The Board's Role in Merger and Acquisition Transactions

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LUSE GORMAN

Who We Are

Luse Gorman is a Washington, D.C. based law firm that specializes in representing community banks and other financial institutions

We are a national leader in representing community banks in mergers and acquisitions, capital raising transactions, corporate governance, executive compensation, regulatory and enforcement and general corporate and securities law

We represent over 250 financial institutions nationwide. Most are community banks ranging from $100 million to $25 billion in assets

Some of Our Accomplishments

- No. 1 law firm in bank mergers and acquisitions in 2015 and through 2016 (ranked by number of deals)
- Top 10 law firm in bank mergers and acquisitions every year since 2001 (ranked by number of deals)
- No. 1 law firm nationally in community bank capital raising transactions since 2000

Topics Covered

- M&A Environment
- Board Responsibilities / Fiduciary Duties
- Types of M&A Solicitation Processes
- Process for Targets and Aquirors
- Due Diligence
- Merger Agreement Issues
- Constituent and Shareholder Approvals
- Regulatory Approvals
- M&A Litigation

M&A Environment

- Consolidation building momentum as volume of transactions is now on par with pre-Great Recession levels (approximately 4% annually during last 3 years)
- M&A activity expected to continue in community bank sector as regulatory/compliance burdens increase, profitability is squeezed and scale becomes more important
- For most community bank acquirors, critical issue is book valuation dilution (assuming that the transaction is earnings accretive) and the time period for recoupment ("earn-back")
- Aggregate deal value is lower as more M&A involves smaller sellers and buyers (under $5 billion) building greater scale
- Buyers are acutely aware of $10B and $50B regulatory thresholds and operating cost ramifications

Board Responsibilities / Fiduciary Duties

- Business and affairs of a corporation are managed under the direction of the corporation's Board of Directors
- Management, not the Board, is responsible for managing day to day operations of the company – remember NIFO
- Fundamental role of the Board is one of oversight, including with respect to M&A transactions
- Board's role and duties are theoretically no different in the context of an M&A transaction (with the exception of Revlon duties) BUT realistically there are higher stakes and more likelihood for lawsuits and scrutiny of Board action

Board Responsibilities / Fiduciary Duties

Fiduciary Duties of Loyalty and Due Care

- Duty of Loyalty - requires independent and disinterested directors acting in good faith on their belief as to what is in the best interests of the company and its stockholders – stock ownership and equity acceleration are not per se disqualifying interests

- Duty of Due Care - requires a board to make informed decisions, and is very much a question of process and the written record of decision making

Board Responsibilities / Fiduciary Duties

- *Revlon* Duty - Board's fiduciary duties have to be exercised to obtain best price "reasonably available"
  - Revlon duty applies when there is a "sale of control" – a cash or predominantly cash transaction
  - No single blueprint directors must follow to satisfy Revlon duties, board behavior has to be reasonable, not perfect
  - Board liability requires a knowing, intentional violation - bad faith

- Fiduciary Out - Most merger agreements, whether involving a "sale of control" or not, will include a "fiduciary-out" clause enabling target board to agree to higher offer from a third-party after merger agreement signing but prior to the meeting of stockholders

Board Responsibilities / Fiduciary Duties

Is there a Duty to Sell?

- Board "is under no obligation, in the abstract, to submit to an external summons to the auction block or otherwise transfer control of the corporation's assets"
- Board may determine in good faith that continuing independence is in the long-term best interests of company
- Board is not obligated to accept or pursue offers because they are at a premium over market price, and refusal is not evidence of a breach of fiduciary duty
- Except for "sale of control," Board has no duty to maximize shareholder value in short-term, even in context of takeovers
- Board has no duty to engage in discussions or to negotiate with an interested party; Business Judgment Rule applies to the "just say no" defense

Board Responsibilities / Fiduciary Duties

Understanding the Market / Staying Up to Date:

- Periodic presentations by financial advisors regarding M&A market, pricing analyses, recent transactions
- "Dry run" examples of mergers, including pro forma analyses, are recommended practice – enables management and Board of targets and acquirors to be informed and make "informed" decisions, creates better record
- Presentations should address possible merger candidates (acquirors and targets) and order by strategic importance

Board Responsibilities / Fiduciary Duties

Understanding Impact of Compensation Matters:

- Compensation and benefit arrangements are critical components of every M&A transaction
- Board decisions today have far reaching effects for future mergers, Board should be aware of such effects and costs of all plans and agreements
- Compensation issues involve tax, accounting, disclosure, ERISA, legal and document drafting issues (for buyers and sellers)

Board Responsibilities / Fiduciary Duties

Understanding Impact of Compensation Matters:

- Golden Parachute Rules (IRC §280G)
- Deferred Compensation Limitations (IRC § 409A)
- Employment and Change in Control agreements
- Tin parachute plan severance payments
- Defined benefit plan terminations and "freezes"
- "Troubled Condition" considerations

- Prior to commencing process, Target board should identify, interpret and quantify all compensation plans and arrangements that will be triggered in the transaction; acquirors expect a preliminary analysis on all such costs

Types of M&A Solicitation Processes

Most Bank M&A involves:

1. "Limited Shop" - most common
2. "Negotiated" or "One-on-One"- sometimes utilized in strategic, stock for stock combinations; standard in mutual to mutual transactions
3. "Full Auction/Shop" – rare; typically used with troubled target situations; sometimes forced by activist shareholder

Most mergers are acquisitions, but a "merger of equals" is usually characterized by an exchange of stock and the absence of an acquisition premium

Types of M&A Solicitation Processes

Limited Shop Solicitation:

- Seller selects limited group of prospects, typically considers: 1) ability to pay, 2) prior acquisition activity, 3) ability to execute, 4) prior expressed interest
- Seller/IB prepare "solicitation book" or Confidential Information Memorandum (CIM)
- 5 - 10+ prospects contacted by IB and, if interested, provided CIM after signing confidentiality agreement (CA/NDA)
  - CA typically includes "standstill" provisions – litigation concern

Types of M&A Solicitation Processes

Limited Shop Solicitation:

- Prospects given bidding instructions and 2-3 weeks to provide non-binding indication of interest
- 1-3 finalists picked, invited for more due diligence and to enhance/modify pricing, Seller conducts reverse due diligence
- Finalist picked, possible exclusivity agreement, due diligence continues while merger/definitive agreement negotiated
- Merger agreement signed, transaction announced

Types of M&A Solicitation Processes

Negotiated or One-on-One Solicitation:

- Process can vary but generally involves Seller and Buyer exclusively engaging in merger discussions, executing reciprocal CA, sometimes with exclusivity period (30-60 days)
  - ❖ Requires stock for stock merger consideration or predominantly stock for stock merger consideration
- Material terms typically agreed to through use of term sheets or non-binding letter before comprehensive due diligence
- Buyer and Seller will conduct due diligence on each other and begin finalizing deal terms and merger agreement
- Seller may "market check" deal or build terms in agreement to effectively allow a "topping" bid due to "Revlon Duties"
- If "market check" is used, then Seller will only sign merger agreement after contacting other prospects to confirm pricing

Types of M&A Solicitation Processes

Full Auction/Shop Solicitation:

- Process involves Seller essentially making a public announcement that it is for sale
  - May announce that company is seeking "strategic partners" or "strategic transaction opportunities"
- Generally not used as it may have negative effect on customer and employee relations and franchise value
- Generally only used as last resort or after failed process
- Negotiations will involve minimal "social issues" and severance payments
- Can be forced upon Seller by activist shareholder

M&A Process - Target

- Typically begins with Target Board considering strategic alternatives, Board determining to initiate process to solicit interest and engaging an investment banker:
  - Investment banker compiles "confidential information memorandum" (CIM)
  - Company counsel drafts confidentiality agreement (CA) to provide interested parties
  - Parties to be approached are identified by investment banker (and bank possibly)
  - Non-binding indications of interest requested by return date
  - One or more parties are invited to conduct due diligence and to present final offer
  - Stock trading black-out commences
  - CA typically includes "standstill" provisions (as to hostile actions, employees and customers)

M&A Process - Acquiror

- Unless CEOs are already "dancing," process for acquiror usually begins with request from investment banker for CA to permit review of Target's CIM
  - Specific board approval may not be necessary for execution of CA - Board should authorize CEO to participate in M&A market reviews and, from time to time, enter into CAs to assess possible transactions
  - Many potential acquirors will likely be solicited to execute the CA and many may be provided Target's CIM
  - There can be exclusive negotiations between parties, especially if stock is predominant portion of merger consideration
  - Initial bid is typically based only on CIM information with more diligence information being in later rounds and bids

M&A Process - Acquiror

- If there is interest in bidding, discussion with/report to Board (or executive or M&A Committee) to discuss due diligence, pricing and terms of non-binding "bid letter"
  - Investment banker will want formal engagement agreement at this point
  - Non-binding bid letter will cover all major deal points requested by Target, including preliminary pricing, treatment of employees, material contingencies
  - Bid "offer" will be subject to further due diligence (now typically via virtual data room, with possible on-site)
  - Extensive review of loan and investment portfolios, compliance records, and benefit plans
  - Due diligence more important than ever
  - Stock trading black-out triggered for acquiror

M&A Process - Acquiror

- If continued interest, proposed pricing and other deal points developed, summarized and presented to Board, along with results of further due diligence
  - Stock and/or cash; exchange ratio; fixed or floating; caps and/or collars; break-up fee
  - Social issues and costs discussed – board seats; management positions; contract payouts
  - Cost savings analyzed and quantified
  - Special diligence issues identified/quantified
  - Board authorizes final non-binding bid letter
  - Diligence continues until deal signed
  - If final bid letter accepted, may want exclusivity period (30-60 days), merger agreement drafting begins

Due Diligence

- Must be thorough before signing - typically very high standard to terminate (Material Adverse Effect - MAE) for errors in representations
- Diligence findings may: kill a deal, substantially affect pricing, or result in special merger agreement terms
- Buyer's "credit mark" on Seller loan portfolio usually biggest diligence/pricing issue, also benefit plan and contract termination costs (*e.g.*, data processing contract)
- Use of outside diligence experts - Buyer may want to use third party loan reviewer to complement loan staff review
- Seller third party/vendor contracts need review and termination fees and restrictions need to be quantified

Due Diligence

- Seller may need to get non-disclosure agreement from any third party that Buyer wants to contact (usually for contract termination payments; actuarial calculation for benefit plans)
- Seller will conduct due diligence on Buyer for stock deal (limited due diligence for all cash deal)
- Buyer and Seller each will create due diligence report for their Board

Merger Agreement Issues

- While further due diligence continues, merger agreement negotiation between attorneys and bankers begins:
  - Agreement provisions need to match final bid letter and results of due diligence
  - Merger agreement will be reviewed in detail with counsel and investment banker
  - Most agreements have "fiduciary out," enabling Target to accept superior deal from third party after execution, provided termination fee is paid
  - Agreement will limit operations of Target (and Acquiror) pending regulatory and shareholder approvals
  - Material Adverse Effect (MAE) termination provision
  - Investment bankers opine as to "fairness" of transaction
  - All other ancillary agreements should be settled before execution of merger agreement

Execution and Public Disclosure

- Merger Agreement presented to and approved by both companies' Board of Directors and executed, followed by press release and 8-K:
  - Press release typically issued following close of market or before opening of market
  - An investor presentation is often utilized and filed with the 8-K, and an investor conference may be arranged – depending on materiality of the transaction
  - Employee meetings may also be held shortly (or immediately) after press release

Constituent and Shareholder Approvals

- If Acquiror issues shares in the merger representing 20% or more of its outstanding shares, Acquiror shareholder approval required (Nasdaq, NYSE, state law requirement)
- Acquiror shareholder approval not otherwise required and not required for a cash transaction
- Target shareholder approval always required
- Mutuals may need member/depositor approval depending on type of transaction, charter and state law

Constituent and Shareholder Approvals

- If Acquiror shares are issued, a registration statement/prospectus will be filed with the SEC and will include pro forma financial statements and target financial statements
  - If Acquiror shareholder approval is required, there will also be an acquiror proxy statement
  - The history/background of the transaction will be disclosed, as well as the material terms of the merger agreement
  - Compensation payments to target management are subject to say on golden parachute vote
- Target shareholder approval requires a proxy statement, which may be a joint document with the acquiror's prospectus/registration statement

Regulatory Approvals

- Generally, only approval of regulator(s) of Buyer is required; Seller bank regulator is largely irrelevant
- In order to participate in the M&A market as a buyer, regulatory house MUST be in order
- Regulatory risk remains significant threat to participating in and completing M&A deals
- Pre-merger regulatory communication now more critical than ever
- Regulatory and shareholder approvals proceed on parallel tracks – can't close without both
- 4-7 month approval process – could be longer if protests or compliance issues develop

Regulatory Approvals

Key Regulatory Issues:

- Buyer MRAs or compliance issues
- "3" rating overall or in certain CAMELs components (management, compliance or asset quality)
- Pro forma capital of less than 8%/12% (leverage/total RBC)
- Below "Satisfactory" CRA rating
- Post-closing concentration issues, e.g., CRE to capital ratios
- BSA/AML compliance
- Consumer compliance

M&A Litigation

- Most M&A transactions were followed by a shareholder derivative lawsuit alleging Seller Board breached fiduciary duties in a flawed process
  - Upon filing of proxy statement with SEC, complaint amended to include disclosure violations
- Most suits settled with additional disclosure and payment of fees to plaintiff's counsel – in practice a transaction tax
- Litigation slowed progress of deal, added costs, sometimes raise regulatory questions, but did not prevent deal closing
- Delaware and other courts pushing back against disclosure only settlements and percentage of deals facing lawsuits has decreased significantly

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