Corporate Governance Issues in Mergers and Acquisitions

Since the recovery from the credit crisis began, much has been written about an impending waive of consolidation in the community bank industry. The majority of practitioners and commentators have seen the state of the economy and the market, and the current and pending regulatory capital requirements, as leading to many institutions strengthening themselves through merger or acquisition. Throughout recent years, many, including us, have predicted that widespread consolidation is right around the corner. To date, however, industry-wide consolidation has not occurred, and there are many reasons why it has not. The absence of a broad consolidation is attributable, in part, to a lack of easy access to capital for most would-be acquirers, uncertainty about impending increased capital requirements, and regulators perhaps providing troubled institutions more time to correct themselves on their own.

Nevertheless, despite the absence of widespread consolidation, deals are occurring, and those deals can tell us something about the current market and where community bank M&A may be heading. Recognizing some key aspects of these deals, while at the same time focusing on traditional M&A issues for community banks, is important for all institutions. Whether an institution is an acquirer, a target, or in the process of trying to improve its regulatory standing or credit deficiencies, understanding the current M&A market and preparing for your institution to become a part of it is important. If and when the waive of consolidation does hit, all institutions will need to be aware of how they fit into the M&A market and how they can use that market to try to achieve their specific goals.

In recent months, the open community bank acquisitions that have occurred tend to involve healthy target institutions receiving a premium to their book value per share that is higher than what has been widely achievable since the credit crisis. Many see this as a step to a more normalized M&A market and as an excellent development. Alternatively, as we shared in last month's e-newsletter, troubled institutions are having success using the bankruptcy courts to sell and recapitalize themselves. Although these two types of examples are on opposite ends of the transaction spectrum, together they illustrate an important point: buyers and sellers are starting to think and act differently in order get deals done.

Thinking differently about how to do a deal starts with having a complete understanding of your institution, regardless of whether you are an acquirer or a target. Without knowing, and truly accepting, your institution's strengths and weaknesses, deciding how to complete a deal will prove difficult and could lead to a regretful outcome. Additionally, with counterparties willing to pay higher premiums or engage in unique court ordered structures, understanding whether your institution is positioned to take advantage of such opportunities is vital.

As we all know, an essential initial step in ensuring that one has a complete understanding of an institution is to focus on its capital position. To a very large extent, an institution's capital position will dictate its role in the M&A market and how its regulators view or restrict the institution. Additionally, with the impending increased capital requirements of Basel III, understanding an institution's capital position is all the more important. Institutions that are having capital difficulties will find it hard to become acquirers, while institutions with excess capital will find it attractive to use that excess capital to fund growth.
While the role of capital is extremely important in assessing M&A, there are many other factors that an institution should examine while uncovering its role in the M&A market. Among the factors to consider are the following:

- Is the institution's market area a positive? A lack of organic growth in the market area could reduce the attractiveness of a target institution or require it to expand its footprint through acquisition or de novo branches. A healthy and profitable market area can be an excellent springboard to increased growth through M&A, or a nice selling feature.
- Does the board of directors or management have a plan for when they are gone? If an institution has an aging board of directors or management team, identifying and securing successors, and understanding those successors' views of the institution, will impact the institution's future role in the M&A market.
- Is the institution's stock attractive? If there is not a developed market for an institution's stock, its currency in an M&A transaction can be significantly reduced. Also, illiquidity can be a risk to a stock's price if a meaningful number of shares are sold at market by shareholders and results in a depressed price. A liquid stock, on the other hand, in particular one registered with the SEC and/or listed on a national exchange, can be a great benefit to a buying institution as most sellers will find it more valuable than illiquid, privately held stock.
- Is the institution capable of successfully integrating another? Integration can be the longest and toughest aspect of an M&A transaction, and an institution having the talent available to organize and lead the process is essential.
- Is the risk of shareholder lawsuits remote? As many recent studies show, virtually all acquisitions over $100 million and involving SEC registered stock yield lawsuits by the target institution's shareholders alleging fiduciary-based claims against the target, its board and possibly the acquirer. Although most community bank M&A deals do not have these characteristics, the frequency of such lawsuits continues to expand and must be recognized.

Although these are but a few of the important questions an institution must ask itself in assessing its role in the M&A market, we can agree that they all could be uncomfortable issues to contemplate. However, it is this type of self-assessment that is necessary to understand the institution and its place in the M&A market. Although being able to answer "yes" to the questions listed above places an institution in a favorable position as an acquirer, all institutions should consistently assess their capital position and the types of issues raised by these questions in deciding what role it can and should play in the M&A market.

© 2018 Schiff Hardin LLP