A COMMUNITY BANKER'S NUTS AND BOLTS APPROACH TO MERGERS AND ACQUISITIONS

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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 spur analysts into predicting a big wave of consolidation in the banking industry, although so far activity has been relatively weak. There are, however, many reasons to prepare for a new wave of consolidation.

As a survivor of a severe recession followed by a slow recovery, you are facing shrinking net interest margins, weak loan demand and a low interest rate environment that challenges the ability of community banks to make a profit. The decline in real estate values reduced the capital of many banks and a quick recovery never materialized. The ongoing debate in Congress regarding the national debt ceiling and federal budget deficit, and concerns over the United States' credit rating (which was downgraded by Standard & Poor's), the European sovereign debt crisis, the overall weakness in the economy and continued high unemployment in the United States, among other economic indicators, have contributed to increased volatility in the capital markets and a very protracted economic recovery, leaving many banks in a precarious position in which the future is still unknown. Capital, earnings, asset generation and operational problems still plague many banks and, together with a harsh and demanding regulatory environment, will add additional impetus to the consolidation movement. Conditions are unlikely to improve as the banking regulators contemplate the Basel III rules and more Dodd Frank rules, adding additional compliance costs.

These economic conditions make this an appropriate time to assess whether to try to stay the course or find a strategic partner. Some of the factors to consider:

1. Will the constant pressure of maintaining high regulatory capital ratios require you to become more efficient through cost savings sooner rather than later to increase profitability?

2. Since access to capital for all but the largest and healthiest banks is limited, how will you grow and/or expand your footprint?

The linchpin to answering these questions is what minimum asset size your bank must reach to be competitive and sufficiently profitable. Size continues to be regarded by most banks as critical to their future survival. As banking becomes more and more about scale and efficiency to overcome the challenges posed to profitability from financial reform, acquisitions offer the only means of rapidly increasing a banking institution's size and market presence.

A properly structured acquisition brings benefits to both the buyer and the seller. The buyer will enjoy short-term as well as long term earnings growth and enhancement to its franchise, even if the premium paid in the transaction creates short term book value dilution. The shareholders of the seller will receive a premium for their stock instead of taking the risk of uncertainty of the value of their shares in the future. To the extent the shareholders of the seller receive all or a portion of their purchase price in the stock currency of the buyer, it is likely that their opportunity for increased 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. This type of partnership combination is known as a "merger of equals" and creates earnings growth through economies of scale and cost savings, franchise value through platform expansion and the opportunity for significant potential increase in long term shareholder value – a "win-win" for both parties and their shareholders. Because they are strategic transactions, there is also typically no premium paid to either side. Instead, any premium to shareholders is to come later, due to cost savings, enhanced efficiency and increases in the franchise value of the stronger combined entity. Culture also plays a key part, but more typically in preventing these combinations.

Planning and execution of an acquisition requires consideration of a complex series of issues, including business, social and accounting matters as well as concerns stemming from securities, regulatory, tax, corporate and in some instances, antitrust laws. Choosing the best means of addressing these issues requires, in many instances, the balancing of competing priorities. The typical bank merger takes longer to consummate than non-bank mergers. Obtaining necessary state and federal regulatory approvals generally takes four to six months following the announcement of a deal. For public companies, complying with the U.S. Securities and Exchange Commission's rules is also a time consuming process.

Once the decision is made by the board of directors of the seller to pursue strategic alternatives, the seller, typically with the advice of an investment banker, will determine whether to conduct an auction process or pursue a single buyer negotiated transaction. In either situation, the board of directors of the seller is subject to certain fiduciary duties that need to be carefully evaluated with competent counsel. When evaluating an acquisition proposal, to ensure the protections of the business judgment rule, directors should follow a process that demonstrates they have acted in good faith, on an informed basis and without the primary purpose of entrenching management. 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 bankers' 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. A buyer may also seek an investment banker's opinion, especially for larger transactions. Fairness opinions in bank acquisitions have become more detailed in recent years as investment bankers have sought to clarify the nature of their analyses and assumptions.

An investment bankers' fairness opinion will typically constitute the centerpiece around which the board's deliberative process is based. By rendering a fairness opinion, the investment banker provides the board with comfort and assurance that its actions are consistent with the best interests of the company's shareholders and provides strong protection against challenges by plaintiffs alleging a breach of the board's duty of care. Moreover, by preparing a detailed opinion, the investment banker provides the directors with additional information against which the directors can apply their independent judgment. While there is no absolute duty that a board of directors obtain an investment banker's fairness opinion, virtually all selling companies and most acquirers (at least with respect to major acquisitions) do so. Fairness opinions are also beneficial in supporting the recommendation of the board as set forth in the proxy statement seeking shareholder approval of 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, (iii) the ability of the buyer to obtain regulatory approval and (iv) in limited instances where the shareholders of the buyer are required to approve the transaction, the likelihood of securing shareholder 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 since its shareholders are receiving the buyer's stock. In assessing the value of stock to be exchanged in a merger, directors should consider, among other factors, the following:

- Past performance of the buyer's securities to be received;
- Asset quality of the buyer as indicated by asset quality measures;
- The buyer's management and organizational culture;
- The buyer's experience in making acquisitions and success in integrating acquisitions;
- The market presence created by combining the banks;
- Expected cost savings and synergies;
- The pro-forma earnings per share accretion or, if dilution, the amount of time required to restore per share earnings levels;
- The pro forma regulatory capital position;
- The possible need for the buyer to raise additional capital in the future and any possible dilutive effect; and
- Whether regulatory or other issues are likely to arise that could either delay consummation or jeopardize the transaction altogether.

Typically stock based transactions involve a fixed exchange ratio relating to the stock consideration, quite often caps and collars (i.e. a ceiling or floor, frequently 10-15% 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 twenty 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. In stock or stock/cash mix transactions, the parties make substantially similar representations and warranties. Many of these representations and warranties are subject to various materiality exceptions. Generally, the buyer makes few, if any operating covenants and the seller provides extensive operating covenants. These operating covenants should be drafted to not unduly interfere with a seller's 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, 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. A "no material adverse change" representation at closing is particularly important in light of the long delay between signing and closing and the asset quality issues some banks have had in recent years. The representations, warranties and covenants of the parties generally terminate on deal completion and do not survive the closing, other than covenants that by their terms are to be performed after deal completion.

Merger agreements are designed to ensure that the buyer is successful and other potential buyers are deterred from making a bid. Under the laws of most states, however, contracting parties are not permitted to contract away their fiduciary duties. Accordingly, there is usually a "fiduciary out," which permits the seller 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% of the transaction value in larger deals and as much as 5% in smaller deals.

Social issues often play an important role in bringing two merger partners to the negotiating table and directors should appropriately take into account the impact of the prospective transaction on the bank, its employees, its customers and the markets in which it operates, since stockholder value may be dependent upon them. The buyer's reputation, its plans for the bank and its employees upon consummation of the merger, and any role for present management (and in some instances for selected directors) following the merger, can be relevant to the value of the combined banks and the likelihood that a proposed transaction will receive regulatory and shareholder approvals.

Proper treatment of employees is also extremely important in assuring a smooth transition period between the signing of a merger agreement and the closing of the transaction. At minimum, the merger agreement should provide for the buyer to honor existing employment arrangements (change of control or otherwise) and all vested benefits. It is also customary to specify the benefits retained employees may receive after the merger and the amount of service credit to be received under the buyer's employee benefit plans for time served as an employee of the seller. This can range from a plan-by-plan agreement to a general covenant to provide substantially equivalent or comparable employee benefits and severance benefits to employees after the merger.

The economics of many bank transactions depend on anticipated cost savings to be realized by the combined entity. One of the key components of these cost savings is downsizing of the work force of the combined entity. Knowing this, many banks enter into employment agreements and other severance arrangements, some with “golden parachute” provisions providing change in control benefits in the event they decide to sell. Severance benefits may be carefully reviewed by bank regulators and shareholders and should be reasonable in light of the size of the seller. It is highly recommended that you discuss the arrangements with your attorney and adopt any severance arrangement well in advance of a transaction that could trigger payment.

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