



MERGERS & ACQUISITIONS

A Community Banker's Guide

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This booklet is designed to help community bank managers and owners execute a successful acquisition or sale transaction. Mergers and acquisitions are virtually inescapable facts of life in the modern banking world. Community bankers must understand enough about the M&A process to know how to represent and protect the interests of the bank's shareholders when the time almost certainly comes. This booklet covers the basic facts every bank CEO should know about how banks are bought and sold.

The guide highlights the most common business and legal issues that arise in community bank M&A transactions, most often from the seller's perspective. It does not offer an exhaustive examination of these subjects, or legal advice, because circumstances and technical issues can vary enormously between situations. Instead, drawing upon the author's practical experience, the narrative offers suggestions about how common issues are typically resolved, which may sometimes include obtaining further specific professional advice from the bank's lawyers, accountants and investment bankers.

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The Role of Investment Bankers

The acquisition process normally begins when the seller's directors and principal shareholders decide that the time has come to sell or to attempt to sell their bank. The board will then typically hire an investment banking firm or broker to help find a buyer.

Good investment bankers are worth their fees. Most selling bank CEOs have had little experience assessing market conditions, finding prospective buyers or negotiating the terms of a successful acquisition transaction. Those who try to handle the process without expert assistance run the risk of leaving too much on the table. Moreover, using a solid investment banking firm affords some protection for the seller's directors against potential claims that they did not exercise the proper care in the way they sold the bank.

When selling a community bank, reputable investment banking firms usually ask for a modest up-front payment to cover their costs of putting together a bidder's package about the seller and lining up potential buyers. They will also want a contingent brokerage fee calculated as a percentage of the purchase price in a successful sale. This contingent fee will typically range from 0.5 percent to 1.5% of the sales price depending upon various factors, including the perceived difficulty of finding a buyer or obtaining a price acceptable to the seller. Without additional charges, the investment banker is usually expected to issue an opinion that the purchase price is "fair" for the selling shareholders. Although the risk of challenge may be slight in most community bank acquisitions, obtaining such an opinion provides additional protection that the seller's board has acted in a prudent manner. All of the investment banker's fees are normally paid by the selling bank rather than its shareholders.

The Marketing Process

The investment banker will put together an informational package about the selling bank and circulate it to potential buyers. Handling interested buyers during the marketing process can be done in different ways. Each prospective buyer would normally be asked to sign a confidentiality agreement upon receipt of the seller's offering booklet. Bidders may also be asked to submit an indication of interest at a specified price range before being allowed to perform more detailed due diligence. An "indication of interest" is nothing more than a non-binding letter saying that the buyer is generally interested in buying at a particular price range. If more than one indication of interest is submitted, the seller may choose the one it believes will best serve the interest of its shareholders based upon the criteria it believes are relevant, as long as price and the buyer's ability to close are paramount concerns.

By this point in the process, it is usually a good idea for the seller to be receiving counsel not only from a financial adviser but also from an experienced M&A lawyer.

Sellers need good investment bankers to get the best price and to protect against director liability.

The adverse publicity for the seller from putting out an informational package for prospective buyers, "putting the bank on the block," is usually outweighed by the resulting better chance for a higher price.

The seller naturally wants to keep the marketing process as quiet as possible, fearing that the bank may be damaged if it is perceived to be “on the block,” especially if it does not find a buyer. The more aggressive the investment banker becomes in marketing the bank or the more time taken by the process, the more difficult it will be to keep word about the prospect of a sale from leaking out. The seller may then need to issue an interim statement about its general intentions for employees and the public alike, although care must be taken to ensure that any such public statements conform to applicable securities laws.

The prospect of adverse publicity makes some selling directors wish to avoid the formal solicitation of bids preferred by most investment bankers. They may think they know the best or most likely buyer for the bank and what that buyer would or should pay. Why not just cut a deal with that bank over lunch at the country club and be done with it? This approach is not advisable. The “adverse” publicity that sellers fear will not be all that harmful, and the seller’s directors could be liable if it was later shown that they failed to take due care in the sale, particularly if another suitor surfaces who offers a distinctly higher price, or if it emerges that the seller’s insiders have some relationship with the chosen buyer and might benefit more than other shareholders from a sale to that buyer.

A seller must be prepared to expose most of its business secrets to interested buyers, although this can be deferred until a buyer has indicated a good faith intent to purchase at an acceptable price.

Due Diligence Procedures

Buyers usually want to conduct some on-site due diligence before going beyond initial indications of interest. It is usually appropriate for the buyer to indicate a proposed purchase price or price range before being allowed to conduct due diligence, although this might not be expected in situations where the selling bank’s financial condition is problematic for some reason. Sellers will usually thus allow interested buyers a few days for due diligence and perhaps a week or two longer to submit any final offer they care to make. Before submitting to the disruption of on-site due diligence, the seller is entitled to impose whatever reasonable conditions it chooses, although limiting due diligence access should never become a barrier to sale.

There is no industry-standard procedure for conducting due diligence in a bank acquisition. An experienced buyer will have a team of people who do this work on each new deal. They will probably have a checklist of things they want to look at, but the quality of the bank’s loan portfolio and the source of its deposits will certainly be two primary areas of focus.

Sellers must normally be prepared to disclose sensitive information about customers and employees even if the buyer is a competitor. Of course, the parties should have in place a confidentiality agreement that includes a clause restricting the buyer’s ability to hire any of the seller’s employees for perhaps one or two years thereafter.

Prospective buyers have a legitimate interest in reviewing the seller's regulatory examination reports, and favorable reports could reduce the buyer's need for independent verification and thus the time required for on-site due diligence.

The seller usually does not need much due diligence about the buyer. In all-cash transactions, the seller wants little more than the buyer's assurances that it can pay the purchase price and obtain regulatory approval to do so. When taking the buyer's stock in the transaction, the seller should look a bit deeper. Usually the buyer in such cases will be a public company, so the seller's directors at least have a duty to consider the buyer's SEC filings and other available information (such as advice from the seller's investment advisers) before ultimately recommending the sale transaction for shareholder approval.

Those are the key questions. How one answers them decides which course of action the bank should pursue.

Purchase Price: Two Sides of the Same Coin

A successful acquisition transaction involves bringing buyer and seller to an agreement on a number of issues, but most important by far is the question of purchase price. The buyer and seller will naturally have different perspectives on the issue.

First, the question is not actually what the selling bank is worth but what a buyer is willing to pay at any given time. Sellers particularly need to keep this concept in mind. The seller's principals may think the value of the bank to be one thing, but if all potential buyers (the markets) hold a fundamentally different opinion, the would-be seller must either face reality or withdraw from the game, perhaps to play another day. A big part of the buyer's job, with the help of both parties' advisers, is to convince the seller that the buyer's offer represents the maximum amount obtainable in the current "market" for the selling bank as a whole.

The buyer's offer will usually be based upon a reasoned assessment of how the costs of the acquisition will impact the buyer's earnings. The buyer will naturally want the acquisition to enhance earnings per share, taking into account how any merger savings realized by the combination could boost future earnings. The maximum price the buyer will normally pay is usually a direct product of this calculation, unless the acquisition is being driven by issues other than price, such as the buyer's ego or competitive considerations, in which case the buyer may be willing to pay a premium price regardless of the future cost of the transaction.

For both buyers and sellers, purchase price is usually determined by evaluating investment return.

The seller has a different calculation to make. After gaining some comfort that the buyer's offer is the best offer obtainable under current market conditions, the seller's board must then decide whether it is prudent for the shareholders to sell at the offered price. Ideally, making this determination involves assessing alternative projected returns to shareholders resulting from selling or not selling. That is, would the shareholders be better off to sell now at the offered price (and perhaps take the buyer's stock) or to wait for a favorable change in the market (or a change in the condition of the selling bank)?

Knowing how to value a bank is not necessarily a skill that the CEO needs to have because investment bankers and valuation consultants usually play an important role in helping both the buyer and seller answer these complex questions about relative value, price and market conditions. But industrious CEOs will want to learn as much as they can about this important subject because experience shows that knowledge and leadership are advantages when it comes to negotiating price.

Bridging the Gap: Spin-outs, Earn-outs and Escrows

Differing perceptions about value sometimes cannot be resolved purely by adjusting the price. If the differences are about the quality of the seller's assets, such as the collectability of particular loans or the market value of repossessed real estate, the parties could consider conveying the assets in question separately to the shareholders at closing as a component of the total purchase consideration. This sort of transaction, sometimes called a spin-out, works best when the seller has only a handful of relatively sophisticated shareholders. Moreover, spin-outs are usually only feasible when the assets in question represent a relatively small proportion of the total purchase price because the value of the spun-out assets will likely be treated as ordinary income rather than capital gain for income tax purposes.

Differing opinions about future value might also be resolved by providing for the seller's shareholders to receive additional consideration or an earn-out based upon actions that might occur in the future, such as collecting a large loan, settling a lawsuit or selling other real estate. Such provisions, which will clearly be unattractive for the seller, require careful drafting because the selling shareholders will have a continuing stake in how the buyer collects or sells the problem asset after the closing.

Escrowing part of the purchase price is yet another possible way of dealing with problem assets or other contingent liabilities. Naturally, sellers rarely acquiesce to such arrangements, particularly when the contingencies in question have to do with problem loans. The problem is the same one faced with earn-outs — the seller cannot depend upon the buyer to pursue collections diligently when the seller's shareholders will be the beneficiaries of the buyer's efforts.

The seller's problem assets could be spun-out to shareholders or the terms of the purchase could be adjusted to reflect performance after the sale.

Understanding Transaction Structure

When the seller is a bank holding company, the acquisition is usually accomplished by merging that holding company into the buyer's holding company while simultaneously or shortly after also merging the seller's bank into the buyer's bank. The holding company merger is really all that matters for the seller because the seller's shareholders are all at the holding company level. The merger at the bank level is in the nature of corporate housekeeping for the buyer and need not be done at all as far as the seller is concerned.

For tax and other reasons, the merger may be structured as a "triangular" merger, in which the target bank is first merged with an interim or "phantom" bank before the resulting entity is merged with the acquiring bank. Triangular mergers can be "reverse" or "forward" and the difference matters for tax reasons.


The advantage of the merger approach, which is all but universal in community bank M&A transactions, is that the buyer can acquire 100 percent of the seller's stock if the transaction is approved by a specified vote of shareholders. Negotiating with individual shareholders is not necessary and individual shareholders are not able to block the transaction by refusing to sell. In situations involving sellers with very few shareholders, however, the parties could dispense with a merger in favor of a direct negotiated purchase of the shareholders' stock. One drawback to this approach is that it may cause some of the expenses of the sale transaction to fall directly upon the selling shareholders rather than upon the selling bank.

Very rarely, the buyer may wish to structure the acquisition of a whole bank as a purchase of substantially all of the bank's assets, which is the procedure commonly used when a buyer is just buying individual bank branches or when the FDIC liquidates a failed bank. For various reasons, especially for tax reasons, an asset purchase structure for a whole bank acquisition will usually not be acceptable to the seller.

Accounting and Tax Considerations


The tax and accounting ramifications of corporate acquisitions can be many and complex, especially for the buyer. Although CEOs do not need to keep current on these topics, they do need to have access to experienced legal and accounting advice when structuring bank acquisitions.

The buyer will mainly be concerned about what effect the acquisition will have on the buyer's balance sheet, particularly in relation to capital adequacy for regulatory purposes. The seller may be indirectly concerned about the same question, even in an all cash transaction, because any acquisition that would cause the buyer to become capital deficient is not going to be approved by the regulators.



Most acquisitions are structured as mergers of the seller into the buyer although negotiated stock purchases and asset sales are possible.

The buyer's main accounting concern will be how much goodwill the acquisition creates on the buyer's balance sheet, since goodwill is deducted from capital for regulatory purposes.



Before revisions of the accounting rules made the concepts obsolete, it was important to know whether a proposed acquisition would be treated as a “pooling” or a “purchase” for accounting purposes. The issue had to do mainly with how the buyer accounted for the “purchase premium” or “goodwill” in the transaction, that is, the amount over book value being paid for the seller.

Current rules require the buyer to assess the market value of the seller’s assets and business and to treat any amount by which the purchase price exceeds this value as goodwill or “intangible capital.” Effectively, goodwill must be subtracted from other forms of equity when calculating capital adequacy for regulatory purposes.

The seller may not usually care about the buyer’s accounting except to understand where the buyer is coming from on price, but the seller will certainly be concerned about the tax effect of the sale on individual shareholders. As a general rule, if the seller takes all or a portion of the purchase price in the buyer’s stock, the stock portion of the consideration can normally be exchanged on a tax-free basis so that the shareholders will have a carryover basis and will not recognize any gain or loss on the value of the buyer’s stock they receive. Any cash received by the shareholders will ordinarily be treated as capital gains.

Transactions Involving Sub S Banks

This booklet does not give detailed consideration of the special issues that arise for Subchapter S banks in the M&A context. Competent legal and tax accounting counsel are recommended. It is sufficient to say here that Sub S banks are normally acquired in stock sale transactions which, as in the case of C corporations, are treated as tax-free reorganizations for selling shareholders to the extent the buyer’s stock is received as consideration. The shareholders would normally recognize gains on cash consideration as capital gains.

One of the special advantages of the Sub S structure may come into play when the target has been an S corporation for more than 10 years. The seller’s shareholders may then prefer a transaction where the sale is fully taxed to shareholders. The shareholders could choose to sacrifice the possible benefits of deferral of gain for a higher net sales price. In such a case, the buyer makes an election under Section 338 of the Internal Revenue Code to treat the acquisition as an asset purchase for tax purposes, although the transaction remains a stock sale in structural terms. The buyer may be willing to pay a higher price for this privilege and for the tax benefits the buyer could derive from treating the transaction in this way.

In taxable transactions, tax benefits for the buyer almost always come at the expense of higher taxes for selling shareholders, so it is vital that Sub S

Mature Sub S banks will be attractive M&A targets but sales transactions require special tax planning and documentation.

banks fully understand the tax consequences for their shareholders of any proposed “338” transaction. The seller’s counsel will also want to be involved in negotiating an allocation of the purchase consideration among the seller’s assets with a view to minimizing adverse consequences.

Letters of Intent

The buyer usually submits its “final” offer in the form of a letter of intent, which can be accepted by the seller and becomes the basis for a “definitive agreement” that would then be prepared. Letters of intent are typically non-binding in a technical legal sense, but they do create something of a moral obligation for parties acting in good faith. The LOI, as it is often called, is simply a letter that sets out the deal points that the parties have agreed upon preliminarily and obligates the parties to move forward in good faith to negotiate and execute a definitive agreement clothing these deal points in formal legal language. The buyer will expect the seller to refrain from soliciting other offers after the letter of intent is signed, which is one reason why the time period allowed for preparation of the definitive agreement is usually limited to 30 days or less. The buyer’s legal counsel is usually left responsible for the next stage, drafting the definitive agreement.

Seller’s Board Approval

The seller’s board of directors, or at least a designated committee of the board, should be intimately involved in the process of deciding whether to sell, engaging an investment banker, finding a buyer, accepting the buyer’s proposal and negotiating a final purchase transaction. The minutes of board and committee meetings should reflect all of these efforts in considerable self-serving detail.


Fiduciary duty does not require that the directors always make wise decisions, only that whatever decisions they make be made with proper care and due diligence (and documentation). An experienced lawyer can help the board make appropriate decisions in a way that protects the directors from later being second guessed.

The Definitive Agreement

The so-called “definitive agreement” is often actually named something like an Agreement and Plan of Reorganization because, among other things, it sets out the structural mechanism by which the proposed acquisition will be accomplished. The definitive agreement is a road map for the entire transaction, which contains all that legally needs to be said to guide the parties to the closing. The selling CEO’s most important job is normally to handle negotiations with the buyer on behalf of the board of directors and

The deal is usually struck when the seller’s board carefully considers and accepts a letter of intent submitted by the buyer.

The definitive agreement is designed to provide a road map to the closing.



then to oversee the process of converting the business understandings of the parties into the binding legal contract that is the definitive agreement. Therefore, after working through issues of price, most of the remaining critical variables of the acquisition process are revealed by understanding what goes into a definitive agreement.

Definitive agreements in bank acquisitions follow a pattern that is easily mastered.

Typical Components of a Definitive Agreement

Definitive agreements ordinarily consist of the same basic components. These will include provisions dealing with the following:

1. Basic terms of the transaction, including purchase price and the procedure for converting the seller's shares into that price.
2. Representations and warranties by the seller and, to a lesser extent, by the buyer. Covenants or agreements by both parties, including clauses designed to maintain the status quo until closing.
3. Conditions precedent to the parties' obligations to close, including the absence of adverse changes and obtaining regulatory and shareholder approvals.
4. Miscellaneous other provisions, including termination rights, indemnifications clauses and other general boilerplate.

Buyers generally do not expect personal liability of officers, directors or large shareholders regarding the seller's representations and covenants but will expect controlling shareholders to commit to vote for the transaction.

Key Negotiation Issues

A major aspect of negotiating a definitive agreement usually involves deciding what kinds of representations and warranties and covenants the seller is prepared to make. The seller's first concern will be to ensure, if possible, that the individual shareholders or directors of the seller will not have any personal liability under the provisions of the definitive agreement and that the selling party under the agreement will only be the corporate entity of which they are shareholders and directors. Since the selling entity will more than likely go out of existence in the acquisition, the buyer would naturally prefer instead to have individual directors or major shareholders backing up the seller's representations about the absence of undisclosed liabilities. Personal liability may be appropriate when the seller has a few truly dominant shareholders (the ones who will have most of the buyer's money if the buyer finds problems after the closing), but in the ordinary course, buyers will not expect to impose personal liability upon individual selling shareholders, and especially not in situations where the seller's stock is held by more than a handful of shareholders. It is more common for the buyer to ask the seller's controlling shareholders or board members to agree personally to vote their shares for the proposed acquisition or to execute a proxy to that effect, which is usually acceptable to the seller because the buyer's need for reassurance on this point is understandable and because no residual personal liability attaches to such an agreement except the obligation to approve the transaction.

Seller's Representations and Warranties

Perhaps as much as half of the bulk of the definitive agreement will be taken up with detailed representations by the seller covering issues such as title to assets, financial condition, status with the regulators and absence of contingent liabilities. The buyer views this part of the definitive agreement as a supplement to its other due diligence activities about the seller. The buyer wants to be told if there are any exceptions to the picture presented by the seller's financials.

Even if the seller has audited financials, the specific representations in the agreement will pick up interim unaudited periods and will usually be accompanied by a statement that reads something like "except as set forth in the Seller's Disclosure Schedules." The seller is expected to list in these schedules all the exceptions to the absolute truth of all representations and warranties in the agreement. Each "schedule" is usually reflected as an item in a single list of all the schedules referred to in the agreement. The seller is expected to put "none" on the schedule if that is the appropriate response.

Sellers and buyers sometime debate about whether a particular representation, such as one regarding the absence of contingent liabilities, should be made without reservation or merely "to the best of the seller's knowledge." The distinction obviously matters more if personal liability attaches to the agreement. Even with the knowledge qualifier, however, the seller is expected to know what it should have known through the exercise of reasonable business practices whether its officers in fact had actual knowledge of such issues.

The buyer will typically want the agreement to specify that all seller representations "survive" the closing for a designated period of time. Such a provision is only meaningful when the shareholders are made personally liable for the seller's representations. The buyer will think that this clause makes it easier to seek indemnification from the shareholders if a problem is discovered after the closing. For that reason, the seller and its shareholders should resist accepting personal liability all the more vigorously if any survival of representations and warranties is proposed. The seller's response to the buyer could properly be: "Go do some more due diligence if you must but, after the closing, she's all yours."

Preserving the Seller's Status Quo

Whether set out in a separate section or not, every definitive agreement will contain affirmative and negative "covenants" or agreements imposed upon the seller, which will generally be designed to preserve the status quo until the closing. The buyer normally expects the seller to continue to operate during the period before the closing as it has operated in the past. Accordingly, the

The seller's representations and warranties are a big part of the definitive agreement. Buyers expect the seller's representations to cover everything material including issues already known to the buyer's agents. Any exceptions to the representations should be scheduled in an attachment to the agreement.

buyer will want to restrict the seller from depleting its assets or taking on material new liabilities, which typically means that the seller may not pay dividends, issue stock or options, increase employee compensation or take other steps that might materially change the value of the deal for the buyer from the time the definitive agreement is executed until the acquisition closes.

The definitive agreement includes various agreements by either or both parties designed to preserve the status quo and map out the respective rights and obligations of the parties through to the closing.

It is typical for the buyer to want the right to approve new seller loans or capital expenditures over certain amounts or at least have the right to be consulted before such commitments are made. The buyer may also want to limit the seller's flexibility in trading its bond portfolio or executing other measures that could increase the buyer's cost for the acquisition.

The seller should resist restrictions on its operational flexibility if they have the potential to unduly distort or compromise the seller's business during the period prior to closing. After all, it is always possible that the deal will not close as planned. The seller's directors have a fiduciary duty to preserve the seller's value. It would not look good for them if the deal were to fall through and leave the seller in a damaged state because key customers or key employees had been lost on account of such restrictions.

The tension can become more pronounced when the buyer and seller are considering how to deal with the seller's key employees. The buyer and seller often have different ideas about which of the seller's officers should be retained by the buyer and which should not. Preserving the status quo until the closing may require that the seller retain the ability to pay special "stay put" bonuses to those key employees who do not have a future with the buyer and might otherwise quit before the closing.

In cash deals, the buyer mainly agrees to obtain regulatory approvals and deliver the purchase price in a reasonable period of time.

Buyer's Representations and Agreements

Whether the buyer should be expected to make extensive representations or representations that mirror those of the seller depends upon whether the purchase price includes shares of buyer's stock. In all-cash purchases, the seller may only want to see the buyer represent that it has the wherewithal to pay the agreed price and knows of no reason why the regulators would not approve the transaction. But when the seller is receiving the buyer's stock, the seller's shareholders are investing in the buyer as much as the buyer is investing in the seller. The seller can then reasonably expect the buyer to make appropriate representations about its financial soundness and the accuracy and completeness of its SEC filings. Logic would perhaps dictate in these cases that the buyer make representations at the same level of detail expected of the seller, but the buyer is usually much larger than the seller, and sellers normally acquiesce in allowing more summary representations for the buyer. The buyer will also make fewer affirmative commitments than the seller. Again, the seller mainly wants the buyer to agree to pay the stipulated price, exert its best efforts to obtain all required regulatory approvals and

close the proposed transaction as expeditiously as reasonably possible. If applicable, the buyer must also agree to register with the SEC any of the buyer's stock being offered to selling shareholders, and the finalization of such a registration will be a condition precedent to closing. Very often the parties will have specific agreements about how employee benefits will be handled for the seller's employees, and the buyer may wish to enter into separate employment agreements (including non-competition provisions) with the seller's most senior officers.


Regulatory Approvals and Timing

The seller is inevitably somewhat at the buyer's mercy when it comes to obtaining regulatory approvals. The applications required are mainly on behalf of the buyer, and it is the buyer's financial strength, community investment act rating and management team that the regulators will evaluate in deciding whether to approve the transaction. With the give-and-take typical of the regulatory process, the buyer could effectively cause a transaction to fail simply by not responding fully to questions and concerns raised by the regulators. There is almost no way to deal with such a contingency completely in the definitive agreement in a manner at once acceptable to the buyer and also fully protect the seller. As a result, the seller usually simply relies upon the buyer's commitments to file necessary applications promptly and then to exert all reasonable "best efforts" to obtain regulatory approval and close the acquisition within a reasonable time period after the definitive agreement is signed.

How much time the buyer should be allowed depends upon which regulatory agencies and which issues are involved. Generally speaking, something is probably wrong if the buyer has not been able to obtain necessary regulatory approvals (and SEC registration if necessary) within six months after the definitive agreement is executed. If it takes longer, it is often because the buyer has encountered some kind of problem with the regulators that either cannot be resolved in a timely manner or that would require a cost or regulatory constraint that the buyer is unwilling to assume.

The seller is somewhat protected in these situations if the definitive agreement allows termination without penalty to the seller if the closing does not occur by some specified date, usually no longer than six to nine months after the date of the definitive agreement. The parties could try to negotiate an escalation in price or some other penalty that would allow the buyer to extend the time period permitted for closing, but the seller is probably better off to keep the allowed time period as short as possible. The parties can always negotiate a basis for extension at the time termination of the agreement becomes a likely possibility. The longer the seller is legally held in suspense under the definitive agreement, the more damage to its franchise value will occur if the proposed acquisition ultimately fails altogether.

If the buyer cannot obtain approvals and close within six months, the seller should be able to terminate.



Conditioning the transaction on the absence of material changes is universal but definitions and materiality thresholds are important.

Officers are entitled to be paid separately for noncompetition agreements.

Material Adverse Changes

The buyer's obligation to close under the agreement will typically be subject to there having been no material change in the seller's financial condition from the time the definitive agreement is executed to the closing. In this context, the seller may want the agreement to define "material" as a large enough number to ensure that anticipated hits to the seller's capital, including loan loss allocations, will not relieve the buyer of its obligation to complete the purchase. Sometimes this concern is perhaps better handled in the definitive agreement as a condition that the seller's capital not be less than a specified amount at the time of the closing. The buyer may also want a termination right under the definitive agreement if the seller's "future prospects" (as opposed to its current financial condition) shall have become adversely changed. However, the preferred practice would be to avoid opportunities for debate of such semi-subjective criteria within the specific confines of the definitive agreement. Exceptions might be made for sellers in coastal communities facing hurricane disaster risks or border banks facing devaluation or currency rate fluctuation risk or other specific circumstances where it might be possible to define adequately what adverse changes in a bank's prospects might be.

Antitrust Issues

If the buyer and seller are operating in the same market and the effect of the acquisition could be to lessen competition in possible violation of federal antitrust laws, the prospect for obtaining regulatory approvals may become more problematic. In these situations, the seller should obtain its own legal counsel's evaluation of the potential risk of undue delay or even outright disapproval before entering into the definitive agreement.

Dealing with Employees and Benefit Plans

In a merger transaction, the buyer succeeds to all the seller's liabilities and obligations by operation of law at the time the merger becomes effective. Employee contracts and options in effect at closing would become the buyer's obligations. The buyer however, will normally want to renegotiate (or terminate) any existing long-term employment contracts before the closing. The buyer might also want to condition the acquisition upon negotiating an acceptable continuation (or termination) plan for key managers, which would be a problem for the seller if the condition effectively gives veto power to individual employees after the definitive agreement is signed. If the buyer requires non-compete commitments from key employees, the employees are entitled to be compensated for such arrangements apart from what they might receive as shareholders.

Typically, seller's employees who have stock options will want to exercise those options before the sale and include the optioned shares in the sale. Alternatively, the buyer and seller could simply agree to pay option holders the difference between their exercise price and the purchase price at closing.

Benefit plans such as 401(k) plans and stock ownership plans can be handled in different ways. Normally such plans are terminated at closing, with the employees having the option to receive vested benefits at closing, although employees are normally also invited to roll over any retirement funds accrued with seller into one of the buyer's benefit plans. Funded pension plans are typically terminated before closing. The seller may want to ensure that the value of any over-funding within a pension plan goes to the seller's employees and not to the buyer.

The definitive agreement usually does not have much to say about the general benefits afforded to seller's employees, such as health coverage and accrued vacation time. Since the seller will be merged into the buyer, the seller's employees will automatically become buyer's employees at closing, which ensures that they will thereafter be eligible for any routine benefits the buyer provides for its own employees. If the seller has promised a particular benefit for an employee, the seller's obligation will become the buyer's obligation upon the merger. It is prudent but not essential for the definitive agreement to make this implied obligation express by stipulating how the seller's employees will be treated, especially noting that the seller's employees would be entitled to carry over their length of service with the seller for purposes of any vesting requirements under the buyer's benefit plans.


No-Shop Clauses, Lock-Ups and Break-Up Fees

The seller will be prohibited by the agreement from continuing to solicit purchase offers after the definitive agreement is signed. But what if the seller receives an unsolicited offer from another buyer at a substantially higher price? Decided cases in Delaware and other states indicate that the seller may have a duty in these circumstances to revoke the first agreement and take the second offer, especially if this can be done without a major penalty to the seller under the definitive agreement. Buyers have come up with many clever ways of dealing with this problem, the most common being to provide that a sizable stipulated "break-up fee" be paid to the buyer if the seller accepts another offer.

At the community bank level, where the seller is usually a nonpublic entity, acquisitions are rarely likely to be so contentious that a "break-up" could occur. The seller should therefore resist a buyer who wants to go beyond a reasonable break-up fee (perhaps up to 2 percent of deal value) to more draconian arrangements such as provisions giving the buyer an option to purchase a big chunk of the seller's stock at a favorable price if the seller

Benefit plans and employee agreements or options not terminated before closing would carry over and become obligations of the buyer.

Sellers may have a fiduciary duty to consider unsolicited offers from third parties. Buyers are normally entitled to a break-up fee if the seller accepts another deal after the definitive agreement.



attempts to take a better offer. Of course, this would allow the initial buyer to block the sale or at least get paid a nice premium for the option stock from the new buyer, which would certainly be effective for the purpose intended but would also be overkill in normal acquisition situations.

Dealing with Continuing Director Liability

The seller's directors will want to ensure that the routine exposure they have had as bank directors is assumed or indemnified against by the buyer going forward. The seller already has a legal obligation to indemnify its directors from this kind of liability, whether or not there is a provision to that effect in the seller's bylaws or articles of incorporation. The seller's corporate indemnification obligation will become an obligation of the acquiring bank after the merger, so the directors would have a right to seek indemnification from the buyer even if the definitive agreement had nothing to say on the subject. Even so, the seller will want to restate this obligation in the agreement and possibly also require the buyer to maintain "tail" coverage under the seller's current liability insurance policy for some period of time after the closing.

Finalizing the Agreement: Public Announcements

Buyers are more likely to be public companies than sellers and are typically more sensitive than sellers about confidentiality and information security. The public buyer will certainly be anxious to issue a press release as soon as the definitive agreement is executed. In fact, the buyer may have been under particular pressure to reach this point because word of the acquisition had already leaked out and triggered activity in the buyer's stock. The seller often simply joins in buyer's public announcement, but the seller's CEO will probably also want to send a brief letter to the shareholders, explaining the basic terms revealed in the buyer's press release and noting the major remaining conditions to the eventual closing of the acquisition, including most prominently the need to hold a shareholders' meeting to approve the transaction. The seller's insiders should also be counseled at the outset to avoid leaking nonpublic information about the proposed transaction, or worse, engaging in trading the buyer's or the seller's stock based upon nonpublic information. These prohibitions will continue in place until the closing.

Seller's Operations Pending Closing

As mentioned, the seller's business could be adversely affected by negative covenants restricting the seller's flexibility during the period between signing and closing. Some buyers may even want to act during this time as if the closing has already occurred. They may want to proceed with employee

The directors right to indemnification will survive the closing, but express acknowledgement by the buyer is desirable.

Public disclosure should not be made before the definitive agreement is signed. Detailed disclosures should be deferred until the shareholder's meeting.

changes and other changes they expect to make after they own the bank. It is reasonable for the buyer to want to monitor the seller's lending activity and even to have the right under the agreement to attend the seller's board meetings. But the seller should not allow management activity by the buyer that goes much beyond merely monitoring the seller's progress. The seller will at least want to avoid making changes requested by the buyer that would harm the bank if the sale does not go through.

Approval by the Seller's Shareholders

Unless a sufficient percentage of the seller's stock can be tied down with a voting agreement between the buyer and the seller's major shareholders, the buyer remains at risk until the seller's shareholders approve the transaction. Although the definitive agreement ordinarily obligates the seller's board to recommend approval of the transaction to the seller's shareholders, individual directors could conceivably still vote against the transaction in their personal capacities as individual shareholders if a better offer came along. But in most cases obtaining shareholder approval can be taken for granted, if for no other reason than because community bank shareholders usually will do what the board recommends. The special meeting of shareholders to approve the sale will normally be held toward the end of the expected processing time for regulatory applications. The seller does not want to risk holding a meeting until it is clear that regulatory approvals will be forthcoming and all other material conditions have been satisfied. In most states, a two-thirds shareholder vote will be required to approve a merger. The seller will want to give ample notice of the meeting and provide shareholders with a proxy statement explaining the proposed transaction in detail. If the seller is taking the buyer's stock, the proxy statement that goes to the shareholders will be much more detailed because it also functions as a prospectus for the buyer's stock and must be filed with the SEC.

Most applicable merger laws will afford dissenters' rights to the shareholders of the selling bank. Shareholders electing to exercise this right will be entitled to dissent from the merger and receive the value of their stock in cash based upon an appraisal conducted in the manner provided by statute.

The Closing

The closing is usually scheduled to occur within a short while after the seller's shareholders' meeting. Today the closing of a bank acquisition rarely features a group of executives actually meeting in a conference room somewhere to exchange documents. Most likely, the exchange will take place by fax and email.

In a merger transaction, the acquisition actually occurs by operation of law at the time specified in merger documents that are filed with the appropriate agencies. The "closing" therefore consists of the buyer and seller exchanging

Seller's shareholders must receive a proxy statement providing all material information needed.

The closing often occurs by exchange of emails and faxes. The actual effective time of the transaction will be when appropriate merger certificates are filed of record.

officers' certificates, opinions of counsel and other information confirming that all of the conditions to the acquisition have been satisfied and that the representations and warranties of the parties continue to be accurate at the time of the closing. Executing one of these certifications would not normally expose an officer to personal liability.

Although larger shareholders may want to arrange for wire transfers at closing, smaller shareholders normally receive the purchase consideration only after they have properly forwarded old stock certificates and endorsements to the exchange agent designated for this purpose by the buyer. A letter soliciting such materials goes out to the shareholders near the time of the closing with a form of transmittal letter for their use in sending in certificates. Shareholders who have lost original stock certificates can complete the transaction by furnishing an appropriate lost stock affidavit.

And so the acquisition ends. The seller's CEO, having carefully navigated the shoals of the acquisition process and brought his or her shareholders safely to the distant shore, can take pride in having accomplished a very important but sometimes thankless task. The buyer's CEO will also deserve a lot of credit for having initiated and sustained the process, although the more important job, making the acquisition work for the buyer, is just beginning.

A Few Last Words

As this booklet has shown, a number of pieces must fall into place to make a successful acquisition. Every executive who hopes to deserve a place at the board table must know how to put the pieces together and how to manage a sale or an acquisition properly.

This booklet illustrates the kinds of questions that come up in typical acquisitions. But the questions chosen will surely not cover every situation, and the answers suggested may be correct in some contexts and incorrect in others. Certainly nothing in this essay should be construed as legal advice on any particular matter or circumstance.

The goal has been to focus on the process, presenting technical information in a way that is easy for business people to understand. Other resources are readily available for those needing more detailed explanations of specific issues, and buyers particularly will probably require a great deal more information than provided here about the nuances of planning and negotiating bank acquisitions.

The long march of economic history and continuing consolidation in the banking industry ultimately will not be denied. Acquisitions do happen for almost all community banks sooner or later. The perspective provided by this booklet may help ensure that your shareholders are well served when that time comes.

This publication is for informational purposes and does not convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting an attorney.

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Joe Ford is a bank attorney who practices from Austin, Texas. He has spent most of his professional career providing corporate and regulatory representation for community banks. His experience encompasses virtually every aspect of bank ownership and operations, including mergers and acquisitions, dealing with major regulatory problems, Sub S conversions, going private transactions, buying and selling branches and other restructuring transactions involving bank ownership and expansion.

Mr. Ford is perhaps best known in industry circles as a speaker and writer on topics relating to mergers and acquisitions involving banks. In addition to this booklet, Mr. Ford has authored a number of published articles on these subjects and has been a frequent speaker at industry M&A conferences over the years. His specific experience includes handling something over 100 individual purchase or sale transactions involving independent banking companies.

Texas Lawyer magazine named Mr. Ford the top “Go-To” banking lawyer in Texas in 2002 and one among five “Top Notch” banking lawyers statewide in 2007. He is also named among the Best Lawyers in America (2010) is profiled as one of the leading Banking & Finance lawyers in Texas in Chambers USA: America’s Leading Lawyers for Business (2010).

Mr. Ford welcomes questions or comments from readers. Please contact him at joe-ford@sbcglobal.net.



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