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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 VI

Tel: 202-295-4513

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

A CRITICAL COMPONENT: REGULATORY MATTERS

While due diligence is being conducted, it is suggested you call your primary federal and/or state banking regulator to discuss the proposed transaction. As highly regulated entities, the regulatory aspects of a transaction are critical, both for buyers and sellers. Contact with regulators is essential, especially if any regulatory issues with regard to either the buyer or seller may exist. The following regulatory related issues need to be understood:

- CAMELS rating-the buyer should be at least a two rated institution and the combined entity should be significantly well capitalized (8% Tier 1 capital) with an expected two rating;
- Anti-competitive issues regarding market share;
- Compliance issues such as AML/BSA/CRA and fair lending compliance;
- Pro-forma capital ratios;
- Ability to integrate and operate if acquisition is buyer's first, or if transaction significantly increases size and/or market footprint;
- Any regulatory agreements or commitment related to closing the transaction, including supervisory resolutions;
- Any Change of Control Act issues created; will any of seller's stockholders have control issues as a result of the transaction; and
- Any Part 359 of the FDIC regulations (for troubled institutions) issues raised in connection with the transaction.

If you are taking advantage of the Federal Reserve Board of Governors' ("FRB") Small Bank Holding Company ("SBHC') Policy Statement ("Policy Statement") (extended by a new law enacted in December 2014 that increased the applicability to bank and savings and loan holding companies with less than $1 billion in consolidated assets) to allow financing for up to 75 percent of the purchase price of an acquisition (a 3:1 ratio), make sure the FRB knows your proposed leverage ratios and how you intend to comply with the Policy Statement. A SBHC must: reduce its parent company debt in such a manner that all debt is retired within 25 years of being incurred; reduce its debt-to-equity ratio to .30:1 or less within 12 years of the debt being incurred; ensure that each of its subsidiary-insured depository institutions is well capitalized; and refrain from paying dividends until such time as it reduces its debt-to-equity ratio to 1:1 or less. As always, the FRB has discretion in applying the Policy Statement, and may exclude reliance on the Policy Statement if it determines to do so for supervisory purposes.

COMPLYING WITH FIDUCIARY DUTIES

Throughout the M&A process, directors must comply with their fiduciary duties which consist of the duty of loyalty (to act in the best interests of the bank and its stockholders as a whole, rather than for personal gain or for any particular class or series of stock) and the duty of care. The duty of care imposes a duty of diligence, to act on a fully informed basis in decision making and oversight. In a M&A context, the duty of care:

- Requires directors commit the time required to inform themselves of and assess, before acting, all relevant information (i.e., make a good faith effort to become knowledgeable of all relevant facts reasonably available at the time when the decision is made); and
- Make inquiries and rely on others - Boards can rely in good faith on information and guidance received from management and retained professionals (such as investment bankers, legal counsel and accountants).

The duty of care does not require:

- Directors sacrifice long-term plans for short-term gain; and
- A board, before deciding to sell, to negotiate with third parties or sell the institution, even at a premium, as long as it makes a good faith, informed decision that the stockholders' best interest is served by rejecting an offer.

If the board has determined on the basis of a rational, informed analysis that remaining independent is the proper corporate strategy then the board may reject a potential buyer's proposal if it is determined to not be in the company's best interests, and courts generally will uphold such decisions so long as the proposal was properly addressed and considered by the board or a board committee.

JUDICIAL REVIEW OF BOARD ACTION

Directors are generally protected under the "Business Judgment Rule" which protects decisions made in good faith, on an informed basis, in a disinterested manner and in the honest belief that the action was taken in the best interest of the company and its stockholders. The rule focuses on the process leading to a decision rather than the substance or reasonableness of the board's determination. Board minutes substantiating the case that an informed decision was made should detail that the following steps were taken:

- Full discussion of the proposed transaction at meetings of the board, including a detailed analysis of the consideration, material terms and conditions of the transaction and fairness opinion received
- Review of the relevant documentation, including summary of the proposed transaction;
- Consultation with financial advisors and legal counsel;
- Assessment of the institution's short-and long-term strategic goals and interests; and
- Discussion of the proposed transaction's expected effect on the institution.

While the law of your company's incorporation will control, many courts look to the Delaware cases as guidance in interpreting applicable state law with regard to fiduciary duties. The so-called Revlon duties under Delaware law generally require that where a board authorizes the sale of control, the institution's duty shifts to achieving the highest price reasonably available. In December 2014, the highest court in Delaware clarified that there is no single blueprint for a sale process and Revlon does not require an auction before a company is sold. A reasonable sale process is all that is required, not a perfect one to attain the best value. Boards should be careful to be actively engaged in the review and consideration of any proposals, including all circumstances and factors at play, so that they can make reasoned and fully-informed decisions. The court noted that when a board exercises its judgment in good faith (no improper motive to enter into the transaction); tests the transaction through a viable passive market check, such as a "fiduciary out" (permitting the board to entertain superior proposals with a reasonable break-up fee if accepted), and/or a post-signing market check by providing for a reasonable period of time before closing to allow serious bidders to emerge; and gives its stockholders a fully informed, uncoerced opportunity to evaluate the board's decision for themselves and vote to accept the deal, the Board's Revlon duties should be satisfied even if aspects of the transaction are less than ideal.

The next guide will discuss representations and warranties and covenants in the M&A definitive agreement.