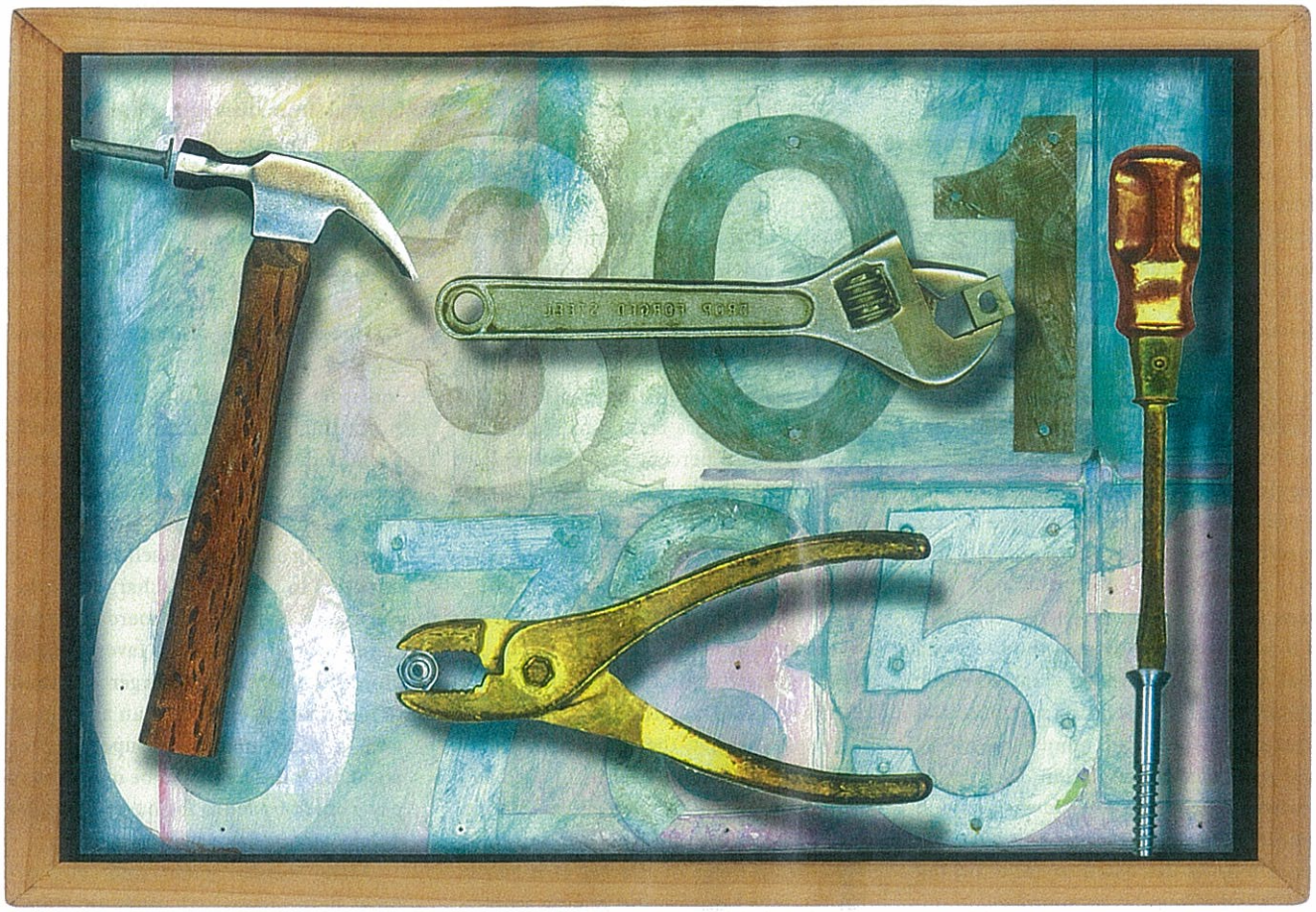
By Dave Muchnikoff

A Community Banker's Nuts and Bolts Approach to Mergers and Acquisitions



THE CONQUEROR FREDERICK the Great said, "It is pardonable to be defeated, but never to be surprised." This wisdom applies equally well today as competitive and regulatory issues will eventually spur consolidation in the banking industry. As a survivor of a severe recession followed by a slow recovery, you are facing a low interest rate environment and an uncertain economy that challenges the ability of many community banks to generate assets and make a profit. The harsh and demanding regulatory environment adds additional impetus to the consolidation movement. Conditions are unlikely to improve as Basel III is implemented and more Dodd-Frank rules increase compliance costs. As banking becomes more and more about scale and efficiency to overcome these challenges, acquisitions offer the only means of rapidly increasing a banking institution's size and market presence.

A properly structured acquisition benefits the buyer through earnings growth and enhanced franchise value, even if the premium paid in the transaction creates short-term book value dilution. The seller's shareholders benefit by receiving

continued on page 16

An acquisition requires consideration of a complex series of issues, including business, social and accounting matters and concerns stemming from securities, regulatory, tax and corporate laws.

continued from page 15

a premium for their stock, and if they receive all or a portion of their purchase price in the stock currency of the buyer, it is likely that their opportunity for liquidity and future appreciation will be significantly enhanced.

In these troubling times, just like in the early 1990s, it is likely that a number of community banks will join forces as equal or substantially equal partners in no premium or very low premium mergers, known as a "merger of equals," creating earnings growth through economies of scale and cost savings, franchise value through platform expansion and potentially a significant increase in long-term shareholder value. Culture plays a key part, but more typically in preventing these combinations.

An acquisition requires consideration of a complex series of issues, including business, social and accounting matters and concerns stemming from securities, regulatory, tax and corporate laws. The typical bank merger takes four to six months following the announcement of a deal, and a number of transactions have been aborted in the regulatory process. It is worthwhile to discuss the proposed deal with regulators very early in the process prior to spending a substantial amount of time and money preparing and negotiating transaction documents. Matters such as *pro forma* capital requirements and non-performing asset levels may be discussed to ascertain the likelihood of regulatory approval.

Once the decision to sell is made, the seller will determine whether to conduct a sale process or pursue a friendly negotiated transaction. In either situation, the seller's board of directors is subject to certain fiduciary duties that need to be carefully evaluated and implemented with its counsel. For obvious reasons, the economic terms of the proposal are the most highly scrutinized factor. While there is no requirement to solicit bids in an auction process or sell to the highest bidder, it is advisable as a seller to obtain an investment banker's opinion that the exchange ratio or consideration to be received is fair to shareholders from a financial point of view. The opinion provides protection in the event the board's decision is challenged and supports the board's recommendation that stockholders approve the transaction.

All-cash transactions are the least complicated because the seller's concerns are generally limited to (i) getting the best price, (ii) the financial ability and available cash resources of the buyer, and (iii) the ability of the buyer to obtain regulatory approval.

When the transaction consists of all stock consideration or a mix of cash and stock consideration the seller must perform due diligence on the buyer and receive substantially parallel representations and warranties from the buyer in the merger or definitive agreement. Typically this transaction involves a fixed exchange ratio relating to the stock consideration, quite often caps and collars (i.e., a ceiling or floor, frequently 10-15 percent above and below the buyer's stock price at the time the merger agreement is signed) and associated "walk-away" provisions are provided based upon the average trading price of the buyer's stock for a specified measurement period, for example 20 trading days prior to deal completion. Some walk-away formulas require that two tests be met, that there be both an absolute percentage decline in the buyer's stock price and a percentage decline in the buyer's stock price as measured against an index of selected peer banks of the buyer during the pricing period. A walk-away may also require the parties to continue to negotiate with each other before unilaterally terminating the transaction. This provides the buyer with the opportunity to increase the exchange ratio before the seller may terminate.

In all-cash transactions, the seller makes extensive representations and warranties and the buyer makes minimal representations and warranties as compared to substantially similar representations and warranties in stock or stock/cash mix transactions. Generally the buyer makes few, if any, operating covenants and the seller extensive operating covenants. These operating covenants should be drafted to not unduly interfere with your ability to operate in the normal and ordinary course of business.

Closing may be conditioned on the amount of non-performing assets, loan charge-offs, the provision for loan losses, earnings or shareholder's equity remaining within a certain range and are extensively negotiated to not be so small as to make a breach likely or so large as to make the condition meaningless. The representations, warranties and covenants of the parties generally terminate on deal completion and thus do not survive the closing, other than covenants that by their terms are to be performed after deal completion.

Under the laws of most states, contracting parties are not permitted to contract away their fiduciary duties. Accordingly, the seller is generally permitted to entertain an unsolicited superior proposal after deal signing and prior to the receipt of its shareholders' approval in order for the seller's board of directors to properly discharge its fiduciary duty. If the seller's board adversely changes or withdraws its favorable recommendation of the merger or wants to terminate to enter into an agreement with a party making a superior proposal, then the seller will be obligated to pay a break-up fee to the buyer, typically 2-3 percent of the transaction value.

Many banks enter into employment agreements and other severance arrangements with "golden parachute" provisions providing change in control benefits. Because of the cost, severance benefits are carefully reviewed by bank regulators and shareholders and should be reasonable in light of the size of the seller. Rather than including these benefits as part of the merger agreement, it is highly recommended that you adopt any severance arrangement well in advance of a transaction that could trigger payment.

Dave Muchnikoff is a partner at Silver Freedman & Taff, L.L.P. in Washington, D.C. He can be reached at www.sftlaw.com and dave@sftlaw.com.