IRS Notice 2001-5 and cover many items, including transition rules, the definition of deferred compensation, and payment timing rules.

Transition Rules

- Although plans have had to operationally comply with 409A as of January 1, 2005, the plan documents do not need to be amended until December 31, 2006, as long as they are operated in good faith compliance with 409A and IRS Notice 2001-5 until that date. Reliance on the proposed regulations is also considered good faith compliance. The proposed rules are expected to be finalized as of January 1, 2007.

- The time and form of payment of a prior deferral election can be changed until December 31, 2006, provided that payment per a 2006 election is not made or accelerated into 2006. The December 31, 2005 deadline by which participants can terminate participation in a deferred compensation plan or cancel a deferral election has not been extended.

- A nonqualified plan can tie the election as to time and form of payment to a time and form of payment election under a qualified plan until December 31, 2006.

What Is Not and What Is Covered by 409A

409A regulates "deferred compensation," which includes compensation deferred in a year that an employee has a legally binding right to receive in a later year. Any such compensation is subject to 409A, unless specifically excluded. The new regulations clarify that the following are not considered deferred compensation, and, therefore, are not subject to 409A:

- Qualified Retirement Plans. Benefits under qualified retirement plans.

- Short-Term Deferrals. Any arrangement requiring all payments to be made within 2½ months after the end of the year in which a deferred amount is no longer subject to a substantial risk of forfeiture.

- Involuntary Severance Pay. Severance pay, if (i) it involves an involuntary termination of employment or retirement window program, (ii) the severance pay does not exceed the lesser of two times the employee's annual compensation for the year preceding the year of termination or two times the Code § 401(a)(17) limit (two times $210,000, or $420,000 for 2005), and (iii) all payments are made by the end of the second calendar year following the year in which the employee terminates employment.

- Stock Options and Stock Appreciation Rights (SARs). Stock options and SARs with an exercise price that does not exceed fair market value of the underlying stock at the date of grant.

The proposed regulations clarify that the following arrangements are subject to 409A:

- Voluntary and Excess Involuntary Severance. All severance arrangements involving voluntary terminations, and severance arrangements involving an involuntary or window period termination that exceed the payment limitations described above, are subject to 409A.

- Extensions or Modifications of Options/SARs. An extension of a stock option or SAR exercise period (past a limited period of time) is considered a further deferral feature, meaning that 409A applies from the initial grant date. Any other modification of a stock option or SAR generally is treated as a new grant which could subject the award to 409A.

Payment Timing Rules

409A provides that a distribution may not be made or begin earlier than (i) separation from service, (ii) disability, (iii) death, (iv) a specified date or fixed schedule designated at the time of the deferral, (v) a change in control, or (vi) the occurrence of an unforeseeable emergency. The proposed regulations provide detailed guidance for the timing of these payments, including:

- Payments During the Year. Payment can be made at any time during the calendar year in which the designated payment date occurs, or if later, within 2½ months following the designated payment date.

- Multiple Distribution Events. Payment can be made on the earlier or later of two permissible distribution events and there can be different forms of payments for different distribution events.

- Delay for Code § 162(m). Payment to a "covered employee" as defined in Code § 162(m) can be delayed to the first year in which the employer reasonably anticipants that Code § 162(m) will not apply or to the year in which the covered employee separates from service.

- Acceleration. Although a deferred compensation arrangement generally cannot permit the acceleration of payments, it is permissible to accelerate payments if there is an intervening permissible distribution event.

- Plan Termination. A distribution may be made as a result of a plan termination if (i) the employer is in bankruptcy or liquidation, (ii) a change in control occurs and the arrangement (and each similar arrangement) is terminated 30 days before or 12 months after the change in control, or (iii) the employer terminates all arrangements of the same type, makes no payments for 12 months, makes all payments within 24 months, and adopts no new arrangement of the same type for five years.

- Payment to Key Employees. The proposed regulations provide no exception for the six-month delay in payments made by public companies to "key employees" following any termination of employment.

* * *

The proposed regulations are extensive and include optional provisions that employers maintaining nonqualified deferred compensation arrangements should consider as part of the plan amendment process. Please contact us to assist you with 409A planning and compliance. ■

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An Authoritative View of Benefits Trends Impacting Financial Institutions — Steven J. Cochlan Answers Key Benefits Questions

Steven J. Cochlan has been serving executives and directors of companies, large and small, in diversified industries since 1983. Regarded as a pioneer in the design, implementation, and financing of nonqualified executive benefit plans, Steve founded Bank Consulting Group, Inc., in 2000 and serves as its President and Chief Executive Officer (www.BankConsultingGroup.com). Schiff Hardin asked Steve to comment on leading benefits trends for readers of our Financial Institutions Newsletter.

Schiff Hardin: There seems to be "buzz" in the banking industry about deferred compensation plans ("DCPs"). What is causing this to be a priority issue for the banking industry?

Steve Cochlan: The answer is competition, cost effectiveness and technology. DCPs are no longer germane to just larger banks. Increased competition to attract and retain key employees and directors is creating a trickle down effect in the banking industry, so much so that DCPs are becoming a necessity.

Because of improved technology and more cost effective financing, DCPs are becoming more affordable for community banks. Also, proper plan structure is a key to cost effectiveness. In fact, when a voluntary deferral plan is properly structured, it can actually generate earnings to the sponsoring corporation.

Schiff Hardin: You have been in the executive benefits consulting industry for decades. What trends have you seen in the development of non-qualified executive benefit plans during this time?

Steve Cochlan: The plans are becoming more sophisticated and increasingly resemble 401(k) plans in that they provide participants a variety of investment choices. Companies, in general, are trending away from defined benefit programs and moving toward defined contribution/cash balance programs.

Additionally, plans are moving away from entitlement programs in favor of performance-based programs. Trends also are evolving from entirely company-paid programs to plans whereby the participant and the company share the costs.

Schiff Hardin: Why should a bank's board of directors consider adopting deferred compensation plans for its top executives?

Steve Cochlan: The primary motivator is to provide competitive benefits in order to recruit people. Plans can also be designed to retain people and improve company performance.

A secondary motivator is cost. With regard to voluntary employee-paid plans, the bank is merely acting as a conduit to assist participants in the creation of wealth on a pre-tax and tax deferred basis. Thus, there is minimal, if any, cost to the bank.

Schiff Hardin: How many banks in the U.S. have adopted deferred compensation plan arrangements for their executives?

Steve Cochlan: The majority of major U.S. banks have some type of deferred compensation arrangements, either company-paid, voluntary, or a combination thereof. Approximately 40% of the banks with assets less than $1 billion have some type of

non-qualified deferred comp arrangement.

Schiff Hardin: Can directors participate in a deferred compensation plan?

Steve Cochlan: Yes. In fact, many banks are actually implementing these plans in lieu of increasing fees. They need to increase director compensation in some fashion because of the heightened degree of responsibility for board members these days resulting from Sarbanes Oxley, heightened corporate governance, etc.

Schiff Hardin: How can a bank finance its deferred compensation plan liabilities?

Steve Cochlan: There are a number of ways. Technically, a bank can set up the plan strictly as an unfunded promise to pay. However, because of exposure to investment risk, depending on plan design, most banks set aside assets to finance DCP liabilities.

Additional financing alternatives include the use of investments such as CDs, treasuries, mutual funds, etc. Most often, however, a bank will use some kind of specially-designed insurance product for application with DCPs — bank-owned life insurance, commonly called “BOLI.”

Schiff Hardin: Haven’t there been some important legal developments recently affecting deferred compensation plans?

Steve Cochlan: Yes — 240 pages of legal developments — contained in the proposed requirements of Section 409A of the Internal Revenue Code — added by the Jobs Creation Act.

Schiff Hardin: Will these important changes in the law affect the benefits of deferred compensation plans?

Steve Cochlan: Every plan in America needs to be reviewed for compliance with the proposed new legislation. So this is an opportune time for sponsoring banks to update their plan for best practices. This includes reviewing goals and objectives and also ascertaining whether the benefits are adequate and are being delivered in the most cost-effective manner.

Schiff Hardin: If an executive has a deferred compensation plan, should he or she be concerned with the “security” of those benefits?

Steve Cochlan: It really depends upon the credit-worthiness of the company. There are ways to improve or mitigate any security issues through the proper plan design, proper wording of legal documents, and, perhaps, the implementation of a “Rabbi Trust.” However, nothing protects against insolvency.

Schiff Hardin: If a bank adopts a deferred compensation plan for its top executives, is it an expensive proposition?

Steve Cochlan: That really depends on plan design. The benefits can create whatever expense the bank thinks is appropriate. However, assuming a reasonable level of benefits and with proper administration and financing, plans can be implemented very cost effectively. ■

When Financial Institutions Need To Look Into Internal Control Procedures They Look To Schiff Hardin For Independent Counsel

Whistle-blowing employees, financial statement restatements, fraud or the discovery of significant deficiencies or material weaknesses in financial controls — financial institutions and their Audit Committees deal with these kinds of situations all the time. Often, the best way to get to the truth and contain the damage is to engage independent, outside counsel.

A thorough "internal investigation" by experienced counsel can give senior management and the Board the assurance they need that any problems have been understood and fixed. It can also reassure regulators and the bank's external auditor. In addition, where the issue arises a solid internal investigation can often persuade law enforcement officials not to prosecute the institution for any wrongdoing that is found. Using outside counsel, rather than other inside or outside professionals, makes it possible to protect the results of the investigation under the attorney-client privilege, so they are not available to potential plaintiffs to bring a civil suit.

Schiff Hardin brings to internal investigations its complete set of litigation, banking, and securities regulation skills. Our firm also calls upon particular key perspectives that come from strong practices in labor and employment, employee benefits, white collar crime, fiduciary activities, insurance, lending, real estate and a host of other areas. We also have lawyers who are CPAs and have audit and financial accounting experience from prior careers, as well as past experience serving in federal and state enforcement and regulatory agencies.

If you need help, call **Christopher J. Zinski** (312.258.5548), **Peter L. Rossiter** (312.258.5579) or **Jay Williams** (312.258.5629).

Who We Are

Schiff Hardin LLP was founded in 1864, and we are Chicago's oldest large law firm. In the past 141 years we have grown to more than 350 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 both routine and not so routine matters. 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, including bank, thrift, and financial holding companies, have special legal needs, too; counseling these companies is central to our practice. ■

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