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

A Community Banker's Pocket Guide to Mergers and Acquisitions

Volume V

Tel: 202-295-4513

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

SOCIAL ISSUES

Besides price, resolution of the social issues, regarding directors, executive officers and employees is of particular concern in a M&A transaction. To the extent practicable, social issues should be resolved after the agreement is reached on price. Social issues generally include the following:

- making sure that all severance is paid under employment or change in control agreements, with tax planning for any executives with Internal Revenue Code Section 280G gross-ups, including the timing (i.e., at closing even if retained, or only upon a subsequent termination) and amount of payments;
- making sure that all employee benefit plans are honored, and whether such plans will be terminated with payments at closing or continued with payments over time;
- whether current directors and executive officers will have positions in the combined company and, if so, their duties, titles and compensation;
- providing severance for lower level employees who do not have employment or change in control agreements;
- covering the participation of continuing employees of the seller in the buyer's employee benefit plans;
- whether the seller will receive any seats on the combined company's Board of Directors; and
- continued indemnification and insurance coverage.

Directorships. In a stock transaction, members of the seller's Board of Directors may become members of the Board of Directors of the combined company based on the pro forma ownership percentage of the seller's stockholders. The Board term is usually one to three years and may be renewed by reelection. These Board seats provide the seller's directors with the opportunity to serve the interests of the seller's stockholders post closing, provide an income stream in the form of director's fees and allow the directors to retain the prestige in the community associated with a directorship. Former seller directors may also serve on an advisory Board of Directors which permits the director to receive fees but allows the buyer to retain control over the entire company.

Employment/Retention Agreements. As an executive officer, your contract may be assumed by the combined company or you may be offered a new employment or retention agreement as part of the transaction to enable the buyer to maintain operations, customers and community relations. Some buyers look at the seller's executive officers in connection with their succession planning.

An employment contract will typically provide for a specified term, typically up to three years, while retention agreements are short term. Employment contracts typically provide for a salary and participation in the buyer's employee benefit programs and may even include a company car. Vacation and sick days, disability coverage, reimbursement of attorneys fees if the contract is disputed, expense account, bonus plan and indemnification provisions should also be considered.

An employment agreement may provide for a change in control payment. The payment amount should be limited to 2.99 times the executive's average annual salary for the five years immediately preceding the year in which the change of control occurs in order to avoid adverse tax consequences. Severance agreements also are used to provide change in control payments such as one to two years lump sum cash compensation or salary continuation during this period.

Stock Awards. Most equity plans provide that restricted common stock awards become immediately vested and options immediately exercisable upon a change of control of the company. **Know your rights and review your vesting schedule and the seller's equity plan for change in control provisions.** While restricted common stock is exchanged for the same merger consideration as the seller's common stock, seller stock options will typically be cashed-out if the purchase price per share is more than your stock option's exercise price (even if the transaction consideration consists, in whole or in part, of buyer stock). Alternatively, stock options may be rolled-over into buyer equity in a stock deal. Sometimes buyers elect to cash-out (rather than rollover) seller stock options that are "in the money" to eliminate the overhang on their stock or because rollover may result in seller employees having buyer stock options in amounts that are inconsistent with the way buyer grants its awards. If the per-share consideration amount is less than the exercise price of your stock option, the stock option is "out of the money" and may be terminated at closing.

If rolled-over, the buyer will exchange your stock options generally subject to their existing terms with the number of options and exercise price adjusted using the exchange ratio in the M&A definitive agreement ("Agreement"). The accrued vesting on your stock option should also be carried over to the buyer stock option received in the exchange. If your options are rolled over instead of cashed out, make sure you know the option's duration after you leave the buyer's employment. Try to negotiate up front, if possible, the grant of new stock options or restricted stock in any proposed employment agreement. At a minimum, include a provision that you will participate in all of the buyer's equity-based compensation programs on a fair and equitable basis with the other senior executive officers of the buyer.

Employee Plans. The Agreement should cover the participation of continuing employees of the seller in the buyer's employee benefit plans, including pension, profit-sharing and any employee stock ownership plan ("ESOP") and welfare plans, including group health, life and disability insurance that are generally provided to buyer's employees. Except for defined benefit plans, past service credit for employee's service with the seller should be counted towards eligibility, participation, vesting and accrual of benefits. Typically the ESOP is terminated, the ESOP loan is repaid and the vesting of shares held in the ESOP is fully accelerated.

In addition, if the seller does not have a change in control severance plan in effect for non-contract employees, the seller will typically negotiate in the letter of intent severance benefits for those employees terminated upon deal completion or within one year thereafter equal to one or two weeks salary for each year of service, but generally not less than two weeks salary or more than 26 weeks salary.

Indemnification. The indication of interest should also address the indemnification of officers and directors, as well as the continuation of director and officer liability insurance. Typically this consists of "tail coverage" to protect against claims that may be asserted against these individuals for a period from three to six years after closing at a cost no more than 250-300% of the current annual premium.

The next guide will discuss regulatory matters, board fiduciary duties and judicial review of the board's actions during a M&A transaction.