

Why is Bank of Montreal Making “Golden Parachute” Payments to Failed Executives at M&I Corporation?

Key takeaways:

- Bank of Montreal (TSX: BMO) has promised M&I Corp. (M&I) Chairman and CEO Mark Furlong over \$18 million in severance payments.
- This amount substantially exceeds the \$5.3 million M&I estimated Mr. Furlong was entitled to the last time it provided a calculation for shareholders.
- Because M&I has not paid back its \$1.7 billion in TARP support, it is prohibited from making severance payments to executives.
- BMO has promised Mr. Furlong an additional \$6 million retention bonus.
- At least 15 top executives at M&I have been promised severance payments totaling \$65 million.
- BMO has further agreed to pay any tax liabilities generated by these payments to Furlong or other top executives.
- BMO has promised these benefits regardless of whether the recipients' positions are terminated as a result of the merger, and has agreed to other unusual and arcane provisions.
- These payments are being made to executives whose bank underperformed peer regional U.S. banks by more than 13% over the past year, and by nearly 40% over the past three years.

“Golden Parachutes” Prohibited By Law

Any institution receiving money under the US governments Troubled Asset Relief Program (TARP, or bank bailout) was required to impose a defined set of executive compensation limits and to obtain signed agreements/waivers from those executives that they agreed to those limits. These were widely seen to be reasonable restrictions on using public money to support distressed financial institutions.

These executive pay limits included prohibitions on the payment of golden parachutes, defined as any payment for departure from a TARP recipient for any reason, other than a payment for services performed or benefits accrued, a payment from a qualified retirement plan, a payment due to an employee's death or disability, or a severance payment required by state statute or foreign law.

M&I's last proxy statement, filed on 3/12/10 explicitly notes such prohibitions, stating that, “As a result [of the TARP statute], no such payments would have been made under any circumstance if any current named executive officer had terminated employment with the Company on December 31, 2009.”

In addition, TARP recipients are prohibited from providing tax gross-ups or other reimbursements for the payment of taxes to any of the Senior Executive Officers or the next twenty most highly compensated employees relating to severance payments, perquisites, or any other form of compensation. As described more fully below, BMO has agreed to pay gross-ups for many executives.

The agreements for the top executives include a modified single-trigger agreement which gives executives undue leverage in any future negotiation and allows for the “self-launch” of the parachute.

While the employment contract provides some very specific language around what would enable an executive to leave for good reason, the agreement for several executives contains a significant escape valve that states: “a termination by the Executive for any reason or for no reason during the sixty (60) day period commencing on the date six (6) months after the Effective Date shall be deemed to be a termination by the Executive for Good Reason for all purposes of this Agreement.” This provision, known as a “modified single-trigger” provides potential windfalls at the executive’s election, rather than requiring a triggering event (such as an actual termination) that is determined by the board or management of the new company. In addition, the modified single trigger is problematic for the acquiring company because if they wish to retain executives covered under these provisions, they have no choice but to negotiate a new contract from a position of weakness. In cases where executives have the option to leave for “any reason or no reason” with such generous benefits, the acquirer is often forced to offer significant retention bonuses. Until a new contract is negotiated the executive may use such a provision as additional leverage for a range of favorable treatments.

It appears that such language may have enabled Mr. Furlong to negotiate a better deal than he would have otherwise been entitled to. In the proxy statement filed 3/13/09, the company estimates had a change in control and qualifying termination taken place on 12/31/08 “the maximum value of the payments and benefits payable” to Mr. Furlong would have been \$5,273,475. As noted above, the proxy statement issued in March 2010 does not include any estimates due to TARP restrictions on such payments.

Top executives will receive golden parachutes regardless of whether they are terminated as a result of the transaction.

The purported goal of golden parachutes is to insulate executives from concern that their company may be a takeover target, and to allow them to better evaluate a transaction from a shareholder-centric position. As such, change-in-control provisions guarantee severance payments if an executive loses his or her job due to redundancies created by a merger. BOM has already agreed, however, that each of the M&I’s Named Executive Officers (NEOs) will eventually receive payment regardless of when and why they leave the company. As described above, Mr. Furlong’s benefit is of the “single-trigger” variety, which he will receive upon consummation of the deal. According to the prospectus cash severance “amounts for each of Messrs. Smith, Krei and O’Neill and two other M&I executive officers will be credited following the merger to an account for the

executive under the M&I 2005 Executive Deferred Compensation Plan.” The prospectus later notes, “These credited amounts will be non-forfeitable and payable from these accounts upon any termination of the applicable executive officer’s employment following the completion of the merger, whenever that might occur.” In other words, even if one of these executives retires a decade after the transaction they will still be entitled to a “change in control” severance (with estimated values ranging from \$4.1 to \$5.5 million.)

The Payments Are Excessive Even By US Standards

The severance paid Mr. Furlong and four other executives will be a cash payment of three times salary and *highest annual bonus*. (An additional 11 executives will be entitled to receive two times this amount.) The use of highest annual bonus in this calculation is both problematic and unclear. In general, most companies use either “average annual bonus” over a specified period of time or most recent bonus. The use of the average bonus can be justified since the IRS uses the average bonus over a five-year term when calculating what constitutes an excessive payment for excise tax purposes (see below). Since in many cases a takeover target is one with a suppressed stock price, the most recent bonus may reflect that performance, and be a reasonable standard. Any language basing severance on *the highest* of two options is inherently favorable to executives over the shareholders.

The prospectus filed by BMO appears to somewhat contradict the employment agreement definition of highest annual bonus, since it describes the highest annual bonus as, “(ii) the higher of the executive officer’s (1) bonus for the most recently completed fiscal year following the change of control or (2) average bonus for the last three completed fiscal years before the change of control date (the higher amount is referred to as the “bonus”).

In addition, the change of control agreement provides that the base salary component of this calculation will be *increased* to include items that may otherwise not be considered salary, for example, any retirement plan deferrals. Specifically, the contract also mentions “cafeteria plan elections, or other deferrals that would have increased Executive’s Annual Base salary if paid in cash to Executive when earned.”

The payments include arcane and outdated features that will significantly increase the payment, including reimbursing executives for personal tax payments triggered by the severance payment.

BMO has agreed to provide a “gross-up” to cover taxes owed by the executive should the IRS deem this payout an “excessive golden parachute,” which we think likely. The imposition of a 20% excise tax was established by Congress with the idea that such a steep additional tax would discourage boards from paying large parachutes. Compensation consultants evaded the intent by creating deals where executives were reimbursed not simply for the excise tax itself, but any tax due on the original gross-up payment. This is the case in M&I’s contracts. When M&I last disclosed how it reached

the figures (proxy statement published 3/13/09), it calculated the gross-up using a 61.2% combined federal and state tax rate, including a 20% excise tax. While gross-ups were once fairly common, they are seen with increasing disfavor among shareholders, and over 300 companies have taken action in the past two years to eliminate them. In addition, we note that when companies offer such gross-ups the offer is generally to a very limited number of executives, typically less than five. BMO is offering this form of compensation to at least 16 executives.

The executives will also receive a separate lump-sum supplemental retirement payment equal to any additional retirement payments that would have been received had the executive remained under the M&I plan. The agreement stipulates that these figures will be determined using “the most favorable to the Executive actuarial assumptions and Company contribution history.” Such additional credit on retirement plans, particularly in a lump sum form, is an unusually generous feature. Many companies have eliminated additional retirement credits.

Finally, according to the prospectus BMO will also make “a payment equal to three times (in the case of Tier I Agreements [provided to most of the NEOs]) or two times (in the case of Tier II Agreements) the executive officer’s taxable employer-provided car-related expenses and club dues.” Many companies have eliminated such perquisites even for current executives. To pay executives a lump sum such as this is another example of the unusual nature of these agreements.

M&I Continues to Lag Regional U.S. Bank Peers

While essentially all U.S. banks and financial corporations have suffered significant losses in the wake of the housing bubble, financial crisis, and recession, M&I has consistently performed much worse than its rivals. Compared to the 7 U.S. regional banks with current market capitalization between \$3 billion and \$8 billion, M&I has been the worst performer in each the past five, three, and one year periods, underperforming the average of this group by 13% in the past year, and by nearly 40% since March 2008.

Bank	1 Year	3 Year	5 Year
M&I	-2.02%	-65.30%	-82.58%
Regions	2.07%	-63.56%	-79.25%
Zion	8.76%	-52.63%	-72.18%
Key	18.49%	-57.77%	-76.06%
Commerce	-0.50%	-1.27%	-11.40%
East West	28.42%	24.07%	-40.30%
BOK	11.04%	-2.60%	11.66%
Peer Average	11.38%	-25.62%	-44.59%
M&I Relative Performance	-13.40%	-39.67%	-37.99%

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