Weighing the Options for Taking Your Bank Private

By Wendy Campbell and Kip A. Weissman

The Sarbanes-Oxley Act—along with related rules and regulations—has dramatically increased the costs and responsibilities that come with public company status.

At the same time, community financial institutions are facing deteriorating economic conditions, increased competition and rising distrust from public investors. As a result, a number of financial institutions are asking: Is public status worth the hassle?

The primary advantages of public rather than private ownership are generally higher stock valuations and superior acquisition flexibility of public institutions. Unfortunately, for many public banks, both the stock valuation premium and the ability to effect a favorable acquisition are minimal in today's environment. As a result, an increasing number of boards of directors are looking closely at taking their institutions private.


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Advantages of Going Private

Securities and Exchange Commission deregistration can enable institutions to reduce their out-of-pocket compliance costs, including legal, accounting, printing, mailing, filing, NASDAQ, transfer agent and D&O insurance expenses. In addition, they can eliminate significant in-house expenses associated with SEC compliance. The amount of savings varies from institution to institution. Larger institutions (more than $500 million in assets) may experience a lower level of savings since they remain subject to significant financial reporting obligations under federal banking law.

A second major advantage to taking an institution private is that it may provide management with greater latitude to pursue long-term goals. This is based on several factors. First, because privately owned institutions are not subject to quarterly financial reporting and daily stock price reporting, their short-term results are not subject to the same level of scrutiny as those of public institutions. Second, because directors and officers of non-public institutions have a somewhat lower level of potential liability than under SEC rules, they may feel less pressure to focus on short-term results. Finally, because of the lower level of stock liquidity of non-public institutions, their stockholders tend to be more patient than those who invest in public companies.

A third major advantage to going private is that, on balance, non-public institutions are somewhat less vulnerable to hostile takeover attempts than public institutions. This reduced vulnerability is due primarily to the difficulty of obtaining current financial information regarding non-public institutions and the difficulty of acquiring large blocks of their stock.

Disadvantages of Going Private

Perhaps the most significant disadvantage of going private for most institutions is the reduction in liquidity of their stock.

If an institution deregisters from its SEC reporting obligations, its securities would no longer be eligible for trading on the NASDAQ. While the securities may remain eligible for quotation on the OTCBB (also known as the "Electronic Bulletin Board") and the "Pink Sheets," securities transactions affected through these mechanisms are typically made at wider spreads than those effected through the NASDAQ, thereby reducing investors' profits. In addition, NASDAQ deregistra-

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tion and the absence of publicly available financial reports will result in a very significant decrease in the number of an institution's market makers and the elimination of any research coverage. For these reasons, most stockholders, including almost all institutional investors, do not like going-private transactions.

Another disadvantage of going private is the reduced ability of private institutions to raise capital and structure acquisitions (particularly stock for stock deals). Although these factors may be very important for undercapitalized or acquisitive institutions, they may not be relevant for institutions which have adequate capital and which are either unwilling or unable to compete for acquisitions in today's hyper competitive acquisition environment.

There are a number of other disadvantages of going private worth noting. First, going private will reduce somewhat an institution's public profile. Second, going private may reduce flexibility in benefit plan structuring. Third, going private will cause certain significant changes to an institution's employee stock ownership plan. For instance, non-public institutions must obtain annual appraisals for their ESOPs and must provide put options to retirees for their ESOP shares (which could result in the creation of a substantial liability under pending accounting guidelines.) Fourth, boards of directors of institutions which implement going-private transactions may feel pressure to increase dividends to placate shareholders. Finally, depending on how a going-private transaction is structured and priced, there may be a risk of stockholder litigation.

SEC Deregistration Requirements

The essence of a going-private transaction is the termination of the requirement that the institution file periodic reports with the SEC. In general terms, this is permitted when an institution has 300 or fewer shareholders of record. The definition of shares held "of record" is significantly different from the definition of shares "beneficially owned." As a general rule, most (but not all) institutions tend to have fewer shareholders of record than beneficial owners. For instance, while an institution may have hundreds of stockholders who hold their shares in "street name," under applicable SEC regulations, such shares may be deemed to be owned of record by only 20 or so holders (typically brokers). As a result, qualifying for SEC deregistration may be easier than it initially appears.

Subchapter S Election

Under current law, a financial institution with 75 or fewer shareholders and meeting certain other requirements is eligible to elect Subchapter S taxation.

In general, institutions that are taxed as Subchapter S corporations are not subject to corporate tax; instead, all pretax earnings are taxed at the shareholder level only. Needless to say, for many institutions, this will result in a substantial increase in after tax earnings of as much as 34 percent. In addition, under applicable IRS rules, the federal income tax basis of stock in S corporations increases by the amount of earnings retained. As a result, a shareholder can save 20 percent of every dollar of such retained earnings in capital gains taxes at the time he or she sells stock. For these reasons, a Subchapter S election can make a lot of sense for many institutions.

The principal disadvantage of making a Subchapter S election is that the institution's stock will become less liquid and the institution may find it more difficult to raise capital and make acquisitions. In general, this disadvantage tends to be less important for the type of institutions which implement going-private transactions. Accordingly, such institutions may want to consider whether it makes sense to combine a Subchapter S election (or a Subchapter S qualification transaction) with a going-private transaction.

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Stockholder Reduction Techniques

Most public institutions have to reduce the number of stockholders of record to qualify for SEC deregistration. In general, this can be effected either through a voluntary or an involuntary shareholder buyout.

The simplest way to reduce the number of stockholders is through stock repurchases. However, while such transactions are simple and low cost, they are not always effective in eliminating the desired number of stockholders.

A second voluntary stockholder reduction technique is a tender offer. A tender offer is generally defined as an offer to purchase shares from all stockholders at a set price for a specified period of time. The advantage of a tender offer is that a properly priced tender offer can create a "stampede effect" as stockholders rush to achieve favorable pricing before the applicable deadline date. The disadvantage is that tender offers are highly regulated by the SEC as to structure and disclosure.

Involuntary stockholder reduction techniques use compulsion to require stockholders to sell their shares. These transactions include techniques such as "squeeze out" mergers and reverse stock splits which force stockholders holding fewer than a designated amount of shares to resell their shares to the institution. The primary advantage of involuntary stockholder reduction transactions is the high level of certainty as to the number of shareholders whose interests will be bought out. The disadvantages of such transactions are the high degree of SEC and state regulation as to pricing, structure and disclosure and the possibility of litigation. In addition, involuntary transactions almost certainly must be priced at a premium to market.

One of the advantages of stockholder reduction transactions in the current environment is the ready supply of third party capital to support such transactions. In particular, there is currently a strong market for holding company loans and trust preferred stock that may be utilized to finance the stock purchases associated with such transactions. In addition, under current law, an institution could form an employee stock ownership plan to finance its going-private transaction. Under federal tax law, both interest and principal payments on ESOP debt are tax deductible.

Legal and Regulatory Issues

There are a wide variety of complex legal and regulatory issues associated with going-private transactions. First, under applicable corporate law, the transaction must be structured so that the directors meet their fiduciary duties of care (such as due diligence) and loyalty (avoidance of conflicts of interest). In general, this involves the implementation of a series of procedures to ensure a full board analysis of all aspects of the transaction and protection and fair pricing for minority stockholders. Because of the possibility of litigation, these procedures are often quite complex.

A second set of issues that often arise in going-private transactions relates to SEC disclosure. While the type of disclosure required depends on the form of the shareholder reduction transaction, in general, a board should expect to disclose in detail the decision making process it utilized in designing the transaction and establishing the price. In addition, detailed disclosure is required of the financial impact on the institution and its insiders of the going-private transaction.

Finally, there are also a number of federal bank regulatory issues that must be addressed in connection with a going-private transaction. In general, these issues relate to safety and soundness, capital compliance, debt coverage, dividend and control issues.

If the advantages of public company status no longer outweigh the disadvantages of such status in today's difficult environment, you may want to take a hard look at taking your institution private.

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