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For questions regarding this guidance or to obtain an electronic copy, contact Dave Muchnikoff at 202-295-4513 or dave@sfttlaw.com or any other SFTT attorney with whom you have consulted in the past. Dave is a partner specializing in capital raising, mergers and acquisitions, and other corporate transactions. He is rated Preeminent AV by Martindale Hubbell and recently selected to the "Top Rated Lawyers in Securities Law" by The American Lawyer and by Corporate Counsel. He has been a guest speaker and written on capital raising, mergers and acquisitions, and corporate governance issues related to community financial institutions for the American Bankers Association and various state and regional banking associations. He is a former Assistant Branch Chief in the Division of Corporation Finance at the U.S. Securities and Exchange Commission, and certified public accountant.

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Silver, Freedman, Taff & Tiernan LLP
3299 K St, N.W.
Suite 100
Washington, DC 20007-4444

Silver, Freedman, Taff & Tiernan LLP
Our Knowledge and Judgment
Foster Speed and Results

A Community Banker's Pocket Guide to Mergers and Acquisitions

Volume IV

Tel: 202-295-4513

This is the fourth installment of our pocket guide for bank directors and executive officers designed to highlight merger and acquisition (“M&A”) considerations.

After receiving an indication of interest, the seller and its financial adviser will evaluate the bids received and the financial adviser will try to get each of the bidders or even a single bidder to improve its offer. The deal structure and purchase price are typically the most significant factors in determining which indication of interest to accept. When negotiating, do not ever discuss the minimum price the Board of Directors is willing to accept. The minimum will then become the maximum price. Also negotiate for an increase in the purchase price or continued payment of cash dividends if there is a material delay in consummating the transaction.

DEAL STRUCTURE

The deal structure is very important as it can significantly affect the after-tax transaction proceeds that the seller’s stockholders will receive in the deal and the seller’s value to the buyer. Other than with respect to Subchapter S corporations, most M&A deals are done as a “tax-free” merger without adverse tax consequences to either party. Typically the buyer wants to acquire 100% ownership of the seller. To accomplish this, most M&A deals are structured as a merger or share exchange, generally requiring under the seller’s governing documents and state law approval of either a majority or two-thirds vote of the seller’s common stockholders, resulting in a forced exchange of all shares for the merger consideration. Rarely, if the buyer has concerns about assuming the seller’s actual or potential liabilities, the deal may be structured as an asset purchase where the buyer purchases specified assets and assumes certain liabilities (while leaving other liabilities behind) of the seller resulting in the seller becoming primarily a “shell company” whose only assets are cash (which is used to pay creditors and the remainder distributed to stockholders) and any “excluded assets” that weren’t purchased by the buyer.

In a merger, the buyer may set up a new wholly-owned subsidiary with which the seller is merged or the seller is merged directly into the buyer. The buyer accounts for the transaction using the purchase method of accounting and, accordingly, the assets acquired, liabilities assumed and consideration exchanged are recorded at acquisition date fair values.

A buyer will typically pay the seller’s stockholders cash or stock or a mix of cash and stock as part of a M&A deal. Most deals involve mergers structured as a tax-free reorganization when selling stockholder’s exchange their equity for buyer equity. If at least 40% of the purchase price is to be paid in the stock currency of the buyer, the transaction may be structured as a tax-free merger to enable stockholders to defer paying capital gains tax on the appreciation of their seller stock until they subsequently sell the buyer stock that they receive in the transaction. The portion of the purchase price paid in cash, if any, is taxed.

PAYMENT CONSIDERATIONS

Typically the purchase price is paid upon deal completion. In limited instances, a deal may provide for earn-outs and other deferred or contingent payments. Buyer stock can be attractive as it can enable the parties to use the tax-free merger structure and enables the seller’s stockholders to participate in the upside value of the buyer. Selling stockholders may also achieve greater liquidity for their investment when the buyer is publicly-traded and the shares received are registered with the Securities and Exchange Commission. When buyer stock is part of the consideration to be received, the seller should perform its own due diligence on the buyer and with its investment banker analyzing the buyer’s business, prospects and capitalization and evaluate the future value of the buyer’s stock.

Stock or stock/cash transactions can be subject to fixed or floating exchange rates and may include caps and collars (upper and lower stock price limits to the transaction). Both buyers and sellers are sensitive to the deal value and each may desire caps and collars which attempt to lock in value both at a minimum (seller) or maximum (buyer). Price protection negotiations often are as involved as the negotiation of the terms of the purchase price per share as the buyer is usually sensitive to potential dilution (unless deal consideration is very minor in comparison to the buyer’s equity outstanding). Caps and collars are also closely tied to termination provisions because exceeding the caps or collars can be grounds for termination of the M&A definitive agreement (“Agreement”). The termination provisions can be as simple as ones providing that a party may terminate if the buyer’s stock price exceeds the cap or collar a certain number of days prior to closing or more complicated using a double-trigger, meaning that in addition to falling below the collar, the buyer’s stock price must fall by a certain percentage below an index, for example the NASDAQ Bank Index. In effect, this two-prong measurement assures that the reasons for the buyer’s stock price decline are buyer-specific. There may also be a “kill or fill” provision (if buyer’s stock price falls, buyer can waive the price collar and also gain the right to issue seller’s stockholders more shares in order to make them whole). If below the collar, a seller may want to terminate because of receiving diminished value while a buyer may also seek the right to walk if its stock price falls significantly below the collar because it may not desire to issue more than a certain amount of its market capitalization. To limit its potential overpayment exposure, the buyer may also seek a termination right if its stock price exceeds the cap. The Agreement typically requires any party wishing to terminate to provide advance notice to the other.

The Agreement can also include various price adjustments and/or termination clauses based upon:

- non-performing asset levels exceeding certain thresholds;
- environmental remediation costs exceeding certain levels;
- the amount of gain or loss incurred in connection with directed asset sales; and
- adjusted stockholders’ equity being less than a specified level at closing.

M&A transactions can also include contingent consideration (“contingent value rights”) which provide for potential additional merger consideration in the future to selling stockholders if certain specified conditions or parameters are satisfied, typically involving a specified loan pool. Although rarely used, it may be a possible way to achieve potential pricing that is attractive to selling stockholders.

The next guide will discuss social considerations for directors and executive officers.