

# The Current M&A Landscape and the Basics of an M&A Transaction

## THE NEW JERSEY BANKERS ASSOCIATION

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# Who We Are

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Luse Gorman is a Washington, D.C. based law firm that specializes in representing community banks and other financial institutions.

We are a national leader in representing community banks in mergers and acquisitions, capital raising transactions, corporate governance, executive compensation, regulatory and enforcement and general corporate and securities law.

We represent over 250 financial institutions nationwide. Most are community banks ranging from \$100 million to \$20 billion in assets.

# Some of Our Accomplishments

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- No. 1 law firm in mergers and acquisitions in 2015 (ranked by number of deals)
- Top 10 law firm in mergers and acquisitions every year since 2001 (ranked by number of deals)
- No. 1 law firm nationally in community bank capital raising transactions since 2000

# Topics Covered

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- Banking Themes that Will Affect M&A
- Regulatory Approval and Current Environment
- Getting Your Deal Done – Planning Phase
- Types of M&A Solicitation Processes
- Due Diligence
- M&A Litigation
- Key Compensation Issues
- Shareholder Approval Issues

# The Banking Landscape

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- Consolidation is building momentum as the volume of transactions is now on par with pre-Great Recession levels – higher as a % of the current banking sector
  - 318 M&A transactions in 2007; 304 in 2014 (287 in 2015)
- Aggregate deal value is lower as more M&A involves smaller Sellers and Buyers (<\$5 billion in assets) building greater scale – Buyers have critical \$10B and \$50B regulatory thresholds to consider
  - \$73.3B deal value in 2007; \$18.8B deal value in 2014 (\$26.1B in 2015)

# The Banking Landscape

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- Increasing number of mutual to mutual mergers, including consolidation under common mutual holding company
  - 14 mutual mergers in last three years in Northeast
- Trend – mergers of healthy mutuals with no asset quality or regulatory issues, recent transactions are not “white knight” deals but strategic decisions to get bigger and more efficient and more relevant
- 515 mutual banks in US (traditional and private MHCs); 8% of all FDIC-insured banks are mutual; 1.4% of all FDIC insured deposits held by mutual banks

# The Banking Landscape

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- Pricing appears more disciplined, with price to book ratios strengthening, but still significantly below pre-Great Recession levels
  - Selective transactions/markets can still attract high multiples
- The stronger the Buyer's trading multiples, the better it can compete in the M&A arena

## Banking Themes That Will Affect M&A

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- Emphasis on growth to achieve economies of scale – for both stock and mutual banks
- Markets favor larger market cap companies
  - Data shows that banks with less than \$1.0 billion in assets have lower ROAs and ROEs, as well as higher efficiency ratios
  - Stocks of banks with less than \$1.0 billion in assets trade at lower price to TBV and P/E ratios
  - The sweet spot for trading valuation seem to be in the \$5B-\$10B range

## Banking Themes That Will Affect M&A

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- M&A valuations are highly dependent upon balance sheet strength, asset size, earnings potential and tangible book value growth, as well as the markets in which the bank operates
- Investors favor deals that create companies with the scale needed to compete effectively and cost savings that will drive earnings growth
- Buyers continue to be highly selective about choosing merger partners

## Banking Themes That Will Affect M&A

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- Tangible book value dilution – and earn back period - is a key factor in pricing for a community bank Buyer
- Earnings per share accretion/dilution is also critical
- For mutual to mutual mergers, non-pricing considerations are paramount, e.g., board seats, management positions and succession, name change, headquarters, cultural fit, integration of benefit plans

## Why the Uptick in Merger Activity?

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- Increased regulatory and compliance costs have changed the banking business in a fundamental way
  - This has squeezed profitability, particularly for smaller stock and mutual banks, and increased pressure to consolidate and achieve economics of scale
- Economies of scale are also important in connection with technology challenges and developments
- Improved stock trading prices has given certain Buyers a stronger currency to effect acquisitions
  - Buyers with higher trading multiples can offer higher premiums without facing the dilution that the market penalizes

# Regulatory Approvals and Environment

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- Dodd-Frank, financial crisis and regulatory aversion to risk have had impact on bank M&A
  - Deals can take longer and get more scrutiny
- Regulatory environment has improved, but regulatory risk remains greatest obstacle to completing an M&A deal buyer - has to have sound working relationship with federal and state regulators
- Pre-merger regulatory communication now more critical than ever

## Regulatory Approvals and Environment

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- Consumer compliance is a key consideration in every M&A deal – the shadow of the CFPB is large
- BSA/AML compliance also critical
- Generally, only approval of regulator(s) of Buyer is required; Seller bank regulator is largely irrelevant
- 4-7 month approval process – could be longer if protests or compliance issues develop

# Regulatory Approvals and Environment

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## Key Regulatory Issues:

- Buyer MRAs or compliance issues
- "3" rating overall or in certain CAMELS components (management, compliance or asset quality)
- Pro forma capital
- Below "Satisfactory" CRA rating
- Post-closing concentration issues, e.g., CRE/capital
- Need to show how deal "fixes" Seller regulatory problems (if any)
- Protests filed by activist groups

## A Successful M&A Transaction – Planning Phase

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- Understand whether you want to be a Buyer, a Seller or just do nothing in the M&A space – this is a conversation that every board should have. Questions that should be asked include:
  - Can we survive and thrive as an independent bank?
  - Do we have the personnel and drive to be a Buyer?
  - Do we operate in a market with organic growth potential?
  - How does a mutual acquire another mutual?
    - ❖ Direct merger or consolidation under common holding company; unique accounting implications

# A Successful M&A Transaction – Planning Phase

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## Getting Your House in Order – Buyers

- Banks that plan to be Buyers should consider strong regulatory relations as a strategic necessity, and CEO must take a personal interest and play significant role in building regulatory goodwill
- Buyers should expect the Seller will have significant interest in Buyer's discussions with regulators

# A Successful M&A Transaction – Planning Phase

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- Buyer needs to address any unresolved supervisory issues and communicate with your regulator regarding your strategic plans
  - Have all MRAs in most recent ROE been addressed?
  - Any outstanding regulatory action, whether a formal action or MOU, may be a bar to regulatory approval
  - A less than satisfactory compliance or management rating may prevent a Buyer from obtaining approval, even if overall CAMELS rating is “2” or better

# A Successful M&A Transaction – Planning Phase

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## Getting Your House in Order – Buyers

- Review your business plan
  - An acquisition may require an updated or new business plan
- Have periodic reviews of the market and deal issues with legal and financial advisers who have completed numerous M&A deals in recent years
  - Understand the legal and regulatory environment
  - Take into account shareholder concerns (e.g., tangible book value dilution/earn back)
  - Know your shareholders

# A Successful M&A Transaction – Planning Phase

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## Getting Your House in Order – Buyers

- Pricing analyses by financial adviser, recent transactions and “dry run” examples enable management and the board to be informed and make informed decisions
- Possible acquisition targets can be prioritized in order of strategic importance
- Consider who your M&A competitors are and their ability to pay

# A Successful M&A Transaction – Planning Phase

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## Getting Your House in Order – Sellers

- Have counsel review and update all employment and change-in-control agreements and benefit plans
  - Do this before process is underway and certainly before transaction is announced
- Executive compensation and employee benefits are important components of every transaction and involve tax, accounting, ERISA, legal and regulatory issues
  - Golden Parachute Rules (Part 359; IRC §280G); Deferred Compensation Limitations (IRC § 409A)

# A Successful M&A Transaction – Planning Phase

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## Getting Your House in Order – Sellers

- Understand the termination costs of significant contracts, e.g., data processing, SERP agreements
- Make sure your directors understand their fiduciary duties
  - Duty of loyalty, duty of care; cash transaction versus stock or part cash/part stock transaction
- Institute trading blackout once process is underway
  - M&A announcement may result in FINRA investigation
- Consider any regulatory/ROE issues that could impact transaction

# Types of Solicitation Processes

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Most Bank M&A involves:

1. "Limited Shop" - most common
2. "Negotiated" or "One-on-One"- sometimes utilized in strategic, stock for stock combinations; standard in mutual to mutual transactions
3. "Full Auction/Shop" – rare; typically used with troubled target situations; sometimes forced by activist shareholder

## Limited Shop Solicitation

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- Seller selects limited group of prospects, typically considers: 1) ability to pay, 2) prior acquisition activity, 3) ability to execute, 4) prior expressed interest
- Seller/IB prepare “solicitation book” or Confidential Information Memorandum (CIM)
- 5 - 10+ prospects contacted by IB and, if interested, provided CIM after signing confidentiality agreement (CA/NDA)
  - CA typically includes “standstill” provisions – litigation concern
- Prospects given bidding instructions and 2-3 weeks to provide non-binding letter of interest

## Limited Shop Solicitation

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- Prospects given bidding instructions and 2-3 weeks to provide non-binding indication of interest
- 1-3 finalists picked, invited for more due diligence and to enhance/modify pricing, Seller conducts reverse due diligence
- Finalist picked, possible exclusivity agreement, due diligence continues while merger/definitive agreement negotiated
- Merger agreement signed, transaction announced

## Negotiated or One-on-One Solicitation

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- Process can vary but generally involves Seller and Buyer exclusively engaging in merger discussions, executing reciprocal CA, sometimes with exclusivity period (30-60 days)
- Material terms typically agreed to through use of term sheets or non-binding letter before comprehensive due diligence
- Buyer and Seller will conduct due diligence on each other and begin negotiating merger agreement
- Seller may “market check” deal or build terms in agreement to effectively allow a “topping” bid due to “Revlon Duties”
- If “market check” is used, then Seller will only sign merger agreement after contacting other prospects to confirm pricing

## Full Auction/Shop Solicitation

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- Process involves Seller essentially making a public announcement that it is for sale
  - May announce that company is seeking “strategic partners” or “strategic transaction opportunities”
- Generally not used as it may have negative effect on customer and employee relations and franchise value
- Generally only used as last resort or after failed process
- Essentially will become first come first serve for Seller/Buyer negotiations and will involve minimal “social issues” and severance payments
- Can be forced upon Seller by activist shareholder

# Revlon Duties

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- Delaware case law, followed by most other states, that essentially says that if a “sale of control” occurs, Seller Board must exercise its fiduciary duties to obtain the best price reasonably available
- Sale of Control – cash transaction (or significant cash consideration component, e.g., >35%), or a transaction which results in a controlling stockholder
- If a sale of control, then Seller Board has *Revlon* duties – obtain best price reasonably available under circumstances
  - There is no “blueprint” or legally prescribed steps directors must follow to satisfy *Revlon* duties – flexibility with *Revlon* obligations

## A Successful M&A Transaction - Due Diligence

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- Must be thorough before signing - typically very high standard to terminate (Material Adverse Effect - MAE) for errors in representations
- Diligence findings may: kill a deal, substantially affect pricing, or result in special merger agreement terms
- Buyer's "credit mark" on Seller loan portfolio usually biggest diligence/pricing issue, also benefit plan and contract termination costs

## A Successful M&A Transaction - Due Diligence

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- Use of outside diligence experts - Buyer may want to use third party loan reviewer to complement loan staff review
- Seller third party/vendor contracts need review and termination fees and restrictions need to be quantified
- Compensation due diligence and 280G issues will be large part of due diligence and negotiation

## A Successful M&A Transaction - Due Diligence

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- Buyer financial advisor and/or counsel will prepare “due diligence list” and deliver to Seller
- Seller will respond to list and set up virtual data room or produce copies and schedule off-site review
- After initial document review (or during end of off-site review), Buyer will typically have key officer interviews
- Buyer due diligence will continue up until signing of merger agreement - nothing is “off limits”

## A Successful M&A Transaction - Due Diligence

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- Seller may need non-disclosure agreement from any third party that Buyer wants to contact (usually for contract termination payments; actuarial calculation for benefit plans)
- Seller will conduct due diligence on Buyer for stock deal (limited due diligence for all cash deal)
- Buyer and Seller each will create due diligence report for their board
- Reciprocal due diligence in a mutual to mutual merger (unless significant size disparity)

# M&A Litigation

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- Most stock deals face litigation alleging Seller board breached fiduciary duties or conducted a flawed process
  - Lawsuit filed following announcement and amended upon filing of proxy statement with SEC alleging disclosure violations
  - Most suits settled with additional disclosure and payment of fees to plaintiff's counsel
  - The likelihood of legal challenge highlights the need to conduct process and create record with care – recent Delaware case holding investment bankers liable for damages for conflicts of interest not communicated to board – cautioning boards to identify conflicts
- Litigation slows process and progress of deal, will add cost, may raise regulatory questions, but should not prevent deal closing
- Delaware courts pushing back against disclosure only settlements

## Key Compensation Issues - Sellers

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- Executive compensation and employee benefits are important components of every M&A transaction and involve tax, accounting, disclosure, ERISA, legal, regulatory and document review and drafting issues
  - Golden Parachute Rules (Part 359; IRC §280G); Deferred Compensation Limitations (IRC § 409A); Employment and Change in Control agreements;
  - Quantification of costs of various plans and arrangements is critical – complete analysis before contacting parties
  - SERP and other benefit plan termination costs could be greater than reflected on balance sheet, *e.g.*, discount rate for early termination of SERP could be greater than that used for accruals

## Key Compensation Issues – Buyer

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- Payout of existing arrangements – quantify costs
- Review compensation and benefit arrangements for legal and regulatory compliance - assess 280G and 409A issues
- New employment or change in control agreements?  
Restructuring of existing arrangements?
  - Needs to be resolved prior to execution of merger agreement
- Severance, retention payments for rank-and-file employees
- Participation in benefit programs

# Shareholder Approval Issues

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- As a result of Dodd-Frank, there are additional SEC disclosures and a shareholder vote as to golden parachute payments in merger transactions
  - Disclosures in “clear and simple terms” of all payments to NEOs that are based on or related to the transaction must be provided
  - The proxy statement must include a nonbinding proposal enabling shareholders to vote to approve the golden parachute payments, unless the arrangements have previously been subject to a say on pay vote
- The SEC has golden parachute disclosure rules for annual meeting proxy statements and for merger proxy statements – they should match up

# Getting The Deal Done – Take-Aways

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- Current banking landscape offers Buyers, particularly those with a strong stock currency, opportunities to expand their franchise and enhance value through acquisitions
- Earnings, pressures, regulatory/compliance costs, and the impact of technology will continue to make it more difficult for banks to compete and be profitable, (which will affect smaller banks disproportionately), which will continue to generate consolidation
- Both Buyers and Sellers need to have their “regulatory houses” in order before beginning the deal process
- Planning is essential for both Buyers and Sellers

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