

# Breakout IV: Addressing Deal Certainty in Uncertain Times

#AOBA23

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# Addressing Deal Certainty in Uncertain Times

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# Who We Are

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Washington, D.C. based law firm specializing in community banks and other financial institutions.

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 matters.

We represent over 300 financial institutions nationwide. Most are community banks ranging from \$100 million to \$25 billion in assets.

# Some of Our Accomplishments

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- Ranked No. 1 in Bank M&A in every year since 2015 - 2021
- Counsel in more Bank M&A transactions than any other law firm in the nation over past 10 years
- Counsel in more Bank M&A transactions than any other law firm in the nation over past 10 years
- Counsel in more Bank M&A transactions than any other law firm in the nation over past 20 years

(based on number of transactions)

# Topics Covered

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- Pre-M&A Planning
- Regulatory Environment
- Hot Button Issues
- Due Diligence Issues
- Unique Transactions
  - Mergers of Equals
  - Credit Union/Bank Deals
  - Non-Bank and Private Investor Deals
- Deal Protections

# Pre-M&A Planning

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## **Assemble Team:**

- Engage experienced advisors - if contemplating a deal with a CU, fintech, mutual, MHC or private investors, make sure advisors have specialized experience

## **Review Prior Engagements:**

- Make sure have no “tail” obligations

## **Get on Same Page:**

- Make sure board, management (and any controlling holders) are on same page in terms of exploring possible merger, purchase and sale and process to be followed

## **Review Fiduciary Duties:**

- Educate Board on fiduciary duties, including in a “sale of control” and how applies in buy and sell context

# Pre-M&A Planning

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## **Assess Franchise Value:**

- Analyze standing in marketplace, capital levels, core deposits, customer relationships, quality and value of loan and investment securities portfolios

## **Review M&A activity in marketplace:**

- Review recent transactions and related pricing
- Consider ability to pay of potential buyers and quality of their “currency”
- Analyze potential partners (MOE, buy or sell)

## **Identify cost savings that can be realized (seller):**

- Understand termination costs of all significant vendor contracts (e.g., data processing), severance obligations and potential personnel redundancies

# Pre-M&A Planning

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## **Identify and Collect All Material Agreements:**

- Locate all material agreements and amendments and schedules – will need for data room
- Identify any provisions triggered by a sale or merger (fees due, notices, timing)

## **Review of Governance Documents:**

- Determine if any supermajority voting provisions or idiosyncrasies that will get triggered in a sale or merger

## **Stress Confidentiality/Possibly NDA or Confidentiality Agreement:**

- Limit involvement to persons on a need-to-know basis

# Pre-M&A Planning

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## **Review and Address Regulatory Issues:**

- Understand any issues that could impact a transaction (e.g., IT, BSA, CRA, loan concentrations, unique or precedential features or parties)
- If not resolved in advance of or due to the transaction, have good answers and plan as to mitigation
- Pre-merger regulatory communication is important, especially for Buyer – Seller should confirm buyer's discussions with regulators

## **Close Trading Window:**

- M&A announcement will likely result in FINRA/SEC investigation, should be closed when board authorizes move forward and engagement of team

# Pre-M&A Planning (for Sellers)

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## **Review and Update Compensation Arrangements:**

- Assess employment / change-in-control agreements, benefit plans and severance arrangements in advance of sale process (one year, if possible)
- Address CIC triggers as they are often not consistent from document to document
- Analyze existing non-competition provisions
- Understand “Golden Parachute” rules (IRC §280G) and deferred compensation limitations (IRC § 409A)
- Plan termination costs may be greater than reflected on balance sheet, (*e.g.*, early termination discount rate of SERP may be different from accrual rate)

# Pre-M&A Planning (for Sellers)

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## **Conduct Severance Payment/280G Analysis:**

- 280G analysis for key executive officers (and possibly directors)
- Analysis should be done at least one year before transaction to allow maximum planning flexibility
- New employment or change in control agreements, amending existing arrangements should be done before CIM goes out
- Analysis should be part of CIM, will reduce negotiation potential and manage expectations

# Regulatory Environment

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## **Some leadership and policy positions still in flux**

- Chairman Gruenberg and two Republicans just confirmed in December 2022; first time full five-member board since 2015
- OCC still has “acting” leadership
- Barr approved as Vice Chair of Supervision for FRB in July 2022
- No major rule writing or changes expected but “tone from the top” and “trickle down” expected to change, likely not for the better
- CFPB again lead the charge in “consumer centric” regulation
  - For example, crack down on “junk fees”
- Heightened focus on climate change, DEI and ESG

# Regulatory Environment

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## **Advice for Unique, Significant or Precedential Transactions:**

- Understand that a lot has changed since Dodd-Frank and FRB involvement in thrift holding company matters
- Understand many “old-timers” have turned over, so little institutional knowledge is left (particularly at some state regulators)
- Check with region and with Washington on issues and red flags, region may say ok only to have Washington ask last minute questions or recommend rescinding of application
- Do your homework beforehand to see if “policies” have shifted with new administration or leadership
- Possibly build in “out” or termination fees for failure to get approvals

# Regulatory Environment – Processing Timing

## Median days lapsed for completed US bank deals since 2016

		Deals announced between 2016-2019		Deals announced between 2020-2022*	
		Median days to close	Number of deals	Median days to close	Number of deals
Combined buyer and target total assets	<\$5B	137	770	136	246
	\$5B-\$10B	151	92	153	33
	\$10B-\$100B	156	122	168	40
	>\$100B	306	5	198	7
	<b>Median for all deals</b>	<b>141</b>		<b>145</b>	

Data compiled Aug. 23, 2022.

Analysis based on the completed U.S. whole bank and franchise transactions announced between Jan. 1, 2016, and Aug. 22, 2022 grouped by combined buyer and target total assets for the most recent quarter as of the completion date. Minority-stake and government-assisted deals along with thrift-merger conversions and bids were excluded.

\* Data for 2022 is year-to-date through Aug. 22, 2022.

Source: S&P Global Market Intelligence

# Regulatory Environment – Processing Timing

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- M&A processing and additional scrutiny has slowed for large deals, smaller deals still getting done on time but with a few more comments and requests for information
- Result (along with economic uncertainty and rapidly rising interest rates) has been reduction in number of deals and specifically larger deals:
  - In 2021, total announced deal value that was 3x higher than 2022 at \$76.64 billion among 205 deals
  - Only 3 bank deals with a value above \$500 million at announcement were announced in 2022 from 23 in 2021
- Delayed approval from regulators and worsening macroeconomic conditions prompted banks to terminate at least 10 deals in 2022, compared with a total of 3 in 2021

# Hot Button Issues – Fair Lending / Redlining

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- October 2021, DOJ announces “cross-government” focus on investigation and prosecution of redlining and discrimination (we have several in-house)
- Many new investigations, DOJ is “borrowing” bank regulatory attorneys to investigate and prosecute
- Not just home lending, auto lending now being scrutinized (indirect can be problematic)
- “Outer edges” of CRA Assessment Area being focused upon by regulators and DOJ
- Imposition of REMA “reasonably expected market area” and MD “metropolitan division”
- Know your and target’s statistics, MSA, Market Area, Majority-Minority LMI tracts
- Analyze loans and geocode, compare your data to census and peers
- Community activist “fair-lending testers/vigilantes” are actively testing

# Other Hot Button Issues

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## Other Key Regulatory Issues:

- MRAs, BSA/AML compliance issues
- Heightened focus on anti-trust (for larger deals)
- Buyer “3” rating overall or in certain CAMELS components (management, compliance or asset quality)
- Pro forma capital of less than 8%/12% (leverage/total RBC)
- Below “Satisfactory” CRA rating
- Post-closing concentration issues, e.g., CRE to capital ratios
- Equal access to consumer compliance issues
- “Non-traditional deals (CUs, Fintechs, Private Investors) carry greater regulatory risk and time delays

# Due Diligence Issues

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- Must be thorough before signing – very high standard to terminate (Material Adverse Effect) for errors in representations
- Generally (other than confidential regulatory information), nothing should be “off limits,” but should be relevant
- “Credit mark” on seller loan portfolio and benefit plan/contract termination costs biggest diligence/pricing issues
- Get NDA if using outside diligence experts or need confirmations (e.g., loan review, confirm termination payments, actuarial calculations)
- Data room – unorganized data room means unorganized seller
- Full due diligence on Buyer for MOE or all-stock deal – Seller Board is recommending investment in Buyer stock

## Due Diligence Issues – Confidential Supervisory Information

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- Unable to review Confidential Supervisory Regulatory Information without regulatory approval – even with signed NDA
- Regulatory inquiries during application process about access to exam reports
- Own party's attorneys permitted to review and can discuss at high level with other attorney
- Needs to be part of management interview process
- Also, need to exclude inclusion of confidential supervisory information from reps/warranties and disclosure schedules

# Due Diligence Issues – Pre-Filing Meeting

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- In light of additional regulatory scrutiny, recommend pre-filing regulatory meeting
- Occur after LOI signed and most of diligence completed but while parties finalizing merger agreement
- Need to provide sufficient detail about transaction and pro forma company to allow regulators to assess
- Will not obtain any conclusions but regulators should be able to note red flags or if transaction as structured is not approvable

# Merger of Equals

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## **Features:**

- All-stock consideration
- Minimum or no premium (focus is long-term value of combined companies)
- Substantial representation of target bank board and management
- Substantial target shareholder representation

## **Challenges:**

- Strong mutual commitment/understand the pros of price restraint
- Making the social issues “work” (two parties are never truly equal)
- Finding “sweet spot” on pricing (balance of earnings accretion/cultural vs. having enough cost saves to make the numbers work)

# Merger of Equals – Principal Social Issues

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## **Principal Social Issues:**

- Board and committee composition:
  - Combine boards based on equity, assets, income contribution
- CEO/key officer succession:
  - Who will be the CEO, CFO
  - Affected by retirement and succession plans
- Chairman/Vice Chairman of the Board
- Autonomy for selling bank (separate)
- Resulting company name and headquarters

# Mergers of Equals – Compensation Considerations

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## **Compensation Considerations:**

- Need to review definitions of change on control to avoid inadvertent triggering of plans or agreements
- Potential need to waive/preserve potential payments
- Evaluation of preferential health and welfare plans
- Documentation of potential executive transition issues
- Need to review resultant company org chart, titles, pay structure to make sure consistent among similar employees

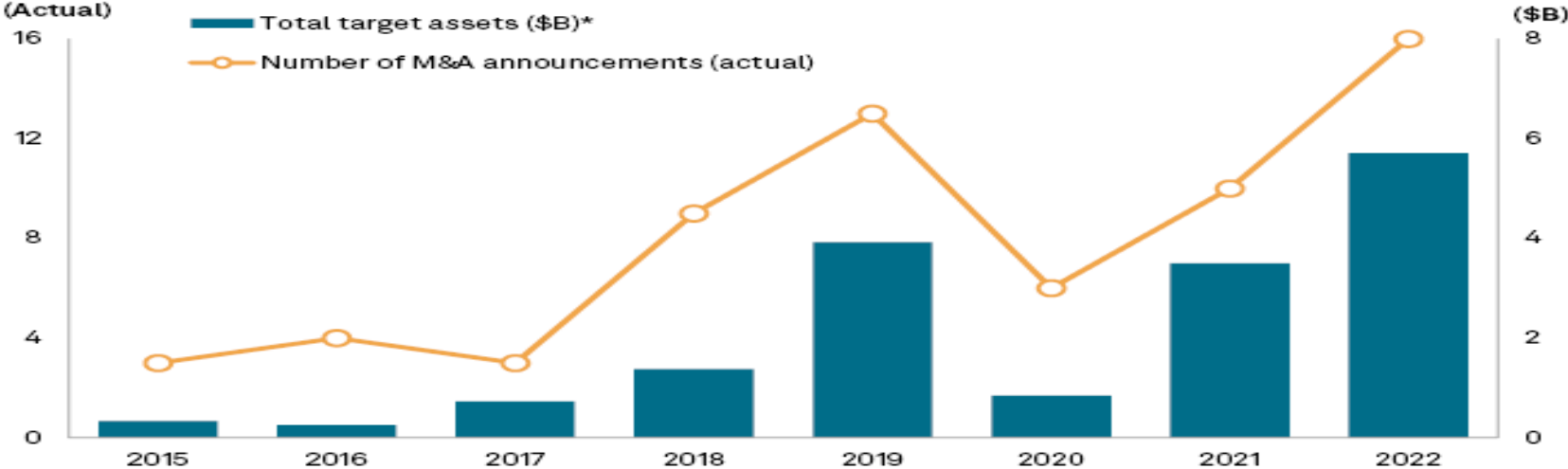
# Merger of Equals – Exclusive Solicitation

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- Generally involves exclusive merger discussions, executing reciprocal NDA, 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
- Reciprocal due diligence while negotiate merger agreement

# Credit Union / Bank Deals

## US credit union-bank M&A deals



Data compiled Jan. 3, 2023.

Analysis limited to whole-company deals announced between Jan. 1, 2015, and Dec. 31, 2022, with a U.S. credit union buyer and U.S. bank or thrift target; excludes terminated deals.

\* Total target assets as of the most recent quarter-end prior to deal announcement for all deals announced that year.

Source: S&P Global Market Intelligence.

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# Credit Union / Bank Deals

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## **CU / Bank Deals are Different:**

- All cash, most are "P&A" transactions as many states do not allow "merger"
- CUs typically must be 3-4X larger due to cash payout and pro forma capital concerns
- Double taxation (at corporate and stockholder levels) - seller must assess not just price but "net" to stockholders
- Seller may need to dissolve - adding wind-down processes and costs - who pays?
- Some states do not permit - know what is possible before signing, even if state previously permitted
- Cash only - "shop" process strongly recommended due to Revlon duties, generally no "one-on-one" or negotiated deals
- "Member-ization" issues - FOM expansion be needed, work-arounds exist but may require approval from CU regulators
- Converted thrifts will involve "liquidation account" analysis and possible payout

# Fintech and Non-Bank Investor Deals

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## **Non-Bank Deals are Different**

- Preference for smaller banks – lower cost of entry
- Structure has huge impact – corporate entity versus individual
  - Bank holding company registration issues versus “change in control” approvals for individuals
- Regulatory “approvability” of controlling parties and acceptability of “new” business plan are key - drastic changes to bank (business plan or capital infusions) may doom approvals
  - Individuals not “known to banking” have much higher hurdle
  - Will want substantive pre-filing meeting with regulators
    - Need to provide information about buyer, any potential financing, new business plan with pro formas

# Fintech and Non-Bank Investor Deals

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## **Non-Bank Agreement Issues**

- Since Buyer is not an existing financial institution, certain additional provisions should be considered to further protect the transaction
  - Bad boy provisions in reps and warranties
  - Reverse break-up fee if Buyer cannot obtain regulatory approval
  - Escrow of merger consideration and reverse-break-up fee
  - Seller holding escrowed funds

# Deal Protections – Merger Agreement Provisions

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- Ensure Material Adverse Effect definition has appropriate carve-outs that reflect current environment and specific deal term (e.g., factor in COVID, interest rate changes, unique buyer)
- Reverse Break-Up Fees – More appropriate for deals with non-traditional buyers or challenging hurdles to completion (e.g., financing contingencies or failure to obtain regulatory approval)
  - Unlike third-party break-up fees (which case law requires to be in 3-5% range), reverse break-up fees can be scaled to reflect actual risks of completion and out-of-pocket costs to target
- Minimum Equity Provision – More traditional for smaller deals with less profitable or unprofitable institutions
  - Key is making sure definition reflects “core” operations vs. “non-core” items (such as AOCI or deal costs)

# Deal Protections – Merger Agreement Provisions

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- Shareholder Meeting – Force the Vote Provision and Adjournment Requirements
- Specific Time Deadlines (for filing, obtaining approval and closing) with walkaway rights or payments if not achieved
- Change in Recommendation – Only permitted upon determination of superior proposal
- No termination right to accept a shareholder proposal
- Voting Agreements – Needs to cover directors, executive officers and larger shareholders
  - Since individuals are not parties to the merger agreement, the voting agreement can mirror no-shop restrictions and contain best efforts regarding completion of transaction

# Deal Protections – Key Employee Retention

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## Locking Up Key People

- Need to incent key players to stay through closing and integration
- If providing individual an employment or change in control agreement, should be signed at time of execution of merger agreement
  - Limits leverage individual would have to potentially prevent closing
- Merger agreement should provide for retention bonus pool (can allow parties to decide recipients and amounts as needed)
- Delicate balance between providing too much leverage and running risk of defections
- Negotiate any non-compete/non-solicitation agreements in advance of signing merger agreement – understand any state laws

# Take-Aways

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- Pre-sale planning is essential, start well in advance
- Executive compensation/280G planning is a must
- Regulatory yellow or red flags should be dealt with regulators and up front
- Unique parties and transactions involve greater execution risk and planning
- MOEs are an evolving trend and involve different considerations
- Non-bank and CU deals are very different with different risks
- Uncertainties and risks can be mitigated through merger agreement terms
- Key employee identification and retention should be done up front
- Hire experienced advisors, they will play a critical part

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