MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Bank Watch

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Noncompete Agreements for Section 280G Compliance

Golden parachute payments have long been a controversial topic. These payments, typically occurring when a public company undergoes a change-in-control, can in some cases draw the ire of political activists and shareholder advisory groups. Golden parachute payments can also lead to significant tax consequences for both the company and the individual. Strategies to mitigate these tax risks include careful design of compensation agreements and consideration of noncompete agreements to reduce the likelihood of additional excise taxes.

When planning for and structuring an acquisition, companies and their advisors should be aware of potential tax consequences associated with the golden parachute rules of Sections 280G and 4999 of the Internal Revenue Code. A change-in-control (CIC) can trigger the application of IRC Section 280G, which applies specifically to executive compensation agreements. Proper tax planning can help companies comply with Section 280G and avoid significant tax penalties.

Golden parachute payments usually consist of items like cash severance payments, accelerated equity-based compensation, pension benefits, special bonuses, or other types of payments made in the nature of compensation. In a CIC, these payments are often made to the CEO and other named executive officers (NEOs) based on agreements negotiated and structured well before the transaction event. In a single-trigger structure, only a CIC is required to activate the award and trigger accelerated vesting on equity-based compensation. In this case, the executive's employment need not be terminated for a payment to be made. In a double-trigger structure, both a CIC and termination of the executive's employment are necessary to trigger a payout.

Adverse tax consequences may apply if the total amount of parachute payments to an individual exceeds three times (3x) that individual's "Base Amount." The Base Amount is generally calculated as the individual's average annual W-2 compensation over the preceding five years.

As shown in Figure 1 on page 2, if the (3x) threshold is met or crossed, the excess of the CIC Payments over the Base Amount is referred to as the Excess Parachute Payment. The individual is then liable for a 20% excise tax on the Excess Parachute Payment, and the employer loses the ability to deduct the Excess Parachute Payment for federal income tax purposes.

Several options exist to help mitigate the impact of the Section 280G penalties. One option is to design (or revise) executive compensation agreements to include "best after-tax" provisions, in which the CIC payments are reduced to just below the threshold only if the executive is better off on an after-tax basis. Another strategy that can lessen or mitigate the impact of golden parachute taxes is to consider the value of noncompete provisions that relate to services rendered *after* a CIC. If the amount paid to an executive for abiding by certain noncompete covenants is determined to be reasonable, then the amount paid in exchange for these services can reduce the total parachute payment.

According to Section 1.280G-1 of the Code, the parachute payment "does not include any payment (or portion thereof) which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control." Further, the Code goes on to state that "the performance of services includes holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement)."

Figure 2 on page 3 illustrates the impact of a noncompete agreement exemption on the calculation of Section 280G excise taxes.

How can the value of a noncompete agreement be reasonably and defensibly calculated? Revenue Ruling 77-403 states the following:

Figure 1

Illustration of Section 280G Penalties	Penalty NOT Triggered	Penalty Triggered	
Base Amount (CEO's 5-yr Avg. Comp.)	$500,000	$500,000	**A**
Threshold (3x Base Amount)	1,500,000	1,500,000	
Hypothetical Change-in-Control Payments	1,499,999	1,500,000	**B**
Are CIC Payments ≥ Threshold?	No	Yes	
Excess Parachute Payment (CIC Payment - Base)	None	1,000,000	**C = B - A**
Excise Tax Penalty to CEO (20% Excess)	0	200,000	**C x 20%**
Lost Corporate Tax Deduction (25% Excess)	0	250,000	**C x 25%**
Total Additional Costs Due to Penalties		$450,000	

What We're Reading

Two recently announced acquisitions, **Horizon Bancorp (Michigan City, IN) – Salin Bancshares** and **Amarillo National Bank (Amarillo, TX) – Lubbock National Bank**, highlight banks' concerns with cost of funds and the competition for core deposits and cheaper funding sources.
(subscription required)

John Maxfield at *Bank Director* **reviews two traditional strategies for approaching acquisitions**, waiting for a downturn in the credit cycle and purchasing healthy banks in good times to take advantage of accelerating growth, as M&A still remains the most effective avenue for entering a new geographic market.

The ***St. Louis Fed on the Economy* blog** discusses the relationship between the rising federal funds rate and U.S. government borrowing costs.

> *"In determining whether the covenant [not to compete] has any demonstrable value, the facts and circumstances in the particular case must be considered. The relevant factors include: (1) whether in the absence of the covenant the covenantor would desire to compete with the covenantee; (2) the ability of the covenantor to compete effectively with the covenantee in the activity in question; and (3) the feasibility, in view of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant."*

Figure 2

Allocation of Value to Noncompete Agreement in CIC Payment Structure	Base Case	Exemption for Noncompete	
Base Amount (CEO's 5-yr Avg. Comp.)	$500,000	$500,000	**A**
Threshold (3x Base Amount)	1,500,000	1,500,000	
Hypothetical Change-in-Control Payments	1,500,000	1,500,000	
- Exemption for Noncompete payments	0	(250,000)	
Adjusted Total CIC Payments	1,500,000	1,250,000	**B**
Are CIC Payments ≥ Threshold?	Yes	No	
Excess Payment (CIC Payment - Base)	1,000,000	None	**C = B - A**
Excise Tax Penalty to CEO (20% Excess)	200,000	0	**C x 20%**
Lost Corporate Tax Deduction (25% Excess)	250,000	0	**C x 25%**
Total Additional Costs Due to Penalties	$450,000	$0	

Some of the factors to be considered when evaluating the "economic reality" of a noncompete agreement have been enumerated in various Tax Court cases, as detailed in Figure 3 on page 4.

A common method to value noncompete agreements is the "with or without" method. Fundamentally, a noncompete agreement is only as valuable as the stream of cash flows the firm projects "with" an agreement compared to "without" one. The difference between the two projections effectively represents the "cost" of competition, or stated differently, the value of the cash flows protected by the noncompete agreement. Cash

Figure 3

Beaver Bolt v. Commissioner
The Seller's (covenanter's) ability to compete
Seller's intent to compete
Seller's economic resources
The potential damage to the buyer posed by the seller's competition
Seller's business expertise in the industry
Seller's contacts and relationships with customers, suppliers, and other business contacts
Buyer's interest in eliminating competition
Duration and geographic scope of the covenant
Seller's intent to reside in the same geographic area

Thompson v. Commissioner
The age and health of the covenanter
The enforceability of the covenant under state law
Whether any payments for the covenant are pro rata to the grantor's stock ownership in the company being sold
Whether any payments under the covenant cease upon breach of the covenant or upon death of the grantor
The existence of active negotiations over the terms and value of the covenant

Beaver Bolt Inc. v. Commissioner (TCM 1995-549)
Thompson v. Commissioner (TCM 1997-287)

flow models can be used to assess the impact of competition on the firm based on the desire, ability, and feasibility of the executive to compete. Valuation professionals consider factors such as revenue reductions, increases in expenses, and the impact of employee solicitation and recruitment.

To illustrate how the three factors of Revenue Ruling 77-403 can be evaluated in light of the specific terms of a noncompete agreement for a bank employee, we put together Figure 4 on page 5.

Mercer Capital provides independent valuation opinions to assist companies with IRC Section 280G compliance. Our opinions are well-reasoned and well-documented regarding the factors influencing the value of non-compete agreements.

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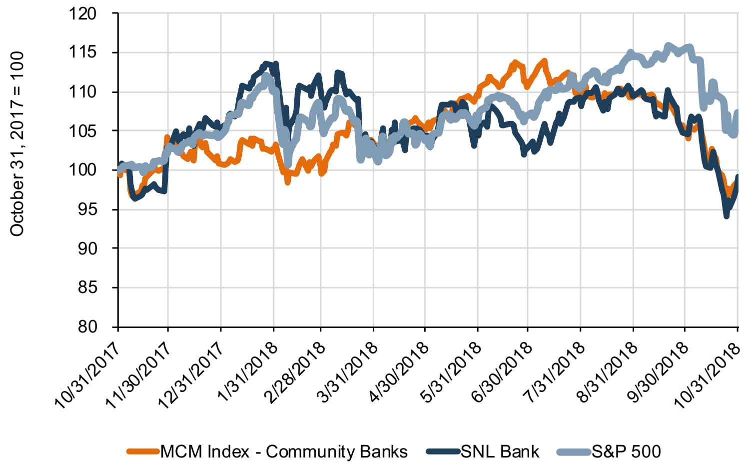
Figure 4

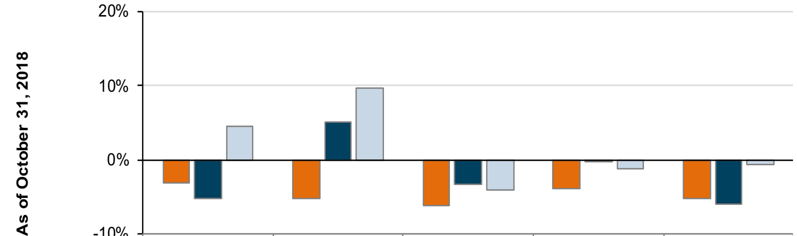
Impact on Cash Flow	• Individual's Impact on Loan & Deposit Volume and Loan & Deposit Growth • Ability to Attract Customers and/or Employees Away from Bank • Ability to Frustrate Implementation of Strategic Plan • Ability to Disrupt Sources of Noninterest Income	• Inefficiencies Associated with Replacing Knowledge Held by Employees in Critical Internal Roles, Such as IT • Duration of the Agreement • Geographic Area Covered By Agreement
Ability to Compete	• Experience in Banking Industry • Tenure at the Bank • Connections With Local Community • Role of Individual in Strategic Plans of Bank • Individual's Relationship with Customers • Individual's Relationship with Other Employees	• Past Recruitment Strategy • Depth of Management Team Without Individual • Knowledge of Non-public Information, Such as Product Pricing, Customer Profitability, or Compensation Data
Willingness to Compete	• Young & Aspiring or Ready to Retire • Known Health Limitations • Experience and Knowledge in Other Industries	• Transferability of Skills & Experience • Financial Need to Compete / Outside Sources of Wealth • Intent to Remain in Banking Industry

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



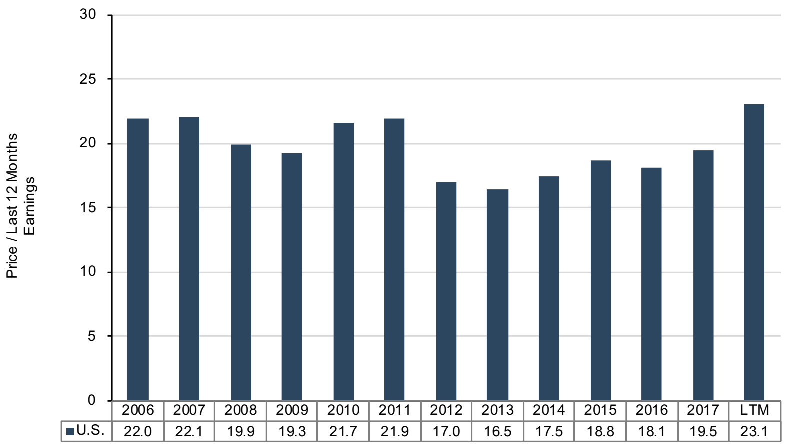
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-3.17%	-5.19%	-6.14%	-3.76%	-5.23%
Year-to-Date	-5.20%	5.08%	-3.23%	-0.13%	-5.91%
Last 12 Months	4.46%	9.72%	-3.98%	-1.10%	-0.70%

Median Valuation Multiples

	Median Total Return as of October 31, 2018			Median Valuation Multiples as of October 31, 2018					
Indices	Month-to-Date	Year-to-Date	Last 12 Months	Price/ LTM EPS	Price / 2018 (E) EPS	Price / 2019 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	-7.2%	-5.3%	-5.3%	19.3x	13.6x	12.7x	128%	147%	2.0%
Midwest Index	-6.5%	-3.5%	-2.6%	16.3x	12.7x	11.7x	143%	163%	2.4%
Northeast Index	-5.4%	-1.1%	-1.1%	16.8x	13.2x	12.0x	135%	155%	2.3%
Southeast Index	-7.1%	-4.3%	-1.3%	20.1x	14.6x	11.9x	136%	148%	1.5%
West Index	-3.8%	2.9%	4.7%	16.3x	13.3x	13.2x	135%	161%	1.7%
Community Bank Index	-6.1%	-2.5%	-1.7%	16.9x	13.2x	12.0x	136%	153%	2.0%
SNL Bank Index	**-5.2%**	**-5.6%**	**-0.8%**						

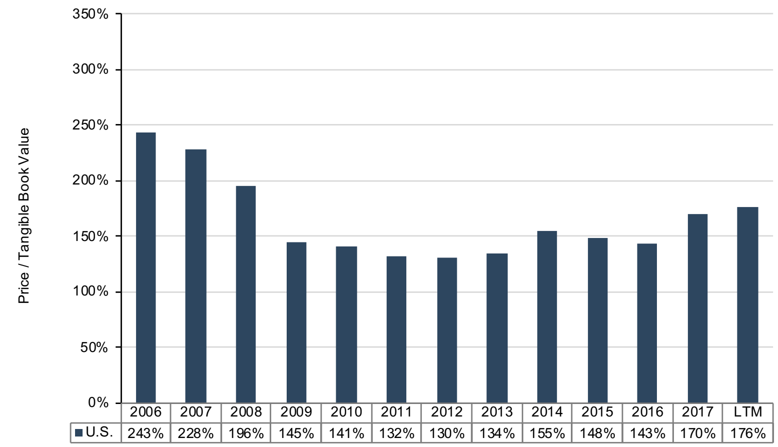
Median Price/Earnings Multiples

Target Banks' Assets <$5B and LTM ROE >5%



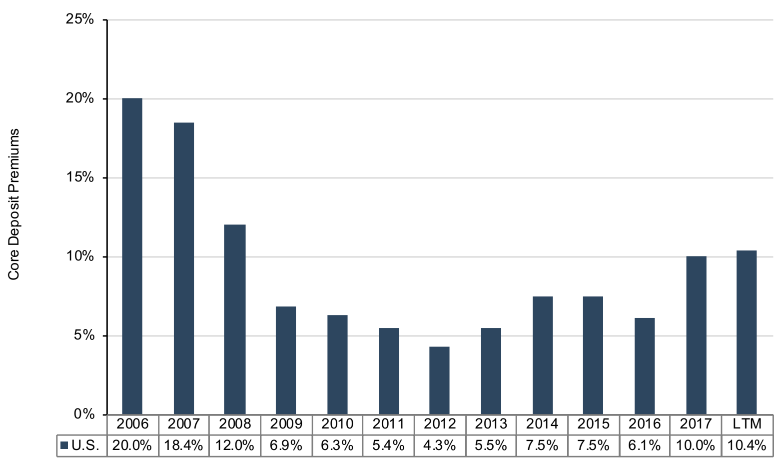
Median Price/Tangible Book Value Multiples

Target Banks' Assets <$5B and LTM ROE >5%



Median Core Deposit Multiples

Target Banks' Assets <$5B and LTM ROE >5%



Median Valuation Multiples for M&A Deals

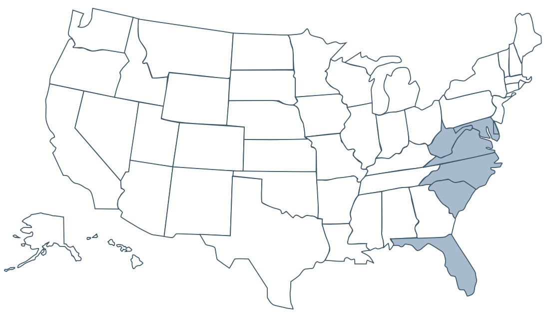
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended October 2018

Regions	Price / LTM Earnings	Price/ Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value ($M)	Target's Median Assets ($000)	Target's Median LTM ROAE
Atlantic Coast	24.8x	180%	11.2%	12	89.2	551,612	7.4%
Midwest	20.8x	169%	9.1%	84	53.4	144,290	9.7%
Northeast	25.6x	188%	11.2%	10	55.5	356,565	6.3%
Southeast	22.8x	173%	10.9%	30	41.8	218,701	9.1%
West	24.2x	194%	12.0%	26	89.3	344,738	8.0%
National Community Banks	**23.1x**	**176%**	**10.4%**	**162**	**57.6**	**228,022**	**8.9%**

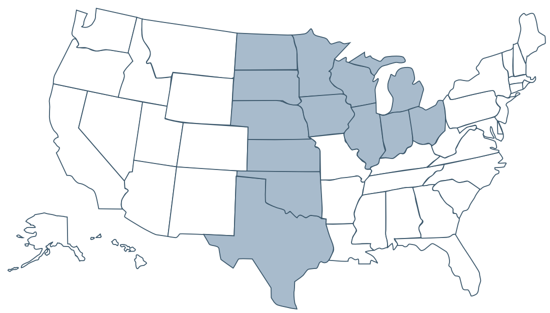
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

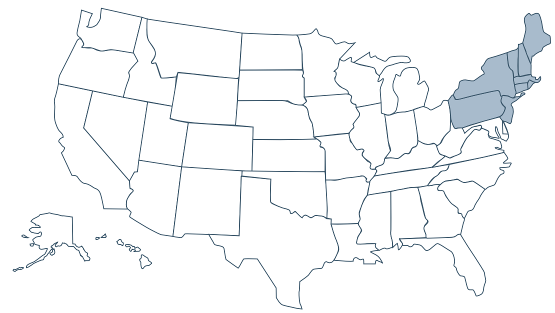
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



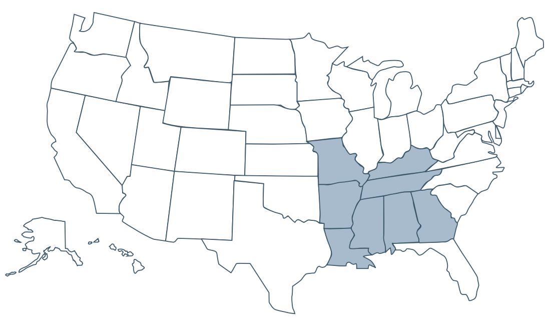
Atlantic Coast



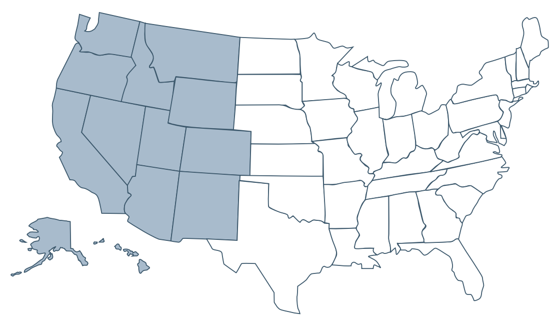
Midwest



Northeast



Southeast



West

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Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transaction advisory services, and other strategic decisions.

Mercer Capital pairs analytical rigor with industry knowledge to deliver unique insight into issues facing banks. These insights underpin the valuation analyses that are at the heart of Mercer Capital's services to depository institutions.

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- Financial reporting for banks
- Goodwill impairment
- Litigation support
- Stress Testing
- Loan portfolio valuation
- Tax compliance
- Transaction advisory
- Strategic planning

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For more information about Mercer Capital, visit **www.mercercapital.com**.

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