# FINANCIAL INSTITUTIONS M&A 2024:
# SEIZING OPPORTUNITIES, NAVIGATING PITFALLS

An Annual Review of Leading Developments

by Edward D. Herlihy, David S. Neill, Richard K. Kim, Lawrence S. Makow, Jeannemarie O'Brien, Nicholas G. Demmo, David E. Shapiro, Joshua M. Holmes, Damian G. Didden, Matthew M. Guest, Mark F. Veblen, Brandon C. Price, Jacob A. Kling, Raaj S. Narayan, Eric M. Feinstein, Steven R. Green, Meng Lu, Amanda K. Toy, Rosemary Spaziani, David M. Adlerstein, Matthew T. Carpenter, Ahsan M. Barkatullah, Yasmina Abdel-Malek, and Fabiola Urdaneta

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## CHAPTER 1.

## KEY TRENDS IN FINANCIAL INSTITUTIONS M&A DURING 2023

### I. M&A FALLS FOR A SECOND CONSECUTIVE YEAR OWING TO GEOPOLITICAL, MACROECONOMIC AND REGULATORY FACTORS

Financial institutions M&A fell for the second year in a row in 2023. Like most other sectors of the economy, financial institutions faced significant M&A headwinds during the year, including geopolitical instability, elevated inflation, high interest rates, challenging and often volatile equity markets, enhanced antitrust risks and uncertainty, and recessionary fears that softened only towards the end of the year.

Deal values announced in 2023 across fintech, insurance underwriters, broker-dealers, speciality lending and banks and thrifts transactions all fell relative to 2022, which was already a significant down year for financial institutions M&A. There were, however, some sectors of the financial institutions space that were more positive. While the investment management space saw a decline in deal volume, deals measured by transaction value rose—although total deal value for all 2023 transactions in the aggregate was less than the deal value of BlackRock's January 2024 deal for Global Infrastructure Partners. Wealth management likewise continued as a bright spot for M&A as multi-year consolidation continued, funded in significant part by private equity. Insurance brokerage transactions likewise saw continued execution in keeping with ongoing consolidation trends.

Within the banking sector, the headwinds were especially stiff. Falling valuations for balance sheet assets resulting from rapidly rising interest rates made the merger math for many potential deals challenging if not impossible given the requirement to mark to market the target's balance sheet. Falling valuations contributed significantly to the successive failures of Silicon Valley and First Republic and the stock price pressures seen across much of the industry. The March bank failures and resulting FDIC transactions were the only bank M&A "highlights" of 2023, and only for the winning bidders in FDIC transactions—not for the several banks that for a time appeared at risk of following them into failure or for the remainder of the industry, which is largely still working to recover from the March trading price declines and grappling with a more challenging regulatory supervisory environment that arose in response to the bank failures.

And even where the bank merger math could work, potential partners faced continued uncertainty regarding the federal regulatory approval likelihood and timeline. While Bank of Montreal obtained its approval for the $105 billion asset Bank of the West transaction in roughly one year, right on the heels of the similarly timed U.S. Bank/Union Bank approval, TD/First Horizon announced the termination of their pending transaction in early 2023, 14 months after announcing the transaction, due to their inability to obtain regulatory approval—a somewhat surprising result in the midst of the March bank failures and the market turmoil at the time. Following the March banking crisis, federal bank regulators indicated an openness to bank consolidation under the right circumstances as evidenced by their prompt approval of the PacWest/Banc of California transaction and approval of the acquisition of a majority of TIAA Bank by a consortium of private equity investors; however, these data points failed to reverse a general perception of regulatory uncertainty and risk.

## II. OUTLOOK FOR STRATEGICALLY OPPORTUNISTIC M&A IN 2024 HOLDS PROMISE

Looking forward, there are reasons to hold out hope for an uptick in transactional activity (with Capital One's landmark $35.3 billion acquisition of Discover announced shortly before publication of this volume serving as a prominent example). The United States has managed to avoid a recession, and the market anticipates the Federal Reserve cutting the federal funds target rate multiple times in 2024. Lower rates and the passage of time have already helped to improve the merger calculus for dealmaking, particularly for bank transactions and private equity portfolio company transactions. Of course, nothing is certain with the current level of geopolitical instability, the risk that inflation could prove more stubborn than expected, ongoing regulatory uncertainty around approval criteria and pending rule making, commercial real estate risk, caustic election year politics, regulatory and supervisory considerations, and a decidedly challenging antitrust environment, but consolidation is needed throughout the financial services industry, financial sponsors have significant dry powder, and there is significant pent-up demand for deals generally. Following is a sector-by-sector review and outlook.

### A. Financial Technology

Fintechs comprise a very diverse array of products and services with a wide range of corporate maturity levels, but across the board 2023 was a down year for fintech M&A. The same factors described above, as well as the general disfavor of growth stocks for much of the year, negatively impacted the results. Still, there were several notable transactions.

The largest transaction of the year was Fidelity Information Services' sale of a 55% stake in Worldpay to private equity firm GTCR. The transaction accelerated a previously contemplated separation of FIS's Worldpay merchant acquirer business from its remaining financial technology businesses in order to improve management focus and provide operational simplification and capital allocation flexibility. The transaction reflected a $17.5 billion valuation (plus potential contingent consideration). Consistent with valuations more broadly, the Worldpay valuation was down significantly from FIS's acquisition price of $43 billion in 2019.

Another notable transaction was Nasdaq's $10.5 billion acquisition of Adenza, continuing Nasdaq's ongoing strategy of enhancing its ability to provide technology solutions to third parties in the financial services industry. Although announced in 2022, Intercontinental Exchange and Black Knight closed their $11.9 billion merger in 2023, and in doing so demonstrated that committed parties can successfully resolve antitrust concerns even in the current challenging environment. ICE and Black Knight defended parallel FTC lawsuits in both federal district court and the FTC's administrative court seeking to block the merger, and ultimately entered into a consent agreement with the FTC that allowed the transaction to close only after the parties entered into two separate divestiture agreements. Historically, parties have negotiated divestitures with the antitrust authorities as part of a settlement, ensuring that the divestitures would satisfy the authorities' concerns. Here, however, the parties pursued a "litigate the fix" strategy—where the parties commit to divestitures or other remedies outside the framework of a negotiated settlement in order to shift the focus of antitrust litigation to the adequacy of the parties' proposed remedy, putting the onus on the government to explain why a negotiated divestiture is insufficient to cure competition concerns. Litigating the fix has become

an increasingly common response to the DOJ's and FTC's stated aversion to traditional settlements, and the Black Knight/ICE result demonstrates its potential effectiveness.

Interest rates notwithstanding, financial sponsors contributed a few notable transactions, including Vista Equity Partner's $4 billion acquisition of EngageSmart and $2.6 billion acquisition of Duck Creek, Brookfield Asset Management's $2.8 billion acquisition of Network International and Thoma Bravo's $1.8 billion acquisition of NextGen. A consortium of investors led by Sixth Street acquired GreenSky, divested by Goldman Sachs as it continued to streamline its consumer finance focus.

As we go to press with this review of 2023 developments, Capital One and Discover Financial have just announced a $35.3 billion transaction that straddles the banking and fintech sectors. With the combination, Capital One will acquire Discover's global payments network, offering the possibility of shaking up the small club of leading payments networks at Visa, Mastercard and American Express. While some politicians and commentators have raised competition considerations, the transaction stands out as having the potential to be one of the most procompetitive transactions in some time.

## B. Investment and Wealth Management

While perhaps not as diverse as fintechs, the investment management space encompasses a broad range of firm types and focus areas, but again M&A was broadly subdued across the range of market participants in 2023. One very notable non-M&A development in the traditional investment management space in 2023 was that passive funds finally overtook active funds in total assets under management. The industry had long been headed to this inflection point, and hopes that the current volatile environment would usher in renewed success among actively managed funds were not met. As has been the case for the last few years, traditional investment management players continue to look for a profitable future state in a flow-challenged world of compressing margins, and M&A will be a necessary part of the future.

A number of traditional investment managers, as well as alternative managers historically best known for their private equity offerings, have looked—either organically or through acquisitions—to private alternatives, including credit, infrastructure, real estate and others, for potential future asset flows. Although not quite making 2023, in January 2024 BlackRock announced the pending acquisition of Global Infrastructure Partners, a leading infrastructure firm with over $100 billion in assets under management. BlackRock's Larry Fink has often spoken about the need for—and executed on—significant M&A. BlackRock's 2009 acquisition of passive asset manager BGI from Barclays helped set BlackRock on the path to becoming the far-and-away largest traditional asset manager, going from $1.85 trillion in assets prior to the BGI to over $10 trillion at year end 2023. BlackRock stated multiple times in 2023 that it was interested in transformational acquisitions, and took such a step in January 2024. As Larry Fink said in the fall of 2023, with application beyond the investment management industry, "Times of uncertainty are often when transformational opportunities emerge and moments like this in our history led to new ideas, new partnerships and acquisitions." Demonstrating the continued interest of historically private equity-focused funds in other alternatives, TPG struck a transformative deal to acquire Angelo Gordon and thereby significantly broaden its credit and real estate offerings.

During 2023, Franklin Templeton undertook a significant strategic step in a transaction with Power Corporation of Canada and its controlled affiliate, Great-West Lifeco. Franklin agreed to acquire Putnam Investments from Great-West Lifeco and entered into a strategic partnership with Power Corporation and Great-West Lifeco. The acquisition of Putnam added to Franklin's position in the U.S. retirement channel and expanded its insurance-related assets under management. Franklin's focus on the insurance-related assets was further seen in the strategic partnership, which included a commitment by Great-West to provide an initial long-term asset allocation of $25 billion to Franklin Templeton's specialist investment managers. As discussed below, asset managers have focused considerable attention in recent years on insurance underwriters, with their significant pool of permanent capital and investment needs.

While many of the transactions in the wealth space during 2023 involved smaller and often non-public target companies, Clayton, Dubilier & Rice started 2023 by announcing a large $4.4 billion acquisition of Focus Financial Partners (itself a frequent acquirer of smaller wealth management firms). In addition to its size, the transaction was interesting in that CD&R managed the transaction through a challenging financing environment, with help from portable debt put in place by Focus investor Stone Point Capital, a significant investment by StonePoint in the post-closing Focus Financial, and an agreement to finance the deal with equity if it were unable to obtain its anticipated incremental debt financing. In an interesting deal facet, management and the funds affiliated with Stone Point agreed to delay payment of the change-of-control payment under a tax-receivables agreement entered into when StonePoint took Focus Financial public in 2018, after rejecting a request by the Focus special board committee to forfeit those payments entirely. Other notable transactions included Goldman Sachs' sale of part of its wealth business (an RIA business formerly known as United Capital Management and purchased by Goldman in 2019) to Creative Planning; Carlyle's investment in CAPTRUST Financial, a serial acquirer partially owned by GTCR, in order to provide further capital for CAPTRUST's M&A machine; and Reverence-owned Osaic's acquisition of Lincoln Financial's wealth business (shortly after it leaked that Reverence was looking to monetize a portion of its ownership in Osaic).

## C. Insurance Underwriting and Brokerage

2023 saw underwriters continue to focus on refining their core products and geographies through limited M&A transactions as well as numerous block sales, and flow and reinsurance transactions The year also saw additional examples of the trend of alternative asset managers acquiring or otherwise investing in and partnering with insurance companies. AIG evidenced a number of these activities recently. In early 2023, American International Group agreed to sell its Validus Re reinsurance business to RenaissanceRe for approximately $3 billion plus the release of certain excess capital. The transaction was part of AIG's overall simplification of its business model, which also included the sale of its crop risk services business in 2023, and the exit of its life and retirement business (now, Corebridge) through a 2022 public offering and continued secondary sales into 2023. The Corebridge IPO was supported in part by a 9.9% investment by Blackstone, which agreed to invest $2.2 billion in connection with entering into a long-term strategic asset management relationship to manage $50 billion of existing investment portfolio assets upon closing of the equity investment (and up to $92.5 billion over the six years following the closing of the investment).

Furthering the asset management/insurance company consolidation trend, in 2023, KKR agreed to acquire the remaining 37% stake of insurer Global Atlantic Financial Group that it had not purchased when it initially invested in Global Atlantic (on balance sheet, not as a portfolio investment) in 2021. This move, similar to Apollo's move in 2022 to bring Athene entirely in-house, and consistent with Franklin Templeton's Power/Great-Western transaction, shows the continued value in partnerships between asset managers and insurance underwriters. 2023 also saw Fortress Investment Group make a minority equity investment in Nassau Financial and enter into a long-term investment management agreement targeted at credit investment strategies.

On the insurance brokerage side, there were a number of significant transactions, including Truist Financial selling a minority stake in its insurance brokerage business, a business that BB&T had spent years building prior to the SunTrust merger, to Stone Point in February 2023. As we go to press with this review of 2023 developments, Truist has announced the sale of the remainder of the business to an investor group led by Stone Point and CD&R at a $15.5 billion valuation. Stone Point has a long history in the brokerage space, and Truist will use the transaction to build capital and strengthen its balance sheet as it continues its efforts to try to realize the promise of the BB&T/Sun Trust combination. Other banks that decided 2023 was the year to exit their insurance brokerage businesses included Cadence Bank and Eastern Bankshares, each of which sold units to Arthur J. Gallagher.

Private equity continued its ongoing activity within the brokerage space, including Aon's $13.6 billion acquisition of NFP Corp., a provider of property and casualty broker, benefits consultant, wealth manager and retirement plan advisor, from funds affiliated with Madison Dearborn and HPS Investment Partners, and European investment firm JAB's acquisition of Embrace Pet Insurance from NSM Insurance Group, a Carlyle portfolio company, a few months after acquiring a majority interest in another pet insurance provider.

## D. Banks

2023 witnessed by far the most significant bank failures since the aftermath of the 2008 financial crisis, with major regional banks First Republic ($229 billion in assets), Silicon Valley Bank ($209 billion in assets), and Signature Bank ($110 billion in assets) all taken into FDIC receivership in rapid succession. The initial harbinger of crisis was the voluntary wind-down in early March, 2023 of Silvergate Bank, an $11.3 billion asset institution with a highly concentrated focus on the cryptoasset industry. Silvergate had been buffeted by the pronounced centralized crypto institutional failures in 2022, including of FTX, as well as by concerted efforts on the part of regulators to discourage the provision of banking services to the industry, which prompted dire liquidity problems.

At first, Silvergate looked like a unique situation rather than the start of a series of more serious liquidations. However, Silvergate's announced wind-down coincided with venture capital industry stalwart Silicon Valley Bank's announcement that, in an elevated interest rate environment and in the face of increased liquidity needs, it had sold a $21 billion portfolio of longer duration treasury securities at a $1.8 billion loss. At the same time, SVB announced that it was also undertaking a capital raise to help fill the gap created by that sale, but the announced portfolio sale and perceived capital hole and liquidity problems at SVB resulted in massive uninsured deposit outflows and scuttled the capital raise, and the FDIC was forced to take over

SVB. The failure of SVB was followed two days later by the failure of Signature Bank, the second largest provider of banking services to the cryptoasset industry after Silvergate Bank (albeit not to the same concentrated degree as Silvergate). Both banks had characteristics shared by others at the time, but were unique in the degree to which they had experienced: rapid growth in deposits that outstripped their ability to productively deploy funding, resulting in large interest-sensitive portfolio exposures; rapid business growth that outstripped their ability to enhance corporate governance and risk management to levels commensurate with their size; overwhelming reliance on uninsured deposits; and concentrated business models with higher-risk customers; with Signature Bank also having the overhang of the crypto business.

The failures of Silicon Valley Bank and Signature Bank were so abrupt that the FDIC had to establish in each case a "bridge" bank under its administration prior to identifying a buyer for a substantial portion of the franchise of each institution (in the former case, First Citizens Bank and in the latter case, Flagstar Bank). While pundits speculated about where Silicon Valley and Signature had gone wrong and who was to blame for the failures, the market watched First Republic, another rapid growth story with significant interest rate risk and uninsured depositor funding, struggle for a path forward. But despite massive FHLB borrowings and industrial efforts to shore up the bank's liquidity, including a $30 billion infusion of uninsured deposits from a consortium of 11 banks, First Republic failed—the second largest bank failure in history, after Washington Mutual—at the beginning of May. As in the case of the Washington Mutual failure, the FDIC found a willing buyer for First Republic's failure in JPMorgan Chase.

The accelerated failures of Silicon Valley Bank and Signature prompted doomsday concerns about regional banks generally, prompting a pronounced migration of deposits from smaller and mid-sized institutions to money-center banks deemed "too big to fail" and the largest regional banks, as well as a sharp sectoral decline in share prices. Ultimately, broader contagion from these failures was averted, but necessitated the imposition of emergency measures, including the establishment of the emergency Bank Term Funding Program and the extraordinary spectacle of the Secretary of the Treasury invoking a statutory systemic risk exception for the failures of Silicon Valley Bank and Signature Bank in order for all depositors—including uninsured depositors—to be made whole; lest all uninsured deposits be pulled from the regional banking system by panicked customers.

The knock-on effects of the 2023 banking failures remain keenly felt, with larger banking organizations funding a $16.3 billion special assessment in order to replenish the FDIC's Deposit Insurance Fund. More fundamentally, the failures prompted profound policy questions about the vulnerability of a banking system heavily reliant as a source of confidence on deposit insurance as currently structured. The debate over this topic remains one of the fundamental challenges before the industry. Another significant knock-on effect of the banking failures has been an enhanced supervisory environment by the regulators, including at the examiner level, in response to a perception that the bank regulators had been lax in identifying the risks posed by the failing institutions, with an increased emphasis on risk management and governance. The post-mortem reports on the failures of Silicon Valley Bank and Signature Bank conducted by the Federal Reserve and FDIC respectively were highly critical of weaknesses in regulation and supervision as well as poor governance and risk management by the Board of Directors and management of those institutions. The bank failures and focus on failures in regulation have also resulted in proposals for more stringent regulation from the FDIC's proposed corporate governance, risk

management and board oversight which would apply to banks with $10 billion in assets to the proposed Basel III rules for enhanced capital requirements for institutions with $100 billion in assets.

Outside of the bank failures, 2023 bank acquisition activity was anemic at best. The only transaction approaching a billion dollar valuation was the combination of PacWest Bancorp and Banc of California. The parties announced the combination in July after months of speculation as to the future of PacWest. Notably, the transaction, which included essential capital support from financial sponsors Warburg Pincus and Centerbridge Partners, received regulatory approval and closed in only four months. Although unique given the environment and the market pressure on PacWest, the regulatory process demonstrated that, at the very least, the Federal Reserve appreciates that consolidation can be a helpful industry tool in the right circumstances. The transaction was also notable in that while Banc of California was the legal acquirer, PacWest was the acquirer for accounting purposes, as a result of which the parties were able to mark to market the healthier Banc of California balance sheet. Another notable M&A transaction that closed in 2023 was the acquisition of a majority stake in TIAA Bank by a consortium of private equity funds including Stone Point, Warburg Pincus, Reverence Capital Partners, Sixth Street and Bayview. Despite historic discomfort with financial sponsor capital, the transaction received bank regulatory approval in only six months from signing, which together with the financial sponsor investments in Banc of California, signals an openness from the bank regulators to significant private equity investments in banks.

Going forward, regulatory uncertainty is likely to continue to weigh on the pace of activity, particularly for institutions that have total assets, or would as a result of a transaction have assets, of $100 billion or more or which involve any material level of branch overlaps or planned branch consolidations. Among other things, many commentators have focused on the OCC's January 2024 notice of proposed rulemaking as proof that the federal regulators are hostile to bank M&A. That NPR included a statement of principles that the OCC would use to analyze Bank Merger Act applications and eliminated expedited bank merger procedures and streamlined bank merger applications. However, the expedited procedures were rarely used, and we believe that the OCC review principles are being over-interpreted and do not reflect a material departure from existing policy. We believe that both the Federal Reserve and the OCC are likely to be reasonably open-minded to bank M&A absent material branch overlaps or branch consolidations. The Department of Justice, however, remains a significant question mark for bank M&A, particularly after Assistant Attorney General Jonathan Kanter's speech in June 2023, in which he introduced significant uncertainty in how the DOJ will analyze and review transactions; the only apparent certainty is that the DOJ intends to be more aggressive and less willing to share views that would allow parties to satisfy whatever concerns the DOJ may have regarding a given transaction.

Some market participants have been heartened by the willingness of Capital One and Discover to move forward and see the transaction as a harbinger of bank consolidation to come. However, it would be a mistake to read too much into this one transaction or the approval process. While, as noted above, we believe that there is room for optimism on the approval front, the Capital One/Discover transaction is unique. Among other things, the transaction does not include any branch overlaps or consolidations – because Discover only has a single branch and is pro-competitive in strengthening the smallest payments network in an industry that has

long been dominated by Visa and Mastercard. Moreover, Discover has had a number of recent and well-publicized compliance issues, including a public FDIC consent order in October 2023, while Capital One has invested in a multi-year effort to build state-of-the-art compliance systems.

## E. Cryptoasset Developments

The frigid "crypto winter" spanning 2022 and 2023 was dominated by legal proceedings ranging from whether cryptoassets would be accepted into the U.S. mainstream financial system to confronting the implosion of cryptoasset exchange FTX, along with a number of other prominent failures from 2022, such as numerous shadow bank-like cryptoasset borrowing and lending operations. Throughout 2023, the SEC continued its regulation-by-enforcement approach to the sector, commencing actions against leading cryptoasset exchanges, numerous other cryptoasset companies, as well as developers, and continuing its long-running litigation against Ripple. Yet signs of a thaw began to emerge later in the year and, as of this writing, cryptoasset prices have recovered to a level approaching their historic peaks. While we have yet to witness much M&A activity of scale among centralized cryptoasset companies, there are important signs of increased institutional acceptance of cryptoassets and blockchain technology:

- *Bitcoin spot ETPs.* In 2023, the SEC declined to appeal a federal court holding that the SEC's denial of asset manager Grayscale's application for a bitcoin spot exchange traded product was arbitrary and capricious. This critical ruling prompted firms including BlackRock and Fidelity, among others, to submit amended applications for bitcoin spot ETP, 11 of which the SEC first approved this January, cementing bitcoin's status as a mainstream alternative investment, and portending the possibility of future ETPs for other digital assets. These product offerings parallel continued growth in institutional blockchain products, such as JPMorgan's "JPM Coin" private stablecoin, reinforcing the depth of financial institutional interest in this technology.

- *Accounting changes.* In March, the Financial Accounting Standards Board proposed a mark-to-market accounting standard for cryptoassets and, in September, reportedly approved drafting of a final rule anticipated to be effective in 2025. This would mark a significant change from the prevailing GAAP standard whereby cryptoassets are accounted at the lower of cost and market value. Although there remain risk considerations associated with holding cryptoassets in a corporate treasury, this change could provide momentum for cryptoassets to find their way into some corporate balance sheets. And in October, the U.S. Government Accountability Office found that the SEC's 2022 Staff Accounting Bulletin No. 121 (SAB 121) amounted to a rule subject to Congressional review. SAB 121 requires a cryptoasset custodian to record a liability for the fair-value of the custodied assets, and has thus constituted a major practical impediment to banks acting as cryptoasset custodians. Although SAB 121 currently remains in effect, it is under renewed scrutiny, including in the form of proposed bipartisan legislation to functionally rescind it.

- *International receptiveness.* Employing a relatively permissive approach towards cryptoassets, foreign bodies including the EU have outpaced the U.S. in adopting tailored rules, with the EU's Markets in Crypto-Assets Regulation to become fully effective in December of this year. Argentina elected an avowedly pro-bitcoin president (on the heels of

El Salvador making bitcoin legal tender in 2021). And numerous countries have made progress towards adoption of a central bank digital currency or integrating stablecoins into economic activity (such as the Bank of England's proposal for a framework for payment systems using stablecoins).

Despite these promising developments (and setting aside longstanding debates over matters such as the environmental impact of bitcoin mining), there remain numerous obstacles to broader U.S. acceptance of cryptoassets and sectoral growth, including the SEC's continued use of enforcement actions to assert that most cryptoassets constitute securities, while simultaneously maintaining that U.S. securities laws are clear and declining to engage in prescriptive rulemaking, and the impulse of some regulators and legislators to address policy concerns around cryptoassets—such as combatting money laundering—by forcing activity to be channeled through traditional centralized rails.

## F. Compensation and Retention Remain Critical Deal Issues

An essential part of the value and sustainability of any financial services firm is the talent and personal relationships of the firm's management and employees. In many financial mergers, the primary assets to preserve and acquire are the people, and thus issues surrounding compensation—such as the treatment of equity awards, severance protection and retention arrangements—are often of critical importance to the deal. In particular, the lengthy periods between signing and closing seen in recent transactions have, in certain cases, increased the significance of retention arrangements at both the executive and lower levels. Some transactions, particularly mergers of equals, also serve as an occasion to implement chief executive officer succession planning. Whether the senior management of a target is intended to depart at closing, stay for some transition period or become part of the combined company's leadership team, a thoughtful and holistic approach needs to be given to the handling and integration of the parties' existing compensation arrangements, taking into account relevant tax consequences and limitations as more fully discussed in Chapter 2.

Both inside and outside of the transaction context, executive compensation and broad-based incentive compensation matters at financial institutions continue to be sensitive subjects that are scrutinized by the media and shareholders. Due to the influence of proxy advisors and increased regulatory focus and public scrutiny on executive compensation, the design of compensation arrangements in the ordinary course has resulted in a heavier weighting of performance-based compensation with decreased leverage, the disfavored use of stock options in favor of full value awards, longer vesting periods and the implementation of holding period requirements. Simultaneously, "golden parachute" excise tax gross-ups and single-trigger vesting are disfavored and have mostly been eliminated.

In businesses where individuals are the key assets being acquired, transaction parties work to ensure the delivery of those assets with the deal by implementing compensation arrangements that are designed to both incentivize and retain key employees, which historically contained non-competition and other restrictive covenants that sought to limit the employee from leaving for a competitor prior to or after the transaction. However, in January 2023, the Federal Trade Commission issued a notice of proposed rulemaking that, if promulgated and upheld, would dramatically overhaul the law governing non-competition covenants across the United

States by prohibiting employers from entering into, and requiring employers to rescind existing, non-compete clauses with employees and consultants. The comment period for the FTC's proposed rule was extended to April 19, 2023 and the FTC is reportedly to vote on the rule in April 2024. Acquirers that are relying on the retention of key employees will need to consider the potential implications of the FTC's actions, in addition to understanding the relevant state laws on non-competition restrictions, or run the risk that a generous multi-year retention offer can be shopped by the employee. While there are several ways to address employee retention risk in a transaction, the deterrent value of non-competition restrictions may become seriously weakened if the FTC has its way, including for significant shareholders who are service providers (subject to a 25% or more ownership exclusion).

The treatment of outstanding equity awards in a transaction is critical since these awards represent a significant portion of an executive or other key employee's compensation for past services, although the recent market turmoil may have dented the value of historic awards and consequently their effectiveness as a retention tool. Severance and termination protections also reduce unwanted defections by addressing executive uncertainty through providing key individuals with greater security against the risk of an involuntary termination (without "cause" or due to a "constructive discharge") associated with combining two companies, as cost savings and synergies are often meaningful considerations when evaluating the benefits of a transaction and it is inevitable that there will be some executive and employee terminations. Relatedly, well-designed retention programs can mitigate the disruptive potential of a deal on needed personnel as an additional and discrete financial incentive to remain focused on the company's best interests and mitigate personal uncertainty; a holistic design incorporating both "upside" incentives (retention awards) and "downside" protections (severance benefits and vesting) is often the most effective approach.

When carefully structured, taking into account tax considerations, deal-related compensation programs can play a critical role in guaranteeing the successful completion and integration of the transaction and the future stability and strength of the combined company.

## CHAPTER 2.

## EXECUTIVE COMPENSATION AND BENEFITS: RETENTION AND CHANGE-IN-CONTROL ARRANGEMENTS REMAIN CRITICAL IN A CHALLENGING ENVIRONMENT

Though the pace of new financial services transactions was modest in 2023, compensation and benefits issues — for new transactions and those awaiting closing — have remained in the forefront. Retention arrangements have taken on a renewed significance as institutions work to motivate executives and key employees to stay on in the midst of disruption and pending transformational change, particularly as the period between signing and closing has lengthened for many transactions due to regulatory scrutiny. Relatedly, change-in-control arrangements for executives continue to be prevailing market practice at financial institutions of all sizes, which help to address executive uncertainty by providing key individuals with "downside" protections in the face of potential synergies and cost savings measures.

Executive compensation and broad-based incentive compensation matters at financial institutions continue to be sensitive subjects that are scrutinized by the media and shareholders both inside and outside of the transaction context. The regulatory requirements and standards relating to the design and administration of compensation arrangements at financial institutions are complex and go beyond a focus on quantum. Organizations are required to assess the interplay among compensation and governance policies and balance corporate risk-taking with short-termism, and have the mandate to design arrangements that balance risk and provide adequate incentives to achieve the ultimate business goals.

Institutions should expect the continued focus of regulators on the structure of compensation throughout the organization to continue. In 2023, publicly traded companies were for the first time required to comply with the long-awaited final rules implementing Sections 953(a) (pay versus performance disclosure) and 954 (compensation clawbacks) of the Dodd-Frank Act, both of which add to the complex disclosure and regulatory regimes with which institutions must comply. Though the SEC put the unfinished rules implementing Section 956 of the Dodd-Frank Act, regarding the regulation of incentive-based compensation arrangements, on its short-term rulemaking agenda in June 2023 following the regional bank crisis marked by the failures of Silicon Valley Bank, First Republic Bank and Signature Bank, it still remains to be seen when those rules will be finalized or even re-proposed in conjunction with the Federal Reserve, the FDIC, the OCC, the FHFA and the NCUA. In addition, compensation design and retention efforts may be further complicated by the Federal Trade Commission's January 2023 notice of proposed rulemaking that seeks to prohibit employers from entering into, and requiring rescission of existing, non-compete clauses with workers. Outside of the United States, highly prescriptive EU regulations on incentive compensation, such as a cap on bonuses to bankers, has resulted in higher fixed compensation (generally through increased salary), as European financial institutions seek to remain competitive in retaining talent. Some EU financial institutions have applied the EU regulations to the compensation of key personnel operating at U.S. subsidiaries, resulting in compensation design that is not always aligned with that of similar U.S.-only peers.

Financial institutions have continued to be a target of unionization activities, bolstered by the tight labor market and increasing trends of labor activism throughout all U.S. industries.

Most notably, on December 20, 2023, employees at a Wells Fargo branch in Albuquerque, New Mexico voted by a 5-3 margin to form a union (the Communications Workers of America Wells Fargo Workers United), the first at a major U.S. bank. Though other Wells Fargo employees at the bank's Bethel, Alaska branch withdrew their petition for a vote scheduled for December 21, the successful New Mexico vote likely means that the push for unionization at financial institutions is far from over. Institutions should continue to closely monitor unionization activities and the consequent requirements — including any that may be relevant to a potential transaction, such as compliance with certain regulations or provisions in the applicable union agreement — stemming from any such established unions.

It is against this backdrop that boards and compensation committees are seeking the most effective and appropriate way to compensate, retain and incentivize executives and other employees. While the protections in place at a target institution or, in the case of a merger of equals, both parties to the transaction, provide the baseline for discussions about retention, severance and future employment or consulting arrangements, the compensatory landscape is ever-changing and requires close monitoring and attention. Some of the key concerns and issues are discussed below.

## I. THE CONTINUED RELEVANCE OF CHANGE-IN-CONTROL ARRANGEMENTS

As institutions face industry consolidation amid regulatory, competitive and business model challenges, employees are understandably anxious about the future should their employer be acquired by, or merge with, another entity. To offset these pressures and to permit successful recruitment and retention of executives, many financial institutions have adopted arrangements containing change-in-control provisions. These typically include change-in-control severance or employment agreements providing enhanced severance in the event of a qualifying termination in connection with a change in control and the acceleration of equity compensation awards either at the closing of the transaction or upon a severance qualifying termination thereafter. Elon Musk's acquisition of Twitter (now X Corp.) in late 2022 brought the importance of these arrangements (both the economics and procedural protections) to the forefront, as the broad employee population had limited to no contractual protections and, for the few executives who did, Mr. Musk took the position that they were fired for "cause" and not entitled to severance under their existing arrangements.

Change-in-control severance and other arrangements are not intended to deter combinations. Instead, by reducing the personal uncertainty and anxiety arising from a merger, such arrangements can help to assure full and impartial consideration of takeover proposals by a company's management and aid a company in attracting and retaining key executives. They are both legal and proper, are widely recognized as effective retention and recruiting devices and are prevalent at U.S. public companies. Potential merger partners will likely have similar arrangements and be familiar with them from prior transactions. The costs associated with change-in-control arrangements are expected transaction expenses, and there is no evidence that appropriately structured arrangements negatively impact shareholder value or are unacceptable to proxy advisory firms, such as Institutional Shareholder Services, Inc. ("ISS") and Glass Lewis, or institutional shareholders generally.

Severance and other change-in-control protections should be reevaluated periodically in light of the changes in market practice and a company's compensation programs from year to year. Key considerations include the impact of changes in compensation mix (fixed versus variable performance-based) on severance amounts, the application of the excise tax under Section 280G of the Internal Revenue Code of 1986, as amended (the "Code"), and the continued application, following a change in control, of clawbacks and performance-based triggers on deferred amounts.

## A. Addressing Executive Uncertainty

Change-in-control protections for senior executives often include the right to receive severance upon a termination of employment in connection with a change in control, either pursuant to an individual severance or employment agreement or a policy applicable to executives or senior management. A change-in-control severance arrangement is designed to provide protection exclusively in connection with a change in control, typically becoming effective only upon the occurrence of a change in control or in the event of a termination of employment in anticipation of a change in control. A standard form of arrangement usually provides for a two-year protected period after the change in control, during which time the buyer is required to preserve the status quo for the executive in terms of duties, responsibilities, work location and certain levels of compensation and employee benefits. If the status quo is not preserved and the executive resigns, or the executive's employment is terminated by the company, the executive is entitled to severance pay (generally, a multiple of base salary and annual bonus).

These arrangements also usually contain provisions addressing the so-called golden parachute excise tax under Section 280G of the Code. The federal golden parachute tax subjects "excess parachute payments" to a dual penalty: a 20% excise tax on the recipient and non-deductibility of the payments by the paying company. "Excess" parachute payments result if the aggregate payments received by a "disqualified individual" are "contingent on a change-in-control" and equal or exceed three times the individual's "base amount." The "base amount" is the individual's average annual taxable compensation with the employer over the five years (or shorter period for which the individual has been employed by the employer) preceding the year of the change in control. If there are excess parachute payments, then the amount of such payments for tax purposes is the excess of the aggregate change-in-control payments over the employee's base amount. That is, although *three times* the employee's average annual compensation is used to test whether there are excess parachute payments, once that test is satisfied, the tax consequences (*i.e.*, excise tax and non-deductibility) apply to *all* payments exceeding *one times* the employee's average annual compensation.

Companies generally take one of three approaches in dealing with golden parachute tax penalties in severance agreements:

- payments can be "grossed up" so that the employee is in the same after-tax position as if there were no excise tax;

- payments that are contingent on a change in control can be "cut back" to 299.9% of the base amount, so that no payments are considered parachute payments; or

- payments that are contingent on a change in control can be cut back only if the result is to give the employee a larger after-tax return than if the payment were not cut back.

Historically, companies adopted "gross-up" provisions to ensure that the excise tax does not undermine the intended incentive effects of change-in-control arrangements. Since the excise tax tends to punish recently hired and promoted employees in favor of those whose performance does not justify advancement, employees who do not exercise stock options early in favor of those who do and employees who elect to defer compensation in favor of those who do not, gross-ups level the playing field among executives. Moreover, changes in the design of compensation programs at financial institutions, including longer vesting periods, cliff vesting as opposed to installments, a greater weighting of performance-based compensation and mandatory deferrals, have exacerbated the impact of Section 280G of the Code on executives. For example, as a result of the manner in which the regulations under Section 280G of the Code value performance-based compensation, the tax is more likely to apply to employees who receive change-in-control acceleration of performance-based compensation (including deeming applicable performance goals achieved at the closing of a transaction without any acceleration of vesting or payment) than it is to those who receive acceleration of time-based awards. In light of the high marginal cost of grossing up parachute payments if they exceed the 299.9% safe harbor by a small amount, which despite its cost to the employer may yield little benefit to the executive, gross-up provisions frequently require there to be some threshold after-tax benefit to the executive before the gross-up applies (otherwise parachute payments are cut back to avoid application of the tax). This threshold may be expressed as an absolute dollar number or as a percentage of an executive's safe harbor amount. For example, agreements often provide that there will be no tax gross-up unless total change-in-control related payments exceed 110% of the executive's safe harbor amount (*i.e.*, 330% of the base amount).

Several considerations apply to amending or implementing change-in-control employment arrangements. Institutions that are, or are in danger of becoming, subject to FDIC limitations on golden parachutes should take into account those restrictions (which are discussed below). Dodd-Frank requirements for say-on-pay votes on executive compensation and golden parachute arrangements are an additional consideration. The requirements to hold a non-binding shareholder vote on named executive officer compensation at least every three years and to disclose golden parachute arrangements and a related shareholder vote in connection with mergers have resulted in even more scrutiny of change-in-control employment arrangements. All indications to date are that the say-on-golden-parachute vote has been of limited consequence and does not impact the overall vote on the underlying transaction.

This requirement for non-binding say-on-pay votes on executive compensation has given shareholder activists and proxy advisory firms, such as ISS, greater influence on compensation and corporate governance matters. ISS continues to focus generally on new or materially modified change-in-control compensation arrangements that include Section 280G gross-ups, excessive severance or change-in-control provisions (*e.g.*, change-in-control payments exceeding three times base salary and bonus) or "walk-away" rights providing for the payment of severance upon a voluntary resignation. Financial institutions should understand the potential consequences of a negative say-on-pay or withhold-the-vote recommendation from ISS before adopting or amending change-in-control arrangements with these features. However, the valid

business reasons to implement change-in-control arrangements should continue to be the primary consideration.

## B. Separation Plans

In parallel with change-in-control employment agreements for senior executives, many companies have adopted change-in-control separation plans, so-called "tin parachutes," for less senior employees. Sometimes these arrangements cover the entire workforce. These separation plans generally either formalize existing practices or provide enhanced severance in the event of layoffs occurring within a limited period (such as one or two years) after a change in control. They generally provide cash severance payments determined on the basis of seniority/position, pay or years of service, or some combination thereof, and may provide for continuation of benefits and payment of all or a portion of the expense of outplacement services. Severance usually is payable following an involuntary termination without cause and sometimes due to a constructive termination, such as workplace relocation, decrease in base salary or wages or material diminution in duties. Institutions should review their existing constructive termination definitions alongside any applicable remote work or "hybrid" work arrangements resulting from the Covid-19 pandemic and determine if any changes or carve-outs to an existing relocation trigger are appropriate (for example, to clarify if a return to office policy or a change to "hybrid" work arrangement does or does not constitute a constructive termination), lest the trigger be inadvertently tripped either before or after the closing of a transaction.

Due to the large numbers of people involved, a careful review of the estimated costs should be undertaken before adopting a separation plan, including an analysis of the potential impact of federal golden parachute excise tax provisions (described above) on the payments and benefits provided under the plan. In certain circumstances, the last-minute implementation of a plan providing broadly for enhanced severance costs may make an otherwise attractive merger economically undesirable. In an in-market merger where branch closings or similar reductions in force are anticipated on both sides, harmonizing the target and acquirer's severance policies can make sense, so that similarly situated employees of the acquirer and target who are laid off are treated uniformly. If the target's severance program is enhanced due to the change in control, implementing this uniformity may be too burdensome and require an acquirer to consider retention or discretionary equity award vesting for the acquirer's employees.

## C. Stock-Based Compensation Plans

Financial institutions should review the change-in-control provisions of their stock-based compensation plans and award agreements to ensure that they are clear on the consequences of a change in control for each type of award and that the required treatment does not give rise to tax concerns. Market standards have evolved away from "single-trigger" vesting provisions (requiring only the occurrence of a change in control to vest) toward "double-trigger" vesting provisions (requiring both the closing of a transaction and a qualifying termination of employment to vest), meaning the terms of the equity award agreements remain relevant following a change in control. It is important to ensure that there is harmony between the terms of the awards and any severance arrangements. It is also necessary for an equity plan and/or award agreements to address the treatment of performance goals applicable to equity awards in a transaction, as the goals' relevance and the ability to measure them may be less clear following a

transaction. For this reason, it is customary for award agreements to provide that performance goals are deemed achieved at the completion of the transaction at the greater of the target level and the level of actual performance (as measured immediately prior to the completion of the transaction), with the award then continuing as a time-vesting award. In the absence of the award terms specifying the treatment of performance goals upon a change in control in a manner that is protective of the award holder's opportunity (such as the greater of target and actual performance), this can unnecessarily become a negotiated point in a transaction.

Equity plans and award agreements should provide adequate flexibility for the awards to be adjusted in the context of a transaction. The default change-in-control provisions in equity awards are often modified in the negotiation of the treatment of the awards in the transaction. For example, in an all-cash transaction, vesting and settling all awards for cash would be considered, even if the default provisions provided for double-trigger vesting. Since the treatment of equity awards in a transaction may result in parachute payments subject to Section 280G of the Code and implicate Section 409A of the Code, their design and any amendments thereto should be considered and implemented in the context of an overall review of change-in-control employment protections. The accounting implications of the treatment of equity awards should be understood by the acquirer, in particular if modifications will be made to provide award holders with more favorable treatment.

**D. Retention of Key Employees**

In financial services transactions, in which individuals are often the key assets being acquired, transaction parties often work to ensure the delivery of those assets with the deal by implementing compensation arrangements that are designed to both incentivize and retain key employees. These arrangements often include a retention pool to be allocated to employees between signing and closing, with payment of awards to be made at specified times following, and contingent upon, the closing of the transaction. In addition, acquirers or parties to a merger of equals transaction may seek to enter into new employment or consulting arrangements — which often contain non-competition and other restrictive covenants to the extent permitted under applicable state law — with key executives at signing in order to have clarity and certainty around such individuals' post-closing employment and intentions. However, the FTC's January 2023 proposed ban on non-compete clauses, if promulgated and upheld, would have a dramatic impact on current practices around employee retention. Though challengers have already raised questions as to whether the FTC has overstepped its regulatory authority, acquirers should begin to consider the potential implications if the FTC's proposed rule is ultimately enacted, including the effects on employee retention and any resultant changes to compensation design. The comment period for the FTC's proposed rule was extended to April 19, 2023 and the FTC is reportedly to vote on the rule in April 2024.

A merger can cause uncertainty and lead to employee departures that can harm the business and, in turn, possibly put the closing of the transaction at risk. A retention program is a helpful tool for a target's management team to ensure that the employees who are necessary to the completion of a transaction and the transition following closing are retained and incentivized to stay focused and committed. The amount allocated for retention programs varies based on the type of business, alternative employment opportunities in the marketplace, incentives and protections already in place and anticipated period from signing to closing. Sometimes the

specific terms of the retention program, such as payment dates and events, are negotiated in connection with a transaction, and the target's management is permitted to allocate awards in their discretion or in consultation with the acquirer. Retention can be denominated in cash or equity or a combination of the two, and while time-based vesting conditions are most common in our experience, performance-vesting conditions are occasionally utilized (more commonly at the senior leadership level and in a merger of equals transaction) either alone or in conjunction with time-based vesting. The impact of the excise tax under Section 280G of the Code and the application of Section 409A of the Code should be understood and considered when developing retention programs and allocating awards thereunder.

## E. Deferred Compensation Plans

Due to the credit risk associated with the payment of deferred compensation and other unfunded non-qualified plan benefits, deferred compensation plans often provide for, or permit participants to elect, an immediate lump-sum payment of the entire account balance upon a change in control. Any such election and the terms of deferred compensation plans generally should be reviewed to ensure that they comply with Section 409A of the Code. The definition of "change in control" applicable to change-in-control distribution provisions in, or individual elections under, deferred compensation plans for employees and directors should be reviewed and understood prior to a transaction, since Section 409A imposes significant limitations on the ability to alter distribution provisions or elections after they are established. Although some companies may prefer the administrative ease of having only one change-in-control definition for all purposes, a change-in-control definition that mirrors the definition in Section 409A of the Code is not required for all change-in-control provisions in all compensation arrangements. In general, companies should use definitions that they believe indicate a true transfer of control of the company and should provide, only to the extent required by Section 409A, that the definition will be triggered if such event also constitutes a "change in control event" within the meaning of Section 409A.

## F. Rabbi Trusts

A rabbi trust is a trust created for the purpose of funding an employer's non-tax-qualified benefit obligations. In general, companies adopt rabbi trusts for two reasons: (1) to provide a way to set aside funds to meet future obligations to pay deferred compensation or unfunded retirement benefits; and (2) to reassure employees that the assets to pay their compensation will be available and in the hands of a neutral third party. The latter concern is generally the primary motivation in establishing rabbi trusts that are only required to be funded upon a change in control. If there is a genuine concern that an acquirer may refuse to pay certain benefits after a change in control, a rabbi trust can be designed to allow payments to be made by the trustee in accordance with procedures designed to protect the employees against unfair treatment by the acquirer. Although an acquirer, especially in a friendly transaction, is rarely reluctant to pay severance following a change in control where the entitlement is clear, the rabbi trust's effectiveness in ensuring payment in a situation in which an acquirer refuses to pay an amount is not altogether certain, as the underlying terms of the applicable benefit plan or agreement control and an employer can challenge the executive's entitlement to the amounts and call into question the authority of the trustee to pay.

Before implementing a rabbi trust, especially one containing provisions that require funding of the full amounts due under the accompanying benefit arrangement or make the trust irrevocable on a change in control or imminent change in control, a company should consider the costs involved in funding the trust, the costs of maintaining the trust, and the costs of using the trustee as paying agent/administrator for the payment of benefits that are funded through the trust upon a change in control. These costs may be large in relation to the benefits to participants because a trustee's fees are often tied to the amount of assets held in the trust. In addition, the amount of money required to fund potential severance benefits or unfunded deferred compensation or retirement obligations can be surprisingly large. The burden on a company of dedicating a large amount of liquid assets to funding for severance or benefits that may never become payable, or will not become payable for many years to come, may be significant. Indeed, it is not uncommon for an acquirer to negotiate that the trust be amended, to the extent permitted not prohibited under the amendment provisions of the trusts and underlying plans, to provide that the proposed transaction does not constitute a change in control under the trust or to seek that participants waive their entitlement to funding of the trust. In addition, the limitations on the ability to fund rabbi trusts under Section 409A of the Code should be considered. Companies should review and examine any existing rabbi trust agreements and potential funding obligations and other costs well in advance of a transaction, and consider whether there is adequate flexibility to amend or de-trigger a trust in connection with a change in control if it is determined to be desirable (or the acquiror insists on it).

### G. Considerations in Mergers of Equals

The social issues, governance matters and executive succession issues that are customarily addressed in great detail in mergers of equals weave their way into compensation arrangements and decisions. In recent bank transactions, new agreements (employment, consulting or both) have been entered into with the chief executive officers of each party to the transaction at the time the merger agreement was signed, based on the view that establishing the ongoing executive leadership and any planned transitions were important to the success of the transaction and critical to the transaction announcement. Retention programs are also prevalent and critically important in this context to ensure the ongoing focus and commitment of employees on each side, some of whom likely will be without a job or in a less desirable position following the transaction.

The compensation and benefits issues in a merger of equals are complex, requiring a careful analysis of the existing arrangements of both parties to the transaction, as well as the tax implications under Sections 280G and 409A of the Code. For example, one must evaluate whether the change-in-control protections of both parties to the transaction are triggered — if they are, the associated rights and potential costs associated therewith need to be understood, or, if the arrangements of only one party are triggered, issues of fairness need to be considered. In addition, the excise tax under Section 280G of the Code will only apply to the executives of one institution, which may require different approaches to what ideally would have been a uniform compensation design. In contrast, it is possible for both parties to the transaction to experience a "change in control event" within the meaning of Section 409A of the Code.

Parties to a merger of equals usually attempt to seek a balanced and equitable approach to compensation matters and retention, recognizing that synergies are a critical aspect of most of

these transactions. As with most compensation and employee retention matters, there is not a one-size-fits-all approach.

## II. APPLICABLE REGULATORY RESTRAINTS AND GUIDANCE

As discussed above, since the financial crisis, regulatory scrutiny of compensation arrangements has substantially increased. A few of the most prominent considerations are summarized here.

### A. FDIC Golden Parachute Regulations

Payments to executives of financial institutions may, in some circumstances, be limited under golden parachute rules issued by the FDIC in 1996 (with additional guidance issued by the FDIC in 2010). These circumstances are likely to be significantly more prevalent in times of significant market stress. With certain exceptions, these FDIC rules prohibit troubled insured depository institutions (or their holding companies) from entering into agreements to make or making golden parachute payments to any "institution-affiliated party" ("IAP"). IAPs include directors, officers and employees, among others. The FDIC rules generally define golden parachute payments as compensatory payments (or agreements to make compensatory payments) contingent on, or payable after, the termination of the IAP's primary employment or affiliation with the institution. There are exceptions for certain *bona fide* deferred compensation payments, qualified retirement plan payments, limited payments under non-discriminatory severance pay arrangements and payments under certain employee welfare benefit plans. An institution subject to the FDIC's golden parachute rules may, subject to obtaining the written consent of the appropriate federal banking agency, make parachute payments to IAPs under an agreement that provides for payment of a reasonable severance payment, not exceeding 12 months of salary, in the event of a change in control of the institution (other than an FDIC-assisted transaction or in connection with FDIC receivership or conservatorship). Accordingly, institutions subject to the FDIC's golden parachute rules should be aware of the additional limitations on severance payments, whether or not in connection with a change in control; severance payments that would have otherwise been due to executives may be subject to reduction — or altogether prohibited — depending on the circumstances.

Though the FDIC's golden parachute rules have not often been in the spotlight in recent years, in July 2022 the U.S. Court of Appeals for the D.C. Circuit overturned a lower court ruling that found the FDIC lacked the authority to determine whether severance payments to two executives of the former Southern Community Bank and Trust were excessive and qualified as golden parachute payments. The case stems from a March 2012 merger of Southern Community Bank and Trust with Capital Bank N.A. following Southern Community's entry into a consent order with the FDIC. At the time of the merger, the executives at issue refused to enter into new employment agreements and their employment was terminated without them receiving severance payments under their original agreements. The executives subsequently brought suit against Capital Bank over the unpaid amounts. After Capital Bank asked the FDIC to determine if the severance payments to the two executives constituted golden parachutes (meaning the payments would be prohibited if payable to executives found at least partially responsible for an institution falling into "troubled" status), the FDIC ruled in June 2017 that any payments to the executives would be prohibited under the rules. The FDIC's recommendation was vacated in September

2020 when the U.S. District Court for the District of the District of Columbia ruled that the FDIC could not make a judgment on the payments since the determination would be based on hypothetical payments in ongoing litigation. Following the D.C. Circuit's ruling, the lower court was ordered to rule on the merits of whether the FDIC's determination was incorrect, and in September 2023, the District Court ruled that the FDIC reasonably determined that the severance, legal fees and other change-in-control benefits under the executives' employment agreements constituted prohibited golden parachutes. However, the District Court found that the ordinary salary and benefits to be paid to the executives for work performed under their original agreements were not contingent upon a termination event and thus not prohibited.

## B. Safety and Soundness Guidance

In 2010, the Federal Reserve, the FDIC, the OCC and the Office of Thrift Supervision (the "OTS") issued final guidance on incentive compensation (the "Safety and Soundness Guidance"). All banking organizations must evaluate incentive compensation and related risk management, control and governance processes and address deficiencies or processes inconsistent with safety and soundness. This evaluation is to be done with a view to the three core principles described in the guidance — that incentive compensation should: (1) provide employees incentives that appropriately balance risk and reward; (2) be compatible with effective controls and risk management; and (3) be supported by strong corporate governance, including active and effective oversight by the board of directors. We note that the Silicon Valley Bank crisis may result in greater scrutiny by the regulators of the compensation design and performance goals at banking organizations, given the focus on the pay of Silicon Valley's executives being based on goals that allegedly rewarded a riskier asset management strategy.

The guidance emphasizes governance and board-level oversight. It provides that the board of directors is ultimately responsible for ensuring that incentive compensation arrangements for all covered employees — not just senior executives — are appropriately balanced and do not jeopardize safety and soundness. The guidance makes clear that the structure, composition and resources of the board of any banking organization should support effective oversight of incentive arrangements. As to incentive compensation arrangements, the guidance requires a compensation committee to: (1) provide active oversight and directly approve arrangements for senior executives; (2) monitor performance and regularly review the arrangements' design and function; and (3) if the banking organization is a significant user of incentive compensation arrangements, review the arrangements on both backward-looking and forward-looking bases.

The consequences of failing to meet the standards of the compensation guidance are significant, as the guidelines provide that supervisory findings on incentive compensation will be included in exam reports and incorporated into supervisory ratings. As a result of the Safety and Soundness Guidance and the ongoing dialogue with the Federal Reserve about supervisory expectations, there have been significant design changes to the compensation arrangements at larger banking organizations. Balancing risk-taking is a primary concern. Design changes have included:

- decreasing incentive compensation payout opportunities;

- deferring a portion of the payout of incentive compensation, both cash and long-term incentives, over at least three years to better understand the risk outcomes, with payment of the deferred amounts to be contingent on achieving performance-based measures; and

- increasing the portion of incentive compensation paid in equity-based instruments, such as performance and restricted shares, with stock options disfavored other than in limited amounts.

These design changes generally contract the upside opportunity and provide for *ex post* adjustments to address negative tail risk. In addition, regulators expect companies to have a framework for the exercise of discretion in compensation matters, so that discretionary decisions may be audited, and recoupment and clawback provisions for all forms of incentive compensation. Financial institutions have worked to balance regulatory expectations with the "pay for performance" demands of shareholders and the need to attract, retain and incentivize executives and key employees.

### C. Section 956 of the Dodd-Frank Act

In 2011, the OCC, the Federal Reserve, the SEC, the FDIC, the OTS, the National Credit Union Administration (the "NCUA") and the Federal Housing Finance Agency (the "FHFA") issued a proposed rule to implement Section 956 of the Dodd-Frank Act. Section 956 prohibits incentive-based compensation arrangements at a broad range of financial institutions that provide excessive compensation or could expose the institution to inappropriate risks that could lead to a material financial loss. It requires such institutions to report their incentive-based compensation arrangements. The 2011 proposed rule was never finalized, and in 2016, the regulators re-proposed a rule that incorporates additional, more stringent requirements on incentive compensation at certain financial institutions covered by Section 956 of the Dodd-Frank Act. The proposed rule under Section 956 of the Dodd-Frank Act would supplement existing rules and guidance of the bank regulatory agencies, imposing additional standards and compliance burdens that overlap, but are not entirely consistent with, existing requirements. The comment period for the 2016 proposed rule ended on July 22, 2016. Likely in response to the Silicon Valley bank crisis, the SEC included Section 956 on its short-term rulemaking agenda in June 2023, but as of this writing, no further action has been taken. Below is a summary of the 2016 proposed rule, though the SEC has previously indicated that it may be re-proposed in conjunction with the Federal Reserve, the FDIC, the OCC, the FHFA and the NCUA (meaning that if re-proposed, the new proposal may deviate slightly or significantly from the 2016 proposed rule described below).

The proposed rule applies to "covered" financial institutions that have $1 billion or more in average total consolidated assets. "Covered" financial institutions include depository institutions and their holding companies (including the U.S. operations of a foreign bank), broker-dealers registered under Section 15 of the Securities Exchange Act of 1934, investment advisers under the Investment Advisers Act of 1940 (whether or not registered), credit unions, Fannie Mae, Freddie Mac and Federal Home Loan Banks. The methodology for determining total consolidated assets under the proposed rule varies depending upon the category of the institution and the applicable regulator. For institutions that are not investment advisers, it is

generally determined based on a rolling average. The 2016 proposed rule introduced subcategories of covered financial institutions based on the amount of average total consolidated assets as follows: (1) Level 1 covered financial institutions would be covered financial institutions with average total consolidated assets of $250 billion or more and subsidiaries of such institutions that are themselves covered financial institutions; (2) Level 2 covered financial institutions would be covered financial institutions with average total consolidated assets of between $50 billion and $250 billion and subsidiaries of such institutions that are themselves covered financial institutions; and (3) Level 3 covered financial institutions would be covered financial institutions with average total consolidated assets of between $1 billion and $50 billion.

The proposed rule applies to "covered persons," including executive officers, employees, directors and principal shareholders. While all employees are potentially covered persons, the proposed rule is intended to apply to the incentive compensation arrangements for covered persons or groups of covered persons that may pose inappropriate risk to the covered financial institution. The 2016 proposed rule also introduces additional limitations on the incentive compensation of "senior executive officers" and "significant risk-takers" of Level 1 and Level 2 covered financial institutions. The "executive officers" of a covered financial institution include any person who is a "senior executive officer" as defined by the 2016 proposed rule (*i.e.*, any person who holds the title or, without regard to title, salary or compensation, performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer or head of a major business line or control function) and other individuals designated as executive officers by the covered financial institution. A "significant risk-taker" is defined as any individual (other than a senior executive officer) whose incentive compensation is at least one-third of their total compensation and who also meets one or more of the following tests: (1) the person is among the top 5% (Level 1) or top 2% (Level 2) of the highest compensated covered persons in the consolidated organization (including affiliates that are also covered financial institutions); (2) the person has the authority to commit or expense 0.5% or more of the capital of the covered financial institution (including affiliates that are also covered financial institutions); or (3) the person was designated as a "significant risk-taker" because of the person's ability to expose the covered financial institution to risks that could lead to material financial loss in relation to the covered financial institution's size, capital or overall risk tolerance (in accordance with procedures established by the primary federal agency with oversight over the covered financial institution, or the covered financial institution itself).

Under the proposed rule, a covered financial institution would be prohibited from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risk-taking by providing excessive compensation. Excessive compensation means amounts that are unreasonable or disproportionate to the value of the services performed. In evaluating excessive compensation, the agencies would consider, among other factors, the following: (1) the combined value of all compensation, fees or benefits provided to the covered person; (2) the compensation history of the covered person and other individuals with comparable expertise at the covered financial institution; (3) the financial condition of the covered financial institution; (4) compensation practices at comparable institutions; (5) for post-employment benefits, the projected total cost and benefit to the covered financial institution; and (6) any connection between the covered person and any fraudulent act

or omission, breach of trust or fiduciary duty or insider abuse with regard to the covered financial institution. Accordingly, while the proposed rule would apply directly only to incentive-based compensation, regulators would consider all compensation and benefits arrangements in the evaluation of the incentive-based arrangements.

The proposed rule also would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangements that encourage a covered person to expose the institution to a material financial loss. To comply with this standard, an incentive-based compensation arrangement must: (1) appropriately balance risk and financial rewards (*e.g.*, through payment deferrals, risk adjustment of awards and/or longer performance periods); (2) be compatible with effective risk management and controls; and (3) be supported by effective corporate governance, namely through board oversight of incentive-based compensation arrangements. The proposed rule also includes recordkeeping obligations for all covered institutions to ensure the ability to disclose records relating to the incentive arrangements to their primary regulator upon request.

Level 1 and Level 2 covered financial institutions would also be subject to several additional prescriptive requirements with respect to incentive-based compensation arrangements, including, among others:

- *"Maximum Opportunities" (i.e., Caps on Incentive-Based Compensation).* Level 1 and Level 2 covered financial institutions would not be permitted to award incentive-based compensation to senior executive officers and significant risk-takers in excess of 125% and 150%, respectively, of the target amount for the incentive-based compensation.

- *Relative Performance Measures.* Level 1 and Level 2 covered financial institutions would not be permitted to use incentive-based compensation performance measures that are solely based on industry peer performance comparisons.

- *Volume-Driven Measures.* Level 1 and Level 2 covered financial institutions would not be permitted to award incentive-based compensation to covered persons that is based solely on transaction revenue or volume without regard to transaction quality or compliance of the covered person with sound risk management.

- *Minimum Deferral (Level 1).* Level 1 covered financial institutions would be required to defer a specified portion of the short- and long-term incentive-based compensation awarded to its senior executive officers and significant risk-takers (60% and 50% for senior executive officers and significant risk-takers, respectively) for each performance period for a minimum period of time (at least four years for short-term incentive compensation and at least two years for long-term incentive compensation). Only up to 15% of a senior executive officer's or significant risk-taker's total incentive compensation awarded in stock options would count toward the deferral requirements.

- *Minimum Deferral (Level 2).* Level 2 covered financial institutions would be required to defer a specified portion of the short- and long-term incentive- based

compensation awarded to its senior executive officers and significant risk-takers (50% and 40% for senior executive officers and significant risk- takers, respectively) for each performance period for a minimum period of time (at least three years for short-term incentive compensation and at least one year for long-term incentive compensation). The same limitation on options as described above for Level 1 covered financial institutions would also apply to Level 2 covered financial institutions.

- *Vesting During the Deferral Period*. During a deferral period as described above, incentive-based compensation may not vest faster than on a pro rata annual basis beginning on the first anniversary of the end of the performance period for which the amount was awarded, and the vesting of the deferred incentive-based compensation may not be accelerated other than in the case of the death or disability of the covered person.

- *"Downward Adjustment."* Deferred incentive-based compensation awarded to Level 1 and Level 2 senior executive officers and significant risk-takers would need to be subject to "downward adjustment" (*i.e.*, forfeiture) if any of the following adverse outcomes occurred at the covered financial institution: (1) poor financial performance attributable to a significant deviation from the risk parameters set forth in the covered financial institution's policies and procedures; (2) inappropriate risk taking, regardless of the impact on financial performance; (3) material risk management or control failures; (4) non-compliance with statutory, regulatory or supervisory standards that results in enforcement or legal action against the covered financial institution brought by a federal or state regulator or agency or a requirement that the covered financial institution report a restatement of a financial statement to correct a material error; and (5) other aspects of conduct or poor performance as defined by the covered financial institution.

- *Clawback*. Incentive-based compensation awarded to Level 1 and Level 2 senior executive officers and significant risk-takers would be subject to a minimum seven-year clawback period following the date on which the compensation vests. Events triggering clawback include: (1) misconduct that resulted in significant financial or reputational harm to the covered financial institution; (2) fraud; or (3) intentional misrepresentation of information used to determine the senior executive officer's or significant risk-taker's incentive-based compensation. It is not clear how this provision would interact with the SEC's final compensation clawback rules released in October 2022, which require issuers with listed securities to adopt a policy that requires it to recover incentive-based compensation from executive officers that would not have been earned based on specified accounting restatements.

- *No Hedging*. Level 1 and Level 2 covered financial institutions would not be permitted to engage in transactions on behalf of covered persons to hedge or offset any decrease in the value of the covered person's incentive-based compensation.

The 2016 proposed rule also incorporates several additional requirements for Level 1 and Level 2 covered financial institutions with respect to oversight, risk management, controls, and

governance policies and procedures, including, among others: (1) recordkeeping requirements that mandate that the covered financial institution maintain detailed records with respect to its incentive-based compensation arrangements for senior executives and significant risk-takers for at least seven years in a manner that allows for an independent audit; (2) requirements that the compensation committee obtain annual written assessments with respect to the institution's incentive-based compensation program from both management and an independent third party; and (3) a requirement to develop and adopt a risk management framework for its incentive-based compensation program that is independent of any line of business and includes an independent compliance program for internal controls, testing, monitoring and training.

As noted above, it is not clear as of this writing whether Section 956 of the Dodd-Frank Act and this proposed rule will be implemented in its current form. While large financial institutions have likely already incorporated much of the process and compensation design aspects of the proposed rule into their compensation programs, the adoption of the proposed rule would require incremental changes, the necessity and benefits of which are unclear.

# CHAPTER 3.

# BOARD EVALUATION OF M&A AND STRATEGIC TRANSACTIONS

This chapter provides an overview of the legal standards and considerations relevant to the evaluation by a board of negotiated and unsolicited M&A transactions. As summarized below, evaluation of M&A proposals is necessarily a complex and subjective task and is generally one in which directors are afforded a wide degree of latitude in the exercise of their business judgment. However, there are exceptions to the general rule. In the sale-of-control context (*e.g.*, an all-cash sale), the directors' judgment to sell the company is subject to enhanced scrutiny under the so-called *Revlon* doctrine, discussed below. For mixed consideration transactions (*e.g.*, part stock and part cash), the level of scrutiny applied is less clear; as discussed below, recent cases continue to explore boards' duties in such transactions. Greater scrutiny can also be expected where the counterparty is an existing large shareholder or other affiliate of the target company. In the evaluation of any M&A transaction, it is difficult to overstate the importance of obtaining advice at all stages of the process from experienced legal counsel and financial advisors.

## I. QUALITATIVE FACTORS IN EVALUATING STRATEGIC ALTERNATIVES; SHORT-TERM VERSUS LONG-TERM VALUES

Courts afford informed and well-advised independent directors wide latitude to direct, customize and even thwart a merger or sale process in the best interests of a target company and its shareholders. In *Air Products & Chemicals, Inc.* v. *Airgas, Inc.*, 16 A.3d 48 (Del. Ch. Feb. 15, 2011), the Delaware Chancery Court reaffirmed the primacy of the board of directors in matters of corporate control under bedrock Delaware law: if directors act "in good faith and in accordance with their fiduciary duties," the Delaware courts will continue to respect a board's "reasonably exercised managerial discretion." *Id.* at 151. The Airgas board had rejected a series of tender offers from Air Products and had used defensive measures, including a staggered board and a poison pill, to block the Air Products bid. Air Products petitioned the court to order Airgas to redeem its poison pill and to allow the Airgas shareholders to decide whether to accept the tender offer. In ruling for the Airgas board, the court found that the Airgas board had acted in good faith in determining that Air Products' final tender offer was inadequate. The court relied on the facts that the Airgas board was composed of a majority of independent directors and that it had relied on the advice of outside legal counsel and three separate financial advisors. The court concluded that it is up to directors, not raiders or short-term speculators, to decide whether a company should be sold: "a board cannot be forced into *Revlon* mode any time a hostile bidder makes a tender offer that is at a premium to market value." *Id.* at 153. In vindication of the Airgas board's judgment and the wisdom of the Delaware Chancery Court decision, Airgas was later sold to Air Liquide in 2016 at more than double the final offer made by Air Products.

In *C&J Energy Servs., Inc.* v. *City of Miami Gen. Emps.' & Sanitation Emps.' Ret. Trust*, No. 655/657, 2014 (Del. Dec. 19, 2014) (en banc), the Delaware Supreme Court reaffirmed that a board of directors has wide latitude to craft a sales process, including to choose a single-bidder strategy, stating that "*Revlon* does not require a board to set aside its own view of what is best for the corporation's stockholders and run an auction whenever the board approves a change of control transaction." Independent and well-informed directors may choose any reasonable path

when selling a company, "so long as the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so."

## A. Stock Deals

A stock merger is a combination of two institutions where target company shareholders continue to hold an equity interest in the combined enterprise after the merger. Stock mergers thus differ fundamentally from cash acquisitions, in which the target shareholders' equity investment is cancelled in return for a cash payment. As a result, in weighing various alternative bids involving stock consideration, directors cannot simply compare a headline, moment-in-time measure of purchase price, as with a cash transaction, but must assess the intrinsic value of the ongoing enterprise in which the shareholders will be investors. This is necessarily a complex and subjective task for which courts afford directors a wide degree of latitude in the exercise of their business judgment. Courts have placed great emphasis on the deliberative record of a board's decision-making process, and have recognized that, in contrast to a cash transaction, assessing the relative value of competing stock proposals requires the exercise of substantial discretion.

Directors must exercise business judgment in making judgments about the intrinsic value of a business by looking at a variety of factors, including making sophisticated financial valuations and qualitative judgments concerning the combined company's potential for success. Due diligence on the part of both parties to the merger is an indispensable prerequisite to informed decision making, as is detailed analysis of pro forma financial information and contribution analyses. In the case of mergers of financial institutions, risk assessment and regulatory compliance are especially critical factors. The required analysis calls for consideration of such factors as:

- *Past performance of the security and potential acquirer*. The historical and prospective performance of the securities being offered by, and the profitability of, the potential acquirer, as compared with the target and any competing bidder;

- *Asset quality*. The quality, integrity and track record of the potential acquirer in maintaining and managing its loan and securities portfolios, asset quality measures, portfolio composition, risk management and loan underwriting standards, practices and processes;

- *Management and regulatory compliance*. The quality of the potential acquirer's management team, upon whom shareholders will depend to realize the value of their investment and comply with applicable laws, and assessment of the organizational cultures of each company. It is important to assess management's track record not only for financial performance but also for risk management, accounting practices, regulatory compliance and integrity;

- *Financial management and controls*. The value of a stock is critically tied to an acquirer's credibility. Any issues regarding accounting practices, internal controls, asset write-downs and loss recognition, disclosure practices, conflicts of interest,

compliance practices, supervisory issues, management relationships with investors and regulators, executive compensation and the like must be considered carefully because they could substantially impact the future value of the stock;

- *Integration and synergies*. The potential acquirer's track record in making acquisitions, which indicates whether it can successfully integrate different operations without disruption while enhancing shareholder value, as well as its appetite for different types of business that may involve varying levels of risk. This includes its track record of achieving initially claimed merger synergies. A board should consider whether differences in the management or operational styles of each institution (*e.g.*, centralized or distributed control, incentive compensation structures) suggest that integration may be more or less likely to be timely and successful. The board should also consider integration risks generally, such as any regulatory concerns and the impact of combining with another company given the time required to integrate IT systems and the cost associated with IT vendor contracts;

- *Capital position, funding and liquidity*. The relative strength of the combined company's capital position, funding capabilities and liquidity, including the possible need for the acquirer to raise additional capital and any possible dilutive effect, as well as the pro forma dividend and what level of dividends appear sustainable and approvable. Pro forma capital and liquidity will also be critical considerations in assessing the likelihood of prompt regulatory approval;

- *Franchise value*. The opportunity to create a substantial market presence in a region or on a national scale, or in particular product markets, and the extent to which the economy, regulatory change or technological trends could impact the buyer's franchise;

- *Antitrust*. Whether antitrust or deposit or liability cap concerns would require the potential acquirer to make significant divestitures, which would impact the valuation of the combined enterprise and would also necessarily increase the risk of non-consummation and raise potentially substantial timing issues. For companies operating outside the United States, the possible impact of competition reviews in other countries must be carefully considered. For mergers involving a larger party (whether in the United States or globally), any issues that might bear on regulatory analysis of financial system stability should be considered;

- *Earnings and capital dilution*. The amount of time and effort required to restore per-share earnings momentum and to avoid potential adverse stock market reaction. In some cases initial EPS dilution can be justified by strong financial, marketing, operating and strategic advantages of the prospective merger. In this regard, much will depend on the track record of the acquirer and its credibility with investors (particularly the market's perception of the acquirer's acquisition discipline and record of achieving projected cost savings); and

- *Certainty of consummation*. Whether regulatory or other issues are likely to arise that could either delay consummation or jeopardize the transaction altogether. A party's

> supervisory issues can seriously impact, delay or prevent receipt of deal approvals. A significant compliance issue, even when prosecuted by an agency that does not have a formal deal approval role, can be expected to impact the transaction. A party's size and systemic significance, pro forma capital and liquidity ratios, and record of risk management can be key. Regulatory issues can become particularly challenging in transactions that cross international borders. Given the changes that can take place in a target organization after the announcement of a transaction (*e.g.*, employee attrition) and the resulting cost of *not* completing the transaction, the track record of a prospective acquirer in completing transactions as agreed is also a vital consideration.

While future value is never certain, a board can and should assess the relevant factors, evaluate the long-term track record of the potential acquirer and test the business rationales and future prospects for the combined companies that underlie a merger proposal. The exercise of judgment and the evaluation of fundamental business points are essential. While the board should evaluate a potential merger principally on the basis of its impact on shareholder value, the company's status as a regulated financial institution makes it relevant for the board to consider that the treatment of other key constituencies (such as regulators, customers and employees) important to maintaining and enhancing the company's franchise and, therefore, of significant relevance to the company's and its shareholders' long-term interests.

In making strategic judgments, directors are not obliged to restrict themselves to an immediate or short-term time frame. The directors are entitled to select the transaction that they believe provides shareholders with the best long-term prospects for growth and value enhancement with the least amount of downside risk; the directors thus have a substantial range for the exercise of their judgment. In its decision in *Paramount Communications, Inc.* v. *Time Inc.*, the Delaware Supreme Court held that the directors' statutory mandate "includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability." 571 A.2d 1140, 1150 (Del. 1989). A court should not be involved in "substituting its judgment as to what is a 'better' deal for that of a corporation's board of directors." *Id.* at 1153.

There are numerous examples of boards rejecting nominally higher bids in favor of a competing bid where the board determined that the nominally lower bid represented greater value, whether as a result of the potential of the combination, the prospects of the bidders, the risks of combining the companies or completing the transaction or otherwise. For example, in December 2016, Heritage Oaks Bancorp signed a merger agreement with Pacific Premier Bancorp, reportedly despite a proposal from another bank, superior in some financial respects, because it could not get satisfactory answers about regulatory risks of the alternative offer. The New York Supreme Court, applying Delaware law, has held that the mere allegation that the merger consideration reflected a discount to market at announcement, and that the merger had been favored over a third-party bid offering higher current market value, was insufficient as a matter of law to deprive the board of the protection of the business judgment rule. *Stewart* v. *Roslyn Bancorp, et al.*, Index No. 015366/2003 (N.Y. Sup. Ct. Apr. 5, 2004).

Broader discretion may be available to boards in selected jurisdictions outside of Delaware. In *Minzer* v. *Keegan*, CV-97-4077 (E.D.N.Y. Sept. 22, 1997), the court expressly rejected the claim that the well-known Delaware decisions of *Paramount* v. *QVC* and *Revlon*

apply to New York corporations. The court stated that, instead, under New York law "in actions involving a change-of-control, the directors of banks are free to consider not only short-term considerations such as merger price, but long-term factors as well" (N.Y. Banking L. § 7015(2)). Notably, because the transaction was a stock merger involving a public acquirer with a diversified shareholder base, *Revlon* duties would not have applied even if Delaware law had governed. The court in *Minzer* made clear that the board of a New York corporation has broad discretion in choosing its preferred merger partner. In particular, the court noted that the Greater New York Savings Bank board's decision to prefer a community-oriented bank as a merger partner was a valid consideration under New York law. The opinion noted that Greater New York Savings Bank and its preferred merger partner, Astoria Financial Corporation, had banking operations in complementary locations with the same "strategic" focus and customer-oriented strategy, and contrasted that with the differing business orientation of a competing bidder, North Fork Bancorporation. The court indicated a reluctance to second-guess what appeared to be a valid business judgment by Greater New York Savings Bank that it would "succeed better at banking" with Astoria than with North Fork.

The directors' responsibility when evaluating a stock merger, then, is to consider carefully and in good faith which proposal serves shareholder interests not only initially or at closing, but also in the longer term. In a stock merger, the qualitative aspects of the security provided as consideration must be carefully reviewed; if proper procedures are followed and full disclosure of all material facts is made, there will be no issue of director liability in accepting a nominally lower-priced bid in a stock merger.

### B. Sale of Control

A sale-of-control transaction, including both all-cash deals (and potentially some part-stock, part-cash deals) and deals involving a controlling shareholder, results in enhanced obligations on the part of the board.

Under the *Revlon* doctrine, the board of a company selling itself is obligated to seek the best value reasonably available for shareholders. This obligation, however, is frequently taken to stand for more than what it really represents and is often mistakenly assumed to require a formal auction process. Directors are not guarantors of price, and the case law makes clear that there is no single blueprint that directors must follow in selling a company. Rather, a disinterested board has reasonable latitude in determining the appropriate method of sale within the basic directive of achieving shareholder value.

This principle is exemplified by *In re Smurfit-Stone Container Corp. S'holder Litig.*, C.A. 6164-VCP (Del. Ch. May 20, 2011). In rejecting plaintiffs' contention that the Smurfit-Stone board had insufficiently managed the merger process, the court noted with approval that the Smurfit-Stone board "took firm control of the sales process," "asserted its control over the negotiations" with multiple bidders and "engaged in real, arm's-length dealings with potential acquirers." *Id.* at 43, 55, 46. The court denied the injunction motion, ruling that the shareholder plaintiffs had not shown a likelihood of prevailing on their claims under any standard. In a matter of first impression, the court ruled that the *Revlon* standard would likely apply to half-cash, half-stock mergers, reasoning that enhanced judicial scrutiny was in order because a significant portion "of the stockholders' investment [. . .] will be converted to cash and thereby

be deprived of its long-run potential." *Id.* at 49. The court twice noted, however, that the issue remains unresolved by the Delaware Supreme Court, and that the "conclusion that *Revlon* applies [to a mixed-consideration merger] is not free from doubt." *Id.* at 38. Based on the *Smurfit-Stone* decision, deal planners should expect that any merger including a significant amount of cash consideration is likely to be subject to enhanced judicial scrutiny under *Revlon*.

There are many ways to seek the highest reasonably available value, including both full auctions and negotiated transactions involving more limited market checks. In the typical auction scenario, a company, usually with the assistance of its investment banker, prepares descriptive memorandums that are circulated to multiple prospective bidders together with a draft merger agreement. Interested bidders are allowed to engage in limited due diligence and then submit their bids together with their contract mark-ups by a fixed deadline. Auctions of this sort often involve more than one round of bidding and may involve simultaneous negotiations with multiple parties. One difficulty in any auction process is that the true "value" of a bid, which must take into account not only the price to be paid but also the likelihood and timing of consummation and the related financing and regulatory approval risks, may be difficult to discern with certainty (and some bidders may propose stock or part-stock deals, which implicate the valuation questions discussed above).

The Delaware Supreme Court has stated that a board may assess a variety of additional practical considerations, including: an offer's fairness and feasibility; the proposed or actual financing for the offer and the consequences of that financing; questions of illegality; the risk of non-consummation; the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on shareholder interests. *Macmillan*, 559 A.2d at 1282 n.29. In the context of two all-cash bids, the Delaware Chancery Court upheld the board's choice of a bid that was "fully financed, fully investigated and able to close" promptly over a nominally higher yet more uncertain competing offer. *Golden Cycle*, 1998 Del. Ch. LEXIS 237, at *49; *accord In re The MONY Group Inc. Shareholder Litigation*, 852 A.2d 9, 15 (Del. Ch. 2004). Such concerns, however, must be evenly applied when evaluating competing bids for the sale of control.

A more important difficulty, however, may be the risk that the auction process itself — and particularly the risk of a busted auction — damages the seller. Many financial institutions are fragile entities that depend on key employees, strong customer relationships, community trust and solid credit ratings. An auction, in which the likelihood of leaks increases greatly with each additional bidder and where confidential information may be shared with numerous parties, can risk premature or unauthorized disclosure and cause great damage to the institution. Thus, within the financial services sector, outside of the FDIC-assisted deal context or carve-out sales of subsidiaries or business units, broad auction processes remain the exception and not the rule. Where it is concluded that multiple buyers should nonetheless be contacted, care should be taken to limit the list to parties likely to have the interest and ability to engage in a transaction, to design the process to further qualify the party and the level of interest and to cautiously stage the release of confidential information and diligence access to key seller personnel.

In any event, a controlled negotiation process in lieu of a formal auction can be undertaken consistent with a board's *Revlon* duties. This process can preserve franchise value, while allowing the seller to conduct a market check and fulfill its board's duties by working with

its investment bankers to understand prevailing deal pricing, the landscape of potential willing buyers and potential buyers' financial wherewithal, among other factors. Moreover, many financial institutions have likely had their own contacts with potential buyers and merger partners through the years, and often have a good idea as to the universe of prospective buyers and the degree of likely interest in a transaction, as well as the company's prospects as an independent entity.

Post-signing market checks, including fiduciary exceptions to no-shop covenants that allow for consideration and discussion of inbound superior offers, can also serve to help fulfill *Revlon* duties. *Smurfit-Stone* reaffirmed that a Delaware company can agree to a merger, even when in "*Revlon* mode," without a broad market check either prior to or following signing, provided that the merger agreement permits the emergence of a higher bid after announcement of the transaction. Given the time commitment and effort required to complete most financial institutions transactions, practices have evolved that have been acceptable to a wide range of buyers, including subjecting the no-shop and shareholder recommendation covenants to reasonable exceptions based on the target board's fiduciary duties and keeping breakup fees within customary and acceptable ranges.

The Delaware Supreme Court has rejected the notion that *Revlon* requires a board to follow a specific checklist or process in selling a company. Rather the court has confirmed that "[n]o court can tell directors exactly how to accomplish that goal [of getting the best price in a sale], because they will be facing a unique combination of circumstances, many of which will be outside their control." *Lyondell Chemical Corp.* v. *Ryan*, 970 A.2d 235, 242 (Del. 2009). The various approaches to satisfying *Revlon* duties should be considered not as boxes that need to be mechanically checked but as points on a continuum. Although there may be more room to strongly protect a deal that has been well-shopped before signing than one that is the product of one-off negotiations, each case will turn on its unique facts, and "there is no single blueprint that a board must follow to fulfill its duties." *Id.* at 242-43 (quoting *Barkan* v. *Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989)).

The point is illustrated by *C&J Energy Servs., Inc.* v. *City of Miami Gen. Emps.' & Sanitation Emps.' Ret. Trust*, No. 655/657, 2014 (Del. Dec. 19, 2014) (en banc), in which the Delaware Supreme Court unanimously reversed an injunction by the Court of Chancery that had in essence reformed a merger agreement and required C&J Energy Services to run a go-shop process because the C&J board did not shop the company either before or after signing the deal, stating that "*Revlon* does not require a board to set aside its own view of what is best for the corporation's stockholders and run an auction whenever the board approves a change of control transaction." Further, independent and well-informed directors may choose any reasonable path when selling a company, "so long as the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so."

In 2011, the Delaware Chancery Court refused to enjoin an all-cash merger transaction negotiated by an actively engaged and independent board of directors, despite the fact that the sales process did not include either a fairness opinion or a fiduciary out, and the fact that the transaction was effectively locked up by the execution of written consents by a majority of the shareholders. *See In re OPENLANE, Inc. S'holders Litig.*, C.A. No. 6849-VCN (Del. Ch. Sept.

30, 2011). The plaintiffs attacked the board's decision to contact only three potential buyers, the lack of a fairness opinion, the lack of a post-signing market check and the lack of any provision in the merger agreement permitting the directors to back out of the deal if their fiduciary duties so required. Rejecting those challenges, the court reaffirmed Delaware's longstanding refusal to impose a mandatory checklist of merger features. The decision cautioned, however, that where "a board fails to employ any traditional value maximization tool, such as an auction, a broad market check, or a go-shop provision, that board must possess an impeccable knowledge of the company's business for the court to determine that it acted reasonably." *Id.* at 14-15. Emphasizing the board's hands-on expertise and detailed involvement with the transaction process, the court held that "this is one of those few boards" capable of satisfying that test. *Id.* at 17-18. As to the claim that the deal was impermissibly locked up via the shareholder consents, the record showed that "after the Board approved the Merger Agreement, the holders of a majority of shares quickly provided consents." *Id.* at 25. Accordingly, the court reasoned, the merger agreement "neither forced a transaction on the shareholders, nor deprived them of the right to receive alternative offers." *Id.* The court thus held that a fiduciary out is not a *per se* requirement of Delaware law and refused to undertake the "perilous endeavor" of "[e]njoining a merger when no superior offer has emerged." *Id.* at 27 n.53.

The Delaware Chancery Court also has recognized that even when *Revlon* duties apply, maximizing value does not simply mean maximizing the financial terms of a transaction in isolation. The Delaware Chancery Court declined to enjoin a stockholder vote on the merger between Dollar Tree, Inc. and Family Dollar Stores, Inc. where plaintiffs had alleged that the Family Dollar board breached its fiduciary duties by not entering into discussions with Dollar General regarding a nominally higher bid made by Dollar General after Family Dollar had entered into its merger agreement with Dollar Tree. The Family Dollar board determined that the Dollar General offer had significant antitrust risks, that it was not reasonably likely to be completed on the terms proposed and that as a result engaging with Dollar General would breach its existing merger agreement. The court stated that "the Board decided to maximize stockholder value by focusing on the financial terms and deal certainty, not the financial terms in isolation" and that the Board's decision "reflects the reality that, for the company's stockholders, a financially superior offer on paper does not equate to a financially superior transaction in the real world if there is a meaningful risk that the transaction will not close for antitrust reasons." *See In re Family Dollar Stores, Inc. Stockholder Litig.*, C.A. No. 9985-CB (Del. Ch. Dec. 19, 2014).

The prevailing theme in these cases is that the board must be fully informed, sensitive to any potential conflicts and satisfied that it is acting reasonably at each step in the process. Because of this, it is important for any potential deal to involve experienced legal and financial advisers from the early stages to help ensure the processes and record developed are robust and well-protected from challenges from shareholder plaintiffs.

## II. PRESERVATION OF THE COMPANY'S FRANCHISE

In considering a proposed merger, directors should appropriately take into account its impact on the institution, its employees, its consumers and depositors and the community in which it operates. Such constituencies are generally entitled to consideration both independently and on the basis that the realization of shareholder value is dependent upon them. The importance of such considerations is heightened in the case of banking organizations because of

the nature of banks' relationships with these constituencies, governmental concessions conferred on banks through deposit insurance and the like and banks' quasi-public responsibility. Indeed, review of most banking transactions by banking regulators involves an assessment of whether the transaction can be expected to meet the "convenience and needs" of the parties' communities and whether the combined bank will have the infrastructure and staffing to meet its regulatory compliance obligations. Delaware recognized the legitimacy of similar concerns in both the *Unocal* and the *Macmillan* decisions. *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Mills Acquisition Co.* v. *Macmillan, Inc.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. Oct. 18, 1988), *rev'd on other grounds*, 559 A.2d 1261 (Del. 1989). Certain other states have specific provisions in their corporate statutes that allow boards to expressly consider the interests of such broader constituencies. *See, e.g.*, 15 PA. CONS. STAT. ANN. § 516(a).

Proper treatment of employee and other constituent interests is also very important in assuring a smooth transition period between the signing of a merger agreement and the closing of the transaction. This has led to the frequent practice of establishing employee retention programs designed to preserve the services of key employees through closing or thereafter. Such programs may be particularly critical in the acquisition of businesses in which employees are the principal assets and where there may be cultural differences between target and acquirer, such as in broker/dealer, asset management and investment bank transactions, although any such program should be structured to take into account the limitations imposed under applicable regulation. Given the time it takes to consummate a merger and the related risks of non-consummation, it is important for the target company to strive to preserve franchise value. The impact of a proposed transaction on the target company franchise and local community interests can have a direct impact on the acquirer's ability to obtain the requisite regulatory approvals in a timely manner.

## III. IMPORTANCE OF THE EVALUATION PROCESS

In today's environment, it is more important than ever that a board's process of evaluating a potential M&A transaction include active board involvement in the decision as well as carefully structured procedures designed to assure full and fair consideration of all relevant factors. Following the board's decision, a fully informed shareholder vote on the transaction would represent the ultimate ratification of the directors' decision and, at least where there is no controlling or majority shareholder, would, as a practical matter, eliminate any claim that the directors had failed in their duty to seek the best available alternative.

The 1993 opinion of the Delaware Supreme Court in the *Technicolor* case illustrates the importance of careful and informed decision making in approving mergers and sale transactions. *Cede & Co.* v. *Technicolor, Inc.*, 634 A.2d 345 (Del. 1993). The court's opinion turned on two findings by the lower court: that the Technicolor board had been "grossly negligent" in failing to reach an "informed" decision in unanimously approving an all-cash merger agreement, breaching its duty of care; and that one or more of the directors had breached their duty of loyalty to the company by placing their personal interests ahead of those of the company and its shareholders. As a result of those findings, the Technicolor board lost the protection of the business judgment rule. The court held that the transaction needed to be scrutinized under the most stringent "entire fairness" standard. Under the entire fairness standard, defendant directors must establish that the

transaction was the product of both fair dealing and fair price. Further, in the context of a sale of a company, directors will have the burden of showing that the sale price was the highest value reasonably available under the circumstances.

The court reiterated its long-held view that the "duty of care requires a director to take an active and direct role in the context of a sale of a company from beginning to end." *Id.* at 368. In doing so, in a merger or sale, the court emphasized that a director is obligated "*before* voting on a proposed plan of merger or sale, to inform himself and his fellow directors of *all material information* that is *reasonably available* to them." *Id.* Implicit in the court's analysis is the importance of involving the directors and the company's financial advisors early in the process.

*Technicolor* is a textbook case study of how not to sell a company. The court appeared to be heavily influenced by the conflicts and self-interest of certain directors, which impacted its perception of the hasty and ill-informed fiduciary decision making. Other decisions since *Technicolor* reinforce the lesson that conflicts, of directors or of key advisors, can frequently lead to legal problems for a deal. This underscores the need for careful planning and structuring of board participation and advisor roles when embarking upon a major corporate transaction such as a sale of a company. It also illustrates the need for full investment banker due diligence, director consideration of available financial alternatives and the necessity for comprehensive valuation analyses.

## A. Investment Bankers: Oversight Considerations and Fairness Opinions

### 1. Oversight Considerations

Courts look to boards to manage all aspects of the sale process, including the actions of the financial advisor engaged to assist with the transaction. The buyout of Del Monte Foods Company highlights the importance of the board keeping a firm hand on the tiller. The Delaware Chancery Court found that after the Del Monte board called off an exploratory process, its investment bankers continued to meet with several of the bidders — without the approval or knowledge of Del Monte — ultimately yielding a new joint bid from two buyout firms. While still representing the board and before the parties had agreed on price, the bankers sought and received permission from Del Monte to provide financing to the buyers, obliging Del Monte to retain another investment banker to render an unconflicted fairness opinion. Del Monte then reached a high-premium deal with "go-shop" rights and deal protections including a termination fee and buyer matching rights. Del Monte's original bankers were then tasked with running Del Monte's go-shop process (which yielded no further offers). The court was troubled by the investment bank's effort to combine two potentially competitive bidders without consulting Del Monte's board and in apparent contravention of a "no teaming" provision in confidentiality agreements. Although the court noted that "the blame for what took place appears at this preliminary stage to lie with [the bankers], the buck stops with the Board," because "Delaware law requires that a board take an active and direct role in the sale process." *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).

There are two key takeaways from the *Del Monte* case (which included a relatively large $89.4 million settlement payment). First, when financial advisors play a dual role — both acting as the target's advisor and also seeking to provide financing to the buyer — conflict issues arise.

The Delaware courts have recognized that, in some contexts, stapled financing can be permissible as a benefit to shareholders of the target by inducing prospective bidders to compete for the target. However, recognizing the potential for divided loyalties, the courts require good reasons for allowing such an arrangement and close oversight by the target's board. In *Del Monte*, the court found both to be lacking, as the record demonstrated no need for, or benefit from, the target banker's participation in the financing and that the target board found out about its banker's interest in providing buyer financing *after* the prospective buyers did.

Second, especially with private equity acquisitions, boards should pay close attention to the management of a sales process to avoid the perception of favoritism. It should lead any sale process and actively supervise its advisors. *Del Monte* also serves as an important reminder that the terms of confidentiality agreements should be properly respected, that bankers should receive and follow clear instructions from target boards and that bankers should ensure that any conflicts of interest are disclosed in advance, with specificity, to the target's board.

The Delaware Chancery Court also sent a strong reminder that boards should actively oversee their financial advisors in its *In re Rural Metro Corp. Stockholders Litig.*, C.A. No. 6350-VCL (Del. Ch. Mar. 7, 2014) decision. The court concluded that the board there failed to actively oversee both the process, and its financial advisor. This responsibility requires directors to be "reasonably informed about the alternatives available to the company" and to "act reasonably to identify and consider the implications of the investment banker's compensation structure, relationships, and potential conflicts." The court noted that the actions taken may have been reasonable had they been made by a "well-informed board."

*Rural Metro* arose out of the 2011 sale of Rural Metro to a private equity buyer. In late 2010, Rural's board formed a special committee to evaluate the potential acquisition of a competitor then being auctioned. The court found the committee's financial advisor believed that if Rural were involved in a sale process at the same time as its competitor, the possibility of combining all or part of the two companies would present financing opportunities to the advisor that would dwarf in value the advisory fees it stood to receive from the special committee assignment alone. Without disclosing its desire to provide buyer financing, the advisor counseled the special committee to commence an auction for Rural, and the committee did so.

The court found that the committee's decision was a breach of duty, because the committee did not give appropriate weight to the facts indicating it was an inopportune time to sell Rural. The court also found fault in the fact that the board never authorized the special committee, established to consider an acquisition, to explore the sale of the company. The court was influenced by evidence that the members of the special committee had their own personal reasons to favor a near-term sale of the company.

Although the special committee negotiated for a sale price representing a substantial premium to market, the Court found that the committee's process was insufficient and ill-informed, as the committee held "only two formal meetings" and "had not received any valuation information until three hours before the meeting to approve the deal." That valuation information, the Court found, was revised downward by the financial advisor at the same time the advisor was "secret[ly] lobbying" to provide acquisition financing to the buyer. Although the directors did not have monetary liability for the breaches because they had previously settled

(and in any event were exculpated under the company's charter), the Court awarded Rural Metro stockholders $76 million in damages against the investment bank under a novel legal theory that the bank aided and abetted the breaches of the duty of care by the directors.

During the pendency of the appeal of the *Rural Metro* case to the Delaware Supreme Court, the Delaware Chancery Court also applied the *Rural Metro* analysis in a variety of other procedural and factual decisions and suggested that certain banker conflicts may be unwaivable (even if independent directors believe that a waiver reflects sound business judgment) and that independent directors may breach their duty of care by failing to investigate a bank's representation that it does not have a material conflict. In one such example involving Zale's acquisition by Signet Jewelers, shortly following the announcement of the transaction, Zale's board learned that one of the bankers previously sought to represent Signet in acquiring Zale.

Zale's board decided to reaffirm its commitment to the merger and disclosed the potential conflict to stockholders, who approved the merger. The court sustained a claim against the financial advisor on the theory that it had aided and abetted a breach by Zale's directors of the duty of care for failing to uncover the financial advisor's conflict prior to announcement of a transaction (even though the court dismissed the claim against the directors because they were exculpated under the company's charter).

However, shortly thereafter, the Delaware Supreme Court issued its groundbreaking decision in *Corwin* v. *KKR Financial Holdings* that the business judgment rule is the appropriate standard of review for claims challenging a third-party merger of a controlled company that has been approved by a fully informed, uncoerced majority of the minority stockholders. Following the *Corwin* decision, the Delaware Chancery Court reconsidered its earlier ruling sustaining aiding-and-abetting claims against Zale's financial advisor and dismissed the claims. *See In re Zale Corp. Stockholders Litig*., C.A. No. 9388-VCP (Del. Ch. Oct. 29, 2015) and *Singh* v. *Attenborough*, No. 645, 2015 (Del. May 6, 2016) (en banc). In applying the holding from *Corwin*, the court determined that the plaintiffs could not meet the standard of showing a breach of the duty of care under the business judgment standard and, because there was no underlying breach to aid and abet, the court dismissed the claim against the advisor as well. This case demonstrates the potentially outcome-determinative effect following *Corwin* of a fully informed stockholder approval in shielding not only boards but also financial advisors from post-closing damages claims.

Following these developments, the Delaware Supreme Court decided the *Rural Metro* appeal in late 2015. *See RBC Capital Markets, LLC* v. *Jervis*, No. 140, 2015 (Del. Nov. 30, 2015). The Supreme Court upheld the Chancery Court's finding that the financial advisor was liable for aiding and abetting a breach of fiduciary duty. The court found that the company's stockholders were not fully informed when they approved the transaction, so the enhanced scrutiny of *Revlon* applied. However, the court adopted a more balanced approach as to the role of directors and financial advisors in addressing conflicts, stating that "directors need to be active and reasonably informed when overseeing the sale process, including identifying and responding to actual or potential conflicts of interest. But, at the same time, a board is not required to perform searching and ongoing due diligence on its retained advisors in order to ensure that the advisors are not acting in contravention of the company's interests. . . ."

The *Rural Metro* decision makes clear that informed boards of directors can, in the exercise of informed business judgment, retain conflicted financial advisors and that, if appropriate procedures are followed, neither the board nor the bankers will face liability for breach of fiduciary duty. It also reaffirms that contractual arrangements between companies and financial advisors will generally be respected. As a result, the decision provides a constructive pathway for well-counseled companies and advisors to navigate the issues of potential conflict that inevitably arise from time to time in the M&A context. Following *Rural Metro*, it has become common practice for financial advisors to make, and update at key points, written disclosure to the client board regarding past relationships and other potential conflicts of the firm and key team members involving potential counterparties in a sale process.

Since *Rural Metro*, the Delaware Chancery Court has continued to emphasize and define the disclosure necessary to fully inform directors of financial advisors' potential conflicts. In *Firefighters' Pension System of the City of Kansas City* v. *Presidio, Inc.*, 251 A.3d 212 (Del. Ch. 2021), a shareholder of target company Presidio alleged that Presidio's financial advisor LionTree favored a sale of Presidio to BC Partners to the detriment of a competing bid from Clayton Dubilier & Rice. The plaintiff alleged that, during a go-shop period following the signing of a merger agreement with BC Partners, LionTree "tipped" the terms of a topping bid from CD&R to BC Partners, allowing BC Partners to strategically increase its bid by only $0.10 per share over the price CD&R offered and ultimately consummate the transaction. The court found that it was reasonably conceivable that LionTree had steered Presidio's board toward a quick transaction with BC Partners due to several factors: (i) LionTree's existing relationships with BC Partners, (ii) the fact that Apollo Global Management, the controlling shareholder of Presidio, allegedly preferred a near-term sale, and (iii) that CD&R intended to replace Presidio's CEO, with whom LionTree had developed a relationship, whereas BC Partners intended to retain him. "Pushing for a competitive process involving CD&R might earn LionTree a little more money in the short run through its contingent fee, but it would not serve LionTree's interests in the long run. If CD&R won the bid, then the Company would have a new owner, a new management team, and no incumbent relationship with LionTree. Meanwhile, people with whom LionTree had existing relationships would be disappointed." *Id*. at 267. Presidio's board did not receive any disclosures regarding LionTree's potential conflicts of interests and relationships with Apollo and BC Partners until nearly a month after it had been leading the transaction and a week after the board had reached an agreement on price with BC Partners. LionTree's alleged "tip" to BC Partners was not disclosed to Presidio's board or stockholders until after the litigation was commenced and the court found that the tip "cast[] a dim light on the sale process as a whole" by hindering an active bidding contest. *Id*. at 269. While recognizing that, absent LionTree's conduct, the sale process would otherwise have fallen within a range of reasonableness, the court found that it was reasonable to infer that the board's actions fell outside the range of reasonableness because the board based its decisions on information that was shaped by LionTree's conflicts of interest and failed to provide active and direct oversight of LionTree. *Id*. at 272. In developing the *Rural Metro* framework, *Presidio* demonstrates the importance of full disclosure to the board by financial advisors of their potential conflicts of interest early in a transaction process. Companies are well advised to involve outside deal counsel in the review of financial advisor engagement letters and conflict disclosures to assist in fully informing the board.

### 2. Fairness Opinions

After *Smith* v. *Van Gorkom*, 488 A.2d 858 (Del. 1985), where a board was held to have breached its fiduciary duty of care by approving a merger without adequate information on the transaction, relying only on market prices of the company's stock in assessing value, fairness opinions of investment bankers became commonplace in mergers and acquisitions. Although such opinions are not required by statute or regulation, they have come to be an important part of a board's evaluation of an acquisition proposal, especially on the target side. A board is generally entitled to rely on the expert advice of the company's legal and financial advisors as well as the advice and analyses prepared by management. Such experts can provide important strategic advice to the board and can help the board evaluate the complex legal and financial issues presented by the proposal. The analyses and opinions presented to the board, combined with presentations by management, and the board's own long-term strategic reviews, provide the foundation for the exercise of the directors' business judgment. Courts reviewing the actions of boards have often commented favorably on their use of investment bankers in evaluating merger and related proposals.

Investment banker fairness opinions from time to time come under criticism. Having been involved in a significant number of merger and acquisition transactions over the past several decades and having closely witnessed the opinion processes at most, if not all, of the leading banks and boutiques, we believe these attacks usually lack any meaningful foundation. The leading firms take their fairness opinion processes seriously and will only sign their names to opinions that have undergone extensive and serious analyses. The opinions generally are issued only after being reviewed and approved by a committee of experienced, senior bankers at the investment banking firm.

The chief criticism has been that fairness opinions have built-in conflicts of interest since they are typically rendered by the principal advisor on a deal whose fee is often contingent upon consummation of the deal. However, to the extent such conflicts exist, they are capable of evaluation by the boards that receive the opinions, and by investors who are informed through detailed merger proxy disclosure of the investment bank's role, the fee arrangements and the analyses and data underlying the opinion. Critics tend to dismiss the fact that financial advisors are deeply concerned about preserving their firm's reputation for independence and integrity. Courts have recognized that financial firms will not lightly put their reputation at risk by issuing a fairness opinion that does not meet their professional standards. A greater risk of criticism exists if the principal advisor on a deal does not disclose its views and analysis as to fairness.

An investment banker's fairness opinion and the detailed analysis supporting that opinion typically constitute a centerpiece of the board's deliberative process. By rendering a fairness opinion and providing such analysis, the investment banker provides the board with comfort and assurance that its actions are consistent with the best interests of the company's shareholders and provides strong protection against challenges by plaintiffs alleging a breach of the board's duty of care. Moreover, by making a detailed presentation to the board of the analyses underlying its opinion, the investment banker provides the directors with additional information against which the directors can apply their independent judgment. Fairness opinions are especially beneficial in transactions requiring shareholder approval, as they support the recommendation of the board to shareholders set forth in the proxy statement. Although at first glance many fairness opinions

appear to be very similar and there are certain standard provisions, there are important variations particularly with respect to limitations and assumptions; a company receiving an opinion should be sure to review a draft with counsel before the final opinion is delivered. Also, in cases where different classes of stock or different shareholders are receiving different consideration in a merger (and there could be a question about how the consideration was allocated between the classes or shareholders), careful consideration should be given to how these issues are addressed from a fairness perspective.

The SEC requires expansive disclosure regarding investment bankers' fairness opinions. This high standard raises a number of significant issues, including potential litigation exposure, the harm that may flow from disclosing values to third parties that wish to compete with a transaction, and the dangers presented by any disclosure of confidential long-range projections, asset appraisals, special due diligence studies or key operational business assumptions. Care should be exercised by investment bankers in preparing the analyses that support their opinions and in the presentation of such analyses to management and the board. The wording of the fairness opinion and the related proxy statement disclosures should accurately reflect the nature of the analyses underlying the opinion and the assumptions and qualifications upon which it is based. Delaware case law underscores this point. In *Maric Capital Master Fund, Ltd.* v. *PLATO Learning, Inc.*, C.A. No. 5402-VCS (Del. Ch. May 13, 2010), the Delaware Chancery Court enjoined a merger vote in part on the basis of deficient disclosure where there was an unexplained mismatch between disclosed discount rates and those implied by the analysis described as being used to generate the discount rates.

When a proxy statement is subjected to a full review, the SEC routinely requests that bankers supply the SEC staff with a copy of their board book presentations on a supplemental basis. The SEC staff has questioned whether, and to what degree, management estimates underlying the banker's analysis differ from published I/B/E/S or First Call estimates. The SEC staff has sought to have public disclosure by the registrant of management projections and concerning estimates of cost savings, restructuring charges and/or pro forma earnings dilution/accretion compared to the estimates contained in the board books. Parties should therefore consider early in the process the appropriate numbers to underlie fairness analyses, and if they choose to base them on internal management projections be aware this may result in the public disclosure of those projections. If the determination is made to rely upon consensus analyst estimates, financial advisors should make sure this is accurately reflected in the fairness analysis and opinion and in the proxy disclosure, avoiding rote references to "projections provided by management."

The SEC staff has also focused on whether the board specifically considered possible conflicts of interest stemming from the fact that the investment banker rendering the fairness opinion receives or has recently received fees for other work performed for either party in the transaction. Rule 5150 of the Financial Industry Regulatory Authority (FINRA) provides for certain mandated disclosures in fairness opinions that the member firm knows, or has reason to know, will be provided to the company's public shareholders, including statements as to:

- whether the fairness opinion was approved or issued by a fairness committee of the member firm;

- whether the fairness opinion expresses an opinion about the compensation to be paid to the company's officers, directors or employees, relative to the compensation to be paid to the company's public shareholders;

- whether the member firm acted as a financial advisor to a party to the transaction and whether it will receive compensation that is contingent upon the completion of the transaction, for rendering the fairness opinion or serving as an advisor, or whether it will receive any other significant contingent compensation;

- any material relationships that existed during the past two years, or that are mutually contemplated, between the member firm and any party to the transaction in which compensation was received or is intended to be received by the member firm; and

- whether any information that formed a "substantial basis" for the fairness opinion has been independently verified by the member firm, and, if so, a description of the information or categories of information verified (where no information has been independently verified by the investment banker, a broad statement to that effect will be sufficient).

**B. The Use of Projections**

Although disclosure of forward-looking information can assist analysts and investors in evaluating a transaction, it should be recognized that existing "safe harbor" protection for such forward-looking disclosure is incomplete, even if the company is careful to provide risk factor disclosures as provided for under the Private Securities Litigation Reform Act of 1995 (PSLRA). Accordingly, issuers should be cautious in forecasting post-merger earnings, cost savings or other transaction-related financial items. When such forecasts are made, careful consideration must be given to the manner in which the forecasts are disseminated, particularly in situations where forecasts are significantly different from prior consensus estimates. Issuers should also use appropriate care, and consider appropriate cautionary language, in making predictions about accretion to earnings. If forecasts are disclosed, and later become unrealistic, before speaking in any way about the prior expectations, companies should give close attention to potential updating and corrective disclosures.

The SEC staff has been quite attentive to statements made by issuers in the period prior to the filing of the definitive merger proxy, has closely scrutinized proxy statement disclosures to ensure that they are consistent with all prior public statements and has routinely inquired in comment letters about whether such statements should have been filed pursuant to Rule 425 under the Securities Act or Rule 14a-12 under the Exchange Act, as applicable. Issuers that wish to avoid extensive disclosure of projections in the merger proxy must be careful about the nature of the statements that they make outside the context of their formal SEC disclosure documents, including in post-announcement analyst presentations.

Companies should also be alert to the requirements of Regulation G with respect to the presentation of projected information where the projections contain non-GAAP financial measures (for instance, where earnings accretion is given on a cash earnings basis or given excluding merger-related charges). Although Regulation G contains an exclusion for disclosures

related to mergers and acquisitions, including synergies and other forecasted benefits of the transactions, historically this exclusion has been limited to disclosures that are required to be filed under the communications rules relating to business combinations (*i.e.*, Rules 165 and 425 under the Securities Act and Rule 14a-12 under the Exchange Act, or a Form 8-K filed in lieu thereof) and has not applied to disclosures in proxy statements or registration statements. In 2017, in response to a spate of litigation regarding the failure to include GAAP reconciliations for projections in proxy statements, the SEC released new guidance providing that projections that were given to a financial advisor for the purpose of rendering a fairness opinion that are then disclosed in a proxy statement do not need to be reconciled to GAAP. Notwithstanding this guidance, plaintiffs' firms have been loath to give up the fight and have continued to cite the absence of a GAAP reconciliation in proxy statements as a material omission.

The sharing of individual company earnings and other financial projections during pre-signing merger negotiations and to financial advisors can have disclosure ramifications. The staff of the SEC's Division of Corporation Finance has consistently held the view that financial projections provided to the other party or its financial advisor during a negotiation are material and should be disclosed in the proxy statement. Responding to SEC staff comments of this kind raises a host of delicate issues, including the level of detail to be provided, how to present the information in the proper perspective so that investors can understand how it is used by the company, competitive considerations and the myriad assumptions and qualifications applicable to such information.

Many shareholder lawsuits include allegations that the target's proxy statement omitted or inadequately disclosed management projections. Although Delaware courts have avoided the establishment of a *per se* rule requiring disclosure of management projections, recent cases suggest a presumption that projections used by a financial advisor to render a fairness opinion are material. *See, e.g.*, *In re BioClinica, Inc. S'holder Litig.*, 2013 WL 673736 at *5 (Del. Ch. Feb. 25, 2013) ("Generally, the failure of a company to disclose management's financial projections in its proxy materials, when those projections have been relied on by a financial advisor to render a fairness opinion, is a material omission that will sustain injunctive relief if not corrected. This is because management's projections of the future value of the company are valuable to a stockholder deciding whether to exchange his ownership for the consideration tendered."). In determining the materiality of projections, the court will look at how the projections would alter the total mix of information disclosed to shareholders.

In *PLATO Learning*, the shareholder plaintiffs claimed that PLATO's proxy statement omitted management's free cash flow estimates provided to the target's financial advisor. The court ordered that the estimates be disclosed, reasoning that "management's best estimate of the future cash flow of a corporation that is proposed to be sold in a cash merger is clearly material information" and suggesting that, in a cash merger, free cash flow estimates were particularly material to shareholders' decisions. The *PLATO Learning* decision extends the rationale of *In re Netsmart Technologies, Inc. Shareholder Litig.*, 924 A.2d 171 (Del. Ch. 2007). In *Netsmart*, the court found a disclosure violation based in part on the fact that the proxy at issue disclosed some preliminary internal financial projections but omitted projections provided to the financial advisor and relied upon for the fairness opinion.

In *In re CheckFree Corporation Shareholders Litig.* (No. 3193-CC, Del. Ch. Nov. 1, 2007), the court rejected the claim that management projections used by a financial advisor for a fairness opinion are always material and must be disclosed, holding that there is no such *per se* rule in Delaware. The court distinguished the *Netsmart* proxy, which disclosed some management projections but not others; the CheckFree proxy did not purport to disclose the projections and made clear that the financial advisors "had to interview members of senior management to ascertain the risks that threatened the accuracy of those projections." The court reasoned that these admittedly incomplete projections were not material and their inclusion may be misleading to shareholders. In *Steamfitters Local Union 447* v. *Walter*, C.A. No. 5492-CC (Del. Ch. 2010), the court held that the absence in a proxy of free cash flow projections would not "meaningfully alter" the total mix of information available to shareholders, noting that free cash flow estimates were not provided to the financial advisor and the proxy disclosed the extensive management projections actually provided to the advisor.

It is worthwhile giving high-level management attention at an early stage of a process to whether and specifically which internal projections will be provided to potential counterparties and bankers. Being discriminating and careful can help avoid later having to make overly broad disclosure of information a company would not otherwise disclose externally.

## C. Responding to Rumors, Media and Stock Exchange Inquiries and News Reports

There is generally no duty under state law or the securities laws for a company to respond to rumors as a result of third-party leaks, a run-up in the company's stock price or inquiries from analysts, the press or the like. In nearly every situation, the best response is the single statement: "It is the company's policy not to comment on rumors." If the company adopts this as its consistent response to all merger-related rumor inquiries, no implication can be drawn from its failure to deny a particular rumor. It is very important that all management personnel in contact with the press be made aware of this policy and adhere to it strictly (and the number of personnel authorized to be in contact with the press should be limited to the smallest possible number). No deviation should be permitted without careful consideration, including consultation with counsel. All communications with the press and stock exchanges should be centralized and closely monitored. The stock exchanges may take a more aggressive stance that disclosure is required under their listing guidelines if the rumors are having a significant impact on the market activity of a company's securities.

The materiality of ongoing merger activity must be judged on the facts of each case. Ongoing merger discussions may be material before a definitive agreement is reached, depending upon the significance that the merger would have for the company and the likelihood of its occurrence. Even when there is a material event, however, the question will still remain as to whether and under what circumstances the company has an affirmative disclosure duty. The question of what actions on the part of the company or independent causes can give rise to a duty to disclose involves subtle issues of fact and law that must be assessed in each individual case.

Many institutions tend to err in favor of making disclosure, but this can have a significant adverse impact on the chances of negotiating a successful transaction and can cause undue concern among employees, customers and other constituencies. It can also cause possibly damaging speculation when premature announcements of merger negotiations are followed by a

termination of such negotiations or are not followed promptly by the announcement of a definitive agreement. Such statements might arguably give rise to an ongoing obligation to update the disclosure. The best course of action is usually to avoid disclosure until a transaction is signed and announced. Pre-announcement conduct should be structured to best minimize the risk of market rumors (including by conducting diligence off-site, strictly limiting the number of personnel to the minimum required for as long as possible and questioning the necessity of some "circle-expanding" steps that are often considered routine, such as financial advisors hiring their own outside counsel prior to announcement of a transaction). In private equity or like transactions where bidders may have numerous outside parties they wish to consult (such as debt and equity financing sources), attempting to keep control of who is brought into the loop and when is an issue to consider in negotiating confidentiality agreements. Even where there is a run-up in stock price, no affirmative disclosure duty may exist, and issuers and their counsel should take a firm stance with respect to any stock exchange inquiries before conceding that disclosure is required.

## IV. SPECIAL CONSIDERATIONS IN THE "GOING-PRIVATE" CONTEXT

Going-private transactions typically involve a controlling shareholder buying out the remaining public interest and involve a different set of legal considerations than those found in the business judgment rule or *Revlon* context. There are any number of methods that eliminate all publicly held shares (such as a cash merger or a tender offer followed by a back-end cash merger), or eliminate enough publicly held shares to allow de-listing from a stock exchange and de-registration under the Exchange Act (including methods designed to reduce the number of shareholders, by selectively eliminating small holders, such as reverse stock splits and odd-lot tender offers). Going-private transactions can involve a private equity investor or can occur when an existing public company that is already predominantly closely held buys the remaining shares held by the public.

Financial institutions consider going-private transactions for a variety of reasons. They may determine that their ability to access the public capital markets is of only limited benefit and may not outweigh the costs and burdens of being a public reporting company, particularly as those obligations have expanded and become more costly. The benefit of access to public capital markets may be particularly limited for small- to medium-sized community banks (which, in some cases, have only a handful of shareholders holding a majority of the outstanding shares) and only a limited public float. The shares may be very thinly traded, and such companies may have a difficult time finding analysts that will follow them or brokers that will make markets in their stock. Other small companies may seek relief from the pressure of analysts and activist investors to meet short-term earnings targets at the expense of long-term initiatives. Going-private transactions can also be an effective means of achieving a sales or control premium in the context of a sale to a new private investor group or private consolidator.

The SEC requires special enhanced disclosure in the case of certain going-private transactions that fall under the definition set forth in Exchange Act Rule 13e-3. Such transactions generally include any purchase, tender offer or solicitation by the issuer, or an affiliate of the issuer, in connection with an extraordinary corporate transaction, such as a merger, recapitalization or reverse stock split, that is reasonably likely or intended to cause a class of equity securities of the issuer to be held of record by less than 300 persons or to cease to

be listed on a national securities exchange or authorized for quotation on an inter-dealer quotation system.

The purpose of Rule 13e-3 is to address the potential for overreaching by the issuer and its affiliates. Accordingly, Rule 13e-3 does not apply to all transactions where a public company is taken private, but only to those where the public issuer or its affiliates: (a) acquire or tender for the equity securities of the issuer; (b) undertake a proxy or consent solicitation in connection with issuer or affiliate acquisitions; (c) purchase substantially all the assets of the issuer; or (d) undertake a reverse stock split involving the purchase of fractional equity interests. Affiliate status is generally measured as of the commencement of the transaction. Sometimes management's participation in a going-private transaction sponsored by a third party private equity fund may cause the fund to be deemed an affiliate, triggering 13e-3 requirements. In these instances, the SEC has often looked as to whether there exists a general understanding that management will receive a substantial amount of equity in the surviving entity, occupy seats on the board of the surviving entity in addition to senior management positions or otherwise be in a position to control the surviving entity, so as to be on "both sides" of the transaction. Interpretations published by the staff of the SEC's Division of Corporation Finance do not establish any bright line tests and the facts and circumstances of any such transaction should be carefully vetted with legal counsel.

Regardless of the method used to go private, and whether or not the transaction fits within the special going-private rules under Rule 13e-3, participants involved in such transactions must pay special attention to the process to ensure that shareholder interests are properly protected under both a substantive and procedural fairness standard. Consideration should be given to appropriate procedural protections for the public shareholders, including whether the transaction should be considered by a special committee of independent directors and/or subjected to a majority of the minority shareholder vote.

In the landmark *In re MFW S'holders Litig.*, C.A. No. 6566-CS (Del. Ch. May 29, 2013) case, the Delaware Supreme Court affirmed that go private mergers and other controlling stockholder transactions can avoid onerous "entire fairness" judicial scrutiny if they are conditioned up front on approval by (1) an independent special committee *and* (2) a fully informed vote of a majority of disinterested stockholders. The Delaware Supreme Court emphasized that proper use of *either* special committee *or* majority-of-the-minority approval alone would provide defendants the benefit of shifting the burden of proof within the entire fairness standard of review framework to the plaintiff. The Delaware Supreme Court recently clarified that a controlling stockholder must agree to the conditions prior to engaging in economic negotiations. Based on prior Chancery Court cases, tender offers by controllers followed by short-form mergers that utilize these same procedural protections are also expected to receive the benefit of business judgment review. While use of a special committee and/or a majority of the minority condition are not required as a legal matter, in transactions involving a controlling stockholder, a company should consider utilizing such a process to facilitate a less rigorous judicial review in the event the transaction is challenged.

## V. MAINTAINING CONFIDENTIALITY OF DATA

Questions are frequently raised concerning the duties of directors of a public company regarding the confidentiality of information which they receive in the course of their service as directors, particularly as it relates to possible or proposed mergers and acquisitions.

As a general proposition, under state law and the federal securities laws, directors owe a broad duty of confidentiality to the company with respect to information they learn about the company in the course of their duties. In a case involving a dissident director the board had deprived of certain information, the court held that a director's right to company information is "essentially unfettered in nature" and companies may not pick and choose which directors receive which information. *Kalisman* v. *Friedman*, C.A. No. 8447-VCL (Del. Ch. Apr. 17, 2013). The court also concluded that "[w]hen a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director," noting, however, that the director could be held to account if company information was misused as a result. *Id*.

In the absence of a public disclosure obligation, which should be addressed by the full board, the company's senior management and counsel, board deliberations should remain confidential. Confidentiality is essential for an effective board process and for the protection of the company and its shareholders. Maintaining confidentiality is also essential for the protection of the individual directors, since directors can be responsible for any misleading statements that are attributable to them. Even when a director believes the subject matter of his or her statements is within the public domain, it is good practice for directors to avoid commenting outside the boardroom on matters concerning the company. A director who receives an outside inquiry may or may not have all of the relevant information, and a response (based on incomplete information) could involve the company as well as the director in a disclosure violation.

The SEC's Regulation FD makes an uncoordinated disclosure approach particularly risky, as an inadvertent disclosure to a person covered by the rule (analysts, brokers, investment advisers, investment companies and certain associated persons, as well as shareholders when it is foreseeable that they may trade on the information) can give rise to a disclosure violation or to an affirmative obligation by the company to promptly make broad public disclosure of the information. Therefore, it is necessary to have only one official spokesperson. All inquiries should be referred to the company's CEO (or other designee) for a coordinated response. The SEC has brought actions against a company and the relevant executive or investor relations employee for alleged selective disclosure of material nonpublic information. In explaining its decision in one case in which it brought an enforcement action against an employee but refrained from bringing action against the company, the SEC emphasized that (1) prior to the improper disclosure, the company had cultivated an environment of compliance by providing Regulation FD training and implementing controls to prevent violations, (2) once the company discovered the disclosure violation, it promptly and publicly disclosed the information by filing a Form 8-K the same day, (3) the company self-reported the incident to the SEC staff the day after it was discovered and (4) the company took remedial measures, including adopting additional controls to prevent similar incidents in the future.

It is also important to remember that surveillance of pre-announcement trades by FINRA and/or the SEC has become a routine sequel to virtually every public company merger announcement. Inquiries can also be expected where there are leaks before announcement and the stock price reacts. Premature or careless disclosures of merger negotiations heighten the risk that improper trading may occur and thus the risk of legal difficulties or embarrassment.

## VI. UNSOLICITED TAKEOVER OFFERS

While banks and other financial institutions remain relatively safe from hostile takeover activity (due to, among other factors, the regulatory approval process) and hostile takeovers of regulated financial institutions remain difficult and time-consuming endeavors, banks and other financial institutions should nevertheless be carefully reviewing their strategic options and defenses. Moreover, as witnessed in the past several years, financial services companies are not immune from aggressive tactics by activist shareholders. Many institutions may be vulnerable at this time given the continuing trend of companies lowering or dismantling their takeover defenses as part of corporate governance campaigns by activist shareholders, including by dropping their rights plans, declassifying boards and changing director election standards. Accordingly, companies may find it prudent to reevaluate these defensive measures, with particular emphasis on revisiting the need for rights plans and updating existing rights plans to ensure that they are state-of-the art, including, where appropriate, extending the terms to pick up ownership of derivatives and certain synthetic interests or adding provisions designed to prevent an ownership change under Section 382 of the Code to protect net operating losses, "built-in" losses and other valuable tax assets.

Hostile deal activity (by deal volume and number) involving banks and other financial institutions has decreased relative to pre-financial crisis levels, in part due to the practice of shareholder activists pushing their targets to be "put into play" by advocating for sale or other fundamental corporate transactions at their targets, but not proposing to be or acting as the actual acquirer themselves. Hostile bids have also become a riskier tactic as shareholders are more willing to say no and vote down an underpriced offer. On the other hand, the increase in activism and pressures toward consolidation in the banking sector could drive more hostile bids in the future. In some cases, it is difficult to characterize a deal as clearly "hostile" or "friendly" as would-be hostile bidders often choose to present to the target's board unsolicited offers that ultimately result in negotiated transactions rather than take their bids to shareholders directly.

Although the potential perils of proceeding with a takeover offer without the benefit of prior due diligence of nonpublic information continue to militate against hostile activity in the financial sector, such activity is not unheard of. Going forward, as institutions with strong balance sheets and capital positions feel increasing pressure to find new opportunities for growth, buyers may consider unsolicited acquisition approaches to strengthen their own institutions and create shareholder value.

### A. Takeover Preparedness

All financial institutions should conduct periodic takeover preparedness reviews along the lines suggested in the M&A preparedness checklist set forth in Annex A. Such reviews are essential to ensure that managements and boards are not caught off guard and unprotected, and

are able to react quickly in the event of a hostile bid or contested proxy solicitation. In addition, banks and other financial institutions that view themselves as potential targets must maintain strong relationships with national and state regulators. It is also important to keep a careful eye on a company's shareholder base, including monitoring trading activity and volume. Aggressive tactics by various hedge funds, including community bank-focused funds, have demonstrated that all companies are vulnerable to focused campaigns by activist shareholders. Building a strong and supportive shareholder base takes time and effort, particularly among smaller banks whose largest shareholders can often include individuals and community bank-focused funds. Investing in this effort can be of critical importance, both in the context of an activist campaign or in the ordinary course of obtaining shareholder support for strategic M&A transactions or organic expansion efforts.

It is often said that the best defense to an unwanted takeover bid is a high stock price. This may or may not be true outside the financial services sector, but it is almost certainly true in the financial services industry. The higher the price/earnings ratio of a target relative to that of the acquirer, the more quickly the acquirer will, for a given acquisition price, reach unacceptable levels of earnings dilution. For banks, the maintenance of strong capital ratios (and, in particular, a strong tangible common equity ratio), which will generally be reflected in a strong stock price, is also important as bank regulators might well be less likely to approve an acquisition of a well-capitalized institution by an institution of similar size that is less well-capitalized. Maintaining strong shareholder relations is also important, especially in the case of smaller or regional banks that, for various reasons, tend to have a larger proportion of individual holders than is typically the case. It is always crucial to try to develop shareholder loyalty. Given strong financial performance, a history of dividends and management depth, individual shareholders are more likely to back management's opinions on building long-term stockholder value.

It also is important that a board be well-prepared. Many banks, particularly regional banks, have boards that consist predominantly of community directors who are unfamiliar with the sorts of issues that arise in the context of a hostile takeover. Successful takeover defense requires that the target board remains unified and that it has the psychological wherewithal to withstand, for a considerable period of time, the extreme pressure that will inevitably be imposed on it by the acquirer. Best practices designed to maintain collegiality among directors and confidentiality and limit discussions to the boardroom are important to maintaining a well-functioning and cohesive board in the face of a hostile takeover bid. An unprepared and uninformed board will, in the heat of battle, very quickly become an anxious board, and an anxious board is unlikely to be able to stand firm for long. The necessary educational process ought to happen before, not after, a takeover attempt is commenced. Most importantly, directors should be informed as to the meaning of the business judgment rule, that they can reject an inadequate offer, that they can refuse to negotiate with an acquirer and refuse to sell the company and, provided that any such decision is made in a manner that satisfies the business judgment rule, that they will incur no personal liability as a result. Periodic reviews of the takeover environment with a company's legal and financial advisors are advisable, as is the development of a sound, long-term business strategy that is responsive to the changing dynamics of the merger environment.

Maintenance of appropriate by-law procedures governing the consent and proxy solicitation process, and change-of-control employee benefit protections, along with a thorough strategic review of a company's takeover and activist risks and response options, remain very important. Companies should ensure that they have state-of-the-art by-law provisions in this area (such as extending the notice periods and enhancing disclosure requirements for shareholder proposals and director nominations, tightening the control over, and making clear that only proper subject matters may be brought before, a shareholders' meeting, and adopting, where appropriate, director eligibility, confidentiality and stock ownership standards) designed to protect against a proxy contest by a competitor. In addition, it is important to undertake any such modifications only at an appropriate time and with appropriate caution; companies should balance their relative strengths and weaknesses from a takeover/proxy contest perspective and weigh their defensive position against the potential for shareholder fallout that could result from such modifications. Rights plans remain a key component of any effective takeover defense, and companies should at least retain the ability to implement a rights plan on a moment's notice if needed.

## B. Responding to Takeover Threats

The essential ingredients for the success of a takeover defense are careful preparedness, a prompt and coordinated response to any takeover overture, a firm resolve to remain independent and flexibility in responding to the bid. There is no single blueprint that will assure independence, but the common thread running through the experiences of those companies that have remained independent is that, once they took a position with respect to a bid, their boards were unwavering in their resolve to maintain independence.

### 1. The Casual Pass

A company's board may well conclude that the interests of the company and its shareholders will be best served if the company remains independent, and that, for this reason, management should not engage in discussions with any party interested in acquiring the company. The so-called "casual pass" by a prospective acquirer carries great potential for misunderstanding and may be misconstrued. The termination of such "friendly" discussions has often resulted in a hostile offer. Because of the unique relationships among bank managements, banking institutions have been especially susceptible to this problem. Management should be in a position to advise any prospective acquirer firmly that the company is not for sale and that the board has absolutely no interest in pursuing discussions.

There is no duty to announce publicly the existence of a casual pass. However, as a matter of sound board relations, management may wish to share the approach with the entire board.

Directors should not engage in takeover discussions if they are approached. The appropriate response is to advise the person making the approach that such communication should be conveyed only to the company's CEO or chairman. The director should immediately report such contact to the CEO. Directors should be aware that many takeover attempts have had their genesis in a misperception by the raider of the target's position or the individual positions of (or splits between) key directors.

### 2. The "Bear Hug" Letter

If a potential acquirer's unsolicited expression of interest is a concrete acquisition or merger proposal, typically delivered in the form of a so-called bear hug letter, management and the board should carefully consider the proposal in keeping with its fiduciary duties of good faith and due care. Whether public disclosure of an acquirer's approach must be made depends on various factors. With respect to banking acquisition proposals, there are numerous examples where such proposals have been made and not disclosed for various carefully considered reasons and subsequently the acquisition proposal was abandoned. Often, an acquirer's bear hug letter is drafted in a fashion indicating a desire not to cause a public disclosure by the target.

Generally, no announcement need be made of invitations to negotiate. If an acquirer's bear hug letter contains a specific price, the recipient may wish to call the author and promise to get back to him after reviewing the proposal, while urging the author to keep the letter confidential.

Many bear hug letters are not concrete offers and reflect nothing more than a mere invitation to negotiate, especially where due diligence or other material conditions are contained in the proposal. Under such circumstances, the most appropriate response may be simply and unequivocally to reject the proposal without commencing discussions or negotiations. To do otherwise could ultimately prejudice the negotiating position of the company and might risk making the company vulnerable to a lower bid.

### 3. Public "Bear Hug" Letter

A frustrated or aggressive acquirer desiring to pursue management and directors of a target may attempt to apply pressure by unilaterally making public disclosure of its unsolicited bear hug proposal in order to put the target "in play."

The appropriate response by the company to such a maneuver largely depends upon a company's advance preparation and consideration of the proposal. If a company has carefully evaluated the same proposal in the past and rejected it because of legal, financial or regulatory issues, it may be appropriate to convey its concerns promptly in order to dispel speculation and to avoid disruption of the company's business.

On the other hand, if a company receives a specific offer that has been publicly disclosed by the potential acquirer, management should ordinarily make a short statement to the effect that the bidder has made an offer, that the board will consider the proposal in due course and that an announcement of the board's position and response, if any, will be made following the board's evaluation of the proposal. If there is a supportable basis for quickly rejecting the offer, this type of response may be entirely appropriate.

## C. Directors' Duties in Considering Takeover Offers

Management and directors have no absolute legal duty either to explore a proposal to buy the company, to meet with, discuss or negotiate with a potential acquirer or to accept a bid, even if the proposal offers shareholders a substantial premium over market price. Depending on the circumstances, the directors of the company may reasonably conclude that the institution's long-

term prospects are more valuable to shareholders than the raider's offer, that the offer violates the law or presents regulatory issues or that the offer should be opposed for other reasons.

An acquirer's need to obtain regulatory approvals will often afford the directors ample time and flexibility to respond to an offer. A rights plan can also provide a board with additional time and leverage in responding to a hostile offer. There is no reason to be hurried into a precipitous or ill-considered decision.

The Delaware Supreme Court's *Paramount Communications, Inc.* v. *Time* decision, 571 A.2d 1140 (Del. 1989), *aff'g*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989), makes it clear that a Delaware corporation's directors have broad discretion in considering various factors in responding to a bid. There is no special rule of fiduciary responsibility governing merger proposals. Rather, the business judgment rule controls, and a director is required to act in good faith and use his or her reasonable business judgment as to what is in the best interests of the shareholders and the institution. If a director does so, he or she is acting properly whether he or she determines to accept or reject an offer. In *In re Santa Fe Pacific Corp. Shareholder Litigation*, 669 A.2d 59 (Del. 1995), *Paramount Communications Inc.* v. *QVC Network Inc.*, 637 A.2d 34 (Del. 1994), and *Arnold* v. *Society for Savings Bancorp*, 650 A.2d 1270 (Del. 1994), the Delaware Supreme Court reaffirmed its view that, absent an active bidding or auction process initiated by the company or a transaction which would constitute a change of control of the company under Delaware law, the basic obligations of the board in responding to a bid are unchanged. In reviewing a board's defensive responses to a takeover bid, the Delaware courts scrutinize whether the action is reasonable in relation to the threat to corporate policy posed by the takeover offer, and, in so doing, emphasize (among other things) the deliberations of the board's consideration of the bid and the preexistence of a carefully thought-out business plan. *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). Notably, no director has ever been held personally liable for rejecting an offer.

In *Unitrin, Inc.* v. *American Gen. Corp.*, 651 A.2d 1361 (Del. 1995), the Delaware Supreme Court again clarified that a board has broad discretion in responding to a perceived takeover threat. In upholding Unitrin's stock buyback program (which significantly increased the percentage of insider holdings) and poison pill defense to American General's hostile takeover offer, the Delaware Supreme Court made clear that it would not substitute its judgment for that of the board. The Delaware Supreme Court stated that defensive measures are permissible so long as they are not draconian (*i.e.*, preclusive or coercive) and are within a "range of reasonableness." *See also Moore Corp.* v. *Wallace Computer Services, Inc.*, 907 F. Supp. 1545 (D. Del. 1995) (reaffirming the right of a target board to stand behind its pill and "just say no" in the face of an all-cash, premium bid).

In *Kahn* v. *MSB Bancorp, Inc.*, No. 14712-NC (Del. Ch. July 16, 1998), the Delaware Chancery Court reiterated that the directors of a bank holding company have no affirmative duty to entertain an unsolicited merger proposal. In that case, the Chancery Court upheld the MSB board's rejection (after considering its investment banker's advice) of two unsolicited merger proposals from Hubco, a New Jersey bank holding company. The Chancery Court ruled that the application of the business judgment rule presumption was appropriate because the MSB board's rejection of a merger offer was not a "defensive" action and payment of customary director fees and stock ownership do not impair director judgment. The Chancery Court also concluded that

the MSB board had informed itself appropriately before refusing to negotiate and electing to pursue a long-term strategy. The Delaware Supreme Court reaffirmed the *Kahn* decision in *Gantler* v. *Stephens*, 965 A.2d 695 (Del. 2009), in which the plaintiff challenged the board's decision to pursue a recapitalization in lieu of offers from three suitors. Citing *Kahn*, the Supreme Court held that the rejection of these offers did not constitute "defensive action" under *Unocal*.

There is no obligation to accept a takeover proposal merely because it is made at a premium over current market prices. Significant factors that a board may focus upon in evaluating a takeover bid are open-ended under Delaware law, but could include the nature and timing of the bid, the price, the quality of the consideration being offered, the likelihood of consummation (including the likelihood of regulatory approval being obtained), the company's current business plan and prospects, the general legality of the proposal, and the transaction's impact on constituencies other than the company's shareholders. Especially in light of the unique quasi-public characteristics of banking institutions, directors should properly consider the acquirer's reputation and the effect of the takeover on the bank's depositors and employees and the communities it serves, as well as any regulatory issues raised.

If a board is of the view that the company's business has peaked or that it lacks effective management or the financial resources to conduct its business, then the board may conclude that the time is right to sell the company at the best obtainable price. On the other hand, if a board is of the view that the company's prospects are favorable, that its management is competent and that it has access to the capital and financial resources to conduct its business and grow, then the board may reasonably conclude that the time is not right to sell and that the current shareholders are likely to reap higher, long-term financial rewards by remaining as owners of the enterprise than by having the business sold at the current time. If this is the board's view, then, from a fiduciary duty point of view, nothing is changed simply because a third party, to serve its own purposes, has chosen to make a bid seeking to force a sale of the institution. The so-called "just say no" defense has received judicial recognition in various courts. Indeed, a number of banks have been successful in remaining independent in spite of repeated public bear hug offers by would-be acquirers, indicating that in many instances a board committed to a long-term plan can reject successive offers and maintain its independence simply by saying "no."

The fact that a takeover proposal represents a premium over the current market price is in no way determinative of the adequacy of the price being offered. Virtually all takeover proposals involve a premium over market price. The stock market serves to fix a price for a company's shares at normal day-to-day trading volumes and does not act as a mechanism to fix fair value for the sale of the business enterprise as a whole. While current market price is not entirely irrelevant, it is by no means a decisive or even critical factor in proper analysis of a takeover attempt.

Where securities are proposed to be offered, their quality and value, dilutive impact and potential additional issuances for regulatory, capital or other reasons are major factors to be weighed by directors. In the case of a transaction involving equity consideration, the historical results, financial and capital positions, proposed cost synergies and other deal-specific value issues, and the management and prospects of the acquirer, including loan portfolio quality issues, must be considered. Current case law emphasizes the importance of the procedures followed by

a board in considering a takeover bid. A board's investigation and careful analysis of a bid are critical to the performance of its duties. Clearly, a response to any particular approach must be specifically structured. Following receipt of an acquisition proposal, bear hug letter or otherwise, management should promptly meet with the company's financial and legal advisors and consider how best to respond.

## D. Rights Plans and Other Defensive Measures

Advance preparation for defending against an unsolicited takeover is critically important for all financial institutions, regardless of size. In addition to making good business sense, advance planning for an unsolicited takeover makes good legal sense. The courts have recognized that the business judgment rule is applicable both to preplanned strategies and to responses to a bid, but, at the same time, have held that defensive measures taken in response to a specific bid will be subject to a higher level of judicial scrutiny. *Moran* v. *Household International, Inc.*, 500 A.2d 1346, 1350 (Del. 1985); *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). More recently, there have been suggestions in the case law that defensive provisions in a merger agreement providing for a stock merger (such as deal protection measures and no-shop covenants) may sometimes be reviewed under the heightened *Unocal* standard rather than under the business judgment rule alone. If gaps in a company's takeover defenses are found, the board must carefully consider whether to address them in the short term in the absence of any particular threat (and thus risk raising the company's profile with shareholder and governance activists), or whether to be prepared as part of a contingency plan to understand any potential vulnerabilities and move to mitigate them in the face of a specific threat.

The landmark decision of the Delaware Supreme Court in *Paramount Communications, Inc.* v. *Time Inc.* illustrates the importance for a company that wants to maximize its ability to reject a hostile takeover bid to consider periodically its long-term business and acquisition strategies. In *Time*, both the Delaware Chancery Court and the Supreme Court were heavily influenced by the documented history of Time's long-term business and acquisition strategies, and its prior consideration and rejection of Paramount as a merger partner. The lesson here is that the courts will respect and defer to a company's long-term plans and will not force a company to accept a hostile takeover bid if its board determines to reject the bid and pursue its long-term plans.

### 1. Rights Plans Provide an Important Structural Defense

The most effective device yet developed in response to abusive takeover tactics and inadequate bids is the share purchase rights plan, popularly known as the "poison pill." The key features of a rights plan are the "flip-in" and "flip-over" provisions, the effect of which, in specified circumstances, is to impose unacceptable levels of dilution on an acquirer. The rights are triggered when the stock ownership of a shareholder, or a group of shareholders acting in concert, exceeds a stated threshold (generally an acquisition of 10% to 20% of the target's stock), and they give all other shareholders the right to purchase either the target's stock (flip-in) or the acquirer's stock (flip-over) at a substantial discount, effectively diluting the acquirer's stock ownership. Rights plans also generally provide that, once the triggering threshold is crossed, the target's board may exchange, in whole or in part, the rights of all holders other than the acquirer for one share of the company's common stock. This provision avoids the expense of

requiring rights holders to exercise their flip-in rights and eliminates any uncertainty as to whether individual holders will in fact exercise the rights (and thereby ensures the intended dilution), and provides the board additional flexibility in responding to a triggering event. The risk of dilution, combined with the authority of a target's board to redeem the rights prior to a triggering event, gives a potential acquirer a powerful incentive to negotiate with the target's board rather than proceeding unilaterally.

Rights plans do not interfere with negotiated transactions, nor do they preclude unsolicited takeovers. The evidence is clear, however, that they do have the desired effects of both forcing acquirers to deal with the target's board and, ultimately, extracting from acquirers higher acquisition premiums than would otherwise have been the case.

With the basic legality of rights plans firmly established, almost all topical litigation now focuses on whether or not a board should be required to redeem the rights in response to a particular bid. In this respect, courts applying Delaware law have upheld, or refused to enjoin, determinations by boards not to redeem rights in the context of a "just say no" defense (*see, e.g.*, *Unitrin, Inc.* v. *American Gen. Corp.*, 651 A.2d 1361 (Del. 1995)), in response to two-tier offers (*see, e.g.*, *Desert Partners, L.P.* v. *USG Corp.*, 686 F. Supp. 1289 (N.D. Ill. 1988)) or inadequate 100% cash offers (*see, e.g.*, *Damon Corp.* v. *Nomad Acquisition Corp.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,041 (D. Mass. Sept. 20, 1988)), as well as to protect an auction or permit a target to explore alternatives (*see, e.g.*, *CRTF Corp.* v. *Federated Department Stores, Inc.*, 683 F. Supp. 422 (S.D.N.Y. 1988)). In a landmark 2011 decision, the Delaware Chancery Court reaffirmed the validity of rights plans in finding that the board of directors of Airgas, in refusing to redeem Airgas' rights in the face of Air Products' all- cash tender offer, had taken defensive measures that fell within the range of reasonableness in proportion to the threat of an inadequate tender offer. *Air Products and Chemicals, Inc.* v. *Airgas, Inc.*, C.A. No. 5249 (Del. Ch. Feb. 15, 2011).

On the other hand, some decisions have held that the rights should not interfere with shareholder choice at the conclusion of an auction (*Mills Acquisition Co.* v. *Macmillan, Inc.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. Oct. 18, 1988), *rev'd on other grounds*, 559 A.2d 1261 (Del. 1989)), or at the "end stage" of a target's attempt to develop alternatives (*City Capital Associates Ltd. Partnership* v. *Interco Inc.*, 551 A.2d 787 (Del. Ch.), *appeal dismissed*, 556 A.2d 1070 (Del. 1988); *Grand Metropolitan PLC* v. *Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988)).

In sum, the case law regarding a board's obligation to redeem rights plans essentially follows the logic of the Delaware courts' sale of control/non-control transaction case law, as well as the basic *Unocal* standard. Thus, as was noted in *QVC*, a board engaged in the sale of control of the company may not apply a rights plan in a discriminatory manner favoring one change-of-control transaction over another. In contrast, as was held in *Unitrin* and *Time*, in a non-change-of-control context, a board may implement or strengthen an existing rights plan as part of a business strategy to remain independent. In the context of a response to an unsolicited offer, a board adopting a rights plan is well advised to consider the adequacy of the unsolicited offer and its impact on the company's long-term business strategy.

The issuance of share purchase rights has no effect on the capital structure or safety and soundness of the issuing company; rather, the only immediate effect is on the balance of negotiating power between the would-be acquirer, on the one hand, and the target and its shareholders, on the other. Accordingly, the adoption of a rights plan should be of no concern to the Federal Reserve. If an acquirer takes action to trigger the rights, however, dramatic changes in the capital structure of the target and/or the acquirer can result, perhaps with significant consequences for the safety and soundness of either or both of the parties.

Rights plans can also provide important protections to financial institutions during periods of increased aggressive activity on the part of selected bank stock investors and industry participants. Rights plans contain a broad definition of beneficial ownership and can protect companies against certain hostile acquisition techniques that do not require prior regulatory approval (*e.g.*, signing up options on significant share positions prior to seeking regulatory approval).

*Chewable Pills*. In order to satisfy activist shareholders, some companies have resorted to a pill that does not apply to a cash offer for all of the outstanding shares. While a so-called "chewable pill" has some limited utility and may avoid a proxy resolution attack, it is not effective in most situations and does not substitute for the state-of-the-art pill.

*Dead-Hand Pills*. The typical hostile takeover attack consists of a tender offer combined with a proxy fight to replace the board with new directors who will redeem the pill. Some companies adopted pills that become non-redeemable by the board if more than 50% of the board has been replaced. After the *Toll Brothers* decision in Delaware in 1998, this type of pill is clearly not legal in Delaware. *Carmody* v. *Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998).

Shortly after the *Toll Brothers* decision, the Delaware Supreme Court ruled in *Quickturn* that even provisions that only limit the redemptive power of a newly constituted board for a relatively short period of time are invalid under Delaware law. *Quickturn Design Sys., Inc.* v. *NWA Inc.*, 721 A.2d 1281 (Del. April 25, 1998). Notably, *Quickturn* was broadly based on the Delaware statute that provides a board with the exclusive authority to manage the affairs of a corporation, subject only to exceptions set forth in the certificate of incorporation. Although the Supreme Court found that a board's statutory mandate made it impermissible to deprive a future board of the power to redeem, the same argument should undercut arguments that Delaware companies can be required, by shareholder by-law or otherwise, to put the redemption question to a shareholder vote or that directors can be removed from service based solely on how they exercise their business judgment concerning the pill. However, different results may be expected in other jurisdictions. A dead-hand plan was upheld in *Invacare Corporation* v. *Healthdyne* under a Georgia statute that expressly granted the board "sole discretion" to determine the terms contained in a rights plan for companies incorporated in that state. Dead-hand provisions also were upheld in the case of Allied Signal's challenge to the AMP rights plan in a decision that appears to be peculiar to Pennsylvania law.

### 2. Rights Plans — Some Current Observations

*Proxy Advisory Firms*. Rights plans have long been the subject of active discussion and debate and continue to contribute significantly to the structure and outcome of contests for

corporate control. This debate has continued, even as many companies have allowed their rights plans to expire, have affirmatively terminated their rights plans, have modified their rights plans with watered down protections and have even agreed not to implement rights plans going forward absent shareholder approval or ratification within some period of time, generally one year from adoption.

ISS now recommends a vote "against" or a "withhold" vote for all directors (except new nominees, who are considered on a case-by-case basis) of boards who adopt a shareholder rights plan without shareholder approval (subject to the condition in the next sentence) or make a material adverse modification to an existing pill (including extension, renewal or lowering the trigger threshold) without shareholder approval. However, ISS evaluates directors on a case-by-case basis if the board adopts an initial pill with a term of one year or less, depending on the disclosed rationale for the adoption and other factors that ISS may consider relevant (such as a commitment to put any renewal to a shareholder vote). ISS policies also provide that it will recommend a vote "against" or a "withhold" vote for all directors of boards that adopt a shareholder rights plan, whether short-term or long-term, with a dead-hand or slow-hand feature.

ISS's general policy is to recommend votes in favor of shareholder proposals requesting that companies redeem their poison pills or submit them to shareholder votes, with certain limited exceptions for companies with existing shareholder-approved poison pills and for companies with policies permitting the board to adopt a poison pill only if shareholders have approved the adoption of the pill or the board, in the exercise of its fiduciary responsibilities, has determined that it is in the best interests of shareholders under the circumstances to avoid the delay arising from a shareholder vote (and submits the pill for shareholder ratification within 12 months of adoption). ISS recommends voting on a case-by-case basis on management proposals to ratify a pill, focusing on the features of the pill and noting that pills should have a term of no more than three years, a flip-in or flip-over threshold of no lower than 20%, no dead-hand, slow-hand or similar feature that limits the ability of a future board to redeem the pill and a feature enabling holders of 10% of the shares to call a special meeting or solicit written consent to redeem the pill if a "qualifying offer" is announced and the board refuses to redeem the pill within 90 days thereafter. In addition, ISS recommends that the rationale for adopting the pill should be thoroughly explained by the company, and shareholders should take into consideration the company's existing governance structure, including board independence, existing takeover defenses and any problematic governance concerns.

However, rights plans — or at least a board's ability to adopt them rapidly when the need arises — remain a crucial component to an effective takeover defense and serve the best interests of shareholders (the available data show that rights plans are associated with higher takeover premiums, and, in any case, a board is subject to fiduciary duties where it is presented with a decision whether or not to redeem a rights plan in the face of a takeover proposal). Accordingly, boards should generally endeavor to avoid situations that would lead to this ability being lost or significantly curtailed. Rights plans remain a highly important tool for the board to be aware of significant acquisitions and control the process resulting from takeover overtures. To keep pace with the complexities of new financial instruments, state-of-the-art rights plans are increasingly being drafted to extend the terms of the plan to cover investors with economic exposure to the company through derivatives rather than solely through ownership of company stock.

*Rights Plans and Net Operating Losses.* Rights plans may also be used to protect a corporation's tax assets. Opportunistic investors who see attractive buying opportunities may present special risks to corporations with net operating losses, "built-in" losses and other valuable tax assets.

Accumulations of significant positions in such a corporation's stock could result in an inadvertent "ownership change" (generally, a greater than 50% increase in ownership by 5% shareholders in any three-year period) under Section 382 of the Code. If a company experiences an ownership change, Section 382 will substantially limit the extent to which pre-change Net Operating Losses ("NOLs") and other "built-in" losses stemming from pre-change declines in value can be used to offset future income. As with operating assets, boards of directors should evaluate the potential risks to these valuable tax assets and consider possible actions to protect them. A growing number of corporations with significant tax assets have adopted rights plans designed to prevent a Section 382 ownership change. Such rights plans generally incorporate a 4.9% threshold, deterring new shareholders from accumulating a stake of 5% or more, as well as deterring existing 5% shareholders from increasing their stake in a way that would cause a Section 382 ownership change.

Recognizing the unique features of such a rights plan, ISS has adopted a voting policy with respect to NOL-protective rights plans and considers them on a case-by-case basis based on factors including, among others, the ownership threshold trigger, the value of the NOLs, shareholder protection mechanisms and the company's existing governance structure. However, ISS recommends a vote against a plan with a term exceeding the shorter of three years or the exhaustion of the NOLs, based on its concern that such a plan's protections not remain in effect indefinitely.

One such "Section 382" pill adopted by Selectica Inc. in 2008 led to the first intentional triggering of a flip-in rights plan by Versata Enterprises Inc. and the first exercise of the common stock-for-rights exchange provision in a rights plan by a board of directors. The exercise of the Selectica exchange provision diluted the acquirer from approximately 6% of Selectica's outstanding shares to approximately 3% of its outstanding shares. Applying the two-part *Unocal* test used to evaluate a board's adoption of defensive measures, in *Selectica Inc.* v. *Versata Enterprises, Inc. and Trilogy, Inc.*, C.A. No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010), the Delaware Chancery Court upheld the validity of Selectica's "Section 382" pill, finding that the Selectica board's use of the pill was a proportionate response to the threatened impairment of Selectica's net operating losses. In a 2010 decision, the Delaware Supreme Court affirmed the Chancery Court's holding.

Although the generally negative view of rights plans by shareholder activists and policy organizations appears to be here to stay, the attack on rights plans is ill-founded. Whether a company should have a rights plan is a board issue, not a shareholder issue.[1] Comprehensive studies show beyond doubt that rights plans do not depress share value and that companies with

[1] However, a 1997 Oklahoma Federal District Court case, applying Oklahoma law, held that Fleming Companies was required to submit to a shareholder vote a by-law amendment to force redemption of any rights plan not previously approved by a shareholder vote. The district court certified the issue to the Oklahoma Supreme Court, which upheld the district court decision.

such plans that are taken over achieve substantially higher values for their shareholders than companies without such plans. As one example, a 2009 study released by Citigroup Global Markets showed that since 2001, initial takeover premiums offered in hostile transactions average 28.5% when the target company has a rights plan, as compared with 22.8% for a target lacking a rights plan or staggered board. The Citigroup study also showed that since 2001, the average upward revision in offer price for companies with rights plans equaled 9.8%, whereas there was no upward revision in offer prices for companies lacking a rights plan or staggered board.

### 3. Defensive Charter and By-Law Provisions

Defensive charter and by-law provisions typically do not purport to, and will not, prevent a hostile acquisition. Rather, their purpose is to provide some measure of protection against specific takeover tactics and to provide a board with additional negotiating leverage, as well as the opportunity to respond appropriately to proxy and consent solicitations. Defensive charter provisions can include: "fair price" provisions (which require that shareholders receive equivalent consideration at both ends of a two-step bid, thus deterring coercive two-tier, front-end loaded offers); "business combination" provisions (which commonly provide for supermajority voting in a wide range of business combinations not approved by the company's continuing directors, absent the ability of the transaction to meet certain substantive requirements); staggered or classified board provisions; and provisions that eliminate shareholder action by written consent and shareholder authority to call special shareholder meetings. Because charter amendments (such as the creation of a staggered board and the elimination of the ability of shareholders to act by written consent) require shareholder approval to implement, and due to general institutional investor opposition to such provisions, few companies have put forth new proposals in recent years (other than in the context of initial public offerings and spin-offs, where such provisions are frequently implemented, although not without institutional investor criticism). By-laws, however, generally can be amended without shareholder approval and can be used to implement some of the structural defenses found in charters, although certain provisions, such as the creation of staggered boards and the elimination of the ability of shareholders to act by written consent, can generally only be effected by charter provisions. By-laws, as discussed in more detail below, often contain provisions in addition to those found in corporate charters, including: advance notice provisions relating to shareholder business and director nomination proposals; provisions that address the subject matters that may properly be brought before shareholder meetings; provisions addressing director eligibility standards; and procedural and information requirements for shareholders to call special meetings or act by written consent. However, discretion may be the better part of valor when it comes to adopting or enhancing by-law protections absent a compelling need or a good opportunity to make changes.

For companies that do have a staggered board, it is important to note that under Delaware law, directors on a staggered board may be removed only for cause, unless the certificate of incorporation provides otherwise. Accordingly, such corporations should make sure that effective supermajority amendment requirements apply to the amendment of staggered board and director removal provisions. Hostile bidders can be expected to be creative in attempting to circumvent a staggered board provision and to find any hole in a target's defenses.

In addition, a firm "just say no" defense may have a significant impact on an acquirer's ability to obtain regulatory approval for the acquisition of a company with a staggered board. If a hostile acquirer cannot provide the Federal Reserve with a feasible plan for obtaining effective control of the target within a relatively short period of time, the Federal Reserve may be reluctant to approve the acquisition, or extend the period to consummate the acquisition, due to safety and soundness concerns. For example, in the order approving Bank of New York's proposed acquisition of Irving, the Federal Reserve stated that it was concerned that a takeover contest that was in doubt for a prolonged period of time after the Federal Reserve Board's approval would subject the target's personnel and financial resources to undue strain. Accordingly, the Federal Reserve said that it would not follow its normal procedure of freely granting requests by the acquirer to extend the 90-day period for consummating the acquisition. Instead, the Federal Reserve said it would carefully evaluate any such request by Bank of New York, would not expect to extend the 90-day period more than once and would grant an extension only if the Federal Reserve were satisfied as to safety and soundness concerns and if consummation were likely within the extended period. *The Bank of New York Co.*, 74 Fed. Res. Bull. at 272. As the Federal Reserve put it in its order approving CP Financial's application to acquire CB Bancshares, "the [Federal Reserve Board] has followed its standard practice of requiring that consummation of the proposal . . . be completed within three months from the date of this order. If the transaction is not concluded within this period, the [Federal Reserve Board] will review carefully any requests by Central Pacific to extend the consummation period and would expect to grant an extension of the period only if the Board is satisfied that the statutory factors continue to be met." Nonetheless, in the Federal Reserve's approval of CP Financial's bid, and, earlier, of North Fork's proposed hostile acquisition of Dime, the Federal Reserve stated that, while it was mindful of the effect that takeover battles can have on the safety and soundness of both the target and the acquirer, it would apply the same criteria under the Bank Holding Company Act when evaluating friendly and contested transactions alike.

By-law provisions regarding the business to be conducted at, and the manner of presenting proposals for, annual and special meetings, as well as shareholder action by written consent, are helpful in protecting against an unexpected proxy contest for control of a board and can be adopted by a board without shareholder approval. Especially in light of shareholder activism, proxy fights and consent solicitations, state-of-the-art by-law procedures, corporate governance guidelines and codes of ethics can be extremely important. Among other things, such procedures help to ensure that boards have an appropriate period of time to respond in an informed and meaningful manner to shareholder concerns and to prepare and clear any related proxy statement disclosure.

Every public financial institution should review its by-laws, including when appropriate with counsel, on a regular basis to assess whether they are state-of-the-art and consistent with recent case law and SEC developments, and whether modifications may be advisable. As a matter of good planning, companies should also be alert to by-law issues when undertaking friendly transactions. For instance, if a transaction is signed at a time of year near an upcoming annual meeting, management may consider putting the proposal to approve the merger on the agenda of the annual meeting rather than calling a special meeting. However, if an annual meeting must be significantly delayed past the one-year anniversary of the prior year's meeting (*e.g.*, due to an extended SEC comment process in connection with the merger), under many standard notice by-laws a later deadline for shareholder proposals may be triggered. Once

triggered, this could enable a potential interloper to run a proxy contest or otherwise interfere with the shareholder vote. In many cases, the special meeting approach will be the right choice.

#### 4. Employment and Benefits Issues

The terms and conditions of change-of-control employment and benefit arrangements and the protections that they provide to executives, management and employees generally do not vary in the context of a hostile deal from those that should be in place in the event of a friendly transaction. As such, change-of-control employment agreements and change-of-control protections under equity and other compensation plans should be consistent regardless of whether the deal is hostile or friendly.

While many change-of-control protections are ideally adopted prior to the time a transaction is contemplated, many benefit plans and arrangements are best left for negotiation as part of the merger or similar agreement. Provisions in broad-based plans that prohibit changes in benefit formulas or termination following a change of control, while appropriate to protect employees against the leveraged break-up artists of the 1980s, may not be appropriate in the context of a strategic combination, the economics of which depend, in part, on a centralized and uniform human resource administration and benefit delivery function.

While it is customary to provide in a merger agreement for the roll-over (in stock deals) or cash-out (in cash deals) of employee stock options and other equity-based awards, the treatment of pension plans, welfare plans, non-qualified deferred compensation plans and other employee benefits in merger agreements has varied greatly. Some acquirers favor simple covenants agreeing to maintain comparable compensation and benefits for some period after the merger or provide compensation and benefits no less favorable than those provided to their own similarly situated employees. Other acquirers favor negotiation of more specific employee benefit arrangements, such as payment of annual bonuses for the year in which the transaction closes, the applicable severance plan for terminated target employees and the treatment of 401(k) plans.

### E. Regulatory Defenses

A target of a hostile offer should take full advantage of its right to file protests and comments with the Federal Reserve regarding the bidder's application. Protests can be made to the Federal Reserve even in situations where no formal application is required, such as a proxy fight, or in the early stages of a hostile bid before the bidder's formal application is filed. A target should insist that a bidder supply all relevant information to the Federal Reserve in its application and that this information be made available to the target for review and comment.

The Federal Reserve is likely to take a target's comments seriously, since the target is in a unique position to evaluate a bidder's proposal and to point out its shortcomings, as well as to challenge in court the Federal Reserve's approval of the application. Similarly, if an interloping bidder is attacking an announced deal, a target can expect the interloper to raise with the Federal Reserve its objection to the merger.

In commenting on the application, a target should be careful, however, to avoid making objections that may seem frivolous or merely dilatory. Such tactics antagonize regulators and

may convince them that the target is acting in bad faith or abusing the Federal Reserve's processes. Instead, a target's comments on the application should focus on the statutory criteria that must be applied by the Federal Reserve in acting upon Bank Holding Company Act applications: (1) antitrust; (2) financial condition and future prospects; (3) management resources; (4) risk to financial stability; (5) effectiveness in combating money-laundering activities; and (6) convenience and needs of the community (and Community Reinvestment Act performance). 12 U.S.C. § 1842(c); *see also* 12 C.F.R. § 225.13. Because a hostile would-be acquirer does not have full access to information about a target, the acquirer will often be at a disadvantage in its efforts to persuade the Federal Reserve that a proposed transaction will satisfy these criteria. For example, an acquirer may lack information necessary to redefine or recalculate markets or market shares in order to avoid divestitures for antitrust reasons. Furthermore, a target may be able to point out areas of concern that might not be apparent to the Federal Reserve without the target's assistance. Other constituencies may also influence the regulatory aspects of a takeover defense: in June 2010, Community Bancshares, Inc. announced that it had applied to the Federal Reserve for approval to acquire up to 100% of the shares of BEO Bancorp (both based in Oregon). When Community Bancshares withdrew the application in July 2010, BEO Bancorp's chief executive officer cited the high volume of letters to the Federal Reserve from customers, shareholders and employees opposed to the takeover as a contributing factor to the withdrawal.

A target is also generally in the best position to make useful criticisms of a bidder's capital position and future prospects. For example, BankAmerica's attacks on First Interstate's accounting methodology and capital plans prompted the Federal Reserve to send First Interstate a letter mirroring these criticisms. This letter, in turn, led First Interstate to withdraw its application. Similarly, Irving was able to point out a number of deficiencies in Bank of New York's accounting and capital plans. Irving also presented the Federal Reserve with a great deal of evidence suggesting that Bank of New York would be unable to integrate its data systems with Irving's and that Bank of New York's projections of anticipated profits from divestitures of Irving's assets were overly optimistic. On the basis of this evidence, some of which was not available to Bank of New York from public sources, Irving contended that Bank of New York's financial projections were unduly optimistic. *The Bank of New York Co.*, 74 Fed. Res. Bull. at 266-67. While the Federal Reserve did not disapprove Bank of New York's application on the basis of these objections, the Federal Reserve appeared to take them seriously. As a condition to approval, the Federal Reserve required Bank of New York to make a number of commitments regarding its capital and operating plans in order to ensure that Bank of New York would have sufficient financial flexibility even if its earnings did not reach projected levels. *Id.* at 267.

Potential antitrust concerns can also be raised by a target in its efforts to deter a hostile bid. Such concerns were raised by Star Banc in its rejection of Fifth Third's hostile approach. As is the case with all regulatory defenses, however, a target must be careful that it does not poison the possibility for an acquisition by a white knight, or, if an acquisition by a hostile bidder does ultimately occur, reduce the size of the acquisition premium that a hostile bidder is able to afford.

A target may also be able to point out weaknesses in the bidder's Community Reinvestment Act (CRA) record or other factors affecting the Federal Reserve's evaluation of convenience and needs. Especially when the two companies operate in the same markets, the

target will often be in a position to learn whether the community has been well served by the hostile bidder and to prove, if true, that certain segments of the community have not been properly served.

Finally, as discussed above, a target may be able to use the existence of other defenses (such as a poison pill or business combination statute) that can prevent an acquirer from obtaining full control of the target and/or consummating a second-step merger as a rationale for denying the raider's regulatory application.

## F. Structural Defenses

### 1. White Knights

A "white knight" transaction, namely a merger or acquisition transaction by the target with a friendly acquirer, can be a successful strategy when the white knight transaction provides greater economic value to target shareholders than the initial hostile offer. White knight transactions, however, are generally somewhat more difficult to accomplish in the banking context than in non-banking transactions. A white knight will require the same regulatory approvals as are required by a hostile acquirer, and, to the extent that it commences the approval process after a hostile acquirer, may suffer a timing disadvantage as a result. In addition, while obtaining regulatory and shareholder approval for a white knight transaction will be facilitated by a target's support, it can be assumed that a hostile acquirer will make every effort to prevent that approval from being granted. Certain targets also may be constrained by a scarcity of available white knight acquirers, depending upon applicable regulatory restrictions, antitrust considerations and market conditions. Advance planning is, therefore, imperative.

### 2. White Squires

A "white squire" defense involves placing a block of voting stock in friendly hands. The 1989 decision of the Delaware Chancery Court upholding the issuance of convertible preferred stock by Polaroid to Corporate Partners, a "white squire" fund, in the face of an all-cash tender offer for all outstanding shares of Polaroid marks one of the most significant legal tests of the white squire defense. *Shamrock Holdings, Inc.* v. *Polaroid Corp.*, 559 A.2d 278 (Del. Ch. 1989). The *Polaroid* decision confirmed the prevailing line of cases upholding the issuance of stock to a white squire as a defensive measure when the result was not to consolidate voting control in management or employee hands. Of course, such sales to "friendly" parties should be carefully structured to avoid an unexpected subsequent takeover bid by the former "friend."

White squire defenses are more difficult to accomplish in a bank acquisition context, however, due to the likely requirement that the white squire will need to obtain regulatory approval for its acquisition or the requisite assurance that no Bank Holding Company Act or the Change in Bank Control Act (the "Control Act") applications are required. Though such considerations can present difficulties, they do not necessarily present insurmountable obstacles. Moreover, even where a Control Act notice is required, it generally is possible to proceed on a much quicker timetable than that associated with a full Bank Holding Company Act application.

### 3. Restructuring Defenses

Like many forms of takeover defense, restructurings are best initiated well before a company is actually faced with a bid. In most cases, a restructuring will only be possible if there has been careful advance preparation by the company, its investment bankers and counsel. Arranging for a friendly acquisition of a particular asset, for example, and restructuring a business to accommodate the loss of the asset are time-consuming, costly and complicated endeavors, and are difficult to effect in the midst of a takeover battle.

## VII. HOSTILE TAKEOVER TECHNIQUES

A hostile takeover of a regulated financial institution will necessarily be expensive, time-consuming and risky, due to, among other factors:

- the need for regulatory approvals, including state regulators in many cases, which will take at least as long as for a friendly transaction (*e.g.*, several months or more) and likely much longer in the context of a hostile transaction, during which time a hostile bid will be exposed to potential adverse publicity, risks from the bidder's own business, risks related to the target's business and risks related to the bid itself, such as defensive attacks from the target;

- the likely need to include some stock as part of the merger consideration, which further complicates the timing of an acquisition and enables the target to challenge the value of the consideration being offered;

- the availability of a rights plan/"just say no" defense to the target, which can block a takeover for a lengthy period of time, pending a proxy fight and removal of the target board;

- the number and capacity of competitor "white knight" acquirers, creating a substantial risk that a takeover bid may simply drive the target into the arms of a third party;

- the need for constant attention by senior management of the bidder for the duration of the bid, with attendant opportunity costs;

- the inability of the bidder to conduct due diligence absent a negotiated agreement with the target, with attendant risks (*e.g.*, quality of loans, portfolio securities and other assets, contingent or undisclosed liabilities);

- the possibility that key target personnel will leave (particularly if they have customary change-of-control benefit protections); and

- the risk of reputational and business harm due to public, legal and regulatory scrutiny of the bidder, its business activities and its tactics.

Nevertheless, hostile or quasi-hostile takeovers can be potentially useful under the right set of circumstances:

- *First*, a bidder's capacity to make a hostile bid — which, in most cases, will result in a target being acquired, even if not by the bidder — can serve as an important backdrop to a negotiated transaction.

- *Second*, institutional shareholders and boards have shown an increasing willingness to be proactive in pushing management of reluctant targets into negotiated transactions. The possibility of such constituencies pressuring a target into a transaction with a potential bidder should not be overlooked. In such circumstances, careful consideration of the right degree of "hostile" pressure to apply is essential.

- *Third*, a hostile takeover may be warranted where a potential target clearly represents the most important strategic acquisition that a bidder can make and is sufficiently ahead of other potential targets to warrant the extra costs and risk involved. Still, ordinarily all steps short of a hostile takeover should usually be taken prior to launching a hostile bid.

## A. Preparation for a Hostile Bid

Before launching a hostile takeover, an acquirer must carefully consider all aspects of its proposed strategy, including all relevant business, public policy, legal and regulatory considerations. No hostile acquisition should be pursued until all such factors have been carefully considered and the acquirer has realistically evaluated its chances for success and the potential risks (or possible rewards) if its efforts are unsuccessful.

Before commencing a full-fledged hostile takeover offer, a bidder should assemble a small group of key officers plus legal counsel, an investment banker, a proxy soliciting firm and a public relations firm that can act quickly and decisively. A working group list with emails and telephone numbers should be kept up to date.

The working team should conduct a careful review of all publicly available target data, including SEC, regulatory and other filings. A thorough financial and legal profile of the target should be prepared and analyzed and the team should determine the scope of affordability and practicality of the proposed acquisition.

In addition, as appropriate, a bidder should undertake a similar candid self-analysis to assess its vulnerability to: litigation, target counterattacks in the regulatory process or in the press, or "Pac-Man" defenses or third-party hostile bids for the bidder. This should include accounting, SEC reporting, legal, compliance, regulatory relations and community and customer relations.

Maintaining the secrecy of a planned hostile bid is critical to its success and to compliance with applicable laws. Internal procedures relating to confidentiality of each party involved should be strictly adhered to and policed. Code names should be used whenever possible, and early drafts of documents should never identify (or contain information that could be used to identify) the target.

## B. Steps Short of a Hostile Bid

The potential for advocating a negotiated transaction between a bidder and target short of a public hostile bid should be fully explored prior to launching a hostile bid.

### 1. Contacts with Target

The target board and management can be contacted, directly by bidder management or through intermediaries, for information and to assess receptivity to a negotiated transaction. Contacts may be possible through bidder board members, bidder advisors and/or trade, social or similar associations. A careful assessment of the right contacts to rely upon is essential and a core team should carefully coordinate all such contacts. Disclosure will likely be required of all material contacts, should the bidder subsequently engage in a tender offer or proxy contest.

### 2. Contacts with Target Shareholders

Bidders should consider whether large target shareholders should be contacted, particularly those with a record of advocating business combinations by companies in which they invest. Among other potential purposes of such contact would be for the bidder to indicate that the bidder would be willing to enter into a negotiated transaction if target management sought one, seek to obtain shareholder support, should the bidder make a hostile bid or commence a proxy fight, and/or seek to obtain shareholder receptivity to possible purchases by the bidder of shareholders' holdings in the target, either in a pre-bid private purchase or in a public tender or exchange offer.

Such contacts should be made only after careful consideration of the potential disclosure and other related issues raised by such communications. In most instances, approaches to the target's management and board should be exhausted before approaches to shareholders are made. Where contacts are made, the number of shareholders contacted should be limited to avoid excessive risk of leaks. Shareholder contacts must be considered carefully in light of Schedule 13D "group" or proxy filing requirements. In addition, disclosure of all material contacts will be required should the bidder subsequently engage in a tender offer or proxy contest.

### 3. Nonpublic "Bear Hug" Letters

As discussed above, a private bear hug letter, not intended or required to be disclosed, can be sent to target management and/or the board of the target. Such letters can be crafted to be more or less clear about the prospect of the bidder making a hostile bid if its initial overture is not successful. Public disclosure of a bear hug letter by a bidder effectively represents the commencement of a hostile bid. Before sending a private bear hug letter, a bidder should assess the risk of the target "going public" with the bear hug letter to embarrass the bidder, increase the target's stock price (and thereby increase the cost of stock accumulation by the bidder) or otherwise interfere with a hostile bid.

### 4. Stock Accumulations

Stock or other securities of a target can only be acquired by a bidder and/or parties friendly to a bidder in accordance with strict legal, regulatory and disclosure restrictions.

- *Hart-Scott-Rodino*. An acquisition of a company's voting securities having a market value of more than $119.5 million (the threshold effective as of March 6, 2024) can trigger the notification and waiting period requirements under the Hart-Scott-Rodino Act (with certain exceptions for investment holdings), which will also require notice to the target. *See* Chapter 9.

- *Control Regulations*. State and/or federal control regulations in most regulated industries require regulatory approval before a bidder can acquire a specified percentage (typically 5% or 10%) of a target's voting shares.

- *Schedule 13D*. A Schedule 13D is required to be filed within 5 business days of any person (or "group" of persons) acquiring beneficial ownership of 5% or more of a security registered under Section 12 of the Exchange Act, although certain passive investors and certain additional categories of qualified institutional investors may file a Schedule 13G. Required disclosure includes bidder intentions, contacts with the target and agreements with others concerning the target.

- *Poison Pill*. If a target has a poison pill, stock accumulations must not trigger its operation (triggers vary with specific target).

- *State Takeover Laws and Charter Provisions*. State takeover laws and charter provisions may restrict stock accumulations of target stock or impose draconian consequences if certain accumulations are made without target board approval. For example, Section 203 of the Delaware General Corporation Law prohibits certain transactions with owners of 15% or more of target common stock for a period of three years following the time such person became an interested shareholder in a transaction not approved by the target board, except under certain circumstances involving board and supermajority shareholder approval.

- *Insider Information*. Rules 10b-5 and 14e-3 generally prohibit trading on inside (material, nonpublic) information.

If target stock is to be acquired, a bidder should establish a buying strategy and procedure to monitor and record volume, price levels and any market effect of the purchases. Consider how best to avoid unnecessary disclosure that could run up the price or tip the target (*e.g.*, use of multiple brokers, nominee accounts). All stock acquisitions by a bidder must cease if the bidder commences a tender/exchange offer and generally should be accomplished prior to making a public hostile bid of any sort. Even if a significant stock accumulation is not made, a bidder should consider acquiring a small number of shares as record holder (*e.g.*, 100 shares) so as to facilitate obtaining shareholder lists in the event of a tender offer or proxy fight.

In addition, would-be acquirers should be aware that Regulation M prohibits a company from buying its own shares during the proxy solicitation process relating to a stock-based takeover offer. For example, in SunTrust's hostile bid for Wachovia, SunTrust instigated an aggressive buyback campaign in order to maintain the premium offered in the face of a decline in its stock price following its announcement of the hostile bid. However, SunTrust was dealt a significant strategic setback when the SEC interpreted Regulation M to prohibit SunTrust from

continuing to buy its own shares (the SEC staff of the Division of Market Regulation has since updated its Staff Legal Bulletin containing questions and answers about Regulation M to reflect this position). The application of Regulation M in this situation (where SunTrust had made only a public bear hug offer and did not have a pending exchange offer) follows on other interpretations by the SEC staff treating public bear hugs involving a proposed stock merger (at least in the context of an already pending friendly transaction) as the commencement of a distribution of the bidder's shares. In the case of SunTrust's bid for Wachovia, this interpretation was particularly damaging because much of SunTrust's pre-announcement earnings momentum could be attributed to an active share repurchase program and it would not have been able to support its share price through open market purchases at the time of any increase in its offer following the mailing of its opposition proxy.

Similarly, would-be acquirers should be aware that during the period from public announcement of a transaction (which can include public announcement of an intent to pursue a hostile acquisition, such as a publicly disclosed bear hug letter) to the shareholder vote, plus any valuation or election period, the safe harbor for share repurchases existing under the SEC's Rule 10b-18 will only cover daily purchases no greater than the average daily Rule 10b-18 purchases occurring in the three months ending prior to announcement of the acquisition. The rule does not limit the availability of the safe harbor for all-cash acquisitions where there is no valuation period for the cash consideration based on the trading price of the bidder's stock. The SEC has reiterated that Rule 10b-18 is a non-exclusive safe harbor, but in most instances most issuers will likely be reluctant to effect repurchases outside of its limits.

### C. Commencing a Hostile Bid

Full commitment by a bidder's board — premised on the length of, and risks posed to the bidder by, a hostile bid — is essential to success. Support from a bidder's employees can also be important to a successful bid. An information strategy for the board and employees of the bidder will need to be developed. Absent such a strategy, the potential impact of the bid on the bidder's existing operations can cause uncertainty, damage employee morale, and potentially lead to employee unrest or even a split in the bidder's board.

For a board, frequent and frank updates on the status of the bid and the significance of upcoming events are advisable. For board, employees, press and analyst relations, consideration should be given to a communications plan regarding: the impact of a successful bid on the bidder, including future prospects, synergies, regulatory or legal issues, and existing jobs; clearly articulating the business rationale for the transaction proposed; and the impact of a failed bid on the bidder.

Regardless of how a hostile bid is pursued, the portrayal of the bid in the press can be critical to the outcome. A press strategy should be developed in advance. A separate strategy should be developed and coordinated for dealing with federal and state regulators, key politicians and community and industry groups as well as important constituencies of the target (*e.g.*, employees, customers, shareholders, directors).

### 1. The Public "Bear Hug" Letter

Both as a matter of strategy and tactics, it will often be advisable to initiate a hostile bid by sending a public bear hug letter to the target board and/or management. Such letters can be disclosed by bidder or (if desired) crafted and timed in such a way as to require disclosure by target. Such letters:

- do not, as a legal matter, necessarily require any response from the target;
- nevertheless, put pressure on the target board and management to respond and can include an offer price against which target performance and planning will be measured;
- focus public and market attention on a target and may lead to negotiations, particularly where a board or management split already exists;
- may also lead to competition from other bidders;
- can be more or less clear about the bidder's intentions should the offer be declined — the more definitive, specific and non-conditional the offer, the greater the pressure on a target; and
- may lead to pro-takeover arbitrageurs acquiring target stock, particularly if the price offered is at a significant premium to market.

Authors of public bear hug letters should be especially sensitive to the fact that such letters have, on occasion, prompted the recipients to agree to mergers with third parties. Authors should also be mindful that a public bear hug letter proposing a stock merger may trigger the prospectus filing provisions of Rules 165 and 425 under the Securities Act.

### 2. Open Market Accumulations

The ability to acquire a significant stock position in a target bank by means of open-market accumulations, secret or otherwise, or "street sweeps" is obviously limited by both the Bank Holding Company Act and the Change in Bank Control Act (to generally less than 5% for acquisitions by other bank holding companies and not more than 10% for acquisitions by non-bank investors), as well as by capital requirements. The purchase of stock in such accumulations requires the expenditure of cash, thereby reducing capital. The ability to acquire a significant stock position in a target insurance company will also be limited by state insurance regulatory regimes that typically require approval for acquisitions of 10% or more.

Nonetheless, open-market purchases, after receiving required Federal Reserve approval or state insurance commission approval, can be a potent tactic for certain acquirers. Such acquirers would include those that have sufficient capital to engage in open-market purchases without raising additional capital, can raise additional capital before commencing any purchases or are able to obtain Federal Reserve approval to defer raising additional capital until after consummation of the purchases.

In many cases, the Federal Reserve has approved minority investments despite the opposition of a target bank. Although targets have had limited success in blocking applications to acquire significant minority states before the Federal Reserve, there is sometimes a second forum available to the target before a state commissioner or state banking regulator.

### 3. Hostile Tender Offers and Exchange Offers

Federal Reserve insistence on the maintenance of adequate levels of capital will generally require that any bank acquisition of significant size include a substantial equity component. As a result, a hostile offer will frequently have to take the form of an exchange offer, rather than a cash tender offer.

An exchange offer requires registration under the Securities Act and qualification under applicable state blue sky laws before tenders of shares may be accepted. However, the tender offer rules permit exchange offers to be commenced upon filing a registration statement and tender offer materials and dissemination to shareholders of a preliminary prospectus and related materials. These rules may help facilitate hostile offers by permitting the would-be acquirer to move more quickly in commencing its offer.

An acquirer proceeding by means of an exchange offer may be at a disadvantage to a competitor that can proceed by means of a cash tender offer if timing is critical, but this will rarely be the case with bank and insurance company acquisitions because of both the regulatory process and the difficulty of making substantial acquisitions for cash.

An exchange offer made in connection with a bank or insurance acquisition will, of necessity, be subject to a number of conditions. These will typically relate to receipt of required regulatory approvals, redemption or invalidation of rights plans and invalidation or inapplicability of state takeover statutes, among others. In the banking and insurance context, the regulatory condition will generally take many months to satisfy and, as such, be the major factor influencing the timing of an acquirer's offer. Receipt of Federal Reserve, state insurance commission and/or other required approvals, however, does not end the acquirer's difficulties. An order granting approval of a proposed acquisition may be subject to conditions relating to such matters as the financing of the acquisition, management of the acquired bank and divestiture of assets or businesses of the target. An acquirer will necessarily condition its offer on the satisfaction of these regulatory requirements.

### 4. Preparing and Structuring the Offer

Before a tender or exchange offer can be commenced, the bidder and its advisors will need to prepare a number of documents and filings. Preparation of the requisite securities laws and other filings will require extensive data collection from the bidder, its advisors, directors and officers, and may take several weeks to prepare.

In addition, a variety of strategic decisions will need to be made regarding the structure of the tender or exchange offer. Such strategic considerations include:

- *Two-Tier Offer Versus an Offer for all Shares*. Two-tier offers may raise issues under state takeover laws and certain charter provisions and generally are more susceptible

to litigation attacks and other takeover defenses. Still, a two-tier offer could be structured so as to offer a partially tax-free alternative to target shareholders if the bidder acquires not more than 60% of target stock for cash in a cash tender offer, with a stock back-end merger to follow.

- *Type of Consideration*. Cash will increase the odds of success but may not be possible for regulatory, cash flow, rating agency or other reasons. If securities are used, the bid will be an exchange offer requiring registration under the Securities Act. Registration may result in some delay relative to a cash offer, although the difference should not be too significant in most instances. An all-cash bid will avoid triggering Regulation M and the limited availability of the Rule 10b-18 safe harbor, which could impact the bidder's ongoing repurchase plans during the pendency of the transaction.

- *Financing*. If external financing will be necessary to complete the transaction, consider whether to proceed with commitments or a "highly confident letter." Contingent financing may raise regulatory concerns or may make the offer appear uncertain.

- *Minimum Condition*. Minimum number of shares needed for the bidder to obtain effective control.

- *Rights Condition*. The offer should be conditioned upon redemption or injunction of any target rights plan.

- *Regulatory Condition*. As noted above, the offer should be conditioned upon receipt of regulatory approvals. Consideration should be given to precise drafting of this condition (*e.g.*, the impact if antitrust divestitures are required).

- *Other Conditions*. Consider the trade-off between making the offer appear less firm and more subject to both securities law and public relations attack, on the one hand, and protecting the bidder against risks, on the other hand.

### 5. Tender/Exchange Offer Regulation

Tender and exchange offers are subject to extensive regulation under the Williams Act and the SEC's related rules. Significant considerations include:

- An all-cash tender offer will require the filing of a Schedule TO with the SEC, and a "tombstone" ad in a national paper and a public distribution of printed offer documents to all target shareholders. This filing does not need to be pre- cleared with the SEC but is subject to post-filing comment.

- An all-stock or part-cash/part-stock exchange offer will require both the filing of a Schedule TO (plus "tombstone" ad and public distribution of printed offer documents to all target shareholders) and the registration of the offered securities with the SEC. The target will likely seek to "bed bug" the letter (*i.e.*, suggest to the SEC comments and problems with the bidder's filings).

- The following requirements also apply to all tender/exchange offers:

- All tender/exchange offers will require a minimum offer period of 20 business days (regulatory approvals will take considerably longer), subject to required extensions in the event of certain amendments, and must be made to all target shareholders on an equal basis.

- Once a tender/exchange offer is commenced, no "side purchases" of target stock may be made outside the offer — with a significant exception for contracts entered into before public announcement of the tender offer that are fully described in the tender offer materials and are "unconditional and binding on both parties." In comment letters, the SEC had accepted the position that purchase agreements with customary conditions to closing (*i.e.*, conditions that are not subjective and that cannot be unilaterally invoked) could still qualify as unconditional and binding contracts.

- Amendments in an offer or material developments in the information disclosed in the Schedule TO or offer documents must be "promptly" reflected in amended filings with the SEC, and, depending upon the amendment or development, may require recirculation to target shareholders.

- Once a bidder or an acquirer has taken a "substantial step" to commence or has commenced a tender/exchange offer, it is unlawful for any other person in possession of nonpublic information relating to the tender offer to trade in the securities subject to the tender offer. "Tipping" with respect to a tender/exchange offer is also unlawful (*i.e.*, communicating material, nonpublic information to a person where it is reasonably foreseeable that the person will trade on the information).

At the time a hostile bid is commenced, the bidder should consider demanding confidential information (*e.g.*, management projections, access to loan files) that could be used to justify a higher bid price. However, Delaware case law gives targets ammunition in resisting such demands. In *NiSource Capital Markets, Inc.* v. *Columbia Energy Group*, C.A. No. 17341 (Sept. 24, 1999), the Delaware Chancery Court affirmed the application of the "business strategy immunity" to valuation analyses prepared by targets in response to unsolicited offers by upholding the target's refusal to provide self-valuation data to the hostile bidder.

Unless a target determines to auction itself, this demand for such confidential information can often be resisted. However, even a negative response from a target can be useful in the event of subsequent litigation regarding the target's response to the hostile bid and/or grant of lockups to a white knight. For example, if a target attempts to give potential white knights a due diligence advantage over a bidder, the bidder may be able to level the playing field through litigation. In any event, detailed records of all information received from a target should be maintained.

### 6. Proxy Contests and Consent Solicitations

Over the years, there have been a number of notable proxy contests for control of boards of banks and financial services companies or solicitations against friendly mergers. Some

contests have occurred within the context of a broader takeover contest, such as in the SunTrust/Wachovia, North Fork/Dime, Ahmanson/Great Western and Bank of New York/Irving contests, and others in the context of a dissident shareholder's opposition to a management-recommended deal, such as HoldCo Asset Management's ultimately unsuccessful campaign against Boston Private and Boston Private's sale to SVB Financial. Other contests have been waged by activists or other dissidents outside the context of a specific acquisition proposal.

Because of the lengthy regulatory approval process, and in view of the additional negotiating leverage and response time that rights plans and state takeover statutes have provided target boards to develop alternatives to hostile bids, a proxy fight or consent solicitation will often form a necessary part of a hostile acquisition. In some states, control share acquisition statutes have helped facilitate proxy contests by enabling acquirers to obtain a shareholder vote on their takeover proposal within a 50-day period. *See, e.g.*, Ind. Code Ann. § 23-1-42. Control share statutes lacking a board opt-out may also have the unintended effect of impeding certain defensive responses to a bid, such as a partial tender offer by a preferred merger partner.

There is an open question as to how far a person or group may go in waging a proxy fight at a bank holding company without first filing an application with, and getting the approval of, the Federal Reserve. Both the Bank Holding Company Act and the Control Act regulate the acquisition of the power to vote securities as well as outright ownership. Both the Bank Holding Company Act and the Control Act, however, contain limited exemptions with respect to proxies. The Bank Holding Company Act provides that "[n]o company formed for the sole purpose of participating in a proxy solicitation is a bank holding company by virtue of its control of voting rights of shares acquired in the course of such solicitation." 12 U.S.C. § 1841(a)(5)(C). In addition, regulations promulgated under the Control Act similarly exempt the "acquisition of the power to vote securities of a state member bank or bank holding company through receipt of a revocable proxy in connection with a proxy solicitation for the purpose of conducting business at a [shareholders meeting] . . . if the proxy terminates within a reasonable period after the meeting." 12 C.F.R. § 225.42(a).

In a number of proxy contests, a target has attempted to challenge a dissident group's solicitation of proxies by claiming that the dissident group is a company or a "group acting in concert" that is seeking to exercise a controlling influence over the management or policies of the target and, thus, is exercising "control" within the meaning of Section 2(a)(2)(C) of the Bank Holding Company Act, 12 U.S.C. § 1841(a)(2)(C). Establishing control under Section 2(a)(2)(C) of the Bank Holding Company Act technically requires a determination by the Federal Reserve, after notice and an opportunity for a hearing. However, Federal Reserve staff often convey preliminary views on whether control concerns are presented. The views of the Federal Reserve staff as to whether a stockholder or group has a controlling influence over the target will be grounded in presumptions prescribed by regulation that depend on the percentage of voting shares held by the stockholder or group (<5%, 5-9.9%, 10-14.9% and 15-24.9%) and the presence of other indicia of control, including the number of representatives of the stockholder or group on the target's board of directors. At higher levels of a stockholder's or group's percentage ownership, there must be fewer indicia of control to avoid a control finding. Under the applicable rules, a stockholder or group is presumed to control a target if it controls 10% or more of any class of voting securities of a target and solicits proxies to appoint a number of directors that equals or exceeds a quarter of the total directors on the board of directors of the

target company. As a result of these rules, arguments that a dissident group is seeking to exercise a controlling influence over a target will be most compelling in situations where the insurgent group controls 10% or more of the voting securities of the target.

Where a dissident group controls more than 10% of the shares of any class of voting shares of a publicly reporting company or would become the largest shareholder there will be a rebuttable presumption that such group has control for purposes of the Control Act unless the group can establish that they are not acting as a "group acting in concert" within the meaning of the Control Act, and, thus, that their individual holdings should not be aggregated for Control Act purposes.

It is more difficult, however, for an existing bank holding company to conduct a proxy contest or consent solicitation to gain control of the board of another bank holding company without obtaining prior Federal Reserve approval under Section 3(a)(3) of the Bank Holding Company Act. Any such company also would need to convince the Federal Reserve that the proxy contest or consent solicitation would not result in its acquiring control of the target within the meaning of the applicable regulations and that the directors elected pursuant to any such contest would be independent of the insurgent institution until all necessary control approvals had been obtained.

The Dodd-Frank Act transferred supervision of savings and loan holding companies to the Federal Reserve effective July 21, 2011. On August 12, 2011, the Federal Reserve issued Regulation LL, its interim final rule which replaced the OTS Acquisition of Control Regulations with the Federal Reserve's established rules and processes with respect to control determinations. Regulation LL includes a proxy solicitation exemption consistent with that under the Control Act, providing that the Federal Reserve does not require prior notice of "the acquisition of the power to vote securities of a savings and loan holding company through receipt of a revocable proxy in connection with a proxy solicitation for the purpose of conducting business at a [shareholders meeting] . . . if the proxy terminates within a reasonable period after the meeting." However, with respect to the definition of a savings and loan holding company, Regulation LL does not exclude companies that acquire control of shares solely through a one-time proxy solicitation, as the Federal Reserve's Regulation Y does with respect to the definition of a Bank Holding Company. As a result, in the absence of further Federal Reserve rulemaking or guidance, in certain circumstances the ability to solicit proxies involving a thrift holding company may be more limited than would be the case for a bank holding company. For example, a company that solicits revocable proxies solely in connection with an annual or special meeting of a thrift holding company may be deemed to be a savings and loan holding company itself if it obtains proxies to vote more than 25% of the voting stock of the thrift holding company.

Most states also have statutes and regulations prohibiting the acquisition of "control" of a state bank or bank holding company without application to, and approval by, appropriate state officials. The definition of "control" used in these laws varies from state to state, and differs in many cases from the language of the Bank Holding Company Act and the Control Act. In the case of a bank holding company having banks in several different states, an insurgent may be faced with a complex situation, in which the authorities in each of these states must be persuaded that the proxy contest is permissible.

## VIII. SHAREHOLDER ACTIVISM AND THE BOARD'S ROLE IN COMBATING SHORT-TERMISM

Shareholder activism is an increasingly prevalent threat to public company boards, and financial institutions are not immune. Although activism can go hand-in-hand with hostile takeover attempts, discussed above, there is no doubt that short-term activism leads to increased discussion of deals. And institutions must increasingly gauge the likelihood of activist pressure not only as part of evaluating strategic deals, but also as part of their ordinary course operations and strategy more generally. Boards have a central role in anticipating and responding to shareholder activism and combatting short-termist pressures that threaten long-term value creation.

"Activist" is a label applied to a wide variety of investors and market participants by the media and market observers. Traditionally it usually meant corporate or governance "gadflies," whether individuals or labor unions or similar entities pursuing political or social objectives, but its usage has expanded to capture hedge funds pursuing financial objectives. This group runs the gamut from long-term holders with firmly held views about business strategies, to short-term traders (whether long or short) focused on nothing more than pushing an event that allows an exit with a quick gain. Financially motivated activism also includes funds whose actions, when examined closely, appear to be motivated by nothing more than marketing their fund to potential limited partners. Broad discussions about "activists" have a tendency to gloss over the complex and divergent motives of those bearing the moniker. The only clear, common thread uniting activists is outsized and increasing influence, bestowed by proxy advisors and a fawning press.

The sheer variety of motivations of activists approaching a financial institution stands in stark contrast to the clear fiduciary and legal duties of the directors sitting on its board. Our firm has long argued that a corporate board owes duties to stakeholders, and that a properly functioning board should reject attempts to force upon their corporation short-term agendas that jeopardize the achievement of sustainable, long-term value creation.[2] In a similar spirit, large institutional shareholders, such as BlackRock and Vanguard, which own a significant portion of the aggregate market capitalization of publicly traded U.S. banks, are vocal in encouraging the leaders of publicly traded corporations to adopt governance practices that create value for a broad set of stakeholders in order to generate long-term value for shareholders.

Importantly, directors of regulated financial institutions have fiduciary obligations established not only by state corporate law but also by state or federal regulation and supervisory guidance. Banks and other regulated financial institutions are expressly required by law to focus on the safety and soundness of their companies, their duties to the communities and customers, and the interests of their long-term shareholders. Because of their enhanced, multi-pronged set of duties, financial institution directors are likewise required by law to be highly skeptical of any external forces that demand excessive risk-taking, a financial restructuring unprompted by safety or soundness concerns or a radical change in corporate strategy. Any activist action or approach

[2] *See, e.g.*, "Thoughts for Boards: Key Issues in Corporate Governance for 2024," *available at* https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.28464.23.pdf.

that threatens the board's ability to comply with these duties must be examined closely and skeptically.

In the deal context, some short-term holders or event-based traders care nothing about the timing of a sale, whether conditions will produce an optimal outcome for long-term shareholders and other constituencies or whether there even exists a merger partner that is capable or interested. It is enough for these traders to foster rumors and speculation about a process or potential sale, which in turn produces short term gains and volume increases and provides an exit opportunity for all or part of the activist's position.

Boards that perceive the activist agenda for what it is can immediately recognize how dramatically it departs from their legal and regulatory obligations and respond accordingly. In the current environment, financial institution directors must strive to remain focused on their primary role as stewards of their institutions, their important legal mandates under regulatory regimes and their special responsibility to protect the interests of their institution's communities, customers and other constituencies. As has always been the case with financial institutions, attending to regulatory obligations, operating responsibly and actively engaging in long-term strategic planning will redound to the benefit of the long-term shareholders. Boards of financial services companies that remain true to these basic principles, and resist attempts to subvert their governance role, avoid potentially disastrous outcomes for all of the company's constituencies. Numerous banks have resisted activist efforts to co-opt the careful strategic planning of their board and management teams, in close communication with regulators.

In the end, companies led by management teams and boards of directors who are well prepared, who speak with one voice and are able to remain unified and resolute in the face of attack, will control their own destinies. Those who fail to live up to this standard — those who are too quick to settle or whose boards and management teams are driven apart by the public pressure of an activist and the commentary of proxy advisors — may find themselves quickly losing control of the governance of their institution.

## IX. THE M&A LITIGATION LANDSCAPE

Few public company M&A transactions are likely to proceed without some form of shareholder litigation. Distressed transactions, which may proceed at a discount to the market price of the target's securities prior to announcement, are particularly attractive to shareholder suits. Parties should expect claims under state fiduciary duty law and potentially the federal securities and ERISA laws and state appraisal statutes. In some instances, SEC enforcement investigations are possible. The litigation issues are complicated by increased judicial scrutiny of claims of attorney-client privilege. The litigation landscape for M&A transactions is surveyed briefly below.

### A. Fiduciary Duty Litigation

In the merger context, claims for breaches of fiduciary duty are common, and suits are often filed seeking not only to recover damages but to enjoin a pending merger on the grounds that the consideration being offered is somehow inadequate or that a higher price could be

procured from another buyer. These suits are generally brought under state law as class actions, and they raise concerns similar to litigation brought under the federal proxy rules.

Plaintiffs do not have to plead or prove that the alleged breaches were done with "scienter" as they would for claims brought under Rule 10b-5, and they can sue to enjoin the merger from taking place. Moreover, even if the claims are being litigated post-merger, the measure of damages is uncertain and susceptible to exaggerated analytics by plaintiffs' damages experts. The legal requirements directors face when considering a potential merger (*i.e.*, prior to the closing of the deal) are discussed in depth elsewhere in this chapter.

### 1. The End of Disclosure-Only Settlements in Delaware

Over the last several years, most public company mergers have resulted in class action litigation under state law asserting claims for breaches of fiduciary duties. At one time, the majority of these suits had been resolved by "disclosure-only" settlements, in which the target company makes supplemental disclosures related to the merger in exchange for a broad class-wide release of claims. In these settlements, the only money that changes hands is an award of fees for the plaintiffs' attorneys.

However, in 2015, the Delaware Chancery Court began to call into question this established practice for settling merger-related litigation. The court repeatedly expressed the view that supplemental disclosures generally appear to provide very little value to shareholders and questioned whether plaintiffs and their attorneys had investigated their claims sufficiently to justify such a broad release of all potential claims relating to a merger. Then in early 2016, the court rejected a disclosure-only settlement of a class-action lawsuit challenging the merger of Trulia and Zillow. *See In re Trulia, Inc. Stockholder Litig.*, C.A. No. 10020-CB (Del. Ch. Jan. 22, 2016). The court made clear that it "will be increasingly vigilant in scrutinizing" such settlements in the future. The court noted the "current ubiquity of deal litigation" and the "proliferation of disclosure settlements." Because such settlements "rarely yield genuine benefits for stockholders," the court held that its "historical predisposition toward approving disclosure settlements needs to be reexamined." The court concluded that claims challenging the adequacy of disclosures should generally "occur in an adversarial process," and not in the context of a settlement. Disclosure-only settlements are now "disfavor[ed]," the court stated, and are unlikely to be approved absent a "plainly material misrepresentation or omission" and a narrowly tailored release of claims.

The Chancery Court's rejection of disclosure-only settlements has had a noticeable impact on fiduciary duty litigation. The percentage of overall M&A deals subject to shareholder litigation has declined, and the Delaware Chancery Court has become much less common as a filing jurisdiction during the pendency of a merger as plaintiffs and their attorneys have sought other jurisdictions friendlier to disclosure settlements and more claims have been brought as post-closing damages claims. Many plaintiffs have attempted to recast their claims as federal disclosure claims, with a significant increase in federal M&A class action filings in the years following the *Trulia* decision. While the Seventh Circuit has responded by issuing an opinion adopting Delaware's *Trulia* standard, *see In re Walgreens Co. Stockholder Litig.*, No. 15-3799 (7th Cir. Aug. 10, 2016), other federal courts have been more receptive to such suits. Exclusive forum by-laws (which have been upheld by the Delaware Supreme Court and many other

jurisdictions) limit the ability of plaintiffs to forum shop, although they do not limit the ability of plaintiffs to bring federal securities claims in federal courts. A practice has also developed of settling disclosure-based claims brought in state or federal court by mooting the claims through supplemental disclosures that entitle the plaintiffs' lawyers to apply to the court for a "mootness" fee based on the materiality of the disclosures. These settlements do not entitle the defendants to a global release from stockholders and the amount of the mootness fee is typically significantly lower than the fees obtained by plaintiffs' firms in exchange for such global releases prior to *Trulia*. This is an area of law that will continue to evolve as courts and companies respond to creative tactics employed by plaintiffs' lawyers unwilling to concede a lucrative practice.

### 2. Post-Closing Damages Claims

As noted above, one tactic employed more commonly by plaintiffs' lawyers in response to the limitations on disclosure-only settlements has been to bring fiduciary duty damages claims *after* the merger closes. Fiduciary duty claims against directors of large, widely held public companies are most likely to arise based on one of two theories. The first is that the board breached its fiduciary duty of care in approving a merger (which can include duties under *Revlon* or *Unocal*, *see In re Santa Fe Pacific Corp. Shareholder Litigation*, 669 A.2d 59 (Del. 1995)). The second is that a board breached its fiduciary duty by failing to provide shareholders with complete and accurate material information concerning the transaction.

The seminal duty of care case in the merger context is *Smith* v. *Van Gorkom*. The court held that directors can be personally liable for the difference between the merger consideration and a judicially determined fair price for the company for agreeing to a merger transaction without appropriate review and consideration of whether it was in the best interests of shareholders. The facts of *Smith* were extreme: the court found that the directors approved a transaction proposed by management upon two hours' consideration, without prior notice and with only an oral summary of the proposed transaction. In the wake of *Smith*, the Delaware legislature amended the corporate statute to provide that a corporation's charter can eliminate the personal liability of a director for money damages for breaches of the duty of care. Since *Van Gorkom*, the Delaware Supreme Court has held that a claim for damages against independent, disinterested directors of corporations with exculpatory charter provisions under § 102(b)(7) must be dismissed absent allegations of disloyalty or bad faith — even in controlling stockholder cases and no matter what standard of review (including *Revlon* duties or entire fairness) governs the challenged transaction. *See In re Cornerstone Therapeutics Inc. Stockholder Litig*., No. 564, 2014 (Del. May 14, 2015). (This statutory protection is available only to directors and not to corporate officers. Individuals who serve in both capacities are eligible for protection as directors, unless it can be shown that their acts were undertaken solely in their capacity as an officer.) However, statutory exculpation is not available for breaches of the duty of loyalty or good faith.

Failure to provide shareholders with all material information concerning a transaction on which the shareholders are asked to decide, without more (*e.g.*, negligence, causation or reliance), may amount to a breach of that duty entitling a plaintiff to at least nominal damages. *See Malone* v. *Brincat*, 722 A.2d 5, 12 (Del. 1998); *see also Arnold* v. *Society for Savings Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994); and *Stroud* v. *Grace*, 606 A.2d 75 (Del. 1992). Although the duty of candor has been described as emanating from the "duty of loyalty" prong of

a director's fiduciary duty, it is now well-established that the exculpation provision of the Delaware statute eliminates personal monetary liability for directors for disclosure failures, absent a showing of bad faith. *Arnold*, 650 A.2d at 1287.

As discussed above, in *Corwin* and cases following it, the Delaware Supreme Court held that the when a third party merger is approved by an uncoerced and informed vote of disinterested stockholders, the business judgment rule is the appropriate standard of review and dismissal is typically the result. *Corwin* v. *KKR Fin. Holdings LLC*, No. 629, 2014 (Del. Oct. 2, 2015) (en banc). *See also Singh* v. *Attenborough*, No. 645, 2015 (Del. May 6, 2016) (en banc) and *In re Solera Holdings, Inc. Stockholder Litig.*, C.A. No. 10485-CB (Del. Ch. Jan. 5, 2017). Not surprisingly, the plaintiffs' bar has objected to this new obstacle and has persistently attacked the sufficiency of disclosures, raising novel claims that stockholder approvals were "coerced." And in circumstances that some observers considered surprising, the courts have allowed several such cases to survive motions to dismiss and proceed to the discovery stage where they acquire vast settlement value. Transaction planners should recognize that *Corwin* has some limits and expect some unpredictability as the doctrine is ironed out in the court, and they should draft disclosure documents with an eye toward negating the inevitable claims that material information was omitted.

## B. Appraisal Litigation

Appraisal proceedings arise under state statutes which provide dissenting shareholders in a merger who follow certain procedural hurdles with the opportunity to opt out of receiving the merger consideration and instead have a court determine and award the "fair value" of their shares in a proceeding following the closing. A significant portion of post-merger appraisal litigation has been brought by hedge funds pursuing an investment strategy known as appraisal arbitrage, where the funds take significant share positions following the announcement of a merger solely for the purpose of bringing an appraisal action. In Delaware, the relatively high statutory interest rate (5% above the Federal Reserve funds rate, compounded quarterly that runs from the effective date of the merger to the date of payment of the appraisal award) provided an incentive for hedge funds to gamble on appraisal actions when prevailing market interest rates were lower. In addition, appraisal has been a mechanism used by some plaintiffs' attorneys following the limitation on disclosure-only settlements.

However, a spate of recent appraisal decisions has reshaped the playing field. In *DFC*, the Delaware Supreme Court stressed the significance of "real world evidence" and held that the Court of Chancery should defer to the market's view of value rather than a "guess" by a valuation expert hired by a party to the litigation. *See DFC Global Corp.* v. *Muirfield Value Partners, L.P.*, No. 518, 2016 (Del. Aug. 1, 2017). In *Dell*, the Delaware Supreme Court reiterated these points and strongly suggested that the price paid by a third party in a transaction should act as a ceiling in an appraisal valuation: "Fair value entails at a minimum a price some buyer is willing to pay — not a price which no class of buyers in the market would pay" and also emphatically rejected the concept of a "private equity carve-out" for market evidence. *See Dell, Inc.* v. *Magnetar Global Event Driven Master Fund Ltd.*, No. 565, 2016 (Del. Dec. 14, 2017) (en banc). Finally, in *SWS*, the Court affirmed the decision by the Court of Chancery to value SWS 8% below the merger price due to the synergies reflected in the merger price that are not included in appraisal claims. *See Merlin Partners, LP* v. *SWS Group, Inc.*, No. 295, 2017 (Del.

Feb. 23, 2018). Similarly, the Court of Chancery approved discounts to the merger price in two other significant cases. *See In re Appraisal of AOL Inc.*, C.A. No. 11204-VCG (Del. Ch. Feb. 23, 2018) and *Verition Partners Master Fund Ltd.* v. *Aruba Networks, Inc.*, C.A. No. 11448-VCL (Del. Ch. Feb 15, 2018). These decisions indicate that an investor who does not want to be a long-term stockholder in the target but instead buys shares only to pursue a lawsuit, cannot confidently be expected to be rewarded in an appraisal. These cases may thus be an important step along the way to limiting most appraisal litigation to private company transactions and controller squeeze-outs — the context to which, as many have argued, it should be confined. The Delaware legislature has also acted to limit the availability of the appraisal remedy in certain circumstances, promulgating 2016 amendments to Delaware law that establish a *de minimis* threshold for appraisal actions and that enable a surviving corporation to stop the accrual of statutory interest by making prepayment to a dissenting stockholder prior to a court's final determination.

## C. Securities Fraud Class Actions

### 1. The PSLRA

In 1995, Congress passed the PSLRA with the intent of preventing "strike suits" (meritless class actions brought to harass corporate defendants and their officers into settling) and of curbing widespread manipulation of securities class actions by "professional" plaintiffs and their lawyers.

The PSLRA is intended to make it easier for courts to dismiss frivolous securities fraud claims brought under the Exchange Act, including claims under Rule 10b-5, at an early stage of the litigation. To survive dismissal, a Rule 10b-5 complaint must include particular details about the alleged fraud, including explanations of how specific disclosures were materially inaccurate and particularized facts creating a "strong inference" that those disclosures were deliberately inaccurate. *See* 15 U.S.C. §§ 78u-4(b)(1), (b)(2). Federal courts of appeals initially divided over the meaning of the "strong inference" standard — and in particular, whether it allowed district judges to weigh culpable inferences against innocent ones. In *Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007), the Supreme Court endorsed the stricter reading of the statute, ruling that, to survive a motion to dismiss, a securities fraud plaintiff must plead facts establishing a "*cogent and compelling*" basis to conclude that the defendants intended to deceive. When lower courts rule on motions to dismiss, they must now "consider plausible *non*culpable explanations for the defendants' conduct." Pleadings must raise an inference of scienter that is more than merely "reasonable" or "permissible"; the inference must be "strong in light of" innocent explanations.

In addition, the PSLRA created a safe harbor from securities fraud liability for forward-looking statements. 15 U.S.C. § 78u-5; 15 U.S.C. § 77z-2. Fraud claims that are premised on nothing more than management's forward-looking projections that turn out to be mistaken will generally not survive a motion to dismiss. However, the Seventh Circuit has allowed discovery into whether the cautionary statements that accompanied forward-looking statements adequately reflected the actual risks faced by the company at the time the statements were made. *See Asher* v. *Baxter Int'l, Inc.*, 377 F.3d 727 (7th Cir. 2004). While a motion to dismiss is pending, the PSLRA gives defendants a reprieve from discovery. 15 U.S.C. § 78u-4(b)(3)(B); 15 U.S.C. §

77z-1(b)(1). This stay prevents plaintiffs with frivolous lawsuits from imposing costly discovery on corporate defendants until they have met their pleading burden.

However, the obligation to preserve documents and information relevant to the lawsuit remains in place while the motion to dismiss is pending. Furthermore, the discovery stay provision of the PSLRA has come under pressure, with some courts lifting the stay to permit discovery of documents produced in parallel proceedings, such as governmental investigations or even ERISA class actions. Given the upward trend of SEC and DOJ investigations, these decisions, if generalized, could render the "filtering" function of the PSLRA meaningless in many instances.

The Securities Litigation Uniform Standards Act (SLUSA) took a step further by preempting standards in securities fraud claims brought under state law while limiting many other kinds of fraud claims to federal court. 15 U.S.C. § 78bb(f); 15 U.S.C. § 77p(b)-(d). The SLUSA also grants federal courts the power to stay discovery in a non-preempted state proceeding where ongoing discovery would circumvent the stay imposed by the PSLRA. *Id.* § 78u-4(b)(3)(D); 15 U.S.C. § 77z-1(b)(4); *see Newby* v. *Enron Corp.*, 2002 WL 1001056, at *2-3 (S.D. Tex. May 1, 2002).

The SLUSA specifically bars private parties from maintaining in-state or federal courts class actions based upon state law that allege "a misrepresentation or omission of a material fact in connection with the purchase or sale" of nationally traded securities. The plain language left open the question of whether the SLUSA preempts state-law class actions in which the class members seek damages caused by their retention (rather than purchase or sale) of securities in reliance on alleged misrepresentations and omissions that coincided with any purchases or sales of securities during the class period. In early 2006, the Supreme Court resolved the question — and a split among the circuits — in *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Dabit*, 547 U.S. 71 (2006), ruling unanimously that "holder" actions were preempted by the SLUSA. The Court specifically reasoned that allowing duplicative state court litigation would undermine Congress's purpose of achieving "national standards for securities class action lawsuits involving nationally traded securities." *Id.* at 1514. The Court thus evidenced an unwillingness to allow litigation tactics to funnel cases involving the national securities markets into state courts. The Class Action Fairness Act of 2005 (which does not apply to securities cases governed by SLUSA) seeks to assure that most nationwide class actions based on state law are litigated in federal rather than state court. It provides for appellate review of orders remanding those actions to state courts, providing the Courts of Appeals with opportunity to determine whether and to what extent class actions survive in state courts.

For the most part, the PSLRA's provisions have been effective. Courts of Appeal have strictly applied *Tellabs*'s "strong inference" pleading standard, and made clear that securities fraud complaints will be dismissed unless the allegations show that senior corporate officers intentionally or recklessly misled investors about matters that reasonable investors would find material. *See ECA* v. *JP Morgan Chase Co.*, 553 F.3d 187 (2d Cir. 2009); *Zucco Partners, LLC* v. *Digimarc Corp.*, 552 F.3d 981 (9th Cir. 2009). Misjudgments, misplaced optimism, misconduct by less senior employees and accounting mistakes do not suffice.

Congress also sought to end the practice of allowing "professional" plaintiffs to drive securities fraud class actions by including new procedures in the PSLRA for selecting a lead plaintiff to represent the shareholder class. The process, which lasts approximately three months from the filing of the initial complaint (and often longer), requires plaintiffs to publish notice of the suit in a widely circulated, business-oriented publication and to invite class members to move to be appointed lead plaintiff. 15 U.S.C. § 78u-4(a)(3)(A); 15 U.S.C. § 77z- 1(a)(3)(A). Courts are then charged with appointing a lead plaintiff based on which plaintiff would most adequately represent the class' interests, which is presumptively the plaintiff with "the largest financial interest in the relief sought by the class," *id.* § 78u-4(a)(3)(B)(i), (iii)(bb); 15 U.S.C. § 77-1(a)(3)(B)(I), (iii)(bb), not on which entrepreneurial plaintiff filed the first complaint. Through these provisions, Congress sought to have sophisticated institutional investors who would be better equipped to oversee class counsel and control the litigation.

Because the precise market effect of a specific public disclosure is so difficult to measure, calculation of damages in these cases remains unsettled, particularly because securities fraud cases rarely go to trial. The PSLRA does, however, include a limitation on damages for cases brought under the Exchange Act based on the market price of a traded security. Premised on the assumption that a temporary drop in share price following a disappointing announcement should not provide the basis for a fraud claim, the PSLRA limits liability to the difference between the price paid for the stock and the average closing price of the shares during the 90-day period following the announcement. *See* 15 U.S.C. § 78u-4(e). If the stock bounces back from the initial drop for most of that 90-day period, then damages would be reduced significantly.

As noted above, there have been a record number of federal filings associated with mergers and acquisitions following the repudiation of disclosure-only settlements in Delaware.

#### 2. Fraud-on-the-Market Presumption of Reliance

In *Halliburton Co.* v. *Erica P. John Fund, Inc.*, 573 U.S. 258 (2014), the Supreme Court declined to discard the fraud-on-the market presumption of reliance that applies in class actions under Section 10(b) of the Exchange Act and Rule 10b-5. The fraud-on-the-market presumption makes possible the certification of massive Section 10(b) class actions by eliminating the need for plaintiffs to individually prove reliance on alleged misstatements in cases involving securities that trade on "efficient" markets. *Halliburton* was not a complete loss for issuers, in that the Court held that the court of appeals had erred in refusing to allow Halliburton to defeat class certification by demonstrating that the alleged misstatements had no effect on price. Allowing defendants to rebut the presumption where there is no price impact will certainly help to get rid of some cases with dubious claims of damages, but in most cases plaintiffs are likely to be able to plausibly claim some price impact.

#### 3. Securities Fraud Litigation in the Merger Context

In a typical friendly merger, shareholders vote pursuant to a proxy statement or proxy statement/prospectus (in the case of a transaction involving stock consideration). This implicates securities law provisions with lower hurdles to establishing liability than Rule 10b-5. Moreover, unlike typical company reports such as reports on Forms 10-Q and 10-K for which a company generally does not have a duty to provide updates between required annual, quarterly or 8-K

filings, a company with an outstanding proxy statement/prospectus must confront the question of whether intervening events require an update between the time of issuance and the time of the vote.

*Proxy Laws*. Proxy statements are governed by Section 14 of the Exchange Act and applicable rules, in particular Rule 14a-9. While the issue has never been fully resolved, merger parties should expect that a "negligence" standard will be applied to privately challenged misstatements in a proxy. *See Gerstle* v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) (Friendly, J.). The negligence standard differs from the "scienter" requirement in the typical securities class action brought under Rule 10b-5. For scienter, a shareholder plaintiff must allege facts raising a strong inference and eventually prove that a company knew its statements to be false or was reckless in not knowing. Negligence does not require knowing conduct or recklessness.

Proxy plaintiffs also benefit from a presumption of causation (*i.e.*, that the misstatement caused the merger to be approved). In *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970), the Supreme Court held that "[w]here there has been a finding of materiality, a shareholder has made a sufficient showing of a causal relationship between the violation and the injury for which he seeks redress if . . . he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction." *Id.* at 377. The effect of this rule is to free proxy plaintiffs from having to demonstrate that a merger would not have passed if a proxy had been accurate. Even if it is clear that a merger would have passed overwhelmingly, liability may therefore still lie for a material misstatement in the proxy.

*Tender Offers*. The general anti-fraud provision that governs tender offers is Section 14(e) of the Exchange Act. The Supreme Court recently agreed to review the Ninth Circuit's determination that only negligence is required to state a Section 14(e) claim in a claim brought by a plaintiff to enjoy a merger transaction styled as a tender offer, in contrast to six other circuits, which require scienter. *Emulex Corp.* v. *Varjabedian*, No. 18-459 (U.S.). However, when the Court dismissed the case on the grounds that the writ of certiorari was improvidently granted, some observers speculated that the Court would have gone further to hold that there is no private right of action at all under Section 14(e), as we argued in an amicus brief submitted to the Court by the United States Chamber of Commerce, but that the Court felt the question was not properly before the Court.

*Securities Act Regulations*. If a registration statement/prospectus is required to accomplish a merger, Sections 11 and 12(a)(2) of the Securities Act will also be implicated.

Section 11 creates strict liability for an issuer of a materially misleading registration statement/prospectus. No knowledge, recklessness or even negligence needs to be pleaded or proven in order for plaintiffs to prevail as long as they can show that the registration statement/prospectus was materially misleading. Perhaps even more importantly, Section 11 or 12(a)(2) complaints do not have to meet the PSLRA's strict pleading requirements.

*Damages*. Assessment of potential damages also becomes skewed in the merger context. Because mergers may affect the entire shareholder body of both companies, the potential exposure may be very large. For example, two companies, each with 100 million shares

outstanding, face $20 million in exposure for every dime of per-share damages. And the precise measure of damages under the proxy laws is uncertain. As Judge Friendly put it, the courts' role is to "do their best to achieve fair compensation for injured plaintiffs without being too draconian on defendants." *Gerstle*, 478 F.2d at 1304. Because stock market volatility can result in significant price drops after the slightest bit of bad news, plaintiffs may be able to generate expert reports claiming hundreds of millions of dollars in damages based on simplistic analysis.

Under the Securities Act, however, there are very strict rules governing damage calculations. Those provisions generally set damages by a statutory formula based on the difference between the amount paid and the value at the time of the lawsuit. Recovery is barred to the extent that a defendant proves that the loss is caused by something other than the alleged misrepresentation.

### D. ERISA Litigation

In recent years, class-action plaintiffs seeking to circumvent the stringent requirements of the PSLRA and driven out of state court by SLUSA have repackaged their securities fraud claims into ERISA claims for breach of fiduciary duty under 29 U.S.C. §§ 1109 and 1132(a)(2). Prominent examples include *Tittle* v. *Enron Corp.*, No. 01-CV- 3913 (S.D. Tex.) and *In re WorldCom, Inc. ERISA Litigation*, No. 02-CV-4816 (S.D.N.Y.).

These hybrid ERISA/securities claims arise in relatively narrow, but not uncommon, circumstances, and are filed against a variety of defendants, including the company, board members and/or members of the ERISA plan's administrative committees. The plaintiffs generally are employee participants in a 401(k) or another retirement plan that invests in the employer's stock. When a disappointing earnings disclosure or other revelation causes the price of the employer's stock to drop precipitously, the participants allege that the defendants have breached their fiduciary duties by (1) misleading them with respect to the value of company stock, (2) failing to prudently invest plan assets and/or (3) failing to monitor the fiduciaries charged with making investment decisions. The Supreme Court in *Fifth Third Bancorp* v. *Dudenhoeffer*, 573 U.S. 409 (2014), rejected the argument that the fiduciaries of an ESOP are entitled to a "presumption of prudence" with respect to their decisions to hold or buy employer stock but laid out an alternative path for courts to protect ESOP fiduciaries from "meritless, economically burdensome lawsuits" by requiring a plan participant's claim that ESOP fiduciaries breached their duty of produce to be based on plausible factual allegations from which a reasonable inference of liability could be drawn in order to survive a motion to dismiss. Participants have also sued for failure to prudently invest plan assets in cases where the employer's stock has consistently declined in price over an extended period of time.

### E. SEC Investigations and Enforcement Actions

The SEC enforcement division has aggressively pursued both formal and informal investigations, paying particular attention to accounting issues. The Sarbanes-Oxley Act imposed a wide array of additional obligations on issuers. The initiation of an investigation should be met with care and diligence since the failure to produce subpoenaed documents to government regulators in a timely manner can, by itself, give rise to liability, independent of the primary matters under investigation.

Coordinating the handling of an SEC enforcement investigation and civil litigation is very important. Shareholder plaintiffs seek to piggyback on these investigations by demanding transcripts of SEC testimony or any memos or submissions made to the SEC. Although there are precedents suggesting that a company can share attorney work product with the SEC without waiving that privilege, the weight of the authority is to the contrary. Counsel must also be sensitive to collateral effects. For example, resolution of an SEC enforcement action under the antifraud provisions of the securities laws by means of a consent order will preclude the company from relying on the PSLRA's safe harbor for forward-looking statements for a period of three years from the date the decree is entered. Similarly, a financial holding company might lose its special powers under the Gramm-Leach-Bliley Act because of a determination that its management practices were deficient.

Whether initiated by a U.S. Attorney, the SEC, bank regulators or otherwise, many formal and informal investigations are nonpublic and confidential. Regulators conduct numerous informal inquiries and many of them do not result in any finding of legal violations, sanctions or adverse regulatory action. Before disclosing the existence of any active inquiry or investigation to third parties, whether to other government regulators, to potential merger partners or to the public, the company must thoroughly consider the issues under investigation, the results and adequacy of any internal investigation of the issues, whether or not there is in fact a reasonable likelihood that material violations will be found and the materiality of any such violations to the company. For this reason, the mere initiation of a formal investigation or receipt of a "Wells notice" from the SEC is not necessarily required to be disclosed, absent a full consideration of the relevant circumstances. In the event that a decision is made to disclose the investigation, care should be taken to ensure that the scope, substance and significance of the investigation are not described in a misleading way. Full disclosure is not the same thing as over-disclosure, which can itself be misleading and have unnecessary negative effects on a company and its shareholders. Accordingly, the possible effects of any public disclosure should also be considered in the mix of relevant facts, and counsel should be consulted to help the company weigh the relevant legal considerations.

### F. Document Retention and Preservation

Once litigation or a regulatory investigation has commenced (indeed, in some cases when reasonably anticipated), and certainly once a document request or subpoena is received, a team of lawyers, with appropriate support personnel from the company's electronic data operations (and outside vendors as needed), should ensure the proper retention and production of documents. Very early in the process, personnel with potentially relevant documents should be directed in writing to preserve all relevant documents. Since the company may be called upon to establish that it fully complied with its obligations to preserve and produce relevant materials, records of compliance should be maintained. A 2005 decision by the judge presiding over Ron Perelman's fraud action against Morgan Stanley (arising out of the Sunbeam/Coleman merger) to instruct the jury that it should assume that Morgan Stanley helped defraud Mr. Perelman due to Morgan Stanley's (apparently rather extreme) failure to provide required documents, and the 2004 conviction of Frank Quattrone (reversed in March 2006 by the Second Circuit) underscore that the failure to take proper steps to preserve and retrieve documents can have dire consequences. *See also Zubulake* v. *UBS Warburg LLC*, No. 02-1243, 2004 WL 1620866, *15 (S.D.N.Y. July 20, 2004) (instructing a jury that it can infer from a defendant's failure to

preserve e-mail back-up tapes that the lost e-mails would have contained information adverse to the defendant).

Careful attention should also be paid to the preservation and production of electronic documents, such as e-mails, and to computer back-up tapes, which can be inadvertently erased and replaced with new information if care is not taken to preserve them at an early stage. Data management practices should be governed by well-documented protocols for the regular retention and deletion of electronic records. These protocols should be designed to address reasonable document retention practices and legal requirements. Once an investigation or proceeding has been commenced, consideration should be given to suspending any automatic or periodic deletion of electronic data.

In addition to preserving the actual documents, special care should be taken in the course of producing documents to protect any and all relevant privileges. These include the attorney-client and attorney work-product protections (protections that a company may ultimately decide to waive as part of its cooperation with investigators) as well as those covering bank examination materials. The protections for bank examination materials under federal and state law belong to the bank regulators and those regulators must be notified when a request for those bank examination materials are received. *See* 12 C.F.R. §§ 261.2(c), 261.20(g).

# CHAPTER 4.

# FINANCIAL INSTITUTION ACQUISITION AGREEMENTS: STRUCTURAL AND CONTRACTUAL ISSUES

The operative provisions of an acquisition agreement are largely shaped by the structure of, and significant deal issues in, the transaction at hand, and the representations, covenants, closing conditions and other terms need to be tailored to the specific situation.

Acquisition agreements for some types of financial institutions (such as investment management firms, broker/dealers and insurance companies) raise their own distinct sets of issues, and are discussed in more detail in Chapter 6. Moreover, different considerations may come into play depending on whether the acquirer is a strategic or financial acquirer.

## I. STRUCTURAL ALTERNATIVES FOR MERGERS AND TENDER OFFERS

### A. Mergers

As with any business combination, the deal structures available for a financial institution merger transaction are numerous, including, among others:

- a merger of the parent holding companies;
- a reverse triangular merger of a newly formed merger subsidiary of the acquirer with and into the target company where the target company survives as a subsidiary of the acquirer;
- a forward triangular merger where the target company is merged with and into a newly formed merger subsidiary of the acquirer where the merger subsidiary survives; and
- the formation of a new holding company into which both companies are merged, either directly into the holding company or with or into separate merger subsidiaries of the holding company.

Tax considerations usually drive the choice of structure to a significant degree. Many variations on these basic structures are possible and are driven by the particular circumstances of the deal. For example, an acquisition is usually for 100 percent of the equity of the target, but need not be. When less than all the equity is acquired, additional considerations may come into play, including takeover statutes and other state laws. When The Toronto-Dominion Bank acquired 51% of Banknorth Group, Banknorth first reincorporated from Maine to Delaware via a merger with a newly formed Banknorth subsidiary. Then, a subsidiary of Toronto-Dominion merged with and into Banknorth (with Banknorth surviving). In the merger, each Banknorth share was converted into a package of consideration that included Toronto-Dominion common shares, cash and an ongoing equity interest in the acquired entity. The reincorporation step was taken because Delaware corporate law made the partial ownership structure more favorable. (Toronto-Dominion later purchased the remaining public shares in TD Banknorth.)

When a party is organized under the laws of a foreign country, the compatibility of that jurisdiction's laws with U.S. merger concepts must be considered. BBVA structured its acquisition of Compass Bancshares, Inc. using multiple mergers, including two reincorporation steps. In this case, the structure was driven by the legal recognition of a merger under a foreign jurisdiction's laws. Compass, a Delaware corporation, first reincorporated to Virginia (which, unlike Delaware, provides for statutory compulsory share exchanges as alternatives to mergers) by merging into a newly formed Virginia subsidiary. BBVA then completed a statutory share exchange to acquire 100% of the reincorporated Compass and effected a merger of the reincorporated Compass into a newly formed Texas subsidiary of BBVA. Similar "double merger" structures can also be useful where the parties, for various reasons, do not wish to use a reverse merger to acquire some of the attributes (*e.g.*, state of incorporation) of the target.

There are other instances in which the transaction structure may be dictated by one party having certain attributes that the parties wish to maintain after the merger by having such party survive as a legal entity, regardless of which party is the nominal "acquirer." For example, in the First Nationwide/Golden State transaction, First Nationwide, a privately held corporation, merged into Golden State to take advantage of Golden State's already listed and widely held common stock. There may be other reasons to favor a particular transaction or merger structure, such as the impact of anti-assignment or change-of-control triggers under existing contracts and the necessity of a shareholder vote.

The use of cash and stock will change over time with views of capital adequacy and the relative cost of equity. While all-stock transactions continue to be prevalent, particularly among larger transactions and mergers of equals (discussed in greater detail in Chapter 7), significant cash components had become a common feature in bank deals (although even deals with significant cash components have generally continued to be structured as reorganizations for tax purposes), including Wachovia's $25 billion acquisition of Golden West, Capital One's $15 billion acquisition of North Fork Bancorporation, PNC's $6 billion acquisition of Mercantile Bankshares, Bank of America's $35 billion acquisition of MBNA, Washington Mutual's $6.5 billion acquisition of Providian and BBVA's $9.6 billion acquisition of Compass Bancshares. In general, the stock portion of the consideration paid in bank mergers is structured to be tax-free to target shareholders. Tax-free structure may, however, not be possible (*i.e.*, if transaction does not satisfy specific tax law requirements as described below) or not desirable for other non-tax considerations. In addition, all-stock deals may be made taxable as well. The JPMorgan Chase/Bear Stearns and M&T/Wilmington Trust mergers were all-stock deals structured as taxable transactions, in view of the merger price being substantially below the targets' trading levels during the period preceding the transaction.

Notwithstanding post-Dodd-Frank enhanced capital requirements, cash consideration can be expected to persist, likely concentrated in smaller transactions. This is particularly true where an all- or part-stock deal might have taken longer to complete or involved added complexity. With many institutions subject to close regulatory scrutiny of dividends and repurchases, appropriate use of cash in acquisitions is another potential avenue to deploy excess capital. Foreign acquirers without a U.S.-registered or listed currency in particular may want to rely on all-cash transactions.

In some situations, issuing stock as all or even part of the merger consideration is not practical. This may be true in acquisitions of subsidiaries of other corporations, though some sellers have accepted a portion of the consideration in acquirer stock such as in Morgan Stanley's sale of its Van Kampen unit to Invesco Ltd. and ING Groep N.V.'s sale of its ING Direct business in the United States to Capital One. Cash is generally the choice where the acquirer is not itself a publicly or widely traded entity or is a foreign bank holding company, such as in Mechanics Bank's all-cash acquisitions of California Republic Bancorp in 2016 and Learner Financial and its Scott Valley Bank subsidiary in 2018, or the CAD$13.5 billion all-cash acquisition by Royal Bank of Canada of HSBC Bank Canada in 2022. Where a seller takes acquirer stock as part of the consideration for sale of a subsidiary or asset, it is usually important to structure the position so that it does not give the seller "control" of the acquirer for bank regulatory purposes.

In some instances, foreign acquirers reported having been reluctant to issue stock due to concerns about "flow back," the anticipation that institutional shareholders in a U.S. target (*e.g.*, index funds) will not wish or may not be permitted to own foreign-based stock issued in the merger and will sell their shares, causing them to flow back into the home country and negatively impact the price and, therefore, the deal value. However, as demonstrated by numerous deals — several Canadian deals including CIBC's part-stock $5 billion acquisition of PrivateBancorp, Royal Bank of Canada's $5.4 billion part-stock acquisition of City National, Bank of Montreal's $4.1 billion all-stock acquisition of Marshall & Ilsley; and others including BBVA's $9.6 billion part-stock acquisition of Compass Bancshares and HSBC's $15 billion all-stock acquisition of Household International — non-U.S. acquirers with an established U.S. stock currency will be willing to use that currency for the right transaction.

Flow back and other concerns have from time to time motivated parties considering cross-border acquisitions to consider alternate ways to combine, such as so-called "dual pillar" structures. In a dual pillar structure, the parties remain legally distinct entities with separate stocks that continue to trade in their respective home countries (and continue to be eligible for inclusion in the major stock indices in those countries), the idea generally being that although the stocks are not combined legally and continue to trade separately, they are to be economic equivalents of one another. Instead of a legal combination, the parties are bound together by contractual "equalization" arrangements and amendments to the charter and by-laws of each institution that usually provide for, among other things, identical boards of directors, a unified management structure, cross-guarantees of indebtedness and ability of both sets of shareholders to vote on matters presented to either company's shareholders for a vote. While the antecedents of dual pillar structures go back about a century, they remain relatively scarce, especially in the U.S. Several non-U.S. financial institutions have used the structure, but most have ultimately gone on to full legal unification and a single stock. Issues cited in collapsing the structures into fully unified entities have included pricing and trading disparities that develop between the shares of each of the two companies as well as difficulties in integrating the two businesses and making further acquisitions.

Companies considering a dual pillar structure also need to focus on a host of other potential issues, such as the need to reconcile regulatory, corporate and securities laws of different jurisdictions, as well as making sure they have a thorough understanding of the possible tax treatment in each jurisdiction of the transaction, the entities involved and likely future

corporate actions, such as dividends and distributions. Other novel structures that may address flow back and related "sovereignty" issues are conceivable, but all need to be thoroughly vetted with respect to governance, tax, regulatory, operational and other potential concerns.

For non-U.S. acquirers whose stock does not trade in the U.S. and who do not report results in the United States, timing and the desire to avoid reporting obligations under U.S. securities laws may be a factor favoring cash consideration. This was the approach taken by Mitsubishi UFJ in acquiring Pacific Capital Bancorp.

In many instances where cash is used as the acquisition consideration, the acquirer will need to raise additional capital prior to, or concurrently with, the consummation of the acquisition. The need to raise equity capital other than through the issuance of shares in a merger can present logistical and strategic challenges, including concerns regarding the allocation of market risk between the time at which the definitive terms of the acquisition are negotiated and the time of closing. Standalone conditions in a merger agreement relating to financing are rare and may expose the primary deal to risk allocation in the financing agreements, where key terms may be defined differently than in the merger agreement (*e.g.*, lender outs for global adverse changes in credit or capital markets are often found in debt financing agreements) and are of particular importance in private equity transactions. In many cases merger agreements and financing agreements will contain identical key terms and conditions in order to mitigate such risks. Agreements for private equity acquisitions of banks will generally be structured differently from private equity deals in other industries due to the absence of debt deal financing on account of regulatory capital requirements. Moreover, the need for equity financing can require careful attention to provisions in the acquisition agreement governing timing of closing. Acquirers planning to finance all or a portion of the acquisition consideration through a rights offering, for instance, may need to keep the offer open for a minimum period of time and/or obtain separate regulatory approval for the rights offering.

Even in all-stock deals, the parties must be alert to provisions that can function as "financing outs" under certain circumstances. As an example, it is common to see a bank merger agreement contain a best-efforts provision that is qualified by stating that an acquirer is not required to agree to a "materially burdensome condition" to obtain the necessary regulatory approvals. In many cases, such provisions were understood as limiting an acquirer's divestiture risk where a deal raised potential antitrust issues. However, the provisions are usually not, by their terms, limited to divestiture requirements. In times when regulators remain focused on capital and meeting capital expectations is more of a dialog than a numerical target, such provisions could arguably operate to limit the acquirer's obligation to raise additional capital or take other required steps in order to obtain regulatory clearance.

### B. Tender Offers

Where regulatory approvals can be obtained on a faster basis than a shareholder vote can be obtained or where formal prior approval by a bank regulator is not required, the tender offer structure offers the potential to avoid the other time-consuming step in consummating most public company bank deals: a shareholder meeting to vote on the merger, with related proxy statement filings and potential review by the SEC (although the timing benefits of a tender offer structure have, to a certain extent, been diminished as the SEC has recently reduced the

proportion of merger proxy statements and related S-4 registration statements that are subject to full SEC review). This structure, most common in the non-bank sector, is sometimes a viable alternative to the single step merger for both strategic and private-equity transaction structures, and is discussed in Chapter 6.

## II. FACTORS INFLUENCING CHOICE OF STRUCTURE

### A. Capital Requirements

Because payment in cash (or debt securities) has the effect of diminishing capital and stock repurchases can be used to manage the dilution of a stock deal (subject to regulatory approvals and securities law restrictions such as Regulation M), stock is often the primary consideration paid in financial institutions transactions of substantial size. Cash deals are often seen when speed of consummation is an issue, where a deal involves a cross-border component, or where there is a significant size disparity between the parties. Part-stock, part-cash structures, particularly in mid-sized transactions, have also been prevalent as companies seek to optimize capital management, pro forma earnings accretion, return on equity and other factors. However, stock and stock value is still key to many significant acquisition programs. Officers of financial institutions with a history of acquisitions speak of their organizations' stock as their "currency" and carefully analyze the effect that a particular transaction will have on that currency. Relative earnings multiples will often define who is an acquirer and who is a target.

It is advisable for an acquirer to develop a close and open relationship with the Federal Reserve concerning the adequacy of its capital position in light of its acquisition strategy. There is no bright line test for the level of capital that the Federal Reserve will require of acquirers, and capital adequacy is tested on a case-by-case basis. The general policy enunciated by the Federal Reserve is that bank holding companies planning "significant expansion proposals" must have strong capital ratios "substantially above" regulatory minimums (12 C.F.R. part 217), and in practice the Federal Reserve expects bank holding company acquirers to have capital ratios well above the minimum thresholds for "well capitalized" status. The Federal Reserve has made it clear that this standard applies to foreign acquirers as well. Under Regulation Y (as discussed in Annex B), being "well capitalized" and "well managed" and having "satisfactory" Community Reinvestment Act ("CRA") ratings (within the meaning of the applicable regulations) are critical to an institution's expansionary expectations and maintaining its status and privileges as a "financial holding company."

Many of the significant acquisitions in the aftermath of the 2008 financial crisis were accompanied by simultaneous common stock offerings designed to maintain healthy regulatory capital ratios. Wells Fargo, Bank of America and PNC executed common stock offerings in connection with all-stock acquisitions of Wachovia, Merrill Lynch and National City, respectively. The same was true in the largest failed bank acquisitions, with JPMorgan Chase and BB&T completing common stock offerings within days of closing their respective acquisitions of the franchises of Washington Mutual and Colonial Bank. Some more recent bank transactions have also featured common equity offerings in close proximity to significant acquisitions, as in the merger of Provident New York Bancorp and Sterling Bancorp, in Sterling Bancorp's subsequent acquisition of Hudson Valley Holding Corp, and in Pinnacle Financial Partners' acquisition of BNC Bancorp.

## B. Tax Considerations

As a result of both an acquirer's need to conserve capital and the desire of the target's shareholders to have the opportunity for tax deferral, many substantial financial institutions mergers are likely to continue to be structured as tax-free stock-for-stock transactions. There are generally four forms of transactions in which tax-free treatment can be achieved for shareholders who exchange their stock in the target company (referred to herein as "Target") for stock in the acquiring entity (referred to herein as "Acquirer").

### 1. Direct Merger

In a direct merger, Target merges directly with and into Acquirer, or vice versa. This will generally be nontaxable to Target, Acquirer and Target's shareholders who receive only stock of the surviving corporation, excluding Non-qualified Preferred Stock (defined below), provided that stock constitutes at least 40% of the total consideration. U.S. federal tax regulations provide that the value of the stock received by shareholders generally is determined as of the last business day before the merger agreement is signed if the merger agreement provides for "fixed consideration" (discussed further below) — the so-called "signing date rule" — and also clarify that taxpayers can rely on the signing date rule even if the acquisition agreement contemplates a shareholder stock/cash election, so long as the aggregate mix of stock/cash consideration is fixed.

For purposes of the requirement that stock constitute at least 40% of the total consideration (and the corresponding limitation on the amount of cash and "other property") in a transaction, stock includes voting and non-voting stock, both common and preferred. Target shareholders will be taxed on the receipt of any cash or "other property" in an amount equal to the lesser of (x) the amount of cash or other property received and (y) the amount of gain realized in the exchange (*i.e.*, the excess of the total value of the consideration received over the shareholder's adjusted tax basis in the Target stock surrendered). For this purpose, "other property" includes preferred stock ("Non-qualified Preferred Stock") that is limited and preferred as to dividends, does not participate in corporate growth to any significant extent and either (1) is puttable by the holder within 20 years, (2) is subject to mandatory redemption within 20 years, (3) is callable by the issuer within 20 years and is more likely than not to be called or (4) pays a variable rate dividend, unless the Acquirer Non-qualified Preferred Stock is received in exchange for Target Non-qualified Preferred Stock. Any gain recognized generally will be capital gain, although it can under certain circumstances be taxed as dividend income.

U.S. federal tax regulations also provide that in certain circumstances, stock of an Acquirer issued to creditors of an insolvent Target, whether in or out of bankruptcy, in exchange for their claims can also count towards the 40% requirement described above. The 40% requirement must be satisfied in order to ensure tax-free treatment of mergers and other reorganizations involving such insolvent corporations. The regulations provide a mechanism, which differentiates between junior and senior classes of claims, to compute how much of a creditor's interest is counted as equity towards the 40% test. These particular regulations, finalized in 2008, were certainly timely as they expanded the ability of troubled corporations to engage in transactions designed to help improve their balance sheets.

Reverse parent-to-parent mergers have been employed in a number of transactions for a variety of structural reasons. Issues that arise in connection with reverse mergers include how the acquisition will be characterized in press releases and public disclosures, which group of shareholders (if any) will be required to exchange its share certificates, whether change-of-control provisions in employment, severance and benefit plans and agreements or other agreements of either company will be triggered by the structure, and possible regulatory ramifications, including the identity of the filing parties and the information required under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a.

In 2006, the IRS issued final regulations that treat a forward triangular merger of Target into a subsidiary of Acquirer that is a "disregarded entity" for tax purposes (such as a single member limited liability company that has not elected to be treated as a corporation) as a direct merger of Target into Acquirer for purposes of determining whether the transaction is tax free. An example in the regulations also provides that certain mergers of a corporation into a partnership, whereby the partnership becomes a disregarded entity of an acquiring corporation following the merger, would qualify as a direct merger.

### 2. Forward Triangular Merger

In a forward triangular merger, Target merges with and into a direct subsidiary of Acquirer that is at least 80% owned (and usually wholly owned) by Acquirer (referred to herein as "Merger Subsidiary"). The requirements for tax-free treatment and the taxation of non-stock consideration (including Non-qualified Preferred Stock) are generally the same as with a direct merger. However, in order for the merger to be tax-free, there are two additional requirements:

- first, no stock of Merger Subsidiary can be issued in the transaction. Thus, preferred stock of Target may not be assumed by Merger Subsidiary in the merger but must be reissued at the Acquirer level or redeemed prior to the merger. In addition, this requirement raises certain technical issues in circumstances in which Acquirer already owns Target stock; and

- second, Merger Subsidiary must acquire "substantially all" of the assets of Target, generally 90% of net assets and 70% of gross assets. This requirement must be taken into account when considering asset dispositions or bad bank spin-offs before or soon after a merger or a redemption of Target stock prior to the merger.

Because of the requirement that Merger Subsidiary be at least 80% owned by Acquirer, it was unclear until 2001 whether the stock of the Merger Subsidiary could be contributed to another 80%-owned subsidiary of Acquirer following the merger without causing the transaction to be taxable. In Rev. Rul. 2001-24, the IRS made it clear that Acquirer may undertake such a "drop down" without causing the transaction to be taxable. In 2007, the IRS issued final regulations which confirm this result and generally provide greater flexibility with respect to post-reorganization asset transfers. The ability to transfer the Merger Subsidiary stock to another subsidiary is perhaps most useful for foreign acquirers, as it permits them to combine Target with the rest of Acquirer's U.S. operations by contributing the stock of Merger Subsidiary to an existing U.S. subsidiary of Acquirer immediately after the merger.

### 3. Reverse Triangular Merger

In a reverse triangular merger, Merger Subsidiary merges with and into Target. In order for this transaction to be tax-free, Acquirer must acquire, in the transaction, at least 80% of all of Target's voting stock and 80% of each other class of Target stock in exchange for its voting stock. Thus, non-voting preferred stock of Target must either be given a vote at the Target level and left outstanding at that level, exchanged for Acquirer voting stock or redeemed prior to the merger. Bank of America/Merrill Lynch is a notable significant transaction in which non-voting preferred stock of Target was exchanged for Acquirer "mirror" preferred with a fractional voting right in order to preserve tax-free treatment. Where it is not practicable to add a voting right to Acquirer "mirror" preferred stock exchanged for non-voting preferred stock of Target (for example, with TARP preferred stock), it is often possible to preserve tax-free treatment by structuring the transaction as a forward triangular merger (subject to the requirements discussed above). In addition, Target must hold substantially all of its assets and substantially all of Merger Subsidiary's assets after the merger.

The IRS has previously made it clear that a two-step reverse triangular merger (*i.e.*, a tender or exchange offer followed by a back-end merger) is permissible, as long as the two steps occur pursuant to an integrated plan and the "control for voting stock" requirement is met in the overall transaction. The IRS has also made it clear that the requirement that Target "hold" substantially all of its assets and substantially all of Merger Subsidiary's assets after the merger is not violated where Target sells assets following the merger if Target retains the sales proceeds (and does not, for example, distribute them to its new parent, Acquirer).

A transaction that in form is a reverse triangular merger will be tested for tax-free status under the more flexible rules described above for direct mergers (rather than the more demanding requirements for reverse triangular mergers) if, pursuant to an integrated plan, Target is merged into Acquirer following the reverse triangular merger. Under the rationale of previously issued IRS guidance and regulations, a reverse triangular merger followed by a merger of the surviving corporation into a disregarded entity of the Acquirer (such as a single member limited liability company that has not elected to be treated as a corporation) pursuant to an integrated plan, similarly should be treated as a direct merger of Target into Acquirer.

### 4. Section 351 Transaction

An alternative, less frequently used structure, is for both Acquirer and Target to be acquired by a new holding company (referred to herein as "HoldCo"), in a transaction intended to qualify as a tax-free exchange under Section 351 of the Internal Revenue Code. As a corporate matter, this typically would be achieved by HoldCo creating two subsidiaries, one of which would merge with Acquirer and the other with Target in two simultaneous reverse triangular mergers. Shareholders of Acquirer and Target would receive tax-free treatment to the extent that they received HoldCo stock, which may be common or preferred (other than Non-qualified Preferred Stock), voting or non-voting, provided that the shareholders of Acquirer and Target own at least 80% of the voting stock and 80% of each other class of stock of HoldCo immediately after the transaction. Unlike the other forms of transactions described above, there is no limit on the amount of cash that may be used in this type of transaction as long as the 80%

ownership test is satisfied. Cash and Non-qualified Preferred Stock received by a shareholder of Acquirer or Target will be taxable up to the amount of gain realized in the transaction.

## C. Other Factors

In addition to the bank-specific concerns for capital and tax and accounting issues, deal structure will be influenced by corporate and securities law considerations common to all mergers and acquisitions. Alternative structures are sometimes designed to address concerns about state law shareholder approval requirements or to avoid class votes by certain classes of security holders. While triangular mergers often reduce the need to seek debtholder or other third-party approvals, they may be considered to be cosmetically undesirable in certain circumstances where a transaction is being framed as a merger of equals (although such structures have been used in some prominent mergers of equals). Where a party to a transaction is not a U.S. company, additional considerations may come into play that affect the choice of structure, and, in some cases, statutory compulsory share exchanges (in states in which such transactions are authorized) or stock purchases have been used in lieu of, or in combination with, a merger to address these issues. Exotic structures for cross-border deals, such as dual-pillar arrangements and exchangeable shares, have been considered from time to time and used by non-U.S. companies, including banking and insurance companies, but so far remain largely untested or rarely used in the United States.

Where an acquirer has a need to reduce excess capital, cash consideration in a deal is often part of the solution. Examples include the conversions of mutual savings institutions into stock form, either into full-stock form or into a "mutual holding company" structure, in which the depositor-members of the mutual savings institution become members of a new mutual holding company, which holds a majority interest in either the (now stock-form) bank or a stock-form, mid-tier holding company which, in turn, owns 100% of the bank. In many cases, the mutual holding company structure proves to be transitory and the institution undertakes a so-called "second step conversion" into a full-stock format. The mutual holding company is a creature of federal banking law and regulations and, accordingly, these companies are federally chartered. Such conversions typically generate large amounts of capital that cannot always be efficiently deployed by the institution in the ordinary course of its business. Accordingly, an all- or part-cash acquisition is sometimes undertaken in connection with the conversion to reduce equity capital to more reasonable levels. Examples have include First Niagara's acquisition of Bank of the Finger Lakes, New Haven's acquisition of two institutions simultaneously with a conversion and Partners Trust Financial's acquisition of BSB Bancorp in connection with its second-step conversion. Thrift conversion transactions raise special regulatory issues, with prior approval usually being required before the transaction can be submitted to shareholders, and they may take somewhat longer to complete than more streamlined bank mergers. A pre-closing special dividend can also be used to reduce excess capital and access available cash on the target company's balance sheet, either in lieu of or in addition to cash consideration provided by the acquirer.

Where a target is a subsidiary or other asset of the seller and the consideration consists in whole or in part of acquirer stock, then the potential exists for the seller to become a significant shareholder of the acquirer, potentially on a long-term basis, as the acquirer will likely not want the seller to attempt to dispose of a large amount of acquirer stock rapidly after the transaction

closes. The possibility that a seller may acquire a significant equity stake in the acquirer raises a number of complex issues, including board representation and other governance matters, and, when one or both of the parties is a financial institution, potentially complicated regulatory issues. These include the possibility that the seller's equity stake in the acquirer resulting from the use of acquirer equity as consideration could raise the possibility of the seller being deemed to control the acquirer under U.S. banking law.

The acquisition of Allfirst Financial from AIB by M&T illustrates these issues. Allfirst was a wholly owned subsidiary of AIB, an Irish company registered as a bank holding company in the United States. The consideration to AIB in the merger consisted of cash and M&T common stock representing about 22.5% of M&T's outstanding common stock on a pro forma basis. Because AIB wished to continue to be an active participant in the operation of the combined company after the merger, the parties negotiated board representation, committee representation and specific consent rights in favor of AIB. It was also necessary to negotiate other provisions relating to AIB's status as a major shareholder, including standstill provisions, provisions governing its right to sell its M&T common stock and antidilution/preemption mechanisms. Fifth Third Bancorp's long-term significant minority interest in Vantiv, Inc. (which was formerly a division of Fifth Third prior to its spin-off in 2009) is another example of such a structure. Fifth Third retained its substantial holdings and governance rights in Vantiv for years. In connection with Vantiv's 2018 acquisition of Worldpay Group plc, Vantiv agreed to repurchase a sufficient number of Fifth Third's shares to bring its pro forma ownership level to below 5% (at which point Fifth Third's board representation rights would lapse) in order to avoid Fifth Third being deemed to control the combined Vantiv/Worldpay for bank regulatory purposes upon completion of the transaction.

In structures involving the acquisition of a considerable equity interest in the acquirer, the seller will need to be satisfied that its governance and other rights are adequate to give it sufficient input into the affairs of the acquirer, not only to protect its investment, but also in light of the fact that it will likely be deemed to control the acquirer's subsidiary banks for purposes of the Bank Holding Company Act, and thus have potentially onerous responsibilities under federal banking laws, including "source of strength" obligations. This requires that a parent bank holding company act as a source of financial and managerial strength to its subsidiary banks. Such control also gives rise to potential "prompt corrective action" obligations under the FDICIA in the form of guarantees (subject to certain limits) of any capital restoration plan required to be submitted by a controlled bank. Accordingly, it may be appropriate to relax certain customary contractual limitations on significant shareholders (*e.g.*, standstill and/or sell-down provisions) should the controlled bank experience capital or other regulatory difficulties.

Control by a significant, but minority, shareholder also raises other regulatory issues, such as affiliate transaction restrictions under Sections 23A and 23B of the Federal Reserve Act, the need for cooperation between the two bank holding companies in future acquisition applications, and the need for both holding companies, as a practical matter, to satisfy heightened managerial, capital, risk management and CRA standards should one wish to become a financial holding company. If the parties wish to avoid a control determination with respect to the seller (or certain selling shareholders) notwithstanding its (or their) continued equity interest in the acquirer, as in the case of Charles Schwab's 2020 merger with TD Ameritrade, in which TD Bank was a significant minority shareholder, care will need to be taken in negotiating these post-

closing governance arrangements to ensure that the seller does not retain any meaningful affirmative or negative control rights. The parties may also condition the closing on receipt of a formal non-control determination from the Federal Reserve, although the process of obtaining a formal non-control determination can create potentially significant complications and risk in closing a transaction. Where such issues arise, prior consultation with banking regulators is imperative.

From the perspective of an acquirer bank holding company in which the seller will have a stake giving it "control," if the seller has its own insured depository subsidiaries (or might acquire them in the future), consideration also needs to be given to potential liability of the acquirer's subsidiary banks on account of the seller's subsidiary banks under the cross-guarantee provisions of the Federal Deposit Insurance Act.

Structural considerations can also affect which state and federal regulatory approvals will be required. For instance, in the AIB/M&T transaction described above, separate Federal Reserve approvals were needed for both M&T's acquisition of Allfirst and AIB's acquisition of a substantial stake in M&T (in addition to applicable state regulatory requirements). After Gramm-Leach-Bliley, banks increasingly make Hart-Scott-Rodino Act filings with respect to some or all of the non-bank portion of acquisitions. The choice of structure can have an effect on the identity of the filing parties and the information required to be obtained for the filings.

Another structure, also rare in U.S. financial institution M&A, is where the acquirer acquires a majority, but less than 100%, interest in the target. Such was the case in Toronto-Dominion's acquisition of Banknorth. Citing the desire to preserve capital, Toronto-Dominion agreed to acquire 51% of Banknorth. Banknorth shareholders received a package of consideration consisting of Toronto-Dominion common shares, cash and a share of the 49% of Banknorth common equity that remained outstanding after closing. Another example is the merger of Merrill Lynch Investment Managers and BlackRock, as a result of which Merrill Lynch held a 49.8% economic and 45% voting interest in BlackRock (which was itself to be governed by a majority independent board of directors), and Banco Santander's acquisition of a minority 24% interest in Sovereign Bancorp, before acquiring the remainder of the company two years later. Such structures are difficult and complex and raise a host of issues, including the need to put into place mutually satisfactory arrangements to govern the relationship between the acquired company, its new majority shareholder and the public shareholders following closing. The complicated issues include whether the majority shareholder will be subject to a standstill, the majority shareholder's right to acquire additional shares in the market and increase its ownership position, anti-dilution rights, registration rights, regulatory cooperation, non-compete covenants, corporate opportunity allocation, minority shareholder board representation, limits on majority shareholder power, eventual going-private transactions and more.

## III. CONTRACTUAL ISSUES

The contractual issues that arise in transactions involving major publicly held financial institutions can be substantially different than those which arise in transactions that do not involve the acquisition of a public company. Disclosure requirements, the risk that a third party will seek to break up a transaction before the parties reach agreement or before the shareholder vote can be obtained, the actions of arbitrageurs and hedge funds and the length of time that the

transaction is exposed to public scrutiny between signing and closing create pressures not faced in non-public transactions. In addition, the fact that there is usually no private seller available to provide an indemnity against breaches of representations and warranties places greater emphasis on pre-signing due diligence.

The contractual issues that frequently arise in the context of bank holding company acquisitions involve (1) price, (2) due diligence, (3) closing conditions and the effort required to close (and more generally the issue of closing certainty, including the "material adverse effect" formulation, regulatory condition language and "fiduciary outs"), (4) employee compensation and benefits and (5) lockups, termination fees, no-shop provisions and other deal protections.

### A. Dealing with Market Risks

Financial institutions mergers take time. Due to the need to obtain regulatory approvals, it is not unusual for a bank acquisition to take six months or more to complete. This has been particularly true in the post-economic crisis, heightened regulatory environment. The Gramm-Leach-Bliley Act generally eliminated the need for prior Federal Reserve approval of domestic non-bank acquisitions by bank holding companies that have elected to become financial holding companies, but Dodd-Frank partially undid that. Federal Reserve approval is now required for non-bank acquisitions by financial holding companies where the target has more than $10 billion in assets. All bank acquisitions require prior regulatory approval. The SEC proxy and registration process is time consuming. Increased regulation and the global reach of today's larger, more complex financial institutions have increased the possibility of delays due to U.S. and foreign antitrust review. Federal Reserve public hearings are possible when particular issues are raised by a transaction and are often granted in larger transactions. State elected officials, attorneys general and regulators often make their presence known, which can affect timing. And the regulatory approval process has become more stringent for financial institution acquisitions under the Biden Administration.

This necessary period of delay between signing and closing, combined with the frequent use of stock as consideration, means that the typical financial institution acquisition is subject to market risks over a lengthy period of time. A drop in the price of an acquirer's stock between execution of the acquisition agreement and the closing of the transaction results in the seller's shareholders receiving less value (at least in the short term) for their exchanged shares or, under some structures, increases the transaction's potentially dilutive effect on the acquirer's shares. Parties occasionally attempt to address such market risk with a pricing structure that uses a valuation formula (instead of a fixed exchange ratio) and a collar. Less commonly, some transactions (often smaller in size) have also included so-called stock-drop "walk-away" provisions permitting unilateral termination by the seller in the event the acquirer's share price falls below a certain level (either on an absolute or an indexed basis or, more commonly, both). However, by far the most common consideration structure in stock deals continues to be a fixed exchange ratio, as reflected in many of the most significant recent bank mergers (*e.g.*, Columbia Banking System/Umpqua Holdings, Huntington Bancshares/TCF Financial, South State/CenterState Bank, BB&T/SunTrust, Ameris Bancorp/Fidelity Southern, Synovus Financial/FCB Financial Holdings, Fifth Third Bancorp/MB Financial, South State/Park Sterling, Pinnacle Financial/BNC Bancorp, and many others). This approach is consistent with the fundamental strategic nature of stock deals, in which each party is making a long-term strategic

decision to combine with the other, and short-term market movements or fluctuations in stock prices are generally not an appropriate basis for altering the agreed upon terms or economics of the transaction. It should also be noted that even without a formal stock-drop "walk-away" right, in transactions that require a shareholder vote on the target side, the target board generally has a right to withdraw its recommendation of a merger if it determines that its fiduciary duties so require, generally obligating it to pay a break fee if the deal thereafter terminates. Inclusion of cash as part of the merger consideration partially hedges against market risk in the acquirer's stock.

In addition to contractual protections, it should be emphasized that since market risks can manifest at any time, the parties should move forward quickly to satisfy the applicable closing conditions and not add unnecessary delay to what can already be a lengthy period between signing and closing. Most agreements contain provisions that require the parties to move as quickly as practicable to get to closing.

### 1. Fixed Exchange Ratios

As noted above, the most common pricing structure (especially in the context of larger transactions) is a fixed exchange ratio set at the time an agreement is signed. A fixed exchange ratio calls for each target share to be converted into a specific number of acquirer shares at closing, without adjustment to reflect intervening trading levels or other factors. The advantage of a fixed exchange ratio for the acquirer is that it allows the acquirer to determine at the outset how much stock it will have to issue (and thus the acquirer can determine its per share earnings impact with some certainty). From the perspective of target shareholders, a fixed exchange ratio allows them to share in the upside from increases in the acquirer's stock price between signing and closing. The vast majority of strategic stock mergers involving U.S. financial institutions have been structured with a fixed exchange ratio without collars or walk-aways.

With a fixed exchange ratio, the seller's shareholders are at the risk of the market, both for financial stocks generally and the acquirer's stock in particular. But the acquirer is also at risk should its intrinsic value per share rise, or that of the target fall, but without sufficient cause for the acquirer to terminate. A basic premise of strategic stock mergers is that, absent an underlying change in either party's business that rises to the level of a material adverse effect, market fluctuations during the interim period between signing and closing should not in and of themselves impact either party's obligation to complete the transaction or affect the agreed upon ownership split of the combined company between the target's and acquirer's shareholders.

### 2. Pricing Formulas and Collars

In the minority of transactions that deviate from a fixed exchange ratio structure, some measure of price protection for the seller's shareholders may be obtained by using a dollar pricing formula: seller shareholders are to receive a fixed dollar value of consideration and the number of shares to be issued by the acquirer at the closing to constitute that dollar value is determined on the basis of the value of the acquirer's stock at that time or, more frequently, on the basis of the average price of the acquirer's stock price over a period (*e.g.*, 10 to 20 trading days) prior to the closing or some other near-closing milestone, such as receipt of Federal Reserve approval. Seller shareholders are protected because, if the acquirer's stock price has

declined in this period, the exchange ratio is increased in inverse proportion to maintain the same dollar level of consideration.

When a pricing formula is used to price-protect selling shareholders, a collar can limit the risks to the acquirer of exchange ratio adjustments. A collar protects the acquirer by placing an upper limit on the amount of stock it will be required to issue in the event of a decline in the price of its stock between signing and closing. Within the collar, which in negotiated bank acquisitions is frequently a window of +/- 5% to 15% centered on the acquirer's stock price at announcement, the acquirer is assured of issuing, and the seller's shareholders of receiving, a number of shares having a value equal to the agreed-upon dollar deal price range. Collar protection is limited because, once the share price is outside the collar range, no further adjustments are made and the exchange ratio becomes fixed at its upper or lower limit. Outside of the collar, the risks are the same as a fixed exchange ratio: seller shareholders bear value risk of acquirer stock price declines, the acquirer bears value risk of acquirer stock price advances.

Sliding exchange ratios without collars limiting the risk of stock price movement are unusual among major transactions, although they are sometimes seen. The former Cendant's attempt to acquire American Bankers Insurance included a merger in which each American Bankers share would be converted into $67 worth of Cendant common stock with no collar. After signing, Cendant's stock fell sharply. At the new trading level, Cendant would have had to issue about four times as many shares as anticipated. Cendant negotiated a termination and paid a $400 million termination fee.

The Cendant situation illustrates the risk shift that results from pricing formulas, and the reason that acquirers may seek a collar to provide a cap on the impact of a sliding exchange ratio. Where the acquirer is much larger than the target, collarless sliding exchange ratios are more common, but still not the norm.

Post-2008 financial crisis, price adjustments for asset quality changes were occasionally seen. For example, First Niagara Financial Group's stock deal for Harleysville National featured a downward adjustment to the exchange ratio if delinquent loans exceeded a threshold. The adjustment capped out at a level of delinquent loans that was expressly specified as a material adverse effect, giving First Niagara the right to terminate should the target's asset quality deteriorate to that level or beyond. Tower Bancorp's acquisition of First Chester County Corporation featured an exchange ratio adjustment based on delinquent loans. The adjustment worked two ways, increasing if delinquent loans were below a floor and decreasing if delinquent loans exceeded a ceiling. Such adjustments must always be drafted with the possibility in mind that they can be gamed, requiring appropriate measures, such as covenants, to minimize that possibility.

### 3. Walk-Aways

In some stock transactions, parties also include termination provisions that give the seller the right to walk away from the merger if the price of the acquirer's stock falls below a certain level during a defined period before closing. A walk-away provision might permit seller termination if, at the time the transaction is to close, the acquirer's stock has decreased by a specified percent. An acquirer will argue that, if the acquirer's stock does no more than move

down with the rest of the market or with the acquirer's peers, there should be no right on the part of the seller to "walk." Thus, many walk-away provisions have included "double triggers," both of which must be tripped before a termination right may be invoked. These walk-aways give rise to a seller termination right only if (1) the acquirer's average stock price prior to closing falls by a set amount (generally 15% to 20%) from announcement price and (2) the acquirer's stock falls by (typically) the same amount relative to a defined index comprised of a group of selected banks during the pricing period. Walk-away pricing formulas are generally tested during a short trading period prior to closing and often include an option on the part of the acquirer to increase the exchange ratio or merger consideration as required to avoid the target's right to terminate (sometimes called a "kill or fill" provision). Columbia Banking System's acquisition of West Coast Bancorp and CenterState Banks' 2014 acquisition of First Southern Bancorp each featured both a "double trigger" walk-away provision and "kill or fill" feature, as did Cadence Bancorporation's 2018 acquisition of State Bank and Independent Bank Group's 2018 acquisition of Guaranty Bancorp, among others. Some "kill or fill" features require the acquirer to "fill" by increasing the value of the merger consideration to a level that is 15% or 20% below the implied value of the merger consideration based on the acquirer's stock price at signing (so that the relative decline of the index does not factor into the "fill" formula); others include a formula that requires a lower "fill" amount if the relevant index has also declined during the period between signing and closing.

If a walk-away termination right is triggered, the parties will need to choose between three possible outcomes: (1) consummate the transaction without any price adjustment (in essence, the target waives its right to walk away), (2) terminate the transaction or (3) agree to increase the exchange ratio (or cash consideration) to either fully or partially offset the impact of the price decline below the walk-away trigger. Since this choice will likely need to be made after shareholders have voted to approve the transaction, it is important to review the proxy statement disclosure and applicable state law carefully to determine whether the boards of either company may need to resolicit the approval of shareholders, particularly if a negotiated resolution that involves enhanced merger consideration short of the entire "fill" amount is agreed. This would require another filing of the proxy statement with the SEC, another solicitation and months of delay. The issuance of additional consideration may require amendment of regulatory applications and submission of revised pro forma financial statements, and could under some circumstances put the continued validity of regulatory approvals at risk. Walk-away provisions also create the possibility of activist or arbitrageur manipulation of acquirer stocks and can complicate primary or secondary capital market activities by an acquirer or its affiliates while the deal is pending, and may present issues for stock repurchases under Regulation M and Rule 10b-18.

The appropriateness and value of a walk-away must be considered in the context of the strategic business rationale for the combination. A stock deal is a strategic transaction and the exchange ratio represents the agreed allocation of the fundamental long-term economics of the combined company among the constituents' shareholders. Short-term price fluctuations do not undermine the strategic rationale for a stock merger, and walk-aways that are tied to the acquirer's stock price run counter to the long-standing principle, reflected in numerous judicial decisions, that a material adverse effect must be predicated on long-term adverse changes in the underlying business of a party. For this reason, stock price changes in and of themselves are almost uniformly specifically excluded from material adverse effect definitions in purchase

agreements. Walk-aways and kill or fill provisions, though ostensibly a protection for target companies, can also create difficult issues for target boards. There have been instances in which the acquirer's stock price triggered the walk-away provision and the acquirer had indicated an unwillingness to "fill" in the event the target sought to exercise its termination right. The target board was then faced with the delicate decision of terminating the merger agreement, with the resulting uncertainty and risk such an action would create for the institution, its various stakeholders and the board, or of abstaining from exercising its walk-away right. Recognizing that short-term stock price movements do not undercut the strategic logic of the transaction or the contribution analysis underpinning the agreed upon exchange ratio, target boards in these circumstances may wisely choose to stay the course and complete the merger on its original terms. An attempt by the target to renegotiate the exchange ratio typically requires it to first formally exercise its termination right by delivering a notice of termination to the acquirer, exposing the target to the risk that the acquirer simply decides to walk away from the transaction. Target shareholders have usually approved the merger before the board is placed in the position of considering whether to exercise a walk-away right; the board is therefore being asked to overturn an informed vote of the shareholders, and subject itself to second-guessing and fiduciary litigation. Perhaps for these reasons, walk-away provisions, which are rare even among bank mergers, are not a feature of strategic stock transactions in other industries.

Acquirers from time to time have insisted on termination rights or price adjustments tied to changes in asset quality metrics at the target. Where such a provision is included, the particulars of an asset test can vary greatly. Some of the basic issues that must be carefully considered when negotiating such provisions include: the financial metric(s) to be measured and whether it is preferable to rely on a broad measure like tangible equity or a more focused metric such as delinquent or non-performing loans or gains and losses on certain securities or other specified assets; the level of adverse performance required to trigger a termination right; the measurement date and whether to include a true-up and dispute resolution process; the sensitivity of a price adjustment to a given level of change in the asset quality metric; and whether it is necessary to make any adjustments to normal GAAP measures to minimize the possibility for managing to a specific result or to minimize the potential disagreement between the parties. Such adjustments have included backing out transaction-related expenses, such as deal advisory fees, third party contract breakage costs and transaction-related employee expenses, and eliminating the effect of accumulated other comprehensive income or loss to exclude the impact of mark-to-market accounting on unrealized securities gains and losses. These provisions can inject significant complexity to a transaction, may be vulnerable to "gaming," and can generate disputes between the parties. Although used on occasion, they are not the norm.

As with anything that creates possible uncertainty about whether or not the transaction will close or about deal pricing, collars, walk-aways and other special termination rights may attract attention from hedge funds and arbitrageurs and therefore have the potential to increase trading pressure on the stock prices of the parties to the deal. Some widely available publications track the arbitrage "spread" on pending deals on a daily basis.

Even without such provisions, hedge funds and arbitrageurs may exert pressure on the parties to a strategic merger involving stock consideration in the event of a perceived decline in the value of the merger consideration relative to the target's standalone value. For example, in the 2017 stock and cash acquisition of PrivateBancorp by CIBC, merger arbs publicly expressed

opposition on the basis that regional bank valuations had significantly increased since the signing of the merger agreement, driven by changes in the banking environment. As a Canadian bank, the argument went, CIBC had not benefited to the same degree as U.S. regional banks. Under pressure from arbs and ISS, PrivateBancorp delayed its shareholder meeting. The board of PrivateBancorp patiently pursued a process of comprehensive shareholder engagement and discussions with CIBC to assess potential revised terms that could obtain the support of shareholders. The parties never wavered in their belief that the strategic transaction was the right thing for both companies, and in the spirit of a committed partnership announced revised terms on two occasions. The transaction ultimately received the resounding approval of PrivateBancorp shareholders, with more than 80% of the shares voting on the deal cast in favor. This outcome was achieved despite an ISS recommendation to vote against the merger, with many institutional shareholders typically identified as ISS followers recognizing the questionable content and process of the ISS analysis and rejecting the recommendation. The diligent, deliberate efforts of the PrivateBancorp board and management team in carrying out all of their fiduciary obligations in the face of exogenous shocks led to significantly more than a billion dollars in value creation for shareholders, as the value of the deal increased from approximately $3.8 billion at announcement in June 2016 to approximately $5 billion at closing in June 2017. Despite the delayed vote, a changing and vocal shareholder base and close media attention, at no time did a competing offer emerge. The PrivateBancorp transaction illustrates the ability of hedge funds and arbitrageurs, and in some cases proxy advisory firms such as ISS, to inject a certain degree of closing uncertainty or impose delay on completing a transaction, irrespective of whether or not the transaction may be perfectly sound from a strategic and financial perspective.

In some cases, unexpected seismic events can also overtake a transaction. While a number of deals signed before the Covid-19 pandemic were completed on their original terms and timeline, including South State/CenterState Bank and Charles Schwab/TD Ameritrade, there were other merger transactions in the financial institutions space, as in other industries, where the parties chose to revisit the strategic rationale for the transaction, and ultimately concluded that the anticipated benefits of the transaction would not be realized under the circumstances. For example, in May 2020, Texas Capital Bancshares and Independent Bank Group decided to terminate their merger agreement, under which the companies had agreed to combine in an all-stock merger of equals. The termination was approved by each party's board of directors after careful consideration and given the significant impact of the Covid-19 pandemic on global markets and on the companies' ability to fully realize the benefits they had expected to achieve through the merger. Similarly, in June 2020, Ally Financial and CardWorks announced that they had agreed to terminate their merger agreement, previously announced on February 18, 2020, after carefully considering the meaningful impacts of Covid-19 on global markets and the economy. In each of these examples, neither party paid any termination fee as a result of the mutual decision to terminate the merger agreement.

Whenever a shareholder vote is required, an element of closing risk is added to the equation, and it can be difficult for any compensating pricing formula to anticipate and capture all of the eventualities that might heighten this risk. Ultimately, a compelling rationale for the long-term mutual benefits of the transaction is the most effective protection.

### 4. Factors Influencing Choice of Pricing Structure

The pricing structure used in a particular transaction (and the allocation of market risk between the acquirer and the seller and their respective shareholders) will depend on the characteristics of the deal, prevailing market conditions and the relative bargaining strength of the parties. A pricing structure used in one deal may, for a variety of reasons, be entirely inappropriate for another. For instance, the pricing structure in an acquisition involving entities of significantly different size may be quite different from that employed in a merger of equals or similar transaction, where the shareholders of each entity are being given the opportunity to participate, over the longer term, in a new partnership.

The decision to negotiate for collar pricing will depend on various factors, including the views on the potentially dilutive impact of an issuance, the overall prospects for the market for bank stocks, the size of the banking companies, the parties' market expectations over time and whether it is desirable or necessary to peg the transaction price to a cash value.

Pricing formulas and collars might be considered inadvisable due to the potential downward pressure on an acquirer's stock price as a result of arbitrage trading. Even where there is little arbitrage risk, sellers should be aware that collars are often symmetrical, in which case a collar not only provides downside protection, it also limits some of the upside potential in the stock consideration.

In the merger of equals or "partnership" type of transaction, as well as other stock deals that represent strategic business combination transactions as opposed to a pure sale of the target company, claims on the part of the seller for price protection, especially walk-aways, often lack a strong philosophical basis. The argument is that the seller's shareholders, once the deal is signed, are (and should be) participants in both the opportunities and the risks of the new enterprise. Moreover, in both this type of transaction and a true acquisition, the seller can always find some comfort with respect to acquirer-specific price risk in the representations on the part of the acquirer relating to the non-occurrence of material adverse effect and other warranties (the accuracy of which will be a condition to closing) and, as discussed above, in the implicit protection against significant declines in the value of the acquirer's stock which inheres in the need for target shareholder approval.

### 5. Equity Price Locks

In some transactions, target companies may be unwilling to take the risk of fluctuations in the price of the acquirer's stock and may insist on cash consideration. In such cases, the acquirer must carefully examine its ability to fund a transaction in cash and the resulting impact on its financial position and capital levels. If the acquirer cannot fund the acquisition with its cash flow from operations, it will need to seek alternative funding mechanisms. In some cases, the acquirer may wish to simply undertake a straightforward securities offering of the sort described in Chapter 5 to fund the cash needed to pay the purchase price. However, this raises potentially tricky issues — including market risk if the acquirer delays the capital raising to coincide with the expected closing of the deal and the risk that the transaction does not close where the equity offering is conducted too soon, giving rise to a need to otherwise deploy the resulting capital. There are several approaches to dealing with the inherent risks of financing

transactions in which all or a portion of the consideration must be paid in cash and access to the capital markets is required.

One structure is a forward sales transaction with an investment bank or other financial intermediary. Capital One implemented a $2 billion equity capital raise via this mechanism relating to its acquisition of the U.S. ING Direct business. Such a structure can lock in the price of the equity that the acquirer would need to issue to fund the pending acquisition several months in advance of the anticipated closing of the deal. By using a forward sales transaction (also known as an "equity price lock"), an acquirer can pre-sell the equity it will need for the deal without taking down the proceeds of the sale or increasing its shares outstanding (and thus not diluting earnings per share, return on equity, etc.) prior to completing the pending acquisition. This structure is also a tool for active acquirers seeking to pursue cash acquisitions on an expedited timetable in lieu of more protracted stock merger structures. The structure involves the following basic steps:

- *Short Sale of Shares*. A financial intermediary borrows shares of the issuer from the securities lending market and sells those shares short in a registered offering and the proceeds of the sale are used as collateral with the securities lender.

- *Forward Purchase Agreement*. The financial intermediary enters into a forward purchase agreement with the issuer in which the intermediary agrees to purchase a fixed number of shares of the issuer's common stock at a fixed current price upon the future settlement of the contract.

- *Settlement of the Contract*. Upon the closing of the acquisition (or another agreed-upon settlement date), the issuer delivers a specified number of shares to the intermediary that in turn delivers the shares to the securities lender to close out its short position in the shares. Simultaneously, the intermediary delivers the cash proceeds from the initial sale of shares to the issuer (net of financing costs).

- *Alternative Unwind Scenario*. The issuer also maintains the right to unwind the transaction prior to its maturity in the event that its planned acquisition does not close. The unwind can occur either through a cash or stock settlement. In the case of a cash settlement, the issuer must pay a make-whole payment to the intermediary in the event that its share price has risen since the date of the initial short sale and receives a payment from the intermediary in the event its current share price is below the share price on the short sale date.

Equity price locks have also been used by Colonial BancGroup to fund its acquisition of Union Bank of Florida as well as by Affiliated Managers Group, Dominion Resources and Bank of New York (in connection with its acquisition of Pershing), among various others.

### 6. Post-Closing Adjustments Mechanism; Contingent Value Rights

Although less common than purchase price adjustment provisions, some transactions have also employed mechanisms that allow for valuation adjustments based on the performance of the target's portfolio after the transaction closes. These arrangements effectively segregate an

identified pool of assets from the economics of the overall transaction in order to side-step valuation disputes by permitting sellers to reclaim future valuation in the event the assets prove more valuable than the acquirer's expectation and protect acquirers from overpaying for an uncertain asset. One way of accomplishing this type of separation of a pool of assets in a transaction with a public target company is to issue to the target's shareholders a contractual right or security, often referred to as a contingent value right ("CVR"), to receive additional consideration if the identified pool performs better over a specified period than some agreed benchmark. In a transaction with a private target company, this can be achieved through earnout provisions.

Examples of transactions involving a CVR include NAFH's controlling investments in Capital Bank and Green Bankshares, Inc. and acquisition of Southern Community Financial Corporation. In each case, NAFH agreed to share with the target's shareholders a portion of the benefit that would result if future losses on specified target assets proved to be less than anticipated. Capital One Financial employed a similar mechanism in its acquisition of Chevy Chase Bank. CVRs have also been used in acquisitions of non-bank financial institutions, as in AllianceBernstein's acquisition of W.P. Stewart & Co., where target shareholders received merger consideration comprised of cash and a CVR tied to AUM of the acquired business during a three-year post-closing period.

CVRs can be complex to create and manage, with potentially challenging registration and reporting issues under securities laws, and issues can arise regarding potential post-closing conflicts or disputes with respect to the management of the applicable assets (the acquirer issuing the CVR often retains an interest in the assets to help align incentives). As a result, payment triggers, measurement periods and determination standards are among the terms that should be carefully negotiated.

The use of CVRs can also affect the tax treatment of the transaction. Although often less of an issue when dealing with a distressed or challenged target (because target shareholders expect to realize a loss on the transaction, even at the upper reaches of an acquirer's valuation), the terms of the CVR may dictate whether the transaction can qualify as a tax-free reorganization. Accordingly, the terms of the CVR (*e.g.*, when the CVR is settled, whether it is settled in cash or stock, whether the CVR is traded or not, the value of the CVR, etc.) will have to be harmonized with the overall tax objectives of the deal.

A different type of contingent consideration was employed in BB&T's agreement to acquire BankAtlantic from BankAtlantic Bancorp. After an injunction obtained by the holders of BankAtlantic Bancorp's trust preferred securities required a restructuring of the original acquisition agreement, the parties agreed that BankAtlantic Bancorp would use certain assets that it had planned to retain to capitalize a vehicle in which BB&T would have a 95% preferred interest, with the minority and residual interest retained by BankAtlantic Bancorp. In addition to providing BB&T with additional consideration (in exchange for an agreement by BB&T to assume the trust preferred securities), this structure provided BankAtlantic Bancorp and its shareholders with the opportunity for significant upside potential from improving economic conditions post-closing based on the performance of the legacy loan portfolio that constituted the assets of the new entity.

## B. Striking the Right Balance in Merger Consideration: Pricing Formulas and Allocation Procedures for Mixed Cash/Stock Consideration

### 1. Overview of the Issues

When negotiating and structuring a part-cash, part-stock acquisition, it is necessary to evaluate a range of complex variations and options without losing focus on the key deal issues. Potential permutations can easily become unduly burdensome and difficult to explain to investors. Accordingly, it is important to ensure that the consideration of complex deal structures does not interfere with the core business deal.

*Setting the Aggregate Pool of Consideration from the Acquirer's Perspective*. The most important threshold issue is defining the aggregate purchase price and the ultimate mix of consideration. This can be accomplished by focusing on the aggregate pool of consideration that will be paid, thus initially separating out the question of how that consideration will be allocated to various target shareholders.

When there is a cash and stock component to a transaction, the number of permutations of possible purchase price formulas can grow rapidly. Perhaps the simplest form of a part-stock, part-cash transaction is to pay each shareholder a fixed amount of cash and a fixed number of acquirer shares, without providing an opportunity for individual shareholders to elect a preferred form. Examples include:

- SVB Financial Group's 2021 acquisition of Boston Private Financial Holdings
- FB Financial Corporation's 2020 acquisition of Franklin Financial Network
- Fifth Third Bancorp's 2019 acquisition of MB Financial
- ACE Limited's 2016 acquisition of The Chubb Corporation
- Huntington Bancshares' 2016 acquisition of FirstMerit Corporation
- KeyCorp's 2016 acquisition of First Niagara Financial Group
- Global Payments' 2016 acquisition of Heartland Payment Systems

This structure has the advantages of being easy to communicate to the market and of assuring the acquirer certainty concerning how much cash and how many shares it will issue at closing.

More complicated pricing formulas have included:

- a fixed pool of shares and/or a fixed pool of cash, with an election feature and the per share stock and cash consideration having equivalent value as of the closing. This has been implemented through a floating exchange ratio and a floating per share cash amount, each determined — and equalized in value — as of closing based on the acquirer's prevailing average stock price, with offsetting adjustments to the proration

formula such that each of the aggregate number of acquirer shares to be issued and/or the aggregate amount of cash to be paid remains constant. Examples:

  - First Horizon National Corp.'s 2017 merger with Capital Bank Financial Corp.

  - OceanFirst Financial Corp.'s 2018 acquisition of Sun Bancorp Royal Bank of Canada's 2015 acquisition of City National Corporation

  - Columbia Banking System's 2013 acquisition of West Coast Bancorp

  - Alleghany Corporation's 2012 acquisition of Transatlantic Holdings, Inc.

- Alternatively, some transactions have featured an election mechanism with a fixed pool of shares and a fixed pool of cash, but where the exchange ratio and per share cash consideration are fixed at signing and are not equalized at closing. Examples:

  - Capital Bank Financial Corp.'s 2016 acquisition of CommunityOne Bancorp

  - BB&T's 2016 acquisition of National Penn Bancshares

  - First Niagara's 2011 acquisition of NewAlliance Bancshares

- an exchange ratio that floats to maintain a constant dollar value for the stock component, without a collar, and a fixed value cash component (*e.g.*, Partner Trust Financial's 2004 acquisition of BSB Bancorp; Regions' 2001 acquisition of brokerage firm Morgan Keegan);

- an exchange ratio that floats to maintain a constant dollar value within a defined collar, for the stock component, and a fixed value cash component;

- a fixed exchange ratio for the stock component, with the cash consideration adjusted to equal the value of the stock component at a future valuation date, subject to a maximum or fixed percentage of the number of target shares to be converted to cash (*e.g.*, M&T Bank Corporation's 2015 acquisition of Hudson City);

- complex pricing formulas including a fixed-exchange-ratio stock component, subject to a clawback feature above certain price levels;

- a fixed exchange ratio for the stock consideration with a cash top-up feature if the value of the stock component is below a specified value, subject to a collar; and

- a fixed exchange ratio where a portion of the consideration is paid in stock and a portion is paid in cash in an amount equal to the value of the stock that the shareholder would have received had the shareholder received all stock (*e.g.*, Washington Mutual's acquisition of Providian, where each share of Providian stock received consideration having a value equal to 0.45 shares of Washington Mutual

stock, but where the holders received 0.4005 shares of stock (0.45 multiplied by the 89% stock component) plus cash equal to the average trading value prior to closing of 0.0495 shares of Washington Mutual stock (0.45 multiplied by the 11% cash component)).

*Protecting the Tax-Free Status of the Acquisition*. Additional complexity may result from the need to adjust the percentage of target shares that will be converted into acquirer stock versus cash depending upon future events.

A part-cash, part-stock merger (including a two-step transaction with a first step tender or exchange offer followed by a back-end merger) generally can qualify as a tax-free reorganization only if at least a minimum amount of the total value of the merger consideration consists of acquirer stock. U.S. federal tax regulations set the minimum amount of stock at 40%.

In the past, satisfaction of this requirement was, in all cases, determined by reference to the fair market value of the acquirer stock issued in the merger (*i.e.*, on the closing date). Accordingly, a part-cash, part-stock merger, particularly with a fixed or collared exchange ratio, that met this requirement when the deal was signed could fail to qualify as a tax-free reorganization if the value of the acquirer's shares declined before the closing date. Absent a contractual formula to solve this tax issue, each party in essence obtained a price-based termination right (a walk-away) by virtue of the customary mutual closing condition requiring receipt of opinions of counsel to the effect that the transaction is tax-free. This would allow either acquirer or seller to walk away from the transaction if the acquirer's share price declined enough to lose qualification for tax-free reorganization treatment.

Fortunately, regulations adopted by the IRS in 2005 and revised by temporary regulations in 2007 permit the parties, in certain circumstances, to determine whether this requirement is met by reference to the fair market value of the acquirer stock at signing rather than at closing, adding certainty to the tax treatment of the transaction. If a merger agreement provides for "fixed consideration," the rules measure whether the test is met as of the end of the last business day before the date of the binding merger agreement. Under the regulations, an agreement provides for "fixed consideration" if it fixes the number of shares of each class of acquirer stock and/or the amount of money and any "other property" to be exchanged for all the target shares or each target share, as the case may be.

The 2007 temporary regulations narrowed the circumstances under which an agreement that provides target shareholders with an election to receive acquirer stock and/or cash and "other property" will be treated as providing for "fixed consideration." Under the 2005 regulations, shareholder elections did not prevent a contract from being treated as providing for fixed consideration if the contract specified minimums and maximums for the acquirer stock and cash or "other property" to be exchanged for the target stock. Under the 2007 temporary regulations, contracts that allow for shareholder elections are treated as providing fixed consideration only if the determination of the number of shares of acquirer stock is based on the value of the acquirer stock on the last business day before the date of a binding merger agreement.

While the temporary regulations expired in 2010, the IRS provided interim guidance in the form of a notice pending issuance of final regulations. The Notice stated that taxpayers may

apply the rules contained in proposed regulations (which were issued in 2007 and are identical to the 2007 temporary regulations) so long as all the relevant parties to the transaction elect to apply the provisions of the proposed regulations. Final regulations were issued ultimately in 2011, largely reflecting the 2007 temporary regulations. The 2011 final regulations also clarify that taxpayers can rely on the signing date rule even if the acquisition agreement contemplates a shareholder stock/cash election, so long as the aggregate mix of stock/cash consideration is fixed. Neither the possibility that some shareholders may exercise dissenters' rights and receive consideration other than the agreed merger consideration nor the fact that money may be paid in lieu of fractional shares of the acquirer's stock will prevent the merger from being treated as a fixed consideration transaction. Unlike the 2005 regulations, which provided that a contract with a "collar" could be treated as providing for "fixed consideration" as long as there was a proration mechanism to ensure that a fixed percentage of target shares would be exchanged for acquirer shares, the 2011 final regulations do not apply to transactions that utilize a "collar." Proposed regulations issued contemporaneously with the 2011 final regulations would extend the principles of the signing date rule to transactions using a "collar," but those regulations are not yet effective and hence cannot currently be relied upon.

*Priced-Based Walk-Away Protection for the Seller*. Walk-away provisions (described in Section III.A.3 above) require special attention in the part-cash, part-stock setting. First, a fixed cash component already provides a natural hedge against stock valuation deterioration. Second, if a price-based walk-away is used in the context of a part-cash, part-stock deal, the price-drop trigger for a walk-away right should take into account the implicit hedge on deterioration in the value of the consideration that is provided by a fixed cash component. For example, if the seller wants a walk-away right if the total merger consideration declines in value by more than 20%, it may be appropriate to take into consideration the fact that in a half-stock, half-cash deal, a 15% decline in the acquirer's share price would only cause a 7.5% decline in the value of the total package of consideration. An example is the Anthem/Trigon merger in which shareholders received a package of both cash and stock without an election. In that deal, the walk-away's 22% absolute price decline trigger actually represented, when the per share cash consideration is taken into account, an approximate 15% drop in overall value. Another example is the 2006 merger between Republic and Citizens in which shareholders elected between cash or stock consideration and the consideration was primarily made up of stock. The walk-away contained both a price-drop trigger based on the performance of Citizens stock against a peer company index and an aggregate consideration price-drop trigger, which both had to be satisfied to create a termination right.

*Distributing the Consideration to Seller's Shareholders — Pro Ration Versus Cash Election Mechanisms*. Once the aggregate pools of cash and stock consideration are defined, the best means of allocating that consideration among the target's shareholders must be determined.

The simplest approach is to give each shareholder a pro rata piece of the total consideration without the opportunity to elect the preferred form, which is typically the approach taken in transactions that include only a relatively small stock component and are not structured as tax-free reorganizations (*e.g.*, Georgia-Pacific's acquisition of Fort James). This approach is often taken in transactions that include only a relatively small cash component as well (*e.g.*, Fifth Third Bancorp/MB Financial, Huntington/FirstMerit, KeyCorp/First Niagara, PacWest Bancorp/CapitalSource, Bank of America/MBNA and Washington Mutual/Providian). The "no

election" structure may also be appropriate even in transactions with more substantial cash or stock components, such as in the Anthem/Trigon merger and the taxable ACE Limited/Chubb Corporation transaction.

However, in many tax-free reorganizations, where by definition there is at least a 40% stock component, the seller wishes to provide (usually through an election mechanism) tax-sensitive shareholders with a low relative tax basis in their shares some opportunity to exchange such shares on a tax-free basis. Structures where shareholders can elect between cash and stock are generally referred to as "cash election" mergers.

In a cash election merger, shareholders may elect to receive either all-cash or all-stock (or sometimes a combination) for their target shares, typically with a cap on the aggregate number of shares that will be converted into either form of consideration. If one form of consideration is over-subscribed, excess subscriptions receive a portion of the under-subscribed form of consideration. Allocating the less-desired form of consideration can either be handled through a random selection (or lottery) process, where every shareholder in the over-subscribed pool has a random chance of being required to receive the under-subscribed form of consideration (*e.g.*, Regions's acquisition of Morgan Keegan), or through a pro rata cutback, where each shareholder selecting the scarce form of consideration has the same proportion, but less than 100%, of their shares converted into their desired form of consideration (*e.g.*, First Horizon/Capital Bank, Capital Bank/CommunityOne, BB&T/National Penn, West Coast/Columbia, Citizens/Republic and Capital One/North Fork). Non-electing shares are typically converted first into the under-subscribed form of consideration to minimize the cutback for shares expressing a preference for the over-subscribed consideration.

Election mechanisms (and the disclosures that accompany such mechanisms) deserve careful attention, especially where there is no mechanism to equalize the value of the cash and stock components at the election deadline. In a number of transactions there has been a significant spread in value between the cash and the stock packages offered to shareholders at the time of the election and there is the potential for significant shareholder confusion.

*Equalization of the Cash and Stock Components*. In light of the concerns raised above for treating all shareholders roughly equally in a cash-election context, a number of companies have used a somewhat complex mechanism for equalizing the value of the cash and stock consideration packages at the time of the cash-election process. This is the approach used in Capital One's acquisitions of North Fork and Hibernia and PNC's acquisitions of Yardville, United National and Riggs.

For example, in the context of a 50% stock, 50% cash transaction, where the stock component is expressed as a fixed exchange ratio and the cash component is expressed as a fixed dollar amount, the parties may agree to value the total package of consideration as of a date close to the closing date and then permit shareholders to elect, for each target share they own, between cash and/or stock packages of equal value.

Assume a deal with a fixed exchange ratio of 0.5 shares of acquirer stock for 50% of the target's shares, and a $10 per share price in cash for the remaining 50%. Also assume that the acquirer's stock was trading at $20 per share on the date the transaction was announced (thus, the

0.5 exchange ratio represents $10 in value per target share). If, as of a measurement date close to the closing, the acquirer's shares were trading at only $18 per share (value of $9 per target share based on the 0.5 exchange ratio), the average per share consideration for the target company's shares would be $9.50 per share (*i.e.*, the average of $9 value in acquirer stock per target share for 50% of the total and $10 per share in cash for the remaining 50%).

In this case, the parties could either allow all shareholders to elect between $10 in cash or $9 in stock (with some shareholders having a low tax basis still possibly preferring the $9 per share stock option), or they could allow all shareholders to choose between $9.50 in stock and $9.50 in cash, while adjusting the total number of target shares that could be converted into stock and cash, respectively, to avoid requiring the acquirer to issue more shares than it originally intended.

In this instance, at an $18 price for each acquirer share, approximately 47.4% of the total deal value is now reflected in the stock portion, and accordingly, 47.4% of the total target shareholders could convert their shares into stock valued at $9.50 per share, and 52.6% of the target shareholders could convert their shares into cash valued at $9.50 per share, while using the same aggregate consideration pool that would be required for 50% of the shareholders to receive $9 in stock and 50% of the shareholders to receive $10 in cash.

Since this formula can be complicated to explain, parties typically include a chart in their public disclosures (typically in the Form S-4 and proxy statement/prospectus) to show how the shares will be exchanged at different illustrative share prices for the acquirer's shares. Assuming a fixed pool of cash and stock, the key points to understand are that:

- the value per target share of the cash and stock consideration will be the same based on the pre-closing measurement period;
- if the acquirer stock price drops, the average consideration value will also drop, but by a smaller amount than in a 100% stock deal, due to the partial hedge created by the fixed cash component; and
- the exchange ratio will be increased to compensate for the drop in the average consideration value such that the per share stock and cash consideration values are equalized, but the total number of target shares to be converted to acquirer stock will drop to compensate, such that the aggregate pool of acquirer shares to be issued remains constant. Similarly, while the number of target shares to be converted to cash will rise commensurately, the per share cash consideration will drop such that the aggregate pool of cash required is unchanged.

### 2. Timing and Other Election Procedures

While equalization formulas are helpful to ensure comparable shareholder treatment and to avoid complaints, no such formula will be perfect, since there will generally be some periods of time between the pricing period for determining the final consideration, the election deadline and the closing of the transaction. When drafting the procedures and time frames for setting final prices and for determining election deadlines, it is important to keep a careful eye on the

potential for arbitrage activity and narrow the window of opportunity for any such artificial pricing pressure during important measurement periods. Election deadlines can either occur before or after the shareholder meeting. Where there is significant value riding on the choice of an election, it is important to provide ample time for shareholders to make an effective and informed election. Mailing or otherwise disseminating proxy and election materials at the same time should generally be avoided; typically it is best to leave at least a week between the two distributions to reduce shareholder confusion. Proxy solicitation firms and information/exchange agents should also work closely with brokers to make sure everyone understands the choices to be made and the significance of each choice or of failing to make a timely election.

The timing of the election deadline relative to the date of the target's shareholder meeting may raise issues under the securities laws involving whether the cash election feature is viewed by the SEC staff as a *de facto* "tender offer" that requires compliance with the SEC's tender offer rules. This issue has arisen where there may be a significant time lag between shareholder approval and closing (for example, due to regulatory approvals) and where the parties wish to have the election deadline close to the closing in order to permit elections to be made on more timely information regarding acquirer stock trading values. The SEC staff has not insisted on compliance with the tender offer rules in these situations where there is a plausible reason for the delay between shareholder approval and the election deadline, such as regulatory approval, and where the parties agree to give at least five business days' prior public notice of the election deadline and to keep the S-4 registration statement "current" through the election deadline by incorporating into it periodic filings under the Exchange Act.

Other issues to consider carefully are repurchase blackouts under Regulation M and the limited availability of the Rule 10b-18 repurchase safe harbor during the proxy solicitation period, any election period and any valuation period. Acquirers that wish to make stock repurchases may negotiate for a shorter election period that overlaps with the proxy solicitation period to minimize the Regulation M blackout; targets may wish to have the election period end close to the closing. If there is expected to be a significant amount of time between the shareholder meeting and closing, as is often the case in bank mergers, these interests may conflict and this may become a negotiating point.

Targets and acquirers also need to navigate timing issues relating to stock held in any tax-qualified employee benefit plans such as 401(k) and employee stock ownership plans. Plan administrators need to calculate participant elections concerning employer stock held in plan accounts. Blackout periods are almost universally imposed on plan participants under ERISA and directors and executive officers under Sarbanes-Oxley in the context of a cash/stock election merger for the period during which the plan administrator tabulates elections. Companies engaging in these transactions should be aware of these tabulation periods and related blackout periods, so they can alert the plan participants and directors and executive officers that they will be prohibited from engaging in prescribed transactions during the specified period and can satisfy advance notice requirements.

In some cases large individual shareholders are in a position to negotiate for obtaining a tax-free exchange of most or all of their shares. Accordingly, in some cash-election mergers, special provisions have been made to provide such shareholders with a preferential right to receive all stock even if there is not enough stock to satisfy all stock elections. In the context of

a significant minority shareholder who is being asked to support a transaction through a shareholder agreement and who may be required to agree to transfer restrictions on his, her or its shares prior to the closing of the transaction (or if a key employee or other shareholder is being asked to agree to non-compete and/or non-solicit restrictions or similar obligations following closing), preferential or differential treatment can often be justified especially where the shareholder's support for the transaction is important to its success. Further, use of a stock/cash value equalization approach, as outlined above, may help to mitigate concerns regarding special treatment as to the allocation of the various forms of consideration.

Other possible approaches include structuring the transaction so that there is a modest economic incentive built into the pricing and election mechanics to encourage shareholders who are less tax-sensitive to accept cash in lieu of stock. More elaborate mechanisms are at least theoretically possible (such as Dutch auction elections for the scarce shares, or obtaining information regarding the tax status of shareholders for use in setting priorities to receive consideration in the allocation process), but are usually impractical.

### 3. Treatment of Employee Stock Options and Other Stock-Based Awards

In the context of any complex pricing formula and mixed consideration acquisition, it will be necessary to determine the treatment of employee stock options and other stock-based incentive awards settled in shares of target common stock. For example, the parties may provide that employee stock options and other stock-based awards will be:

- rolled over into options or awards with respect to acquirer shares at the applicable exchange ratio;
- fully cashed out; or
- rolled over and cashed out in the same proportion as the target company shares are to be converted into stock and cash in the transaction.

Note that the issue discussed above with respect to the equalization formula for the cash and stock consideration will also be relevant here: namely, should the options be rolled over at the fixed exchange ratio for the stock component or should the exchange ratio be readjusted to reflect the blended value of the per share consideration being paid for the target shares at the time of the closing.

The governing employee benefit plan documents should be carefully reviewed in order to determine whether the desired adjustment is permissible. In determining the applicable treatment of options and other stock-based awards, the type of awards and the vesting status of each type of award, including whether there will be accelerated vesting as a result of the transaction, should be considered. For stock options, whether the awards are "in-the-money" based on the transaction price and the remaining exercise period of the option should be considered. In addition, care should be taken to ensure that equity compensation awards are adjusted in a manner permitted under the deferred compensation legislation embodied in Section 409A of the Code.

### 4. One-Step Versus Two-Step Acquisition Structures

The evolution of the law relating to exchange offers has added the potential for yet another layer of complexity in the "going private" context.

In the context of a parent company taking a public subsidiary private, there may be legal reasons to consider a two-step structure over a one-step merger, particularly for Delaware corporations.

Developments in Delaware case law (*Siliconix*, *Aquila*) created a roadmap to take a publicly traded subsidiary private through a tender or exchange offer followed by a so-called "short form merger," which permits a parent corporation to merge with a subsidiary in which it owned at least 50% under Section 251(h) of the Delaware General Corporation Law without the need for a shareholder vote or action by the subsidiary board. Following *Siliconix*, *Aquila* and *In re Pure Resources*, there was a path to accomplish this while avoiding the litigation risk associated with heightened "entire fairness" review. A subsequent series of Delaware cases has considered the applicable standard of review in these transactions based on which shareholder-protective devices are deployed: *In re CNX Gas Corporation Shareholders Litigation* (2010), *In re MFW Shareholders Litigation* (2013) and *Kahn* v. *M&F Worldwide Corp.* (2014). Accordingly, in addition to committing to consummate a back-end short form merger at the same price and refraining from making any retributive threats, controlling shareholders are well advised to carefully consider the wisdom in each particular case of (1) obtaining an affirmative recommendation on the offer from a well-functioning independent special committee of the subsidiary and (2) adopting a non-waivable "majority of the minority" condition to the tender offer (with the minority not including target management, who might have different interests in the transaction). *In re MFW* in particular clarified that proper use of both of these procedural protections will beneficially shift the standard of review whether the transaction is structured as a one-step merger or a tender or exchange offer followed by a back-end merger. Where only one of the procedures is used rather than both, it appears that it is possible for the defendant to shift to the plaintiff the burden of proof on fairness under entire fairness review.

Structuring a cash-election process using a two-step acquisition structure is challenging, but not impossible. In such a structure, target shareholders are offered the opportunity to elect between cash and stock consideration in an exchange offer context. The election mechanism in the exchange offer is very similar to that provided for in a typical cash-election merger, and in the back-end merger shareholders receive a pro rata mix of the remaining consideration.

By reducing the time between signing and the election deadline, an exchange offer structure can reduce the concern regarding the possible divergence in value between the cash and stock components of a deal. There is some risk, however, that shareholders that do not tender (and whose shares are thus converted in the back-end merger) may complain that they are receiving less value than was paid in the first-step tender offer, particularly if the relative mix of consideration paid in the first and second step are not the same (which could be the case if one form of consideration was more heavily subscribed than the other in the first-step offer). The legal risk should be mitigated by the fact that all shareholders will presumably have had an equal opportunity to participate in the first-step offer.

It is not necessarily beneficial to parties negotiating a part-cash, part-stock deal to open up a Pandora's box of complex options and alternatives. Simple structures work well when business principals are trying to first get comfortable with the very notion of combining their two institutions and wish to remain focused on the compatibility of the two franchises and their management teams. That said, once the main deal is struck, it may be useful to revisit some of the issues raised above to make sure that all possible post-signing scenarios are contemplated and that the acquisition agreement has appropriate provisions for protecting the various constituencies in each such circumstance. If there is a potential for the value of the stock and cash consideration to diverge, then the parties should make sure that the mechanisms governing how shareholders will be treated in such a circumstance are clear, and that disclosures to shareholders fully and clearly inform them about the choices they will need to make and the consequences of making any specific elections or of failing to take any requisite actions.

The courts have not as yet settled on precisely how large the cash portion of a deal can be without triggering *Revlon* review. The 2011 Chancery Court decision in *In re Smurfit-Stone Container* did indicate that a half-cash, half-stock merger may be subject to *Revlon*. But at lower levels of cash, part-cash, part-stock transactions can, if properly structured, remain subject to normal business judgment principles. These standards permit a fully informed board, acting in good faith, to "protect" an agreed-upon transaction with such provisions as no-shop clauses, breakup fees, "force the vote" provisions, and stock options (including options of up to 19.9% of shares outstanding without caps on the upside value of the option).

On top of these procedural and structural issues, there is an overriding substantive concern that the target board properly understands the structure it is proposing and the choices it is presenting to the shareholders. There is no one correct structure, and, absent *Revlon* duties or entire fairness review, directors will be fully protected under the business judgment rule as long as they make fully informed decisions while acting in good faith.

Full and complete disclosure is also important — starting with the initial press release announcing the transaction — to protect the target company and the acquirer from subsequent shareholder challenge or confusion. In the effort to stay focused on business themes in the press release, merger partners sometimes fail to fully explain the intricacies of sophisticated pricing formulas and may find they need to spend the next several days clarifying to the market the precise terms of the transaction. An annex or set of summary bullet points and, in some cases, even illustrative examples, may be useful to avoid such confusion when dealing with such complex deal structures.

## C. Due Diligence

Given the concern over pre-signing disclosure of merger plans, acquirers and targets often limit their pre-signing due diligence to higher-level due diligence conducted between a limited number of representatives on both sides. Confidentiality and speed are significant considerations, particularly in public company transactions.

Confidentiality agreements are a must before detailed diligence may begin. The typical confidentiality agreement used in the bank merger context specifies that the agreement is being entered into in contemplation of a negotiated merger and covers information that may have been

exchanged before execution of the agreement as well as information that is exchanged afterwards. A well-drafted confidentiality agreement should cover not only information that is provided to the other party (and its bankers or other representatives) but also any summaries, analyses, presentation decks or other materials (including materials prepared by the recipient or its representatives) that are derived from any such information. The confidentiality obligation will usually be quite comprehensive, with only limited exceptions for information that becomes public without any violation of the confidentiality agreement or where the recipient is legally compelled to disclose the information (and even then will require the recipient to take steps to limit the information disclosed and allow the provider to seek appropriate relief, including a protective order) or such information is disclosed in confidence to a regulatory authority, such as a bank examiner, at its request. In addition to the obligation to maintain information in confidence, the confidentiality agreement should limit the permitted uses of the supplied information (*e.g.*, the information shall be used solely for the purpose of evaluating a possible negotiated business combination). This provides protection against the recipient using confidential information to facilitate an unfriendly or unilateral bid in the event discussions fall apart, which is helpful if there is no express standstill provision in the confidentiality agreement.

In addition to confidentiality and use provisions, confidentiality agreements sometimes contain provisions limiting, usually for a one-to-two-year period, the right of the acquirer to solicit for employment and/or hire employees of the target that acquirer representatives meet or become aware of (other than through a general list of employees) during the diligence process, or in some cases covering all target employees of a certain seniority level. Often there is an exception for generalized employment advertising or use of search firms not specifically aimed at the target's employees (and often hiring individuals who respond to such general solicitations). If the stronger "no hire" covenant is included, the acquirer may negotiate an exception for employees who are terminated or whose employment with the target has ceased prior to the initiation of employment discussions with the acquirer, often subject to a minimum "cooling off" period. Also, confidentiality agreements sometimes contain standstill provisions, usually involving the acquirer agreeing, again often for a one-to-two-year period, to broad restrictions on its ability to take actions to acquire or control the target or any substantial portion of the target, or to influence or attempt to influence the target's management or the conduct of its business, outside of the confines of a friendly negotiated transaction.

Whether or not non-solicitation and standstill provisions are appropriate to include or propose involves an assessment of the particular facts of a situation, including the historical relationship between the parties and the reputation of the acquirer. Many financial institutions acquirers eschew unfriendly approaches as a policy matter and because a financial institutions transaction will often require the parties to work together to obtain required regulatory approvals, and thus will not object strongly to a standstill; other acquirers understand that a standstill can be useful to them if a definitive merger agreement is signed because the existence of the standstill can add an additional layer of protection against interloping third-party bids by enhancing the potency of the merger agreement's no-shop clause, which typically requires a potential interloper to sign a confidentiality agreement no less restrictive than the one signed by the acquirer and may require the target to enforce its existing standstill agreements with third parties. In some recent shareholder class action litigation, plaintiffs have attempted to make an issue of provisions that bar a potential acquirer from privately asking the seller to waive the standstill.

One issue that arises occasionally is the reluctance of diversified financial institutions with investment banking businesses to agree to standstills without appropriate carve-outs. Some have investment banking subsidiaries that provide M&A advisory services. While the larger companies might wish to look at a potential asset that comes on the market, they may be reluctant to sign onto a broadly worded standstill that, read literally, would prevent their affiliated investment banks from providing services to a third party that might wish to acquire the target. At the same time, sellers may rightly be concerned about providing confidential information to a party when its affiliate is free to advise a potentially hostile bidder if discussions do not work out. However, structured correctly, an appropriately tailored exclusion to the standstill that exempts affiliated M&A advisory activities should be beneficial to both parties. The wording of any exemption should make it clear that there must be appropriate internal information barriers in place so that the potential acquirer cannot use any diligence information it obtains or even its awareness of a possible transaction to solicit and assist M&A advisory clients. As indicated above, even if there is an exception to the standstill for such advisory activity, the acquirer should still agree not to use any information provided for any purpose whatsoever other than its own consideration of a possible negotiated business combination, and the confidentiality agreement should make clear that the existence of any preliminary discussions with the target, and of the confidentiality agreement itself, is confidential information covered by the non-use and non-disclosure provisions of the agreement. This approach balances the legitimate concerns of the seller to keep control of the process with the legitimate concerns of the acquirer not to competitively hobble its M&A advisory arm by limiting its ability to accept mandates for deals that the parent organization has previously considered.

Hedge funds and other trading firms have become more frequent participants in recent transactions, including capital raising transactions. Such firms are particularly sensitive to potentially possessing material non-public information that may impede their ability to trade securities of the issuer freely in public markets, and therefore will often seek to limit their diligence to only public information, or to limit their obligation to keep non-public information confidential to a very short period (after which they can disclose it so they can resume trading). Sometimes these diverging needs can be bridged by a more careful and more specific focus on the nature of the particular information that the investors require. In these situations, care must be taken to develop a diligence process that enables the appropriate range of investors to participate but that does not threaten to compromise the confidentiality of the issuer's information.

In asset dispositions in particular, acquirers will want to undertake a thorough examination of any service contracts, supply contracts, vendor agreements, customer arrangements and other agreements of a similar nature that are tied to substantial portions of revenue or expense. Understanding assignment provisions, counterparty termination rights and rights of counterparties on a change-of-control or sale of all or substantially all of the assets of a business is critical to evaluating the risks associated with customer retention, asset depreciation and the soundness of revenue streams and business plans.

The confidentiality of important regulatory exam reports and other supervisory material requires potential acquirers to plan their strategy for regulatory due diligence thoughtfully. Regulators consider exam reports and certain other communications relating to supervisory matters to be their property, not the bank's, and take the position that such material is

confidential and cannot be disclosed without their prior consent. On the other hand, the information in such materials may be of great significance to a potential acquirer. Indeed, such information about the acquirer will frequently be of critical importance to the seller, as it can bear on the likelihood that a deal will be approved without undue delay. In most cases, a reasonable accommodation can be worked out without running afoul of legal or regulatory restrictions. Even if such diligence is deferred until a relatively advanced stage of the process, the parties early on should try to agree on a mutually acceptable strategy to accomplish it.

## D. Conditions

### 1. Regulatory Approvals

Nearly every bank holding company transaction is subject to one or more federal regulatory approvals or notices, and many other financial institutions transactions are subject to their own regulatory clearances (FINRA, OCC, state consumer finance bodies, state insurance regulators, etc.). The receipt of the requisite approvals is always a condition to the parties' obligations to close. Some agreements permit a party to refuse to close if regulatory approval, when received, is conditioned on actions being taken, or steps being agreed to, that would make the transaction materially economically unattractive to that party (sometimes referred to as the "materially burdensome" or "unduly burdensome" condition). Such conditions, for example, could include a requirement that the acquirer make extensive divestitures for antitrust reasons, or that it raise unexpectedly large amounts of capital. On the other hand, many targets desire greater assurances from the acquirer that it will close the transaction even if the acquirer is required to raise additional capital or make reasonable divestitures, and insist on assurances to such effect in the merger agreement. Such assurances can be particularly important in in-market transactions, where there is a clear need for a given level of divestitures, and may also be seen as desirable where antitrust issues are expected to be potentially significant. In many cases, though, such language does not add much to what is contemplated by a customary "reasonable best efforts" covenant, and a target company that is overzealous in negotiating for such language runs the risk that its presence is overly publicized, and may telegraph a belief that, for example, required divestitures may be large, and may stimulate competitors, political constituencies or community activists to exert greater pressure on regulators to extract concessions as the price of regulatory approval.

Acquisition agreements have not generally attempted to specify with any precision the types of events that would represent a failure of the regulatory approval condition, and have continued to use one or another loosely phrased formulation. The existence of several different formulations makes it even more important that careful attention be paid to the precise wording of such clauses, as a court could deem the fact that one version of such a provision was chosen, and not another, to be significant in interpreting its meaning.

Where parties anticipate some necessary branch divestitures, they may modify the requirement that regulatory approvals be obtained without the imposition of a materially burdensome condition by clarifying that a divestiture requirement would not be deemed materially burdensome if such divestitures were consistent with Department of Justice and Federal Reserve guidelines, policies and practices as applied in recent bank merger transactions. A similar approach may be taken with capital ratios, although that is somewhat harder to do

because of the wide range of factors regulators take into account as a prudential matter in establishing capital requirements (including expansionary activity and asset composition).

Financial holding companies have a choice in how to proceed with the non-bank portion of a bank holding company acquisition or the acquisition of a non-bank in each case of less than $10 billion in acquired total consolidated assets: (1) provide notice under the provisions of Section 4(c)(8) of the Bank Holding Company Act to the extent the non-bank activities are permitted activities under that Section or (2) forego prior notice to the Federal Reserve with respect to these activities and instead make a Hart-Scott-Rodino filing. The choice will depend upon the specifics of the transaction and should be discussed with regulatory and antitrust transactional counsel.

As institutions become more complex and multinational, the antitrust, competition and foreign direct investment laws of foreign jurisdictions, such as Canada, the European Union and China, are increasingly becoming factors to consider. In particular, EU and Chinese competition clearance can often be a major factor in assessing both the certainty and timing of closing, and it may be all too easy to misjudge the level of scrutiny a transaction will receive. When the merging companies have significant non-domestic operations, these approvals, and the appropriate allocation in the merger agreement of the risk of not obtaining them, are best addressed early in the negotiation process. Also, the presence of target foreign operations may implicate the need for a Federal Reserve filing under Regulation K, although a financial holding company acquirer would not otherwise need to apply to the Federal Reserve to complete a non-bank acquisition.

Failure to obtain the required regulatory approvals has historically been a rare occurrence in announced bank transactions in the U.S., perhaps because regulators are often consulted informally before a transaction is announced and any hesitancy would normally be taken quite seriously by the parties. Still, a few notable transactions have been terminated due to regulatory issues arising with a party, and a few more have been subject to delay and uncertainty. Where material supervisory issues arise after a regulatory application has been filed, the Federal Reserve may deny an application, or a transaction party may withdraw the application in order to avoid denial.

### 2. Shareholder Approvals

Target shareholders will generally be required to approve a transaction under state corporate law, and if the target and the acquirer are similar in size, the acquirer's shareholders will also likely be required to approve the transaction under relevant state corporate law or stock exchange rules, depending on whether the transaction is structured as a direct or triangular merger and whether stock is being offered as all or part of the merger consideration. Delaware law provides generally that each constituent corporation to a merger requires a vote of its shareholders (a majority of the shares outstanding, if a greater vote is not required by the certificate of incorporation), but that the surviving corporation does not need to obtain such a vote unless the number of shares of its common stock to be issued in the merger exceeds 20% of the company's outstanding shares immediately prior to the effective date of the merger. When a triangular merger structure is used (target merges not with acquirer but with acquirer's subsidiary), the acquirer is not a "constituent" corporation in the merger and Delaware law (and

the law of many other jurisdictions) does not require a shareholder vote. However, the stock exchanges require the approval of a majority of the shareholders voting on the matter for an acquirer to issue common stock representing 20% or more of the acquirer's outstanding voting power prior to such issuance, and for certain issuances to related parties. This is a lower vote standard than the vote required to approve mergers in Delaware and many other states, which require a majority of the outstanding shares entitled to vote (or, in some states, supermajority of the outstanding shares), rather than a majority of votes cast. Parties occasionally structure a transaction as a two-step merger — a triangular merger followed immediately by a second-step merger of the target into the acquirer — to take advantage of this lower vote standard on the acquirer side (*e.g.*, Pinnacle Financial Partners' 2017 acquisition of BNC Bancorp, Huntington Bancshares' 2016 acquisition of FirstMerit Corporation).

In a transaction that does not implicate any related party stock exchange rules, it may be possible to avoid the need to obtain acquirer shareholder approval by keeping the share issuance under the 20% level. Adjustments to the stock/cash mix may influence whether the 20% threshold is triggered, however, the desire to avoid acquirer shareholder approval should be balanced with the consideration that a minimum amount of stock may be necessary if the parties wish to keep the stock component tax-free. Where it is clear that acquirer shareholder approval must be obtained given the size and economics of the transaction, attention should be paid to the potentially different shareholder vote requirements depending on whether the requirement arises under state law (*e.g.*, majority of outstanding shares of common stock) or stock exchange rule (*e.g.*, majority of shares voted on the deal).

Where the target has outstanding preferred stock, counsel should determine whether the preferred shareholders are entitled to vote on the transaction. If they are entitled to vote, it must be determined whether they vote together as a single class with the holders of common stock or as a separate class or classes. Preferred stock of bank holding companies has often been converted in a merger on a one-for-one basis into "mirror preferred" (preferred stock of the acquirer having the same terms), as in Huntington Bancshares/TCF Financial, TCF Financial/Chemical Financial and BB&T/SunTrust. On occasion, other approaches may be taken (*e.g.*, cashing out the preferred stock). A careful analysis of the terms of preferred stock and of the relevant corporate law should be undertaken to determine whether the planned treatment of preferred stock in the merger is permissible and, if it is, whether it could trigger class voting rights, potentially giving the preferred stock the ability to "hold up" the transaction. In Delaware, the incidental modification of preferred stock in a merger is generally considered to be a legally separate action from amending a target's charter to change the terms of preferred stock. Accordingly, preferred stock provisions that give the holders of a series of preferred stock a separate class vote on charter amendments diminishing the rights of holders of that series generally do not require a class vote in Delaware if the same change is undertaken as part of a merger, unless the terms of preferred stock provisions explicitly grant such rights in the context of a merger.

Approval of the acquirer's shareholders must also be sought if the acquirer desires to amend its charter in connection with a transaction. For example, the acquirer may need to increase its authorized capital stock where the issuance of stock in the merger exceeds available shares or may leave the acquirer without sufficient remaining authorized but unissued shares. The acquirer may also wish to update its corporate governance in connection with the

transaction. In addition, name changes are not infrequently a component of bank holding company transactions. All of these measures may require charter amendments, which can generally only be accomplished with shareholder approval. Due to the SEC's "unbundling" policy for proxy card voting items, such charter changes may require a separate line on the proxy cards, for both the target's shareholder vote and the acquirer's shareholder vote, even if the change is being made as an integral component of the merger if they result in a material change to the equity securities that are received by target shareholders in a transaction and therefore substantively affect shareholder rights. Amendments to an acquirer's charter that are not undertaken pursuant to a merger agreement, and are neither a condition to nor conditioned upon the consummation of the transaction (*e.g.*, an increase in the authorized shares of the acquirer that is not necessary to complete the transaction and is not required by the terms of the merger agreement), but as a matter of convenience are presented for acquirer shareholder approval at the same meeting at which the merger is being voted upon, should not require separate target shareholder approval under the SEC's unbundling guidance (*e.g.*, South State's 2017 acquisition of Park Sterling).

Where a tender offer or exchange offer is used, the need for approval of the target shareholders will be obviated if the acquirer is able to obtain enough of each class of the target's voting stock to use a "short form" statutory merger for the final step. This threshold is a majority in Delaware, but could be as high as 90% in other jurisdictions, and attention should be paid to the requirements under the law of the target's jurisdiction of incorporation. However, if an exchange offer involves the issuance of 20% or more of the acquirer's stock, a vote of acquirer shareholders may still be required under stock exchange rules.

In rare circumstances, it may be appropriate for exchange-listed targets in significant need of capital in the very short-term to structure a transaction in which an investor or group of investors purchases equity securities amounting to more than 20% of the company's outstanding equity in a private placement without requiring a shareholder approval under the applicable exchange's "financial viability exception." In the fallout from the 2008 financial crisis, several investment transactions were approved by the NYSE and NASDAQ under the financial viability exception, including investments in Pacific Capital, Central Pacific and TIB Financial. An exception was also granted in the 2012 equity investment in Knight Capital Group by a consortium of financial institutions investors. Note that, unlike the NYSE, NASDAQ has taken the position that the exception does not apply to shares issued to facilitate a merger.

### 3. Material Adverse Effect

A typical merger agreement will contain broad representations, warranties and covenants (often qualified by materiality standards and confidential disclosure schedules) as well as closing conditions tied to the performance by the other party of the other party's covenants and the truth of the other party's representations and warranties, as well as either specific closing conditions with bright line tests that must be met or, more commonly, a general closing condition tied to the non-occurrence of a material adverse effect (also known as a "material adverse change") subject to various materiality exceptions. Although "tight" materiality standards are generally not as prevalent in public transactions as in private deals, a "no material adverse effect" representation with a bring-down to closing is particularly important in light of the long delay between signing and closing in most financial institutions deals and the sudden and sometimes severe asset

quality or regulatory problems that banks and other financial institutions have experienced. Together with the requirement that regulators approve the transaction, the "no material adverse effect" provision remains the most important source of downside protection for both parties.

In ordering Tyson Foods to adhere to its merger agreement with IBP Inc., the Delaware Chancery Court (interpreting New York law) gave significant definition to the interpretation of "material adverse effect" clauses. Tyson, among other things, claimed that IBP had suffered a material adverse effect due to factors including poor financial performance following execution of the merger agreement, and sought to terminate the merger agreement. In requiring Tyson to adhere to the merger agreement, the court engaged in a highly fact-intensive inquiry into the great deal of information about IBP provided to Tyson during due diligence, including information concerning the financial developments that Tyson alleged constituted a material adverse effect and that showed that IBP's business had been historically cyclical. Significantly, the court stressed that a long-term point of view was appropriate when determining if a material adverse effect had occurred, holding that a material adverse effect contemplates a development that is durationally significant, and consequential to a company's earning power over a commercially reasonable period (likely to be measured not in months but in years) and that events should be viewed from the vantage point of a reasonable acquirer with a long-term outlook, not that of a speculator interested only in a short-term profit. The decision is generally viewed as making it challenging to terminate a merger on the basis of a material adverse effect.

In the closely watched Delaware decision in *Akorn Inc.* v. *Fresenius KABI AG*, the Delaware Chancery Court found that Akorn had suffered a material adverse effect following signing of the transaction which, along with certain other identified breaches of the merger agreement by Akorn, permitted Fresenius to terminate the merger agreement and abandon the transaction. The court based its determination that a material adverse effect had occurred on Akorn's persistent violations of FDA requirements and the dramatic decline in Akorn's financial performance after signing (including a 55% decline in year-over-year EBITDA), notwithstanding that Akorn had reaffirmed its full year guidance the same day the merger agreement was executed. In the Chancery Court's decision, which was affirmed by the Delaware Supreme Court in December 2018, the court reiterated the principle from *IBP* that a material adverse effect requires a durationally significant impact to the overall earnings potential of the company, but concluded that the facts at issue were sufficient to meet that standard. While affirming the high threshold for establishing a material adverse effect, the decision represents the first time that the Delaware Chancery Court has permitted an acquirer to walk from a deal based on a finding that the target suffered a material adverse effect.

Parties may attempt to go beyond a "plain vanilla" material adverse effect formulation by specifying triggering events in greater detail. For example, with respect to asset quality, the contract could define a material adverse effect to exist for specified increases of non-performing assets and charge-offs, with a bring-down to closing, or the agreement could contain a minimum shareholders' equity or tangible book value condition. In some cases (generally, though not always (*e.g.*, Banner Corporation's 2018 acquisition of Skagit Bancorp, Inc.), limited to private transactions that allow for a post-closing dispute resolution and true-up process) there may be a provision for a purchase price adjustment in lieu of entirely excusing the obligation to close. This approach, however, involves the risk that the target may insist upon a cushion of deterioration beyond current levels before the material adverse effect clause will be breached,

and that the cushion will be so large as to make the protection virtually meaningless. In earlier years, some contracts had included earnings tests, generally tied to the projections which underlie the premium being offered by the acquirer, but these are rarely seen today.

It is customary to include broad carve-outs from the changes that trigger a material adverse effect for events of a general nature not specifically related to the particular parties to a transaction — including general changes in the U.S. or global economy, changes in financial markets and indices (including interest rates), changes in laws, regulations and accounting principles, general changes in the industry in which a party does business, the impact of entering into and announcing the deal (*e.g.*, on target employees or commercial counterparties), and most recently in light of the global outbreak of Covid-19, pandemics (including Covid-19 and any additional waves or permutations of Covid-19, however, in light of the waning risks posed by Covid-19 practitioners are starting to push back on specific inclusions of a Covid-19 exception), epidemics and other global health disasters, and governmental actions (including any quarantine, "shelter in place," "stay at home," workforce reduction, social distancing, shutdown, closure, sequester, safety or similar law, directive, guidelines or recommendations) taken in response to the foregoing. Transactions with a material adverse effect clause that contains such carve-outs should be relatively well-protected against unilateral termination based on catastrophic global events, and their subsequent ripple effects. Often these carve-outs from events that may count towards a material adverse effect are limited to those that do not affect the company "disproportionately" compared to others in its industry — the idea being that the other party is accepting general systemic risk of deterioration in the industry but not deterioration specifically attributable to its counterparty. The upshot is that material adverse effect provisions may become complex.

The deterioration of the capital markets beginning in 2007 placed a spotlight on material adverse effect clauses as a few acquirers and financing sources sought to terminate or renegotiate deals signed prior to the tightening of the capital markets. The many examples of transactions in which a material adverse effect or similar dispute arose in 2007-2008 include:

- JC Flowers, JP Morgan and Bank of America/Sallie Mae
- KKR and GS Capital Partners/Harman International Industries
- Radian Group/MGIC
- Finish Line/Genesco
- Lone Star Funds/Accredited Home Lenders
- Bain Capital, Carlyle Group and Clayton, Dubilier & Rice/HD Supply
- Acxiom/ValueAct Capital Partners and Silver Lake Partners
- Fortress Investment Group and Centerbridge Partners/Penn National Gaming, Inc.
- Blackstone and GE Capital/PHH Corp

Similar disputes have arisen in more recent post-2008 financial crisis transactions as well, including in the context of the significant global equity market declines in early 2020 as a result of the Covid-19 pandemic and resulting severe dislocation and distress in the broader economy. The resolutions of claimed material adverse effects in these transactions have been varied (and very fact specific), with some transactions being terminated or renegotiated and others proceeding to litigation.

Also important are closing conditions and termination provisions. Merger agreements often provide that a party may not terminate for breach of representations and warranties (including that there has been no material adverse effect) if that party is itself in material violation of its representations, warranties or covenants. In a stock transaction in which the parties have similar operations and similar exposure to industry or market conditions, there may be questions regarding the ability of an acquirer to invoke the termination provision in view of a potential violation of its own material adverse effect representation. If the seller has negotiated for a rep/warranty closing condition tied to the absence of inaccuracies that would have a material adverse effect on the seller on a consolidated basis (rather than the material accuracy of each individual representation and warranty), care should be taken to ensure that the corresponding termination right uses the same standard. In transactions requiring external financing, a seller should ensure the material adverse effect definitions and provisions in the transaction agreement and financing documents are as nearly identical as possible. Even in the absence of a financing condition, a seller should be aware of the acquirer's financing requirements and alternatives and its likely ability to successfully identify alternative financing sources if necessary. Finally, parties must focus on whether a non-breaching party has available to it the full range of remedies, including direct and indirect monetary damages and the remedy of specific enforcement of the contract, or whether the contract limits the available remedies. To the extent remedies are limited, each party must consider the possibility that the other could find it economically attractive to simply breach the contract and accept the consequences. Regarding damages for breach, parties should consider how target company damages would be measured in a busted deal — for instance, based on financial damage to the target company or expectation damages of its shareholders (who are generally not parties to the transaction).

It is not uncommon to see both a condition that there be no material adverse effect at closing and a bring-down of representations and warranties that includes a representation that there has been no material adverse effect since a specified date (often the date of recent financial statements). In almost all transactions, the seller will deliver a disclosure schedule of exceptions to the representations and warranties, and these matters are typically not counted against a seller when determining whether the representations and warranties are true when "brought down" at closing. Absent careful drafting, however, these matters may well be considered when determining whether or not a separate "no material adverse effect" closing condition is satisfied.

Some merger agreement provisions may function as "outs in disguise." Parties should focus on how a transaction may fare in light of steep changes in stock prices that may follow a significant external shock. In part-stock/part-cash transactions intended to qualify as tax-free reorganizations, unless the merger agreement provides for "fixed consideration" permitting the "continuity of interest" tax requirement (*i.e.*, that acquirer stock is at least 40% of the consideration) to be tested at signing, customary closing conditions that each party receive a tax opinion from its respective counsel may give each party a right to walk away from the deal if the

acquirer's stock price declines significantly enough to threaten meeting that requirement, unless the transaction contains a mechanism to deal with the possibility (*e.g.*, through an adjustment of the mix of consideration). Where a vote of the acquirer's shareholders is required, the ability of the acquirer's shareholders to vote against a deal may constitute a "back door material adverse effect out" for the acquirer, requiring careful consideration of alternatives that may mitigate the vote requirement (such as obtaining support agreements from significant shareholders) and of the acquirer's obligations with respect to its shareholder vote, including continuing to recommend the transaction and otherwise to use efforts to obtain a positive outcome. An acquirer may also claim a material breach of the interim operating covenants by the target to walk away from the transaction.

Global events following the 2008 financial crisis and its aftermath also focused attention on condition language found in transactions involving tender offers that permit a purchaser to abandon an offer in the event of a variety of significant external circumstances — a general suspension in trading on national exchanges or markets, specified percentage declines in broad stock indices, banking moratoria, governmental limitations on the availability of credit or a commencement of armed hostilities or other national or international calamity. Parties should focus on such provisions and sellers should not accept them as inevitable tender offer boilerplate. If such outs would not be acceptable in a merger agreement that does not involve a tender offer, there is no reason why they should be accepted in one that does. In recent years the more common approach has been to modify material adverse effect definitions to specifically provide that events relating to global terrorism or war are not considered in determining whether a material adverse effect has occurred.

A seller's ability to negotiate a favorable material adverse effect clause and other language regarding outs and termination rights will, of course, depend on the circumstances and the respective negotiating leverage of the parties. Given the critical risk allocation function served by these provisions, however, they should be raised early in discussions — at least in conceptual form — and considered key deal points, not mere drafting or lawyers' issues.

Deals have been tested by such things as terrorism (September 11), weather (Hurricane Katrina), big stock market moves, resolution of outstanding regulatory issues and, most recently, cyberterrorism and pandemics (Covid-19). Material adverse effect clauses have been the principal areas in which these disputes have played out.

There are risks involved in using a material adverse effect clause to try to hold up or renegotiate a deal. These were demonstrated by Johnson & Johnson's $25 billion cash/stock deal to acquire Guidant Corporation. Guidant announced safety issues and recalls involving its medical devices, and Johnson & Johnson delayed closing the deal and sought to renegotiate the price. This encouraged Boston Scientific to make an unsolicited bid, initially slightly lower than the value of the Johnson & Johnson deal. A bidding war ensued. The Guidant board ultimately deemed Boston Scientific's revised $27 billion offer to be superior and terminated the agreement with Johnson & Johnson. While Johnson & Johnson may not have been willing to complete the deal under any circumstances at the original price, it is worth pointing out that its final bid represented a mere 1.6% discount to the original terms. Invoking a material adverse effect clause to renegotiate a deal brings with it a significant risk of losing the deal altogether, particularly when there is another acquirer waiting in the wings.

#### 4. Fiduciary Outs

Targets will often demand that the contract contain fiduciary exceptions, which generally condition some obligations of the target upon its board not having determined that to take the action would constitute a violation of its fiduciary duties under state corporate law. For example, the contract almost always prohibits the target from soliciting or encouraging higher bids from third parties, but there is frequently an exception to this covenant permitting the target board to talk with and provide information to third parties who have made an unsolicited proposal if the failure to do so would or could violate the board's fiduciary duties. Similarly, covenants requiring directors to recommend the approval of a transaction to their shareholders are often made subject to the proper exercise of the directors' fiduciary duties. Beyond this, in financial institution deals, the acquirer typically can count on getting a firm commitment by the target to take the deal to its shareholders. Full "fiduciary outs" enabling the target to terminate the agreement to take a superior bid remain the exception, rather than the rule, in financial institution mergers, and as noted below can provide a route for an interloper to eventually succeed with a hostile bid. Acquirers requiring a shareholder vote to complete a deal similarly will often negotiate for fiduciary exceptions to their obligation to recommend the transaction to shareholders — though it is important to recognize that the issues raised by an acquirer's fiduciary out may be different than those presented by a seller's fiduciary out.

The Delaware Chancery Court has had several occasions to consider "no-shop" clauses in the context of stock-for-stock deals. In litigation arising over the attempt by Phelps Dodge to acquire Cyprus Amax and Asarco, which had agreed to merge, the Court in dicta found "troubling" a no-talk provision that, on its face, had no fiduciary duty exception, stating that even though there was no duty to negotiate with unsolicited bidders in the context of a stock-for-stock merger of equals, the decision not to negotiate must be an informed one. However, the Court declined to enjoin the troubling no-talk clause because, in light of the fact that the target shareholders would have the opportunity to "simply vote down" the friendly deal, there was no showing of "irreparable harm" to the plaintiff sufficient to support injunctive relief.

However, in *Ace Limited* v. *Capital Re Corp.*, the merger agreement was "tied to voting agreements ensuring consummation." There, the Delaware Chancery Court stated that the no-talk provision (which it analyzed by applying the heightened scrutiny accorded to corporate defensive devices under Delaware's *Unocal* doctrine) was likely invalid even though it contained an exception that allowed discussions with third parties based on written advice from counsel that not engaging in such talks would breach the board's fiduciary duties. The court indicated that the outcome might have been different had the shareholder vote not been "locked up" in advance as a result of the voting agreements. Neither *Phelps Dodge* nor *Ace* was a case of the original parties to a friendly deal displaying a united defensive front to an interloper. In both cases, one of the parties to the original friendly merger agreement was attempting to talk to the interloping bidder.

*In re IXC Communications, Inc. Shareholder Litigation* upheld a "no-talk" clause with an out for a "superior proposal" in a stock-for-stock merger agreement, stating that no-talk provisions are "common" in merger agreements and do not imply some automatic breach of fiduciary duty. *IXC* returned to the use of the business judgment rule, rather than *Unocal* scrutiny, to review the no-talk clause. Similarly, in a 2000 opinion relating to the Medco/King

stock-for-stock transaction, the court expressly applied the business judgment rule in upholding the collar, termination fee, no-talk, no-shop and stock option provisions.

A divided Delaware Supreme Court in *Omnicare, Inc.* v. *NCS Healthcare, Inc.* held that, where a controlling shareholder of the target has agreed to vote in favor of the deal and thus a favorable shareholder vote is assured, the merger parties may not rely, without any fiduciary out on the part of the target board, on the provision of Section 251(c) of the Delaware corporation law that permits a corporation to agree to take a merger to a shareholder vote even if the corporation's board no longer recommends the merger. The majority suggested that such measures can violate fiduciary duties by preventing the board from exercising its "continuing fiduciary obligation to negotiate a sale of the company in the interests of the stockholders." It appeared to confirm the suggestion in *Ace* that deal protections, at least in the context of a transaction with a locked up vote, are analyzed under *Unocal* and not the business judgment rule, and must be reasonable in relation to the threat and neither preclusive or coercive.

Special care should be used in drafting agreements when there is a controlling or near-controlling shareholder that agrees with the acquirer to vote in favor of the deal. After *Omnicare*, the Delaware Chancery Court in *Orman* v. *Cullman* upheld a strong deal protection — an 18-month post-termination lockup of the vote of a controlling shareholder — where the merger was contingent upon a "majority of the minority" vote and the target board retained the ability to exercise its fiduciary duties, if required, to withdraw its recommendation of the deal. Shareholder voting agreements, even when they strongly deter third party bids, appear to pass muster under *Unocal* if, when combined with other deal protections and applicable provisions, they do not make the challenged transaction an absolute *fait accompli*.

At the very least, Delaware courts are willing to scrutinize no-talk and no-shop clauses, even in stock-for-stock transactions otherwise subject to the business judgment rule, and the results will be highly fact-specific. What these cases have not held is that a party to a stock-for-stock non-*Revlon* transaction has any *per se* duty to enter into active negotiations with an intervening third-party bidder, or that (absent a locked-up vote) the agreement for such a transaction must contain an outright fiduciary termination right excusing the target from bringing the transaction to its shareholders for their vote. Parties should accord focus and careful draftsmanship to no-shop clauses and similar protective devices in merger agreements based closely on the specific facts of the transaction (particularly where a substantial enough percentage of the target shareholder vote is locked up as of the date of signing so as to make the possibility of shareholder rejection slim or nonexistent), as well as developing a persuasive record supporting the rationale for the final contract terms. Where there is a majority shareholder willing to have its vote locked up, the acquirer may nonetheless consider whether limiting the percentage of locked up shares (whether at the outset or by providing that, upon a change of recommendation by the board of directors, certain shares get released from the voting agreement and voted either in the discretion of the shareholder or on a pass-through basis in the same proportion as the votes cast by minority shareholders) such that the approval of the merger is not a *fait accompli* may be a better alternative than foregoing a "force the vote" provision or granting an express fiduciary termination right.

In the 2011 *In re OPENLANE, Inc. Shareholders Litigation* decision, the Delaware Court of Chancery rejected an argument that a merger was an impermissible "*fait accompli*" simply

because the merger, which did not include a fiduciary termination right, was approved by a majority of the shareholders by written consent the day after the merger agreement was signed. The court reasoned that the merger agreement did not "force[] a transaction on the shareholders," who freely chose to submit their written consents, nor did it "deprive[] them of the right to receive alternative offers" because the board could have terminated the agreement without paying a termination fee if a majority of shareholders had not consented within 24 hours of signing. Despite the *OPENLANE* decision, however, written consents can be expected to be disfavored when the acquirer intends to issue registered stock to the target's shareholders because the SEC takes the view that a consent approving a merger constitutes a private offering of the acquiring company's securities that precludes the acquirer from subsequently registering the offering on Form S-4.

Fiduciary termination rights allow the target board to actually terminate the acquisition agreement in order to accept a superior proposal after making a determination, after advice of counsel, that permitting consummation would violate the board's fiduciary duties.

Fiduciary termination rights (including those based on a superior proposal) are rare in financial institution merger agreements. A notable example of a contract containing such a termination provision was the First Bank Systems/First Interstate agreement (where the termination right was used by the First Interstate board when it opted to terminate its transaction with First Bank System in favor of a Wells Fargo proposal). In late 2010, Cadence Financial Corporation terminated a transaction with Trustmark Corporation in favor of a higher value offer from Community Bancorp, LLC, an investment vehicle formed and capitalized for the purpose of acquiring financial institutions. It is possible that the existence of a fiduciary termination right (based on a superior proposal) in the merger agreement at issue in *Ace* may in fact have contributed to the outcome in that case, as the court seemed troubled that the fiduciary termination right for which Capital Re Corp. had negotiated might be illusory if there was no clear path to having discussions with a third party that would be a predicate to getting a superior offer.

Fiduciary termination rights are typically only found in all or predominantly cash merger transactions in which a target's *Revlon* duties are implicated, though even in that context they are by no means ubiquitous (for example, neither California Republic Bancorp nor EverBank Financial Group had such a termination right in their all-cash transactions). More common than an outright fiduciary termination right is to condition the target board's obligation to recommend the transaction to shareholders and to use its reasonable best efforts to obtain shareholder approvals on such actions being consistent with the proper exercise of the board's fiduciary duties, which is a protection included in the vast majority of both stock and cash public company transactions. At least where the target shareholder vote is not locked up from the outset (or where a majority of the minority voting condition has been agreed to), this structure gives the acquirer its proper seat at the table should a competing bid arise and an appropriate right to bring its proposal to the target shareholders for a vote, while enabling target boards to properly discharge their duty of candor to shareholders in the event a change in circumstances demands a change in their recommendation. Virtually without exception, if the target board invokes its right to change its recommendation to shareholders as required by its fiduciary duties, the acquirer can then terminate the transaction and collect a customary termination fee. A notable but extremely unusual exception was Hanmi Financial Corporation's failed merger with SWNB

Bancorp, Inc., the holding company for Southwestern National Bank, where Hanmi's right to terminate the merger agreement and receive a break-up fee on its face appeared to be limited to the circumstance where SWNB's board changed its recommendation in response to a competing acquisition proposal. After Hanmi's stock price declined post-announcement, the SWNB board withdrew its recommendation until the parties amended the deal to increase the cash component of the merger consideration and decrease the stock component. SWNB shareholders nevertheless failed to approve the transaction and the merger agreement was terminated, resulting in litigation as to, among other things, whether Hanmi was entitled to a fee or any other remedy for SWNB's withdrawal of its recommendation.

Some counsel have argued that merger agreements must contain fiduciary termination provisions as a matter of state law. We believe this view is incorrect and that there is no such obligation under Delaware or other state laws with which we are familiar. This view also seems quite difficult to square with the tremendous weight of precedent in the financial services space. Language in the cases that speaks of an "unflagging" or "continuing" obligation on the part of a board to exercise its fiduciary duties cannot be taken out of context and expanded indefinitely into an amorphous and open-ended right to terminate acquisition agreements, considering that the courts have also recognized the legitimate need on the part of acquirers not to be used as stalking horses and on the part of sellers to be able to make firm commitments in order to bring an acquirer to the table. The Delaware statute expressly allows a merger agreement to require that a merger be presented to the target shareholders for a vote, regardless of whether the target board continues to recommend approval of the transaction, or even recommends rejection of the transaction, at that time. Thus, where a board retains the flexibility to withdraw its recommendation of a merger based on its fiduciary duties and there will be a meaningful shareholder vote (not locked up through voting agreements *ab initio*), the parties may legally require that the transaction nonetheless be submitted to the target's shareholders, which in essence is a fiduciary "out" if the shareholders vote the transaction down.

### 5. Special Considerations in Private Equity Transactions

Undertaking a private equity transaction in the financial services sector raises a host of special considerations. Private equity transactions will necessarily require the private equity firm (or private equity consortium) to obtain financing in order to complete the transaction, and also may require substitute capital markets funding arrangements to run the target's business given the prospective change to the leverage of the institution, which may limit access to capital markets or other historical sources of funding. This raises a number of deal certainty considerations for the target company.

Even in transactions where the private equity acquirer has agreed not to expressly condition the closing on financing, the acquirer will still necessarily require funding and, therefore, there will still necessarily be a risk that the transaction will not close due to the failure to obtain financing. Targets have sought to address this risk in different ways, including through the use of reverse breakup fees. Of course, reverse breakup fees are only as good as the credit of the acquirer, and the acquirer in the typical private equity transaction will be a shell company. Thus, in order for reverse breakup fees to be effective (or to otherwise seek damages in the event of a breach of the agreement by the acquirer), the target will need to obtain guarantees from the sponsoring private equity firm(s) or third-party rights to enforce equity commitment letters.

Even where credit is not a problem, reverse breakup fees may as a practical matter amount to just a few percentage points of deal value and may be less of a cure for a busted deal than a limited *ex-ante* deterrent to the prospective acquirer walking.

In addition, in any transaction, whether or not conditioned upon the receipt of financing, target companies will want to ensure that the sponsor or sponsors have entered into the necessary equity commitment letters and debt commitment letters with tight closing conditions that parallel (or come as close as possible to paralleling) the closing conditions in the merger agreement. It will also be important to work with the target's bankers to ensure that they view the equity and debt levels contemplated by the transaction, and other key financing considerations, as realistic. Binding bridge financing commitments and an obligation on the part of the acquirer to close on bridge financing, if necessary, will also be very beneficial from the seller's perspective. Finally, sellers should seek to associate only with private equity investors of high caliber and standing, with a proven track record for closing the transactions that they have announced. This is important to ensure that a deal, once signed, gets prompt regulatory and shareholder approvals and that after the deal closes the company remains solvent and a good regulatory citizen to avoid fraudulent conveyance and other reputational and liability concerns.

During the LBO boom of 2005-2007, many private equity deals did not allow for specific performance of the acquirer's obligation to close the transaction (or allowed such specific performance only in limited circumstances), and capped the damages at the reverse breakup fee, in effect creating a transaction structure resembling an option and permitting the private equity firm to pay a fixed cost (the reverse break fee) to walk from the deal. Today, following the 2008 financial crisis which put this option structure to the test, most private equity transactions include a reverse termination fee payable upon an acquirer's failure to obtain debt financing despite using efforts required by the transaction agreements, which also serves as the seller's sole remedy, and a specific performance right of the seller to require the acquirer to draw on the debt financing and the equity financing and close the transaction if the debt financing is available. A variation occasionally seen in leveraged deals is a two-tiered reverse termination fee structure, in which a lower fee is payable for financing failures or non-willful breaches and a higher fee is payable when the financing is available or in the event of a willful breach. In many private equity deals even claims for monetary damages outside of a scenario where a reverse termination fee would be payable are capped at the amount of the reverse termination fee. In some recent private equity deals, target companies have negotiated a cap on monetary damages to mirror the limitation of liabilities of a private equity acquirer under the merger agreement.

Common issues in private equity acquisition agreements include the definition of material adverse effect; the closing conditions; limitations on remedies for breach (*e.g.*, the ability to specifically enforce performance of the contract versus the "reverse breakup fee"); and the identity of the acquirer (shell company vs. company with substantial assets) and the scope of any applicable equity commitments and guarantees. As sellers, private equity sponsors will object to providing post-closing indemnities often seen in private company sales and increasingly insist on public company-style acquisition agreements in which representations and warranties and pre-closing covenants do not survive closing, although in certain circumstances post-closing indemnities from private equity sellers or their affiliates may be appropriate and have been obtained. Increasingly, acquirers are able to accommodate private equity sellers' preference for a clean break by purchasing representation and warranty insurance as protection for breaches of

the seller's representations and warranties, although such representation and warranty insurance has not become readily available in bank deals.

Private equity acquisition of control in banks is fairly unusual and limited to a handful of expert sponsors who specialize in the area. These deals tend to be financed 100 percent with equity in contrast to the debt-heavy structures of many private equity deals in other industries. The acquiring private equity fund and various related entities (such as the general partner) will need to become bank holding companies if they are not already, with significant implications for regulatory approval of the deal. Regulators can be expected to closely examine the structure of a private equity sponsor, focusing on issues such as the size of interests owned by individual limited partners (or groups of affiliated limited partners) and compliance with capital standards. The acquirer's proven track record and credibility in acquiring and running banks is critical in such deals.

### 6. Other Conditions

Beyond the minimums of shareholder approval, regulatory approval, material compliance with covenants (including with respect to conduct of business during the interim period) and accuracy of representations and warranties (including the absence of a material adverse effect), subject to materiality standards, the conditions to closing and the events giving rise to a right to terminate can vary enormously from transaction to transaction. The price paid and the perceived vulnerability of the transaction to third-party breakup attempts, as well as other deal risks, will determine the parties' general stance towards conditions and termination rights. The higher the price that the acquirer is paying, and the more third parties that are able or likely to make competing bids, the more limited the acquirer will want the target's "outs" to be.

When representing a seller that wants an airtight contract, certain conditions that might otherwise seem innocuous should be considered carefully. State regulatory approvals, for instance, may not be appropriate as conditions to closing where the subsidiaries involved are small relative to the size of the overall transaction, or where state regulatory officials have publicly expressed hostility to the acquirer or the proposed transaction. Likewise, approval of third parties other than governmental or quasi-governmental bodies is usually not appropriate as a condition to the acquirer's obligation to close; a sometimes acceptable variation is to only permit such private approvals as a condition where closing without having obtained them would have a material adverse effect.

In an era of larger institutions operating across national borders and the increasing prevalence of cross-border transactions, the role of non-U.S. national and transnational regulatory bodies on transactions, even between nominally "domestic" companies, is growing. For instance, in a number of significant investment banking, finance company and consumer finance deals, the approval of bank and financial institution regulatory bodies in a number of nations was involved, as well as competition clearance by the EU or European antitrust authorities. The involvement of such non-U.S. regulatory bodies will require parties to canvass the applicable laws to determine the nature of the regulatory requirements and process in each relevant jurisdiction and grapple with which approvals and clearances should be conditions to the transaction. One approach that has been used is to require the receipt of only those non-U.S.

approvals and clearances that would have a material adverse effect on either of the parties if they were not obtained.

Other, more objective conditions, which may be appropriate in certain circumstances, include:

- receipt of a tax opinion (nearly universal in the context of deals intended to be tax free);
- absence of any injunctions or legal prohibitions (a customary condition, as opposed to the much lower threshold of no pending or threatened proceeding seeking such an injunction, which can make completion of the deal hostage to any private shareholder litigation unless such pending proceedings are limited to those brought by a governmental entity);
- effectiveness of the registration statement pursuant to which stock to be issued by the acquirer is registered; and
- listing of the acquirer stock to be issued in the transaction on the appropriate exchange, subject to official notice of issuance.

In transactions in which shareholders have appraisal rights under applicable state law (which, in Delaware, will be the case if all or a portion of the merger consideration consists of cash), acquirers may sometimes seek to negotiate a condition that not more than a specified percentage of the target's shareholders have exercised their appraisal rights. Target companies will often resist such a condition, which could give a large shareholder, including hedge funds and merger arbitrage funds, potential hold-up power over the transaction. If an appraisal rights condition is accepted, the target should take care to ensure that the threshold is set so that no particular shareholder or group is likely to have the ability to trip the condition (typically, the cap would not be set below 10%).

Whether any particular condition is appropriate in a given deal depends on all the facts and circumstances of the deal. As discussed in Chapter 6, in certain types of deals (*e.g.*, acquisitions of brokerage firms and asset managers) the acquirer may demand a condition relating to the continued employment of specified key target employees at closing. Obviously, any such conditions must be negotiated with great care to ensure that the entire transaction does not rise or fall on the willingness of a small number of individuals to continue their employment.

Finally, representations, covenants and conditions can only be relied upon where a non-breaching party has effective recourse if they are breached or not satisfied. Accordingly, any proposed limitation on remedies for breach should be carefully reviewed and fully understood.

## E. Compensation and Employee Benefits

Financial institution and, in particular, bank, managements and boards typically have strong ties to the institutions they have helped create and as a result the social issues in any proposed merger transaction can take on as great a significance as the financial terms. Especially in the context of a stock-for-stock merger transaction, it is essential for the success of the

transaction that there be a good fit between the organizations and that the management and board of the merging company be fully committed to the successful implementation of the transaction.

Employee benefit provisions can vary greatly from transaction to transaction; however, merger agreements generally provide for either a rollover of all stock options and other outstanding equity-based awards or rights (in a stock-for-stock deal) or a cash out of all stock options and other outstanding equity-based awards or rights (in an all-cash deal). While less common, it is also possible to treat different categories of awards differently based on factors such as the type of award, vested status of the award, or vesting conditions of the award (*i.e.*, performance versus time vesting). In the event that outstanding stock options are "underwater" or have little intrinsic value, the impact of cashing out stock options should be evaluated and the plan and award agreement provisions reviewed with care. In addition, a target company should ensure that the acquirer will honor its employees' employment arrangements (change-of-control or otherwise) and vested benefits. It is also typical to include a commitment by the acquirer to provide target company employees with a specified level of compensation and/or benefits for a specified period after the merger. This covenant represents a promise by the acquirer to provide aggregate compensation and/or benefits generally no less favorable than or substantially equivalent or comparable to either those provided by the acquirer to its employees or by the target to target employees before the merger. With respect to future benefits, an acquirer will sometimes seek to exclude equity-based compensation from the general benefits covenant, which is not uncommon when the acquirer is a non-U.S. entity or a private equity firm. In addition, the merger agreement may contain commitments by the acquirer to provide or preserve a particular type of benefit for a particular period, most typically relating to severance, pension or retiree medical.

Targets and acquirers may also negotiate and establish retention programs. The goals of retention programs vary and can range from assuring the continued dedication of key employees (in the short- or long-term) to providing new incentives and/or equalizing the level of incentives between employees of the merged companies. Generally, the programs are structured to provide for the allocation of a fixed pool of money (or acquirer stock options, restricted stock or phantom stock) to key employees of one or both companies by the senior management of each company. The retention awards may be subject to terms and conditions relating to continued employment, such as a vesting schedule and forfeiture provisions relating to certain terminations of employment.

## IV. PROTECTING THE DEAL

### A. Break-Up Fees and Similar Arrangements

Lockups and break-up or termination fees are designed to provide an acquirer with additional assurance that the planned transaction will be consummated without interference from a third-party bidder and that the acquirer will be compensated if a third party does break up the transaction. Acquirers are typically unwilling to become "stalking horses" for other bidders and wish to be compensated for the expense and risk of making a failed bid. Even when there seems little likelihood of a competitive bid, an acquirer is likely to insist upon a lockup or termination fee, since the absence of a lockup may be perceived as indicating that the parties are less than fully committed to the transaction.

Deal protection is an art as much as a science. The courts have long recognized that it is fully appropriate to give strong, robust protection to stock-for-stock transactions in order to induce acquirers to agree to acquisitions. Strong lockups, together with firm, binding merger agreements, can create a signal to the market that the parties are committed to the transaction as the preferred strategic alternative and that the target is not looking to shop itself or put itself in play. However, there are both legal and practical limits to deal protections. Deal protections that are highly unusual or that push the envelope to get incrementally more protection may backfire — either because they are subject to legal challenge or criticism by the market, or because they signal that the parties may believe that a deal is especially vulnerable.

There is a trend toward the use of cash termination fees as the preferred means of deal protection rather than lockup stock options. However, lockup options continue to be a viable alternative for deal protection and, as discussed below, they can also be given features that enable them to behave in much the same way as a cash termination fee.

Cash termination fees vary in a number of respects, including the size of the fee relative to deal value, the events that trigger payment of the fee, and whether the fee is the exclusive remedy for termination in the situations in which it is payable. When it comes to the size of the fee, often acquirers wish to be aggressive and seek a fee near the upper end of what practitioners generally feel would survive legal scrutiny (*e.g.*, around 5% of equity value), on the theory that the larger the fee, the larger the deterrent effect on interloping bids. However, fees must be examined in the context of all the available facts and guidance under applicable law and, in some cases, moderation may be appropriate in order to avoid drawing unwanted scrutiny from either critics of the deal or potential litigants and the courts.

Practice varies regarding the triggers for payment. In some cases, termination fees may become payable under a broad variety of circumstances, including situations that may have nothing to do with an interloping bid. It is generally more appropriate, however, to tie the payment of the fee to certain events that relate to a third-party bid, as these fees are generally designed to provide reasonable assurance to the acquirer that the transaction will be completed without outside interference, and not to punish the target should the acquirer wish to terminate for an unrelated reason. Termination events that typically trigger the payment of a cash breakup fee may include:

- termination by the acquirer for volitional breaches of the seller's representations, warranties and covenants after a competing bid has been disclosed or communicated;
- termination by the acquirer because the seller board exercises a fiduciary exception in order to change its recommendation of the deal in a manner adverse to the acquirer, or recommends a competing bid, or breaches its no-shop covenant or its covenant to promptly convene a shareholder meeting to vote on the merger;
- termination by the acquirer or seller because the seller's shareholders vote the deal down after a competing bid has been disclosed or communicated or the drop-dead date is reached after a competing bid has been disclosed and prior to consummation of the transaction; and

- termination by the seller under a fiduciary termination right with respect to a competing offer.

In the situation described in the third bullet above, typically the termination fee (or at least a portion of the fee) would not be immediately payable upon termination of the transaction, and would only become fully payable if the target enters into an agreement for or consummates a competing acquisition transaction within a 12- to 18-month window after termination of the original transaction agreement. The language of these provisions may pick up any competing acquisition, or just one that may have been on the table when the merger agreement was terminated. In such cases the parties should pay attention to how a competing acquisition transaction is defined so that the target is not inappropriately penalized if it engages in transactions that are clearly acquisitions on its part. An acquirer would typically insist that, in the case of exercise of an outright fiduciary termination right by the target, a change in recommendation or a material breach of the no-shop covenant, the termination fee be payable immediately upon or as a condition to termination.

While the focus with termination fees is, as reflected by their alternate name "break-up fees," often on the possibility of an intervening third-party bid for the target, in some cases where there is some kind of extraordinary risk or uncertainty of closing relating to the acquirer, a "reverse breakup fee" may be appropriate to consider. Typical situations involve financing contingencies (both in private equity transactions, as discussed above, and otherwise) or elevated regulatory approval risk. For instance, in the acquisition by Partners Trust Financial of BSB Bancorp, where a condition to the merger was a second-step conversion of Partners from mutual holding company to full public stock form, a reverse breakup fee provision was included whereby Partners would pay a breakup fee to BSB if the deal was terminated for various reasons relating to the failure of Partners to successfully complete its second step conversion. In some instances, targets are motivated to ask for such fees where there is a particularly difficult regulatory issue for the deal relating to the acquirer, but the desire to be compensated should such an issue scuttle the deal should be tempered by the realization that the existence of specific provisions in the merger agreement contemplating the issue could invite needless focus and otherwise exacerbate it. On the other hand, an acquirer's willingness to agree to such a provision can be an expression of confidence and a competitive differentiator. In connection with ING Groep's agreement to sell its ING Direct business in the United States, Capital One, in an auction context, agreed to a reverse termination fee under certain circumstances if U.S. regulatory approvals unrelated to ING Groep were not successfully and timely obtained. A number of other significant transactions across multiple industries have similarly featured antitrust or regulatory reverse termination fees. In merger of equals transactions, it may be appropriate to have traditional break-up protections made mutual and applicable to both parties. This is similar in concept to dual "cross" lockup options (discussed below).

Lockup options generally take the form of options to purchase unissued stock of the target and are exercisable only in the event of third-party interference with the proposed transaction. While some question the continued utility of lockup options (as opposed to cash breakup fees), there may still be an incremental deterrent effect to the acquirer's ability to obtain a significant equity position in the target, and lockup options can be given cash put features, cash floors and value caps that enable them to simulate very closely a cash breakup fee.

In large transactions, especially in mergers of equals, cross lockups have frequently been granted by both parties. The $2.3 billion merger of PacWest Bancorp and CapitalSource Inc. is an example of a transaction that included a reciprocal 19.9% cross-option in the merger agreement. Substantial transactions that are not quite mergers of equals have been addressed with the use of reciprocal options with different amounts of stock involved; for example, in the NationsBank/Barnett transaction, NationsBank received a customary 19.9% option on Barnett common stock, while Barnett was granted a 10% option on NationsBank common stock.

In the context of hostile takeovers, lockups have been heavily litigated. However, where the transaction sought to be protected is an arm's-length stock-for-stock deal in which the public shareholders of the target retain a sizable percentage of the ownership of the resulting company, and where the resulting company remains publicly held, it is beyond cavil that lockups will not be held *per se* invalid.

The Delaware Supreme Court decision in the *Paramount* case caused a good deal of confusion concerning the use of lockups. While the *Paramount* decision was critical of the lockup and break-up fee arrangements entered into between Paramount and Viacom, the court also made clear that such arrangements are not presumptively invalid. Indeed, the court cited two other cases in which stock options were upheld. The court in *Paramount* was critical of certain "unusual" features in the *Paramount* lockup option, including a put feature and note feature, and of the open ended value of the option. Lockup options have, however, long been accepted as part of bank merger transactions. For example, the Pennsylvania district court in *Keyser* v. *Commonwealth National Financial Corp.* stated that lockups are "very common in bank mergers" and may be necessary to induce an acquirer to enter into an acquisition agreement. Notably, the criticism of the Paramount option was in the context of a change-of-control transaction in which so-called *Revlon* duties applied — *i.e.*, the Viacom transaction always contemplated voting control shifting to a single individual. Parties should continue to be wary, however, of the opening that "unusual features" may give to a potential interloper. For instance, in contesting First Union Corporation's merger with Wachovia, SunTrust criticized a feature of the Wachovia lockup option that it claimed permitted First Union to potentially pay the exercise price with any assets, including distressed loans; First Union and Wachovia ultimately amended the option to remove this provision.

In most large bank merger transactions, the target company has negotiated a cap (equal to approximately two to five percent of the aggregate transaction value) in the total value obtainable by the acquirer under the customary 19.9% stock option granted to the acquirer upon the execution of the merger agreement. However, it is not clear that a cap on the aggregate value obtainable pursuant to a traditional stock option agreement is necessarily required in the context of a typical strategic stock merger transaction under Delaware law or other state standards.

Strong deal protections are particularly appropriate in the financial institutions context, where mergers between financial institutions are complex endeavors that dramatically impact both institutions, and their respective customers, employees, communities, regulators and shareholders. Often important irrevocable decisions are made at the outset of a merger. Perhaps uniquely in bank deals, the inherent time lag until closing supports the need for certainty of consummation; similarly, the process of planning for the integration of the two enterprises realistically must begin virtually from the time of announcement, and "safety and soundness"

concerns make certainty essential. There is also the risk that, without assurance of consummation, the constituent companies to an announced transaction could suffer serious employee attrition. Parties understandably cannot undertake such transactions unless there is a high likelihood of successful completion.

If there is a break-up fee as well as an option, where a cap is appropriate it should serve as a limit on the combined value of both forms of deal protection (as in the JPMorgan/Bank One transaction). A corollary of this principle is that the payment of a termination fee and the exercise of a lockup option should generally be triggered by the same events, since the purpose of both should be deal protection. A simple way of doing this is to avoid a separate break-up fee and to build it into the option by providing in the option for a minimum surrender value that does not depend on the price of the target's stock at exercise. Often such a break-up fee is called a "floor" on the value of the option. Such a surrender right would ordinarily be triggered at the same time a put would become exercisable (as described below), but would be in lieu of the put. It is also possible to have "early triggers" on the termination fee in which some fraction of the total termination fee is payable before the option would become exercisable (*i.e.*, on certain terminations, with the balance becoming payable, and the option exercisable, if a competing transaction is entered into during a post-termination tail period).

SunTrust's attack on the First Union/Wachovia transaction in 2001 led to litigation in North Carolina that illustrates the potential issues involved in a capped lockup option as well as reaffirms the ability of a well-informed board to agree to strong deal protections in the context of a stock-for-stock merger. The North Carolina court hearing SunTrust's challenge ruled that, under North Carolina law (although the court heavily relied on citations to evolving principles of Delaware law in arriving at its conclusions), the 19.9% stock option Wachovia granted to First Union in connection with their merger agreement, which was capped at a payout value of $780 million (about 6% of deal value), was valid and that the Wachovia board was "informed, independent . . . and knowledgeable" in approving the provision. The court found that the existence of such an option would not unlawfully influence the vote by Wachovia shareholders. The court did, however, describe the 6% fee as "in all likelihood a new high for cases with a cap," but reasoned that the trading price for Wachovia stock indicated that the "market did not believe other offers were precluded." (This is in keeping with Delaware law to the effect that deal protection devices that create barriers to the ability of the target to accept a competing bid are not *per se* coercive of the shareholder vote, including the 2004 *Orman* v. *Cullman* decision discussed in this chapter that upheld a voting agreement with a majority shareholder that prohibited the shareholder from voting its shares in favor of a competing transaction for 18 months.)

Lockup options granted in connection with bank acquisitions frequently include a so-called "cash put" provision providing that, in the event of a higher bid, the acquirer has the right to "put" the option, and shares previously purchased under this option, back to the target at a per-share price equal to the difference between the option exercise price and the higher bid (or simply the bid price, in the case of shares). The put right gives the option more bite, because exercise of the put generally does not require prior regulatory approval (provided the amount of cash paid out on exercise of the put does not exceed 10% of the target's consolidated net worth). By contrast, exercise of an option to purchase in excess of 5% of the target's outstanding shares could be subject to prolonged regulatory review that could result in the acquirer being deprived

of much of the benefit of its bargain. The exercise of the put right can serve to both protect the initial transaction and provide the acquirer with a profit should the initial transaction be outbid.

Some bank holding companies continue to have “anti-greenmail” or similar provisions in their charters. Typically, these provisions do not permit the corporation to buy back stock from a holder of a substantial percentage of the outstanding common stock without shareholder approval. Sometimes the prohibition is limited to purchases at a price greater than market value or some other measure of fair value. Where such provisions are present, it may be appropriate to extend the time allotted to exercise put rights under the option as necessary for any required shareholder approvals to be obtained, similar to the manner in which such time frames are extended if regulatory approvals are required.

A target will want to limit exercise of both the underlying option and the put to actual change-of-control events (that is, the consummation or definitive execution, and not just the proposal, of a competing offer) so as not to expose the target to a third-party bid that allows the initial acquirer to exercise the put but is then never consummated, leaving the target with depleted capital and a long face. So-called “double triggers” have developed that provide for certain “vesting” events (such as a publicly announced competing bid) that extend the life of the lockup beyond the normal termination provisions, as well as events giving rise to the right to exercise the option and the put.

Lockup options must be structured in accordance with the Federal Reserve’s Policy Statement on Non-voting Equity Investments by Bank Holding Companies but, if properly structured, should withstand challenge before the Federal Reserve.

### B. Management/Shareholder Support Agreements

Where a target has significant shareholders, lockups can be combined with commitments by those shareholders to support the transaction, either through voting agreements or through options on such shareholders’ stock. Where a tender offer is used, the significant shareholder may also agree to tender into the tender offer. The visible up-front support of major shareholders for a transaction can be a significant deterrent to third-party bids and an important signal to the market that the transaction has the support of key constituencies. Indeed, the failure to obtain support agreements from significant shareholders can inject closing risk to a transaction, and depending on the relevant shareholders’ ownership level relative to the required vote standard, it may effectively give those shareholders a pocket veto over the transaction, or close to one. The same is true on the acquirer side where a vote is required of its shareholders, either as a matter of state law or stock exchange rules.

Where voting or support agreements are used, consideration should be given to the technical requirements of the proxy rules or the provisions of Section 5 of the Securities Act. A standard form support agreement that has been used in numerous bank merger and other financial institution transactions combines a commitment by a limited number of significant shareholders (almost always limited to directors and, sometimes, greater than 5% shareholders (as in Charles Schwab’s 2020 merger with TD Ameritrade, Independent Bank Group’s 2018 acquisition of Guaranty Bancorp, South State’s 2017 acquisitions of Park Sterling and Southeastern Bank Financial, First Horizon National’s 2017 merger with Capital Bank,

OceanFirst Financial's 2018 acquisition of Sun Bancorp, Associated Banc-Corp's 2018 merger with Bank Mutual Corporation, Pinnacle Financial's 2017 acquisition of BNC Bancorp, Bankrate, Inc.'s 2017 sale to Red Ventures, Hampton Roads Bankshares' 2016 merger with Xenith Bankshares, Sterling Bancorp's 2015 acquisition of Hudson Valley Holding Corp. and PacWest Bancorp's 2015 acquisition of Square 1 Financial), consistent with SEC guidance) to vote their shares in favor of the proposed merger with a covenant not to dispose of their shares and, in their capacity as shareholders, not to act in any manner that would promote or assist a competing acquisition proposal. Significant shareholders, depending on the size of their holdings in the post-merger entity and whether they hold restricted securities under the securities laws, may seek to negotiate registration rights with the acquirer. The extent of a holder's registration rights may vary, and can include customary demand and underwritten shelf takedown registration rights (as in Charles Schwab's 2020 merger with TD Ameritrade, Xenith Bankshares' 2017 merger with Union Bankshares and TD Ameritrade's 2017 acquisition of Scottrade Financial Services) or a more limited obligation on the part of the acquirer to put up a shelf registration statement allowing a significant shareholder to sell into the market, but not requiring the acquirer to specifically facilitate underwritten offerings by the shareholder (as in Global Payments' 2017 cash and stock acquisition of the communities and sports divisions of ACTIVE Network from Vista Equity Partners).

As indicated above, when all or a significant portion of the votes required for the target to obtain shareholder approval of a merger are locked up at the time the merger is signed, attention should be paid to case law that may limit the ability of a target to commit to the more restrictive versions of no-talk clauses or to bring the transaction to a shareholder vote regardless of whether the target board continues to recommend it. In the *Omnicare* decision discussed earlier in this chapter, the Delaware Supreme Court invalidated a structure, in the context of a strategic merger, in which an agreement with a majority shareholder guaranteeing the required target shareholder vote was combined with a "force the vote" provision that required the target board to bring the transaction to a shareholder vote notwithstanding any intervening third-party bid and the absence of a fiduciary termination provision. The decision remains controversial, and the Delaware Chancery Court in *Orman* v. *Cullman* distinguished Omnicare and upheld a voting agreement with a majority shareholder where the parties voluntarily agreed that target shareholder approval of the merger would require a vote of a majority of the minority — giving the public shareholders an opportunity to reject the merger even though, if they did so, the voting agreement would prevent a competing bid from being approved for 18 months. In *In re OPENLANE*, the Delaware Chancery Court held that a majority of shareholders could execute written consents immediately following the execution of a merger agreement, thereby providing the shareholder approval necessary to complete the merger, without constituting an impermissible lock up of the transaction. Practitioners have developed other creative solutions to address *Omnicare* concerns, including the grant of stock purchase options from significant shareholders allowing an acquirer to purchase shares directly from the shareholders upon the exercise of a target's fiduciary termination right (as in Thermo Fisher Scientific's 2017 acquisition of Patheon N.V.). In short, while the reach of *Omnicare* may be narrowing, particular care must be taken under Delaware law where the vote required to approve the transaction, or a vote very close to that requirement, is locked up or guaranteed when the merger agreement is executed.

### C. Equity Positions

A modified take on the classic "white squire" investment emerged in 2008 to cope with rescue transactions where liquidity concerns required that a transaction be negotiated and definitive documents executed within a matter of days and certainty of closing was of supreme importance to maintaining the franchise value of the target company.

This structure was used in the JPMorgan Chase/Bear Stearns deal, which was struck over a weekend. The timing was driven by the fact that Bear Stearns was facing a "run on the bank" and a risk of bankruptcy if a deal was not arranged before markets opened. As part of the deal and in order to assure markets that the troubled Bear Stearns would actually be acquired by the stronger JPMorgan Chase, Bear Stearns ultimately agreed to sell JPMorgan Chase 95 million shares of Bear Stearns stock, representing 39.5% of the company's voting power (without Bear Stearns shareholder approval, in reliance on the 312.05 "distressed company" exception to the New York Stock Exchange's shareholder approval rule), that could be voted in the Bear Stearns' shareholder vote on the merger. (The merger vote was required as a matter of corporate law.) To keep Bear Stearns's franchise together pending the merger, JPMorgan Chase also, immediately upon signing the merger agreement, guaranteed certain of Bear Stearns's trading obligations in order to reassure customers and counterparties.

Wells Fargo's acquisition of Wachovia involved a similar situation. Wachovia was facing defecting customers and counterparties and also faced regulatory pressure to resolve its problems. A prior agreement-in-principle to sell part of the company had not fully stanched Wachovia's declining business. Again, in order to preserve Wachovia's value pending the closing of its acquisition by the stronger Wells Fargo and to communicate certainty of closing to the market, Wells Fargo required Wachovia to sell it a substantial amount of voting preferred stock (in reliance on the same New York Stock Exchange exception utilized by Bear Stearns) that Wells Fargo could vote at the Wachovia shareholder meeting (and in return Wells Fargo accepted a contract with a narrow "material adverse effect" clause that limited its ability to terminate the merger agreement).

In each of Wells Fargo/Wachovia and JPMorgan Chase/Bear Stearns, the acquirer obtained a substantial voting bloc to enhance the market's confidence that the transactions would be successfully consummated. In each deal, the acquirer's ability to vote its stake at the special meeting of shareholders to approve the transaction was challenged in court (Delaware and New York in the case of Bear Stearns and North Carolina in the case of Wachovia). Under the extraordinary facts of these transactions, the courts upheld the acquirer's ability to vote the voting bloc in favor of the transaction structure in light of the exigent circumstances.

Precedents for the path through the NYSE Rule 312.05 exception (or NASDAQ's corollary exception) can be found outside the banking industry. Delta Airlines availed itself of the exception in 2004 in connection with an out-of-court restructuring, and Continental Airlines took the same path in 2005 in connection with employee benefits modifications. In 2008, Thornburg Mortgage relied on the exception to complete a significantly dilutive offering and Moneygram International used the exception to effect a recapitalization in what essentially amounted to an acquisition by TH Lee and Goldman Sachs. In 2010, similar investments amounting to acquisitions were completed by NAFH (of TIB Financial) and Ford Financial Fund

(of Pacific Capital). In 2012, Knight Capital Group relied on the exception to sell equity securities to a consortium of financial institution investors after it experienced substantial capital losses as a result of a technology malfunction in its trading systems.

## V. BANK BRANCH SALES

Some of the significant branch sale transactions in the past have included Huntington's sale of its Florida bank branch franchise to SunTrust (and its 2018 sale of its Wisconsin branch operations to Associated Bank), Pacific Century's sale of its California branch network to U.S. Bancorp, Mellon's sale of its remaining retail branch network to Citizens Financial, a unit of Royal Bank of Scotland, PNC's sale of former National City branches in separate transactions to First Niagara Bank, Marquette Savings Bank and Emclaire Financial, BB&T's sale to U.S. Bancorp of the Nevada branch franchise BB&T acquired as part of its FDIC-assisted acquisition of assets and liabilities of Colonial Bank, as well as its acquisition of Citibank branches in various Texas markets, HSBC's sale of its branch network in western New York state to First Niagara, Banco Popular's sale of its California branches to Banc of California, and Bank of America's numerous sales of branches in various states.

There has been some branch sale activity related to restructuring needs, as exemplified by PNC's acquisition of BankAtlantic's Tampa branch franchise as well as BankAtlantic's subsequently announced sale of branches to BB&T. A significant volume of branch sale activity over the years has also been motivated by antitrust divestiture requirements, such as Sovereign's $1.4 billion purchase of FleetBoston bank branches in connection with the merger of Fleet and BankBoston, BancWest's acquisition of 30 First Security branches in connection with Wells Fargo's purchase of First Security, PNC's sale of former National City branches, and Huntington's sale of former FirstMerit branches to First Commonwealth Bank.

Of course, a large source of branch sales during and since the 2008 financial crisis has been the FDIC resolution process, as the FDIC has sold off bank assets after putting troubled banks into receivership. Generally the acquirers in these transactions have succeeded by hewing closely to the FDIC's form of agreement, although key financial terms and loss-sharing provisions have sometimes varied. Notwithstanding the preference for full deposit assumption, the FDIC has permitted acquirers to reject other bank liabilities in certain transactions, as occurred when JPMorgan Chase did not assume some Washington Mutual Bank indebtedness when it acquired its branch operations. This dynamic may be different if there is a failure of an institution that has issued debt under the FDIC debt guarantee program instituted during the 2008 financial crisis. As the number of bank failures climbed in 2009 and 2010 (and to a lesser extent 2011 and 2012), the FDIC relied more on competitive auctions for predetermined packages of assets and liabilities with largely standardized documentation.

As with other transactions involving the sale of a substantial portion of a company's assets, sales in this context require careful attention to creditor's rights issues, such as potential fraudulent conveyance claims, in order to ensure that the acquirer does not end up bearing liabilities it did not agree to assume in the transaction or become entangled in claims asserted by the bankruptcy estate of the seized bank's holding company.

Regardless of a seller's motivation, branch purchases frequently offer acquirers the opportunity to extend market share or enter new markets at more attractive prices than available in whole-company acquisitions. Particularly for acquirers with an existing strong presence in the particular geographic market, there may be opportunities to leverage marketing efforts and product offerings and reduce costs in the acquired branches. Of course, competitive issues can arise in certain transactions if the combined presence would exceed antitrust limits on market concentration.

## A. The Purchase Agreement

Branch purchase agreements are typically structured as asset sale transactions and, therefore, are usually more complex than typical merger agreements. Even where a transaction more closely resembles the sale of a whole business or bank than the sale of specified assets and liabilities, such as the sale of Mellon's retail franchise or Pacific Century's California franchise, the form of agreement used has often been that of an asset sale. However, as discussed below, the appropriateness of certain substantive provisions may vary between acquisitions involving only a few branches (such as in some divestiture scenarios) and those involving a more complete franchise.

Both acquirer and seller should approach the contract drafting and negotiation process with care. Particularly important are pricing provisions, the descriptions of the assets being sold and the liabilities assumed, conversion and other post-closing transition matters, real estate provisions, employee-related provisions and non-solicit and non-compete provisions.

## B. Pricing

The consideration paid in bank branch sales is generally expressed as a premium on branch deposits at or before closing. Deposit premiums vary widely depending upon the branches' business mix, customer base and geographic location and the number of branches being sold, with percentage premium levels ranging from the single digits to the teens. Other assets of the branches are typically sold to the acquirer at fair market value (*e.g.*, real property) or book value (*e.g.*, fixed assets and loans), with vault cash, ATM cash and other cash and cash equivalents held in the branches sold at their face amount.

Since the premium percentage is only one-half of the pricing formula, an issue almost as important as the premium percentage is the manner in which deposits are calculated. Deposits can fluctuate on a regular basis and, more significantly, can fall as a result of deposit run-off following announcement of the transaction. Depending on the identity of the acquirer, it is possible that run-off could be exacerbated when notices are sent to customers informing them of the transaction. This issue can take on even more significance in transactions where the acquirer intends to close or consolidate certain of the acquired branches in connection with the transaction, as in the case of the Huntington/SunTrust transaction, where SunTrust had announced its intention to consolidate certain closely located Huntington and SunTrust branches. Sellers will seek to avoid "paying" for the acquirer's post-closing integration plans by assuming the run-off risk in calculating deposit balances.

Partially to address run-off issues, and partially to address ordinary fluctuations in deposit levels, the deposit premium is generally based on average deposit balances over a pre-determined time period, and not simply the deposit balance on the closing date. This averaging period typically covers a time ending close to completion of the transaction, although formulas vary, and in some cases it may be appropriate to use an earlier time period. Covenants that regulate the acquirer's actions to notify customers of branch consolidations and closings prior to completion of the transaction can also help sellers address the run-off issue. However, the acquirer should be aware that it could pay a premium based on deposits that it never assumes (of course, there will also be some risk of deposit run-off post-closing).

In addition, the deposit premium may vary for different deposit products and for deposits located in different branches. Other variations on deposit pricing are possible, including premium payments paid against deposit balances as of a date prior to entering into the definitive documentation, premium payments paid based on closing date deposits but subject to a minimum and maximum payment and post-closing true-up arrangements. Other variations are certainly possible to meet the needs of the parties.

It will also be important to carefully draft any exclusions or exceptions to the deposits used to calculate the premium. The definition of deposits will often contain exclusions for certain types of deposits, such as those held in respect of trust accounts not being assigned to the acquirer and deposits securing loans not sold to the acquirer. Certain governmental and wholesale deposits and brokered CDs may be specifically identified for special pricing treatment. Also important to the calculation of the purchase price is the level of any required reserves in respect of loans, as reserves are usually netted against loans for purposes of determining the purchase price. In particular, the seller will want to ensure that all reserving and other accounting methods used to calculate the purchase price (both for closing purposes and for post-closing true-ups) are consistent with the seller's methods of accounting or are agreed upon in advance in order to avoid unpleasant surprises. If the acquirer wishes to be able to request that the seller make adjustments to its reserves in connection with the transaction, the parties must determine whether, and to what extent, such adjustments will impact the calculation of the purchase price.

### C. Assets and Liabilities

In a merger, the acquirer is usually acquiring an entire company; in a branch acquisition, however, the acquirer is only purchasing a portion of the seller's business, and both acquirer and seller will need to pay close attention to how that portion is defined. Disclosure schedules and electronic media are typically utilized to specify in great detail the assets being purchased and sold.

Some of the assets typically transferred include real estate and related fixtures and improvements, real property leases, freestanding remote site ATMs, personal property located at the branches, safe deposit contracts, loans, overdrafts, servicing and similar contracts, ATM cash and cash and cash equivalents located at the branches. Assets may also include software licenses, brokerage and investment advisory contracts and accounts, trust accounts, derivative transactions, routing and transit numbers and, in some cases, operation centers that service the branches being sold. Acquirers and sellers alike should take care if specific assets are excluded

from the sale but are used or located in the branches, such as proprietary merchandising equipment, rights in the seller's name and other intellectual property and assets held for use in connection with activities not being sold.

Liabilities assumed by the acquirer are generally deposit liabilities and other liabilities incident to the deposits and the assets being acquired, such as employee compensation, real property leases, safe deposit contracts and servicing contracts. As with assets, some categories of liabilities are typically set forth in disclosure schedules and electronic media. The acquirer will generally seek to exclude all liabilities not relating to the specified liabilities. In that regard, the acquirer may also seek to exclude even related liabilities to the extent arising prior to the completion of the transaction (*i.e.*, an "our watch, your watch" approach as opposed to a going concern sale). There is no "right" result, although in situations where the transaction more closely resembles the sale of a whole bank (*i.e.*, the sale of substantially all of a company's branches or the sale of a substantial branch network in a particular geographic market), the seller may be able to argue that even pre-closing liabilities (to the extent relating to transferred assets) should be assumed by the acquirer (and where all the branches of a bank are being sold, the parties of course may wish to consider whether a merger or purchase of the stock of the bank makes more sense). Conversely, where the seller is only offering selected branches in one or more geographic markets that do not constitute an entire separate business unit, and the transaction more closely resembles a "true" asset sale, it may be more appropriate for the seller to retain historical liabilities. Undisclosed liabilities are also sometimes addressed indirectly by way of an indemnity for breaches of representations and warranties regarding branch assets and liabilities, or for all pre-closing liabilities more generally, subject to an appropriate cap, basket and time period for submitting indemnity claims.

### D. Conversion and Post-Closing Transition Matters

Unlike mergers and other whole-company acquisitions, branch transactions generally involve the sale of branches that cannot operate on a stand-alone basis. Even substantial branch networks operating within a particular state will often operate from a company-wide systems platform and will use administrative and back-office support also used by other branches within the seller's organization. Accordingly, the acquirer will either need to convert the data processing and other systems from the seller's platform to the acquirer's platform simultaneously with closing or will need to have the seller agree to provide some level of interim servicing. Although simultaneous conversion and closing will typically be more convenient for both parties, the conversion process will make it more difficult to complete the transaction quickly, and the acquirer may have other conversions "in the pipeline" that it does not wish to disturb. If interim servicing is necessary, the parties will need to negotiate an appropriate servicing agreement addressing, among other matters, the services required, the servicing standards and any servicing fees. Even in transactions involving simultaneous conversion and closing, the parties will need to agree on procedures for forwarding and settling automated clearing house and Fedwire transactions, direct deposit and debit transactions, and similar matters. These issues will be somewhat simplified in transactions in which the seller is able to transfer routing and transit numbers to the acquirer.

Branch purchase agreements will typically set forth a timeline and action items for addressing conversion issues such as data processing conversion, issuance of new checks and

ATM cards, and interest reporting and withholding. As noted above, the agreements will also typically address matters relating to customer notifications. In addition to notifying customers regarding the transaction, parties will frequently be required to obtain consents in connection with the transfer of brokerage, trust and asset management accounts as discussed in Chapter 6.

Sales out of FDIC receivership must often close immediately upon announcement in order to provide the necessary stability to depositors. This of course provides special challenges to acquirers in terms of system integration and a smooth transition process, generally mitigated by the fact that the acquirer is often purchasing an entire institution along with its systems and management personnel. Still, acquirers will need to be nimble in terms of dealing with technology and customer issues and will need to pay appropriate attention to retaining key members of the target's employee base through the transition.

## E. Real Estate Matters

Unlike a financial institution merger transaction, where real estate is not typically an asset that receives substantial separate focus in an agreement, real estate assumes greater significance in bank branch sales where the acquirer pays separately for the properties. Accordingly, branch purchase agreements often require heightened real estate due diligence and more robust real estate representations and warranties than in a typical merger agreement.

The branch purchase agreement will usually include a schedule of the owned real property that sets forth the seller's proposed "fair market value" calculations for the properties, although sometimes owned real property is sold at book value. There are different approaches to real estate problems that may arise or be discovered post-signing or post-closing. Some agreements have provided for a limited post-signing period during which the purchaser is allowed to conduct diligence investigations regarding title and environmental matters, and may specify an escalation procedure of initial or existing Phase I environmental surveys suggesting potential problems requiring remediation. Problems that arise can be addressed in a variety of ways, including cure of the problem by the seller (by fixing the problem or by providing an appropriate insurance policy or bond), reduction in the fair market value to be paid in the transaction to reflect the diminution in value, or exclusion of the property from the purchase (potentially leaving the property in the transaction by permitting the acquirer to lease the property or else arranging for alternative space). If the latter approach is taken, the acquirer and seller will both negotiate to be the party with the right to elect among these choices. On occasion, parties will provide for environmental indemnities specifically tailored to transferred real estate properties apart from any general indemnity provisions of the purchase agreement, which may limit or eliminate the right of the acquirer to indemnification if it exercises or waives its inspection and investigation rights and nonetheless accepts the property.

## F. Employees

A purchase agreement will often require the acquirer to make comparable offers of employment to branch employees, with possible exceptions — depending upon the transaction — for branch management, shared services and back office employees, employees with performance problems or who do not satisfy the acquirer's employment screening requirements and employees on leave or disability who do not return to work within a specified

period of time. The comparability of job offers is often described in terms that relate to the seller's severance plan; the acquirer is required to offer employment on terms (such as salary/hourly wages, position and work location) that will not result in a severance event if the employee accepts employment with the acquirer, and the seller's severance plan often provides that an employee who declines a comparable job offer will not be eligible for severance under the seller's severance plan.

Another purchase agreement issue will likely be the level of health, medical, retirement and other benefits, including severance benefits, that will be available to the transferred employees. These matters may impact the willingness of employees to accept positions with the acquirer, which may, in turn, impact the seller's ability to continue the smooth operations of branches prior to closing and the potential severance obligations of the seller. In that regard, sellers and acquirers should also consider what — if anything — will be required in the way of retention or stay bonuses for the pre-closing period, especially if the back office conversion date is to occur after the closing date, and whether the financial obligation is seller's, acquirer's or shared. Such programs are likely to be particularly important for in-market transactions where there is the greatest risk that a seller's employees will leave the seller and seek employment elsewhere in the face of uncertainty over potential post-closing job losses. The seller will likely want to exclude the effects of announcing the sale — including possible employee attrition — from the definition of "material adverse effect" used in the agreement.

Other matters that may need to be addressed (either by the seller as a practical matter or in the purchase agreement) include apportioning liability for obligations for health care benefit coverage (*i.e.*, pre- and post-closing expenses and COBRA obligations) and the Worker Adjustment and Retraining Notification Act of 1988 and any similar state or local statutes, the treatment of seller equity compensation awards granted to employees who will become employees of the acquirer (acquirers usually ask the seller to vest outstanding awards), asset transfers between the seller's and acquirer's 401(k) plans (or vesting and direct rollovers of 401(k) account balances including outstanding loans, which require the seller to consider whether a partial termination of the seller's plan may occur) and appropriately tailored agreements by the seller not to solicit transferred employees.

Finally, acquirers will want to ensure that they have the ability under the agreement to meet with the employees to be transferred to the acquirer in the transaction so that those employees can be trained with respect to the acquirer's systems and operating procedures. Pre-closing training will help to ensure a smooth transition of the branches from the seller to the acquirer, and can frequently be accomplished with appropriate protections for the seller. The branch purchase agreement often specifies the times during which these activities may occur and the allocation of any incremental costs that seller may incur if these activities occur during normal business hours.

### G. Closing Conditions

As in other areas of M&A, sellers will typically want to negotiate strongly for certainty of closing. As noted above, branch sales can have a significant impact on employee and customer retention. Once the sale process begins, non-consummation is likely to have a negative impact on the future results of the branches to be sold and the ability to sell the branches to an

alternative acquirer who might view the branches as damaged goods. (As stated above, in the receivership context transactions are often signed and closed simultaneously, so that there will be no closing conditions.)

Appropriate closing conditions can include:

- accuracy of representations and warranties, subject to appropriately drafted materiality or "material adverse effect" standards;

- material compliance with obligations under the purchase agreement;

- absence of a material adverse effect with respect to the branches being sold;

- receipt of necessary regulatory approvals — most branch sales will require an application under the Bank Merger Act to the acquirer's primary federal bank regulator, and may require notice to or approval by the state banking authorities for transactions involving state-chartered banks;

- delivery of required closing documents such as real property deeds, estoppel certificates from real property lessors to the extent obtainable, an instrument of assignment and assumption, and foreign person ("FIRPTA") tax affidavits; agreements will often include substitute arrangements so that the transaction as a whole can move forward even if particular non-governmental third-party consents cannot be obtained;

- execution of a servicing agreement (if required in connection with closing and conversion); and

- absence of injunctions or other legal prohibitions on consummation.

### H. Non-Competition and Non-Solicitation Provisions

Acquirers will typically request an agreement from sellers to not solicit the seller's former customers and, in sales where the seller is exiting the market, an agreement not to compete with the acquirer in the relevant product and/or geographic market for some period of time following closing. Sellers should exercise caution to ensure that the non-solicit and non-competition provisions will not harm their ability to undertake future business combinations with parties that may have operations in a restricted area or that include restricted products, and should consider appropriate exceptions for competing activity resulting from such business combination transactions. If the seller intends to continue banking activities in the particular market following closing (*e.g.*, continuation of mortgage lending, securities brokerage or Internet banking), the seller will need to draft both the non-solicit and the non-compete to contemplate such continued activities.

# CHAPTER 5.

# CAPITAL RAISING STRATEGIES

## I. CAPITAL CONTINUES TO BE A DOMINANT THEME FOR FINANCIAL INSTITUTIONS

### A. Overview of Capital Raising Activity Since the Financial Crisis

Since the financial crisis, regulators have debated the role of bank regulatory capital in mitigating losses and preserving the integrity of the financial system. In the immediate aftermath of the financial crisis, expectations for bank regulatory capital increased significantly. Passed in the immediate aftermath of the financial crisis, the Dodd-Frank Act set the bar higher for capital by empowering U.S. regulators to demand higher standards for larger, more systemically significant institutions and by refining the permitted composition of regulatory capital for bigger holding companies by phasing in an elimination of trust preferred securities. The "Basel III" regulatory framework (which was further supplemented by December 2017 revisions that have been dubbed by some bankers as "Basel IV") similarly established higher capital benchmarks and increased the emphasis on common equity, with changes to risk weightings magnifying the impact.

But as these regulatory frameworks imposed higher capital requirements on financial institutions, regulators in the United States were also revisiting the regulatory burden of such mandates on small- and medium-sized institutions. On May 24, 2018, President Trump signed into law the "Economic Growth, Regulatory Relief, and Consumer Protection Act" (the "2018 Act"), which provided certain limited amendments to the Dodd-Frank Act, as well as certain targeted modifications to other post-financial crisis regulatory requirements. While the legislation preserved most of the Dodd-Frank framework, it included modifications and exemptions that provided meaningful regulatory relief for small and regional banking organizations, including with respect to capital requirements. In October 2019, the Federal Reserve issued final rules (the "2019 Tailoring Rules") to implement these modifications and exemptions from the 2018 Act and further tailor its regulations for domestic and foreign banks to more closely match their risk profiles. Specifically, the 2019 Tailoring Rules, which became effective on January 9, 2020, establish a framework that classifies banks with $100 billion or more in total assets into four different categories based on several factors, including asset size, cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance sheet exposure.

In January 2021, the Federal Reserve issued a final rule ("2021 Rule"), which became effective on April 5, 2021, to tailor the requirements in the Federal Reserve's capital plan rule applicable to large bank holding companies and U.S. intermediate holding companies of foreign banking organizations. The 2021 Rule, among others changes, (i) conforms the capital planning, regulatory reporting, and stress capital buffer requirements for firms with $100 billion or more in total assets that do not meet the criteria for Categories I–III ("Category IV") with the 2019 Tailoring Rules, (ii) makes additional changes to the Federal Reserve's stress testing rules, stress testing policy statement and regulatory reporting requirements, such as the assumptions related to business plan changes and capital actions, and the publication of company-run stress test

results for savings and loan holding companies, including removing company-run stress test requirements and implementing biennial, rather than annual, supervisory stress tests for firms in the lowest risk category (*i.e.*, those subject to "Category IV" standards) and (iii) applies the capital planning and stress capital buffer requirements to covered savings and loan holding companies subject to Category II, Category III, and Category IV standards under the 2019 Tailoring Rules.

In early 2023, the U.S. banking system experienced a historic series of bank failures, including the collapse of Silicon Valley Bank, representing the largest domestic failure since Washington Mutual Inc. in 2008. Many banking regulators viewed the regional banking crisis of spring 2023 as evidence of the fragility of the U.S. banking system and in turn called for more stringent capital and liquidity rules to increase the strength and resilience of the financial system, which culminated in an interagency proposal on July 27, 2023 by the Federal Reserve, the FDIC and the OCC (the "July 2023 Proposal") that would implement the final components of the "Basel III" regulatory framework and impose significant changes to the U.S. regulatory capital rules for large banking organizations. Notably, the July 2023 Proposal would substantially increase capital requirements applicable to all banking organizations with $100 billion or more in assets.

The passage of the 2018 Act and the issuance of the 2019 Tailoring Rules and the 2021 Rule indicate that the pendulum had swung in the direction of more prudential, tailored regulation targeting factors that result in risk and complexity at a bank, and which can in turn bring risk to the financial system and broader economy, but the July 2023 Proposal signals a shift in approach whereby U.S. banking regulators are seeking to unwind the tailoring of the capital framework in favor of more stringent and standardized capital and liquidity requirements for all large banks. The regional banking crisis of early 2023 and the July 2023 Proposal indicate that capital requirements continue to be a regulatory focus, with regulations aimed at three main objectives: (1) to reduce the likelihood that any large financial institution fails; (2) to limit harmful spillovers that would be triggered by the disorderly failure of a large financial institution; and (3) to ensure that private investors, not public taxpayers, will absorb losses in a future crisis. Capital remains king for both ordinary course operations and strategic initiatives, and the quality of capital, in addition to the quantity, has become increasingly important. To see how we arrived at this point, it is worthwhile to review capital raising activity in the immediate aftermath of the crisis.

### 1. Capital Raising Activity During 2008–2010

Beginning during the financial crisis in 2008, financial institutions of all shapes and sizes sought to increase their capital levels for a variety of reasons, including to help absorb current and future losses, to ensure that capital ratios stayed above regulatory minimums, and also to convey a sense of financial strength and confidence to investors, customers, counterparties and competitors. Capital raising in 2008 was significantly aided by the implementation of the Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP") in which financial institutions sold senior preferred shares and warrants exercisable for common stock to the Treasury. By December 31, 2008, the Treasury had invested approximately $178 billion in 214 financial institutions through the CPP, and by year end 2009, the Treasury had invested in nearly 700 banks with over $200 billion in TARP funds.

During the most volatile periods of the financial crisis, in the fall of 2008, raising capital without government assistance was a difficult proposition for many institutions, although as that year wore on stronger institutions found a way to successfully pursue private capital raises, in most cases of common stock or common stock equivalents. Among these capital raises were the public offerings of common stock conducted by JPMorgan Chase & Co. ($11.5 billion), Bank of America Corporation ($10 billion) and Wells Fargo & Company ($12.6 billion) to raise capital to help support their respective acquisitions of Washington Mutual Inc., Merrill Lynch & Co., Inc. and Wachovia Corporation. These large issuances were viewed as demonstrations that the capital raising markets remained receptive to institutions with strong credit quality looking to raise capital to fund important growth opportunities.

Capital raising accelerated following the release of the Federal Reserve's Supervisory Capital Assessment Program ("SCAP") stress test results in May 2009, which were widely viewed as building the confidence of capital markets. Of the 19 stress-tested bank holding companies, 10 were instructed to raise additional capital and were told to submit detailed capital plans. These institutions were told that if they were unable to raise sufficient funds privately or through the markets, they could request additional capital from the government through the Treasury's Capital Assistance Program.

Almost immediately, Wells Fargo announced an $8.6 billion common stock offering and Morgan Stanley also quickly announced a $3.5 billion common stock offering and a $4 billion senior notes offering. Several of the other stress-tested bank holding companies followed suit, and a significant portion of the identified shortfalls were filled by capital raises in the weeks following the release of the stress tests. By the SCAP deadline in November 2009, the SCAP institutions identified as having capital shortfalls had issued $29 billion of common equity, converted $23 billion of existing preferred equity to common equity and sold assets that increased common equity by $9 billion. As a result of these actions, Tier 1 common equity at these institutions increased by more than $77 billion following the release of the SCAP stress test results, and almost all of the institutions increased their capital sufficiently to meet or exceed the required capital buffers. The Capital Assistance Program was officially closed on November 9, 2009, without any investments made by the Treasury.

Following the release of the SCAP stress test results, many of the healthier institutions began voicing their desire to redeem TARP preferred stock. In June 2009, the Federal Reserve announced the criteria it would use to evaluate applications from eligible financial institutions to repay TARP and redeem the preferred shares issued to the Treasury. These criteria included approval from the institution's primary federal banking regulator and also required that a banking organization demonstrate its ability to access the equity and long-term debt markets without relying on the Temporary Liquidity Guarantee Program. JPMorgan Chase and Morgan Stanley were first out of the gate in early June 2009 and priced offerings of $5 billion and $2.2 billion of common stock, respectively, to help meet the TARP redemption requirements. In mid-June, JPMorgan Chase, American Express, Goldman Sachs, U.S. Bancorp, Capital One Financial Corp., The Bank of New York Mellon, State Street, BB&T Corporation, Morgan Stanley and Northern Trust Corporation redeemed an aggregate of $68 billion of TARP preferred stock.

The strong desire among financial institutions to receive approval to redeem TARP continued to drive capital raising activity during 2009. In early December of that year, in

connection with the redemption of its TARP preferred stock for $45 billion, Bank of America raised approximately $19.3 billion in fresh capital, seizing the available window despite insufficient common capacity under its charter by issuing common equivalent securities (discussed in further detail below), and also announced a plan to further increase its common equity by $4.0 billion through the sale of non-core assets and to raise further equity capital by issuing $1.7 billion in restricted common stock to certain of its employees in lieu of a portion of their cash incentive compensation. In mid-December, Citigroup announced that it had reached an agreement with the U.S. government to redeem $20 billion in TARP trust preferred securities and to terminate its loss-sharing agreement with the U.S. government. On the same day, Wells Fargo launched a $10.4 billion common stock offering in connection with its repurchase of $25 billion of TARP preferred stock. Wells Fargo also announced a plan to raise $1.25 billion through the issuance of common stock to Wells Fargo benefit plans and in lieu of a portion of other compensation, and to increase equity by $1.5 billion through asset sales or a backup common equity raise. Ultimately, Wells Fargo raised $12.25 billion of common stock, obviating the plans for asset sales. This trio of TARP redemptions helped make December 2009 the highest monthly volume in history for public offerings, according to Thomson Reuters.

The capital raising activity of 2009 and early 2010 focused primarily on large, national institutions raising capital to meet SCAP "stress test" needs and/or redeem TARP preferred stock, but during 2010 the capital markets also opened to community and regional banks. In February 2010, PNC redeemed its $7.6 billion of TARP preferred stock using proceeds from common stock and debt offerings and the $2.3 billion sale of PNC's global investment servicing business to The Bank of New York Mellon. Others such as Comerica and City National also redeemed TARP preferred stock during the first few months of 2010. Many other regional banks that entered 2010 with TARP, such as Huntington, Fulton and First Horizon, redeemed TARP preferred stock by year end, with Fifth Third exiting TARP shortly thereafter.

As a result of the capital markets opening more widely in 2010, new possibilities arose. Many institutions increased their capital substantially above regulatory requirements and positioned themselves to take advantage of acquisition opportunities by preemptively addressing potential regulatory and capital issues. Some financial institutions generated even higher capital through rebounding earnings and lower dividend ratios as compared to historic levels. Common equity offerings, while down significantly from 2009, continued to receive strong interest.

In addition, due to the receptivity of the capital markets, the U.S. government was able to accelerate its exit from some of the largest investments made during the financial crisis. Building off the success of the $23 billion General Motors stock offering, the Treasury in early December 2010 sold off its remaining investment in Citigroup. From April through December, the Treasury gradually sold 5.3 billion shares of Citigroup common stock into the market prior to the December underwritten secondary offering of 2.4 billion shares.

Banks that were hit relatively hard by asset problems, but that nonetheless continued to represent strong franchises in good markets, were able to find private capital in 2010. Institutions such as Pacific Capital and Sterling Financial announced and successfully completed recapitalizations involving private equity firms or other private capital sources (including bank-focused "blind pools" formed in 2009 and 2010). In some cases, initial investments were conditioned on additional investments by other investors on specified terms and/or a

reorganization of more senior pieces of the bank's capital structure, including TARP preferred stock. (Clearing out these senior pieces was only sometimes successful and required a variety of innovative approaches.) These investments often resulted in the new investors in the aggregate holding a significant majority of the outstanding common stock of the company, and were sometimes followed by rights offerings allowing existing shareholders to purchase shares at the same price at which the investors had purchased shares. These recapitalizations required navigating legal, regulatory and stakeholder issues, often spanned many months between signing and closing, and involved a combination of many of the capital raising and balance sheet management techniques discussed in this chapter. The success of these transactions also signified the important role that private equity and other private investors played and are continuing to play in the financial services industry.

### 2. Capital Raising Activity Since 2011

Capital raising activity by the largest banks in 2011 was focused primarily on senior debt, with banks raising approximately $43 billion. Community and regional banks continued to be the most active issuers of common stock and preferred stock, although a few large issuances accounted for the majority of the dollar volume in 2011 ($11.25 billion for common equity and $10.61 billion for preferred equity). Berkshire Hathaway's $5 billion investment in Bank of America preferred stock in August was the largest capital raise in 2011. Other large issuances in 2011 included $1.04 billion in common stock by SunTrust and $625 million in common stock by KeyCorp in advance of repaying TARP, $1 billion in preferred stock by PNC in connection with its acquisition of RBC's U.S. business and $3 billion by Capital One in connection with its acquisition of ING Direct U.S.A. 2011 began with a successful IPO by BankUnited and its investors in January that priced above the anticipated range and represented the first IPO by a bank that received a financial lifeline from private investors during the financial crisis. The Treasury successfully sold a portion of its stake in AIG and Central Pacific Financial Corp. through public offerings in mid-2011.

These trends largely continued through 2012. A number of the largest financial institutions conducted notes offerings in excess of $1 billion, including JP Morgan, Goldman Sachs, Bank of America, Morgan Stanley, Capital One and Wells Fargo. Citigroup undertook the largest preferred stock offering, raising $1.5 billion, and several community and regional banks also looked to the capital markets in 2012, taking advantage of opportunities for moderate size debt and stock offerings across a range of public and private transactions.

Initial public offering activity involving financial institutions has also been prevalent before the Covid-19 pandemic. Two of the largest "blind pools" — National Bank Holdings Corp. and Capital Bank Financial Corp. — completed successful IPOs in 2012 despite turbulent market conditions. In 2014, the more than 20 completed bank IPOs more than doubled the prior year's level, and several financial company subsidiaries of larger firms — Santander Consumer USA Holdings Inc., Synchrony Financial and Citizens Financial Group, Inc. — completed some of the largest IPOs of 2014. The trend has continued in recent years before the Covid-19 pandemic, with 10 completed bank IPOs in 2015, six in 2016, 14 in 2017, 12 in 2018 and nine in 2019. In 2020, only one bank IPO was completed and in 2021, six bank IPOs were completed. In 2022, as investors faced high inflation and rising interest rates, the IPO market experienced a drastic slowdown, and only two bank IPOs were completed. As high inflation and rising interest

rates continued in 2023, the IPO market slowdown continued, and only three bank IPOs were completed.

Beginning in 2012 and continuing strongly into 2013 and 2014, bank holding companies increasingly issued preferred stock in order to meet Basel III capital requirements and prudential buffers and to optimize the efficiency of their capital structures. Public issuances of preferred stock grew from approximately $375 million in 2011, to over $10 billion in 2012, over $15 billion in 2013, and remained over $20 billion in each of 2014 and 2015. In light of increased regulatory focus on common equity tier 1 capital before the 2018 Act and the 2019 Tailoring Rules, which is discussed further below, the volume of public preferred stock issuances has declined in recent years to approximately $11 billion in 2016, $7.5 billion in 2017 and $4.5 billion in 2018. With the passage of the 2019 Tailoring Rules, the volume of public preferred stock issuances increased in 2019 to $9.7 billion. In 2020 and 2021, preferred stock issuances topped $19.4 billion and $28.4 billion, respectively, driven by the fiscal and monetary stimulus in response to the Covid-19 pandemic and favorable market conditions. In 2022, the volume of public preferred stock issuances declined to $6.2 billion, driven by unfavorable market conditions, including rampant inflation, fears of recession and war in Ukraine. The headwinds that slowed public preferred stock issuances in 2022 endured in 2023, and the volume of public preferred stock issuances declined to $5.1 billion.

Subordinated notes issuance also grew substantially in 2013 as investors returned to that market. In 2020, subordinated debt issuance levels topped $16 billion and remained strong even as other capital raises experienced drops as a result of increased stock market volatility. This growth continued in 2021, 2022 and 2023, with subordinated debt issuances exceeding $21 billion in both 2021 and 2022 and exceeding $26 billion in 2023. Senior debt issuance also grew in recent years, from $248 billion in 2015 to over $438 billion in 2023, as did the frequency of $1 billion or larger issuances.

## B. Capital as a Buffer Against Losses and Uncertainty

Capital continues to be a dominant theme for financial institutions and banking regulators, and there continues to be significant focus on the capital requirements embodied in the Basel III guidelines and in the capital provisions of the Dodd-Frank Act. In its overview of the SCAP stress test results released in 2009, the Federal Reserve stated: "A banking organization holds capital to guard against uncertainty. Capital reassures an institution's depositors, creditors and counterparties — and the institution itself — that an event such as an unexpected surge in losses or an unanticipated deterioration in earnings will not impair its ability to engage in lending to creditworthy borrowers and protect the savings of its depositors."

Given the context, it is not surprising that common stock — a permanent part of a company's capital structure and one that does not subject the company to mandatory dividend payments, redemptions, or the like — has been the focus of regulators.

Tangible common equity was a term that quickly became part of the wider vernacular during the financial crisis. Tangible common equity is generally defined as common equity less goodwill and other intangible assets (although certain intangible assets, such as mortgage-servicing rights, that are seen as having real value may be added back). Regulators and investors

often focus on the tangible common equity ratio, which is tangible common equity divided by tangible assets. Regulatory capital, on the other hand, has historically included common equity and also certain preferred and trust preferred shares, which do not have the same loss absorption qualities as common equity.

When the Federal Reserve conducted the SCAP stress tests, it did not use tangible common equity as the measuring stick, but did adopt a similar metric known as "Tier 1 Common," which also highlights the amount of common equity of an institution. Tier 1 Common is calculated as Tier 1 capital (which already deducts many intangible elements) less non-common elements, including qualifying perpetual preferred stock, qualifying minority interest in subsidiaries and qualifying trust preferred securities. SCAP required each bank holding company to achieve a Tier 1 Common capital ratio (Tier 1 Common divided by risk-weighted assets) of at least 4% at the end of 2010 under the more adverse macroeconomic scenario presented by the stress test.

Basel III, which was fully phased in on January 1, 2019, requires financial institutions subject to the regulations to maintain a Tier 1 Common equity ratio of at least 4.5% plus an additional 2.5% "capital conservation buffer," which is designed to absorb losses during periods of economic stress. Basel III also includes a narrow definition of Tier 1 Common as well as stricter asset risk weightings, particularly on trading, derivatives and securitization activities. In addition, Basel III also introduced a minimum "leverage ratio," a non-risk-based leverage ratio that is calculated by dividing Tier 1 capital by the bank's average total consolidated assets (the sum of the exposures of all assets and non-balance sheet items). In December 2017, the Basel Committee introduced revisions to the Basel III framework (commonly dubbed "Basel IV"), which is designed to further limit the flexibility of financial institutions in using advanced approaches to calculate credit and other risk factors (which is discussed further in this chapter).

While applicable U.S. financial institutions are currently subject to Basel III, they are not yet subject to the enhanced requirements of Basel IV. On July 27, 2023, the Federal Reserve, the FDIC and the OCC announced an interagency proposal that would implement the final components of the Basel III regulatory framework, also known as Basel III Endgame, and impose significant changes to the U.S. regulatory capital rules for large banking organizations. The comment period for the proposed rule expired on January 16, 2024 following the submission of hundreds of comment letters from representatives across a variety of industries and political parties. As of this writing, a final rule implementing Basel III Endgame has not yet been published.

In addition to improving the Tier 1 Common ratio by raising additional Tier 1 Common, financial institutions may also seek to improve the ratio by reducing the mix of assets. The process is likely to be iterative, as higher capital requirements and a shift to less-risky assets will affect achievable returns on capital and equity and investor receptivity to bank stocks — in other words, the cost of capital.

While the Dodd-Frank Act did not expressly adopt Tier 1 Common as the measuring stick, it increases the capital requirements applicable to bank holding companies and also moves closer to Tier 1 Common by phasing out the treatment of trust preferred and other hybrid

securities as Tier 1 capital (as discussed in more detail later in this chapter). Under the Dodd-Frank Act, the current leverage and risk-based capital requirements applicable to FDIC-insured depository institutions will be the minimum requirements for bank holding companies and systemically important non-bank financial companies. To be considered "well-capitalized," a bank holding company will have to meet a Tier 1 capital ratio of 6%.

In December 2016, the Federal Reserve finalized its total loss-absorbing capacity rules aimed at ensuring that financial institutions carry not only sufficient equity capital but also sufficient debt with particular features designed to make the debt available to serve as "bail-in" capital and be converted into equity in the event an institution's capital is depleted. Under these rules, domestic global systemically important banks ("GSIBs") would be required to hold long-term debt of at least the greater of 6% of risk-weighted assets, plus its GSIB surcharge and 4.5% of total leverage exposure. Domestic GSIBs would also be required to maintain total loss absorbing capacity ("TLAC") equal to the greater of 18% of risk-weighted assets and 7.5% of total leverage exposure (reduced from 9.5% under the proposed rule; the Federal Reserve adopted a 2% buffer on top of the leverage component of the external TLAC requirement). The final rule allows long-term debt issued on or before December 31, 2016 to count towards a firm's long-term debt requirement, even if it has contractual terms the rule would otherwise not permit.

The final rule also imposes on domestic GSIBs so-called "clean holding company requirements." These mandate that the top-tier holding company avoid a broad range of financial arrangements that are thought to create obstacles to an orderly resolution. These arrangements include issuance of short-term third-party debt, entering into qualified financial contracts (derivatives, securities lending, repos), liabilities guaranteed by subsidiaries or subject to contractual offset rights for subsidiaries' creditors and issuing certain guarantees of subsidiaries' liabilities providing for default based on the resolution of the holding company.

The 2018 Act introduced changes to the Dodd-Frank framework that meaningfully reduced regulatory burdens on smaller institutions, especially on community banking organizations. Among the changes introduced, the 2018 Act provided an exemption from the U.S. Basel III-based capital requirements for certain smaller banking institutions with less than $10 billion in total consolidated assets. These changes were implemented by the 2019 Tailoring Rules, which, among other things, established asset thresholds at $100 billion, $250 billion and $700 billion. The exemptions and relief for certain smaller banking institutions provided by the 2018 Act and the 2019 Tailoring Rules, as well as the additional tripwires for increased regulation in the 2019 Tailoring Rules, are discussed in further detail below.

## C. Capital Requirements in the Future

The consistent focus on capital, and in particular common equity, from regulators and investors since the financial crisis has resulted in many financial institutions already having built higher capital cushions. In September 2010, the Federal Reserve, OCC and FDIC released a joint press release supporting the Basel III guidelines, which were fully phased in on January 1, 2019, and stating that the U.S. banking supervisors would be evaluating an institution's capital adequacy on the basis of the then-applicable standards as well as the strength of an institution's plans to meet future standards as they come into effect.

Indeed, even prior to the full phase-in date for Basel III, U.S. banking regulators had demonstrated an expectation that banks were on a realistic path to meet the requirements. For example, following the announcement of the original Basel III framework in 2010, the Federal Reserve required each of the 19 SCAP institutions to submit a comprehensive capital plan by January 7, 2011, which included the results of a new stress test. In determining whether to approve capital plans that included a request to increase capital distributions, the Federal Reserve required that: (1) the institution had to have completed the redemption or exchange of any outstanding securities issued to the U.S. government under TARP, (2) the institution's pro forma post-stress capital estimates had to meet minimum regulatory capital standards as well as a 5% Tier 1 Common Ratio and (3) the institution had to demonstrate with great assurance that it could achieve the Basel III ratios (after giving effect to any such capital distributions) as these ratios come into effect. In addition, the Federal Reserve considered other factors, including whether a proposed redemption of regulatory capital instruments would be funded by the issuance of instruments of equal or better quality in terms of loss-absorption capacity and whether common share repurchases were designed to offset increases in share count related to employee share-based compensation awards. The Federal Reserve granted approval to certain of the banks to increase their dividends, including JPMorgan Chase, Wells Fargo and U.S. Bancorp and also granted certain of the banks' requests to engage in share buybacks, including Goldman Sachs (with respect to Berkshire Hathaway's 2009 investment), Wells Fargo, JPMorgan Chase and U.S. Bancorp.

In 2012, the Federal Reserve conducted another round of stress tests as a part of the Comprehensive Capital Analysis and Review ("CCAR") on 31 U.S. bank holding companies with assets of $50 billion or more (including the 19 institutions that participated in the 2011 stress tests). The 2013 CCAR included 18 institutions covered in 2012 (excluding MetLife, Inc., which deregistered as a bank holding company in 2013), and in addition to the CCAR, 11 other bank holding companies with assets of $50 billion or more participated in the Capital Plan Review ("CapPR") in 2013, which had similar objectives to the CCAR. In addition to the 18 firms that participated in 2013, 12 firms with more than $50 billion in total assets that had not previously been part of the CCAR participated in 2014. Four additional institutions participated in the CCAR process from 2015 to 2017; in 2018, one additional institution participated, bringing the total number of participating institutions to 35. In March 2019, the Federal Reserve announced that it will limit the use of the "qualitative objection" in the CCAR exercise, effective for the 2019 cycle. The CCAR is now an annual process and the announced aim is to ensure that institutions have robust, forward-looking capital planning processes that account for their unique risks, and to help ensure that institutions have sufficient capital to continue operations throughout times of economic and financial stress.

The 2019 changes eliminate the qualitative objection for most firms due to the improvements in capital planning made by the largest firms. While the qualitative objection will no longer apply to certain firms as a result of this change, all firms will continue to be subject to a rigorous evaluation of their capital planning processes as part of CCAR. Firms with weak practices may be subject to a deficient supervisory rating, and potentially an enforcement action, for failing to meet supervisory expectations. In addition, all firms remain subject to a potential objection on quantitative grounds. In 2019, only 18 firms were subject to the CCAR exercise, with five of those firms being subject to potential qualitative objection because they continued to exhibit "material deficiencies in capital planning." Financial institutions must demonstrate that

they have sufficient capital so that they can continue to lend to households and businesses, even under severely adverse conditions, and are well prepared to meet the Basel III regulatory capital standards. Boards of directors of the institutions are required to approve the capital plans before they are submitted to the Federal Reserve. The Federal Reserve will review these banks' plans to distribute capital to their shareholders through dividends or stock repurchases and approve or deny such actions based on the outcome of the stress tests.

In 2020, 34 banks, each with more than $100 billion in total consolidated assets, were subject to the CCAR exercise. In light of the economic turbulence as a result of the Covid-19 pandemic, in addition to the annual CCAR and Dodd-Frank stress tests completed in June 2020, the Federal Reserve performed a second round of stress tests as well as additional sensitivity analyses of how banks would fare under three different recession and recovery scenarios from least to most severe: V-shaped, U-shaped, and a W-shaped double-dip. In response to the considerable economic uncertainty, the Federal Reserve put several restrictions in place in June 2020 to ensure that banks would preserve capital, including suspending share repurchases, limiting dividends, and requiring capital plan resubmissions for all CCAR participants. These restrictions limited dividends and share repurchases to an amount based on income over the prior year. If a bank did not earn income, it was not able to pay a dividend or make repurchases. The temporary and additional restrictions on bank holding company dividends and share repurchases ended for most firms after June 30, 2021, after completion of a round of stress tests; specifically, firms with capital levels above those required by the stress test were subject to the additional restrictions as of that date, while firms with capital levels below those required by the stress test remained subject to the restrictions. On January 1, 2021, the Federal Reserve's authority to object to capital plans on qualitative grounds was eliminated entirely.

In December 2017, the Basel Committee introduced revisions to the Basel III framework, stating that these changes are designed to improve the comparability of banks' capital ratios and to further limit the flexibility of financial institutions in using advanced approaches to calculate credit and other risk factors. These revisions, introduced by the Basel Committee as an extension of the Basel III framework, have been commonly dubbed "Basel IV" in light of the banking communities' initial views that these new restrictions could have a significant impact on their operations and ability to extend credit once implemented. Specifically, the "Basel IV" revisions envision four primary changes: (1) tightening the robustness and risk sensitivity requirements of Basel III's standard approaches for credit risk, credit valuation adjustment ("CVA") risk and operational risk, (2) constraining the use of internal model approaches, including by placing limits on certain inputs used to calculate capital requirements under the internal ratings-based ("IRB") approach for credit risk and by removing the use of the internal model approaches for CVA risk and for operational risk, (3) introducing a leverage ratio buffer to further limit the leverage of GSIBs and (4) replacing the existing Basel II output with a higher, risk-sensitive floor. When fully phased in, "Basel IV" mandates that a bank's risk-weighted assets calculated under a regulatory-approved method cannot be lower than 72.5% of risk-weighted assets according to standardized Basel approaches. The Committee has targeted 2022–2027 for regulators to implement the revised framework in their respective jurisdictions. The July 2023 Proposal, which would implement the final components of the "Basel III" regulatory framework in the United States, would take effect beginning July 1, 2025 (but as noted above, as of this writing, regulators in the United States have not yet published a final rule in response to the 2017 revisions).

As noted above, the 2018 Act introduced changes to the Dodd-Frank framework that meaningfully reduced regulatory burdens on smaller and mid-size institutions. Among other things, the legislation raises the BHC asset threshold, above which the Federal Reserve is required to apply Dodd-Frank's Section 165 "enhanced prudential standards," including CCAR, from $50 billion to $250 billion. The Federal Reserve issued final rules in October 2019, which became effective on January 9, 2020, that established asset thresholds at $100 billion, $250 billion and $700 billion. However, the 2019 Tailoring Rules went beyond the 2018 Act and established additional tripwires for increased regulation. Specifically, the Federal Reserve adopted four "risk indicators" which can trigger an increase in regulation regardless of the asset size of the bank — the level of a banking organization's: (1) cross-jurisdictional activity; (2) weighted short-term wholesale funding; (3) nonbank assets; or (4) off-balance sheet exposure. Based on these criteria, the Federal Reserve established four categories. Banking organizations with total assets of $100 billion or more are assigned to a particular category and subject to a specified set of regulations. Importantly, if a banking organization exceeds $75 billion in any of the four risk indicators, it will be automatically assigned to a category even if it is below the relevant asset threshold. The categories and their thresholds are (1) Category IV: Banking organizations with $100 billion to $250 billion in total consolidated assets, (2) Category III: Banking organizations with ≥ $250 billion in total consolidated assets or ≥ $75 billion in nonbank assets, weighted short-term wholesale funding or off-balance sheet exposure, (3) Category II: Banking organizations with ≥ $700 billion in total consolidated assets or ≥ $75 billion in cross-jurisdictional activity and (4) Category I: Global systemically important banking organizations, which consist of the largest and most complex U.S. banks.

This framework has already led to some arbitrary and anomalous results. For example, as of this writing, the sole banking organization in Category II is Northern Trust Corporation, a banking organization with (based on the most recent publicly available data) only $approximately $160 billion in total consolidated assets — well below the category's $700 billion asset threshold. Although Northern Trust has a relatively low-risk business model based predominately on providing custody and wealth management services, its cross-jurisdictional exposure exceeds $75 billion. More broadly, the adoption of the 2019 Tailoring Rules opened a new chapter for the banking industry — one which favors deposit funding over wholesale funding and disfavors the growth of nonbank assets and international operations. For large diversified financial services companies, this effectively means that the path to avoiding more burdensome regulation is to move to a more bank-centric business model, even though such a shift increases the potential exposure of the federal Deposit Insurance Fund.

Another significant change introduced by the 2018 Act is the exemption of certain smaller banking institutions with less than $10 billion in total consolidated assets from the U.S. Basel III-based capital requirements. Instead, Section 201 of the 2018 Act requires the federal banking agencies to promulgate a rule establishing a new "Community Bank Leverage Ratio" ("CBLR") of 8–10% for depository institutions and depository institution holding companies (including banks and BHCs) with less than $10 billion in total consolidated assets. The 2018 Act provides that if such an institution maintains tangible equity in excess of this leverage ratio, it would be deemed to be in compliance with the leverage and risk-based capital requirements promulgated by the federal banking agencies. In November 2019, the Federal Reserve, OCC and the FDIC issued a final rule to implement Section 201 of the 2018 Act. The CBLR final rule became effective on January 1, 2020, and allows qualifying community banking organizations to

calculate a leverage ratio to measure capital adequacy. Banks opting into the CBLR framework ("CBLR Banks") are not required to calculate or report risk-based capital. Under the CBLR final rule, a qualifying community banking organization must have less than $10 billion in total consolidated assets, a leverage ratio greater than 9%, off-balance sheet exposures of 25% or less of total consolidated assets, and trading assets and liabilities of 5% or less of total consolidated assets. It also cannot be an advanced approaches institution. Institutions that opt into this framework are not subject to other risk-based and leverage capital requirements, and are considered to have met applicable "well-capitalized" ratio requirements and to be in compliance with the generally applicable capital rule. A CBLR Bank may opt out of the framework at any time, without restriction, by reverting to the generally applicable risk-based capital rule. A CBLR Bank that ceases to meet any qualifying criteria in a future period and that has a leverage ratio greater than 8% will be allowed a grace period of two reporting periods to satisfy the CBLR qualifying criteria or comply with the generally applicable capital requirements. The CBLR is calculated as the ratio of "Tier 1 capital" divided by the average total consolidated assets, thereby adopting tier 1 capital and the existing leverage ratio into the CBLR framework. The tier 1 numerator takes into account the modifications made in relation to the capital simplifications and current expected credit losses methodology ("CECL") transitions rules as of the compliance dates of those rules.

In addition to the July 2023 Proposal described above, which would implement the Basel III Endgame capital reforms, the U.S. banking agencies issued another proposed rule in 2023 designed to improve financial stability through enhanced capital requirements. On August 29, 2023, the Federal Reserve, the FDIC and the OCC requested comment on a proposal that would require large banks with total assets of $100 billion or more to maintain a minimum amount of long-term debt to absorb losses. As of this writing, regulators in the United States have not yet published a final rule to implement these proposed long-term debt requirements; however, some banking organizations have already begun issuing long-term debt that would satisfy the proposed requirements.

## D. A Lesson for the Future

The financial crisis and ensuing regulatory initiatives, including the Dodd-Frank Act and Basel III, highlighted the importance to financial institutions of developing a capital structure that is ready for the next part of the business cycle, and in doing so of retaining direct control of their capital structure as much as possible. Trust preferred securities issued prior to the financial crisis have resulted in many unintended consequences and can serve as a valuable lesson for the future. The trust preferred securities were crafted during good times for banks and accordingly were designed to be attractive in an environment of strong earnings and excess capital, providing relatively limited equity dilution, deductibility of debenture interest payments and (up to regulatory limits) Tier 1 capital treatment. When the cycle turned and banks faced losses and declining capital levels, the securities generally looked a lot more like long-term, high-coupon non-redeemable debt.

Even before the Collins amendment to the Dodd-Frank Act (which, among other things, disqualified trust preferred securities from Tier 1 capital), under existing rules, the Federal Reserve only permitted a limited amount of trust preferred to be included in Tier 1 capital (*e.g.*, it could constitute no more than 25% of Tier 1 capital). In an environment of declining Tier 1

capital levels driven by loan losses, less and less of an institution's outstanding trust preferred securities were eligible to be included in Tier 1 capital, accelerating the decline in regulatory capital levels. For institutions experiencing a potentially extended period of such losses, the deductibility of the interest payment on the related debentures was less valuable. Because of the ability to defer dividend payments for up to five years (and regulatory insistence in numerous cases that the deferral be implemented), when banks began to experience financial difficulties, ratings agencies were quick to downgrade the securities and numerous trust preferred issues traded at distressed levels.

The low trading levels made potential buyers of distressed holding companies reluctant to take on the long-lived trust preferred obligations at their full value, but they proved hard to buy at a discount. Trust preferred securities have frequently been a sort of fulcrum security in acquisitions of troubled institutions. Several notable transactions, including Ford Financial's recapitalization of Pacific Capital in 2010 (which is discussed in more detail later in this chapter) included conditions around effecting discounted tender offers for trust preferred securities, which have often proven difficult in execution. Several other deals have attempted to solve the issue of trust preferred securities at the holding company level by focusing on bank-level transactions, but holders of the trust preferred securities have used the "fulcrum" position of their holdings to attempt to block the transaction. BB&T's transaction with BankAtlantic in 2012 is one such example. An initial bank-level transaction was enjoined in a lawsuit by holders of BankAtlantic's trust preferred securities (alleging that the transaction violated certain covenants contained in the trust preferred securities indentures and that the assumption of the trust preferred securities by BB&T was required). The deal was subsequently restructured, and BB&T assumed the approximately $285 million in outstanding trust preferred securities.

Many trust preferred securities, particularly those of smaller institutions issued in relatively small principal amounts in pooled offerings, ended up being repackaged into CDOs, creating significant practical difficulty for taking out these securities by tendering for them in the market or by exchanging them for other securities. The nature of the CDO (although some are managed, many are so-called "static" CDOs and have no collateral manager) may make it difficult to even find counterparties that are willing or able to negotiate. Moreover, indenture trustees for these CDOs are often hesitant to take the necessary actions or to assist in soliciting the approval of CDO interest holders to dispose of a portion of the CDO assets in the absence of a default on the assets to be sold. The trust preferred securities and the inability to obtain approval of the CDO holders to redeem them can act as a barrier to a recapitalization or other investment or acquisition of a troubled institution, resulting in receivership or bankruptcy. In the Pacific Capital recapitalization, the CDO structure rendered it effectively impossible to locate or negotiate with the beneficial owners of the trust preferred securities, requiring them to be left in place.

As the five-year deferral periods on trust preferred securities for which issuers commenced deferring interest following the financial crisis began coming to an end, a number of bank holding companies were forced into bankruptcy and sold their bank subsidiaries through so-called Section 363 sales. The buyers acquired the bank subsidiaries free and clear of the holding companies' obligations, including trust preferred securities, and the holding companies' creditors were left to share in the proceeds.

Transactions like these or those that withered on the vine due to "hold up" issues embedded in target capital structures are stark reminders of the value of healthy skepticism when evaluating proposals to use complex securities to raise capital. There is no doubt that common equity can be an expensive form of capital. But among their many other advantages, simple equity securities, such as common stock, benefit from their relative clarity of ownership, limited and well-understood holder rights and well-developed custodial and administrative systems to facilitate trading. Reflecting the upside potential of the securities, the investor profile of common equity and debt securities is markedly different. These features make it easier to deal with common equity in the context of a transaction, including obtaining a charter amendment or taking other actions requiring shareholder approval when there is a need.

## II. RAISING ADDITIONAL CAPITAL

Today's capital markets support a diverse range of capital raising alternatives, including those discussed below. With the sustained regulatory and commercial focus on capital levels, these are useful capital management tools and valuable adjuncts to creative restructuring and/or acquisition strategies.

### A. At-the-Market Offerings

As financial institutions searched for ways to raise additional common equity in a volatile and unpredictable stock market during 2009, at-the-market offerings took their place as a supplement to the traditional underwritten offering. At-the-market offerings were previously seen as a technique for smaller issuances over a longer time period. However, the extraordinary success of Bank of America, PNC and others broadened the circumstances where corporations with adequate liquidity and trading depth will look to the option of at-the-market offerings. Following the release of the 2009 stress test results, PNC raised more than $600 million in common equity through an at-the-market offering over a period of two weeks. Bank of America raised nearly $13.5 billion in common equity through an at-the-market offering in approximately 11 days. Other financial institutions, such as Huntington, SunTrust, Fifth Third, KeyCorp and Cathay General Bancorp, also used at-the-market offerings during 2009 as a means to raise additional common equity. Since 2009, at-the-market offerings have been successfully used by Zions Bancorp, West Coast Bancorp, Citizens Financial Group and Unity Bancorp, among others.

An at-the-market offering allows an issuer to gradually sell shares of its common stock into the market over a period of days or weeks and provides flexibility to better manage turbulent market conditions. An issuer attempting to execute an underwritten offering in such a market faces substantial execution risk. Unfavorable market conditions can lead to an aborted offering. An at-the-market offering often allows an issuer to manage such challenging conditions by actively selling into the market when conditions are favorable and selling less or not at all on a day when market conditions are less favorable.

In an at-the-market offering, an issuer files a registration statement (or a prospectus supplement to an existing registration statement) that is very similar to the registration statement/prospectus supplement that would be filed in connection with an underwritten offering. At-the-market offerings are only available to issuers who are eligible to conduct shelf offerings

using Form S-3 under Rule 415 of the Securities Act, because the shares are considered to be offered on a continuous basis. The issuer typically enters into an equity distribution agreement with an investment banking firm, which is filed with the SEC on a Form 8-K at the beginning of the at-the-market offering. Shares sold under the equity distribution agreement typically may be sold on a stock exchange, at market prices prevailing at the time of sale, at prices related to the prevailing market prices, or at negotiated prices. Most equity distribution agreements permit the investment banking firm to act either in a sales agent or in a principal capacity. NASDAQ views shares sold on a principal basis to the investment banking firm for its own account as indicative of a private placement and, depending on the percentage of shares sold in a principal versus agency capacity, NASDAQ could initially view the at-the-market offering as a private placement for purposes of NASDAQ's shareholder approval requirements.

Typically, an at-the-market offering is better suited for a small- to moderate-sized capital raise because the trading volume of a stock can limit the ability to sell a significant number of shares into the market at any given time without putting downward pressure on an issuer's stock. Potential advantages of an at-the-market offering include: shares sold during an at-the-market offering will not generally have the same discount to market price as those issued in a firm commitment underwritten offering; an at-the-market offering is not marketed through roadshows or meetings with management — management's involvement is limited to calls with the investment bank to discuss market conditions and execution (*e.g.*, pricing and amount of shares to be sold); and an at-the-market offering typically does not involve the issuer committing to a lock-up period and can be suspended or terminated at any time. In 2009 and 2010, a number of banks, including Huntington, SunTrust and Cathay General Bancorp, were able to leverage these features to suspend/terminate an at-the-market offering in favor of a firm commitment underwritten offering on short notice when market conditions became more favorable for a larger issuance of common stock that could be more easily distributed into the market through an underwritten offering.

## B. Underwritten Offering Combined with Wall Cross

Another tool used to raise common equity is a traditional underwritten offering combined with a "wall cross." Historically, wall crossing was used in the private placement context to allow an issuer to canvas interested private investors to allow the issuer to announce the completion of a successful private placement without first having to publicly announce that the issuer was seeking capital. In a wall cross, institutional investors sign confidentiality agreements that allow them to gain access to information about the offering before it is publicly announced, provided that these investors also agree not to trade in the issuer's stock until the public portion of the offering is completed or the occurrence of a "cleansing event." After institutional investors are lined up, the public has the opportunity to buy the stock at the same price offered to the institutional investors. The wall cross allows an issuer to quickly gauge investor appetite for the offering without being exposed to as much risk of announcing an offering and failing to price, sign up large orders with anchor investors who can help the issuer market the remaining portion of the offering, and sell shares in an offering without being subject to the pressure of short selling that often accompanies a publicly announced offering.

In order to be successful, a wall cross requires that management be very involved in marketing the offering to the institutional investors through road shows and management

meetings. When the deal is publicly announced, the issuer must disclose, either through the prospectus or through another securities filing, any material non-public information that was provided to the investors who crossed the wall. One risk of a wall cross is that investors entering into a confidentiality agreement will typically only agree to be restricted from trading in the issuer's securities for a fixed period, which is often very short. The terms of the confidentiality agreement will require the issuer to "cleanse" the investors by publicly releasing at the end of the fixed period material non-public information provided to these investors, if any, which could adversely affect the issuer if the offering fails to materialize.

This technique was used by Wells Fargo in May 2009 to raise $8.6 billion in an offering that priced one day after the SCAP stress test results were released, bringing the offering to market on an extremely compressed timeline. The wall cross technique had also been used by Wells Fargo in its 2008 common stock offering in connection with the Wachovia acquisition and by JPMorgan Chase in its 2008 common stock offering in connection with its acquisition of Washington Mutual.

## C. Rights Offerings

In a weak market, large capital raises have often caused concern about diluting the existing investor base. Rights offerings provide a means for existing investors to participate in what may be seen as an attractively priced opportunity. Although rights offerings were seen in the early 1990s as a method for issuers to raise substantial amounts of equity in situations where a public offering was not practical or attractive, rights offerings in the United States in the years following the financial crisis have typically been limited to offerings by smaller community banks where often a substantial portion of the shareholder base comprises customers as a means to raise cash to address capital and liquidity needs or in connection with third-party recapitalization transactions as a means of addressing, if only partially, the dilution experienced by existing investors; these have met with mixed success.

Following the initial dislocations in the credit markets that began during the summer of 2007, KKR Financial launched a $270 million rights offering with an at-market subscription price and backstop commitment from affiliates of KKR Financial to acquire up to $100 million in common stock if the rights offering was not fully subscribed. Paired with a substantial private placement of common stock and asset sales, the rights offering was a pivotal piece of KKR Financial's efforts to raise capital in a volatile market.

Significantly larger rights offerings are seen in Europe, where for legal and structural reasons the approach has traditionally been more prevalent. For example, in September 2010, Deutsche Bank completed a €10.2 billion rights offering coinciding with the commencement of the Basel III accord. Europe saw several significant rights offerings announced in 2008 and 2009, including offerings by ING Groep NV, AXA, Lloyds Banking Group Plc, Royal Bank of Scotland and UBS. Significant rights offerings in Europe have continued since then, including multi-billion dollar rights issued by Barclays in 2013, Deutsche Bank in 2014, Credit Suisse and Standard Chartered in 2015, Banco Popular Español in 2016 and Banco Santander, UniCredit and Banco Comercial Português in 2017 as banks continued to take actions to enhance capital ratios.

Beginning at the end of 2009, rights offerings to legacy shareholders following the closing of a substantial private investment cropped up in several bank recapitalizations in the United States. These rights offerings typically allowed legacy shareholders to buy shares at the same per share price that the investors had invested the capital. An early example was a $10 million rights offering announced by West Coast Bancorp in December 2009. Post-closing rights offerings were also included in the $500 million investment in Pacific Capital by Ford Financial Fund, the $175 million investment in TIB Financial and the $181 million investment in Capital Bank, each by NAFH, and the $325 million capital raise by Central Pacific Financial anchored by The Carlyle Group and Anchorage Capital Group. These recapitalizations, which are discussed in more detail later in this chapter, generally resulted in the new investors collectively owning in excess of 80% of the company's equity prior to the rights offering.

In a rights offering, an issuer distributes to its shareholders the right, exercisable for a limited time period (typically 30 to 45 days), to subscribe for additional shares of the issuer's stock at a price that is normally less than the market price of the issuer's outstanding shares. The rights may or may not be transferable. To assure the success of the offering, issuers often obtain a standby commitment from one or more standby purchasers, often investment banks, to purchase the unsubscribed shares. The presence of such a backstop commitment can raise additional legal issues that should be carefully considered, including possible shareholder approval requirements under stock exchange rules and potentially also sale of control issues under state corporation law. Rights offerings following bank recapitalizations have not used backstop commitments because the primary purpose of the offering is not to raise additional capital over what was just raised but to provide legacy shareholders with the opportunity to purchase shares at a particular price and offset the dilution experienced by them in the recapitalization.

## D. Trust Preferred and Other Hybrid Securities

The phase-out period under the Collins amendment in Dodd-Frank for trust preferred securities and other hybrid securities as a component of bank holding companies' Tier 1 capital began on January 1, 2013 and concluded on January 1, 2016, subject to limited exceptions. Trust preferred securities are hybrid securities combining features of both debt and equity that became very popular following the Federal Reserve's determination in 1996 to permit their Tier 1 treatment for bank holding companies. Properly structured, these securities are treated as debt for tax purposes and the interest the company pays in connection with the securities is tax deductible. Since the securities do not involve the direct issuance of equity by the company, they do not dilute the company's earnings per share or return on equity.

In a trust preferred issuance, the bank holding company typically establishes a statutory business trust. The trust then sells preferred securities to investors (the company retains the common interests in the trust) and uses the cash raised in the offering to purchase subordinated debentures from the holding company. The subordinated debentures, which are the trust's only assets, pay interest in amounts and on dates coinciding with the payment of dividends by the trust on the preferred securities, and the trust uses the interest payments from the debentures to pay the interest on the preferred securities. The securities typically have terms of 30 (sometimes as long as 50) years and are sometimes callable after five years.

With the loss of Tier 1 equity credit, trust preferred securities — which typically bear a relatively high coupon — have become an expensive form of capital relative to other Tier 2 securities (particularly expensive during periods of losses or marginal profits where the tax deduction is not worth much). Trust preferred securities were intended to serve as quasi-permanent capital and thus have maturities of 30 years or more and limited redemption rights. However, for these very reasons, many trust preferred securities provide a window for redemption by the company in certain circumstances, including in the case of "regulatory capital events." These are typically defined to include a change in law or proposed change in law giving rise to a "more than insubstantial risk" of impairment of the ability to treat the trust preferred securities as Tier 1 capital. In anticipation of the phase-out of Tier 1 capital treatment for trust preferred securities, financial institutions actively replaced outstanding trust preferred securities with other forms of regulatory capital. For example, in 2011, Huntington Bancshares completed a novel exchange offer for several specified series of outstanding trust preferred securities. In the offer, Huntington exchanged outstanding floating-rate trust preferred securities for a new series of floating-rate non-cumulative perpetual preferred stock, which — unlike the trust preferred securities — will retain Tier 1 treatment under Dodd-Frank and will also continue to be recognized as a Tier 1 instrument under Basel III. Huntington's exchange offer involved four different series of trust preferred securities, and the offer was tailored to each series, including through the use of additional cash consideration for two of the series and by employing a waterfall of acceptance priority levels among the four series in the event that the offering was oversubscribed. By conducting the exchange as a registered offering rather than relying on the exemption from registration provided in the exchange provisions under Section 3(a)(9) of the Securities Act, Huntington was able to employ a dealer manager to solicit trust preferred holders in an effort to maximize participation. Note, however, that while Huntington's exchange offer was completed in the scheduled time frame, the SEC must declare an exchange offer registration statement effective prior to closing, and the SEC review process can risk a delayed closing. Under the securities laws, the offer must be open to all holders and generally must remain open for at least 20 business days.

Many financial institutions, including Comerica, KeyCorp, PNC, Wells Fargo, Fifth Third, JP Morgan, Citigroup, Bank of America, BB&T, Capital One, SunTrust and Regions also took action with respect to trust preferred securities, including in certain cases redeeming trust preferred securities under the early redemption indenture provisions triggered by the Dodd-Frank regulatory capital treatment changes. The three-year phase-out of Tier 1 capital treatment is now complete, and financial institutions have continued to replace trust preferred securities with securities having preferred regulatory capital treatment (and/or a lower cost of capital) and to deploy excess capital to repurchase or redeem trust preferred securities where economically advantageous. Any redemption or replacement strategy requires careful coordination with regulators, financial and legal advisors and consideration of all applicable circumstances, including the investor base of the outstanding trust preferred securities, to appropriately tailor the terms of the transaction and ensure the best opportunity for a successful exchange or redemption. Issuers should also bear in mind applicable corporate and securities law issues, including disclosure obligations. Also, because of the relatively high yield, particularly in the context of a low interest rate, fixed income environment, holders may seek to legally challenge redemption efforts (although a federal district court in 2012 dismissed a class action lawsuit brought under New York law against Wells Fargo by purported holders of trust preferred securities, concluding

that the passage of the Dodd-Frank Act did in fact constitute a capital treatment event triggering a redemption right).

Under current Federal Reserve guidelines, any redemption of trust preferred securities will require prior regulatory approval. Moreover, a number of issuers entered into "replacement capital covenants" in connection with trust preferred issuances in order to obtain better rating agency treatment for the securities. Under these covenants, redemption (notwithstanding any accelerated redemption right) is generally subject to raising specified levels of common stock or other equity securities within the six months prior to redemption (*e.g.*, issuing common stock for proceeds equal to 75% of the proposed aggregate redemption price). While the replacement capital covenants are often designed to prevent "double counting" any single replacement equity raise for the redemption of more than one particular series of trust preferred securities, they generally do not prohibit an equity raise undertaken for purposes of redeeming TARP preferred stock from counting towards a replacement capital obligation. Of course, all redemption plans would need to be discussed with the regulators as part of the approval process.

## E. Contingent Capital Securities

Windows of opportunity to raise a particular type of capital or to achieve a particular price often open and close very quickly. This requires agility and speed from a financial institution and its legal and financial advisors to move before the window closes. In the context of large common equity raises, possible obstacles include an insufficient amount of available authorized common stock under the corporation's charter, and stock exchange limitations requiring a shareholder vote before issuing common stock equal to 20% or more of the amount outstanding prior to the issuance.

The insufficient authorized stock obstacle can be addressed by amending the corporation's charter, but this requires shareholder approval. Obtaining shareholder approval is generally a lengthy process, often a minimum of six to eight weeks, and possibly much longer. In a number of situations during and after the financial crisis, capital needed to be raised quickly and during favorable windows of uncertain duration. A tool that can sometimes be used to allow a corporation to immediately raise the capital is issuing a mandatorily convertible security that converts into common stock upon (later) shareholder approval and behaves much like common stock in the meantime. Designing such securities is a complex undertaking, with numerous legal, regulatory and corporate needles that need to be threaded.

An example is the 2009 capital raise by Bank of America in connection with redeeming its TARP preferred stock for $45 billion. Bank of America had an insufficient number of common shares available to raise the needed amount of capital. In order to quickly take advantage of the window to exit TARP, Bank of America structured a common equivalent security convertible into common stock contingent upon shareholder approval of the necessary increase in authorized common stock and quickly raised $19.3 billion in an offering. Each Common Equivalent Security consisted of (1) a depositary share representing a 1/1,000 interest in a series of Bank of America junior preferred stock and (2) a contingent warrant to purchase 0.0467 shares of Bank of America common stock. At the time of issuance and until one of the triggering events discussed below, the junior preferred stock had voting, dividend and liquidation

rights generally equivalent to those of common stock, although there were no voting rights with respect to the shareholder vote to increase the authorized common stock.

Upon receipt of shareholder approval, each Common Equivalent Security converted into one share of common stock through conversion of the underlying preferred stock and cancellation of the underlying warrants. Bank of America committed to use its reasonable best efforts to hold a shareholder meeting within 105 days of issuance of the Common Equivalent Securities. In order to compensate holders of the Common Equivalent Security for the risk that shareholder approval would not be received in a timely fashion, either (1) a failure to receive shareholder approval within 105 days of issuance or (2) a vote against the proposal by shareholders would have triggered certain terms of the securities that were favorable to investors. If Bank of America had failed to obtain the shareholder approval within 105 days, the warrants and depositary shares would have separated and begun to trade separately (although the warrants would not have become exercisable unless a negative shareholder vote had occurred), the depositary shares would have been partially converted on a pro rata basis into about 15% of the aggregate amount of common stock issuable upon conversion (and would have converted into the remaining amount of common stock upon a subsequent affirmative shareholder vote) and an additional non-cumulative quarterly cash dividend at an annual rate of 10% would have become payable on the underlying preferred stock with the rate increasing by 2% each subsequent quarter that the preferred stock remained outstanding up to a maximum of 16%. Bank of America would also not have been permitted to pay dividends or distributions on its common stock unless these additional non-cumulative dividends were paid in full. In addition, upon a negative shareholder vote, each of the warrants would have become exercisable for 0.0467 shares of Bank of America common stock for a period of 30 days at an exercise price of $0.01 per share. The issuance of common stock upon the partial conversion combined with the amount issued if all of the warrants were exercised would have used up the remaining unissued common stock that Bank of America had available. Bank of America was also required to continue to seek shareholder approval at least every six months until shareholder approval was received.

The stock exchange limitations on the amount of common stock that may be issued absent shareholder approval only apply if an offering is both (1) for 20% or more of the currently outstanding common stock and (2) not considered a "public" offering under the applicable exchange's rules and regulations. This issue arises in private equity investments and acquisitions since these deals typically are not "public" under stock exchange rules. As in the Bank of America example described above, many of these investors use contingent securities to strike the balance between a company's desire to immediately raise capital and improve its regulatory capital ratios and the risk to an investor that shareholder approval is delayed or not received.

While some of the bank recapitalization transactions relied on the financial viability exceptions contained in NASDAQ Rule 5635(f) and Section 312.05 of the NYSE Listed Company Manual to dispense with a shareholder vote, these exceptions are only available in limited circumstances. One such example where a financial viability exception was used was Knight Capital's issuance of $400 million of cumulative convertible preferred stock to investors following the extraordinary trading loss sustained by the company in August 2012, which significantly depleted Knight Capital's capital base and in turn precipitated a liquidity crisis that would have threatened Knight Capital's ability to continue to operate. The preferred stock represented, on an as-converted basis, approximately 73% of Knight Capital's outstanding

common stock. As a result, the completion of the capital infusion normally would have required stockholder approval pursuant to NYSE rules. However, Knight Capital's audit committee determined that the delay that would result from obtaining stockholder approval would seriously jeopardize the financial viability of the company, and it approved Knight Capital's reliance on the NYSE's financial viability exception. The NYSE informed Knight Capital that it did not object to the company's reliance on the financial viability exception under the circumstances.

In reliance on the financial viability exception, Knight Capital mailed to all of its stockholders a letter notifying them that it had issued shares of common stock without seeking stockholder approval. Reliance on the NYSE financial viability exception requires that the letter to stockholders be mailed to stockholders 10 days prior to the date on which the convertible preferred shares can convert into common stock or vote as a class with common stock. However, the investors in Knight Capital's capital raise were not willing to undertake the transaction absent a reduction in that time period and, as a result, Knight Capital requested an accommodation from the NYSE to shorten that time period in light of its need to complete the capital infusion immediately. After considering Knight Capital's request, including the fact that Knight Capital believed that without the capital infusion there would be no assurance that Knight Capital's counterparties would continue to support Knight Capital's activities, the NYSE filed a rule change that permitted the preferred stock that would be convertible into more than 19.99% of Knight Capital's common stock outstanding to become convertible (subject to the receipt of other required regulatory approvals) on the later of five days following the press release notifying stockholders of the issuance and two days following the mailing of the letter to stockholders.

In contrast to the Knight Capital raise, the Warburg Pincus investment in Webster Financial and the investment by a group of private investors in West Coast Bancorp, each of which is described in detail later in this chapter, were both private transactions that contemplated issuances in excess of 20% of the common stock and were structured to comply with stock exchange limitations (as well as regulatory approvals and the need for charter amendments) through the issuance of a combination of contingent securities, including convertible preferred stock and warrants.

Another example of the use of a contingent security to deal with the need to move promptly in the context of a public offering of securities occurred in the context of Allied Irish Banks' ("AIB") disposition of its minority holding of M&T common stock, acquired years earlier. The main difference in that case was that the security was designed to be temporary, whatever the result of the shareholder vote. AIB was under a strict timetable with its Irish regulator to dispose of this asset and determined that a cross-border public sale of the stock in the United States was the most likely path to success. At the same time, applicable stock exchange rules in the UK and Ireland deemed the M&T stake sufficiently significant to AIB that an AIB shareholder vote would be required for the sale. But the price at which AIB would be able to sell the M&T stock would not be known at the time of a shareholder vote, and it was unclear whether the resolution voted upon by AIB shareholders could be sufficiently general to authorize the sale under all possible market conditions that AIB could face. To deal with these issues, AIB instead issued a convertible debt instrument that mandatorily converted into a specified amount of AIB's M&T common stock upon the receipt of shareholder approval. The proceeds of this issuance would be escrowed until the shareholder vote. If shareholder approval were not received,

purchasers of the debt instrument would get a refund of their purchase price out of the escrow plus a small fee to compensate them for holding the debt instrument for the several weeks needed to seek shareholder approval.

Structuring a transaction involving contingent securities requires coordination and creativity among the financial institution and its legal and financial advisors to ensure that the terms of the securities achieve the appropriate balance between company and investor and comply with applicable state law, stock exchange rules and regulations and regulatory requirements. In view of the experiences of institutions that have engaged in urgent capital raising, it may be worthwhile for the stock exchanges to review whether their rules and interpretations regarding shareholder approval of security issuances strike the proper balance between giving shareholders a voice when dilutive issuances are contemplated and giving listed companies adequate flexibility to deal with exigent circumstances and regulatory requirements.

### F. Partial Subsidiary IPOs

Another method of accessing the capital markets — and at the same time focusing market attention on potentially undervalued assets, and/or preparing the way for an eventual spin-off — is to sell a minority stake in a subsidiary to the public. Examples include Citigroup's offering of approximately 23% of the common equity of Travelers Property and Casualty, The Equitable's offering of approximately 20% of the common stock of Donaldson, Lufkin & Jenrette and BGC's offering of approximately 14.7% of the common stock of Newmark Group. These transactions can also provide exit transactions for parent companies that have previously raised capital by selling equity in a subsidiary on a private basis. For example, in January 2014, the IPO of Santander Consumer USA Holdings Inc. enabled three private equity firms — Centerbridge, KKR and Warburg Pincus — to sell shares that they had acquired several years earlier in a private placement.

In early 2010, Citigroup combined a partial IPO of Primerica, Inc., its wholly owned subsidiary, with a private sale of Primerica shares to Warburg Pincus. In November 2009, Citigroup announced plans to spin off Primerica via an initial public offering of stock as part of its restructuring plan to shed non-core assets. Prior to launching the IPO, Citigroup entered into an agreement with Warburg Pincus under which, concurrently with the partial IPO, Citigroup would privately sell Warburg Pincus approximately 16 million shares of Primerica common stock (approximately 22% of the shares outstanding). The investment by Warburg Pincus may have helped to attract additional investors to the IPO. Warburg Pincus agreed to pay $230 million to Citigroup to purchase the 16 million shares of common stock and warrants to purchase an additional 4,103,110 shares of common stock at a somewhat higher valuation. Warburg Pincus also received the right to acquire an additional $100 million of Primerica common stock at a price equal to the IPO price but waived this right prior to the IPO. In connection with the investment Warburg Pincus received the right to nominate two directors to the Primerica board, veto rights with respect to certain corporate actions, a right of first offer on shares of Primerica sold by Citigroup in the future and also agreed to a standstill limiting it to a 35% voting stake and a 45% economic stake. In the IPO, Citigroup sold approximately 24.6 million shares of Primerica (approximately 33% of shares outstanding) at a price of $15.00 per share. Following the IPO, concurrent sale to Warburg Pincus, and issuance of equity awards to certain Primerica employees (all completed by April 2010) Citigroup owned less than 40% of

Primerica's outstanding common stock. In December 2011, Citigroup sold its remaining stake in Primerica in a public secondary offering.

Other notable transactions in recent years have addressed regulatory imperatives, such as Royal Bank of Scotland's IPO of Citizens Financial Group, or sought to reduce the size of the financing operations of a company designated as a systematically important financial institution, as in the case of General Electric's IPO of Synchrony Financial. After completing the initial IPO of Citizens Financial Group in late 2014, Royal Bank of Scotland held approximately 75% of the company and proceeded to complete three registered secondary offerings over the succeeding year to sell its entire ownership interest. General Electric followed a different path, first selling approximately 15% of Synchrony Financial to the public in mid-2014, and then completing an exchange offer late in 2015 to General Electric's own shareholders in which General Electric exchanged all of its remaining shares of Synchrony Financial for tendered shares of General Electric stock.

Companies considering such transactions should be aware of the special regulatory, state corporate and securities law issues that may be implicated in the holding of a non-wholly owned subsidiary, especially if the parent may wish to consider increasing its stake or taking the subsidiary private in the future.

## III. TRANSACTIONS BY PRIVATE EQUITY FIRMS AND OTHERINVESTMENT VEHICLES

With the virtual shutdown of the leveraged loan/LBO market in the second half of 2007, there was renewed interest by private equity firms in the financial services sector. The transactions since then have generally fallen into two broad categories: the acquisitions of a controlling interest and non-controlling minority investments. Initially following the financial crisis, the focus of private equity investors was participation in assisted acquisitions of failed banks from the FDIC, but this began to shift in 2010 to investments in troubled banks and other open banks through minority investments and recapitalizations, including by investment vehicles referred to as "blind pools."

### A. Regulatory and Structuring Considerations in Private Equity Transactions

The structures of private equity investments in financial institutions have been significantly affected by regulatory guidance that was issued in the fall of 2008. The 2008 release allows board representation for investments of up to 15% of the voting power and one-third of the total equity of a company. Previously, the Federal Reserve required that an equity investment be capped at 24.9% of total equity, voting power was often kept to 9.9% or less and board representation was not permitted for an investment of 10% or greater of the equity or voting power. The OCC also began taking steps in 2008 to facilitate the participation of private equity and other non-bank investors in FDIC auctions by providing for a streamlined procedure to set up, in advance, a contingent "on the shelf" national banking charter.

In late August 2009, the FDIC released a policy statement on private equity investments in failed banks. It imposed significantly higher requirements for private equity and other private investors seeking to acquire failed banks than for strategic acquirers. The FDIC policy statement

does not apply to private equity investments in institutions other than failed banks and also does not apply to, and in fact encourages, investment structures where private equity investors acquire a failed bank in conjunction with a bank or thrift holding company with a successful track record where the bank/thrift holding company has a strong majority interest in the resulting bank or thrift.

It is important that private equity investments, at least in their final form in the case of contingent securities, in banks and thrifts in need of capital be treated by bank regulators as Tier 1 capital. Tier 1 capital generally includes common stock and non-cumulative preferred stock meeting certain parameters, including among others: the capital must be permanent and have few, if any, ongoing "strings" attached (*i.e.*, the instrument does not need to be redeemed at any particular time and does not require set, cumulative dividends, sinking funds or the like). Because Tier 1 capital can have only minimal investor-protective terms, the cost of raising Tier 1 capital is likely to be higher than issuing more protective instruments. Concerns raised by the Federal Reserve as to whether some investment terms are consistent with Tier 1 treatment — and more recently with Tier 1 common equity treatment under Dodd-Frank and Basel III — underscore this point.

In 2008, Federal Reserve staff closely scrutinized "reset" or "clawback" provisions of certain capital raising transactions — these provisions enabled investors to claw back some of their investment if the financial institution raised additional equity or entered into a merger at an effective share price below the original investment. The clawbacks were payable in cash with an option for the issuer to use stock, but that option was subject to limitations such as regulatory control ownership thresholds. The regulators objected to those provisions as going too far in burdening the institutions' future capital raising capability. TPG's investment in Washington Mutual and Corsair's investment in National City each contained these provisions. In June 2008, National City and most of the participants in its capital raise announced they were changing its terms. The changes effectively capped the amount of the clawback obligation at a lower level and required that it be paid only in stock, not cash. Apparently, one investor did not agree to all the changes and, as a result, National City indicated that $200 million of its $7 billion capital raise did not qualify as Tier 1 capital. There was no similar announcement from Washington Mutual. In mid-September 2008, however, as it tried urgently to raise additional capital, Washington Mutual announced that the investors in the earlier capital raise had waived the reset provision, which was a significant deterrent to potential follow-on investors.

Because the process of obtaining Federal Reserve approval may be time consuming, it may be desirable to structure the proposed transaction to avoid the requirement of such approval. Even with ownership limitations, under the Federal Reserve guidelines, the Federal Reserve likely will require the purchasers to make additional commitments — so-called "passivity commitments" — designed to prevent the purchasers from exercising control over the company. As an example, in many of the private equity-led recapitalizations of recent vintage, those private equity firms that intended to hold more than 5% of the equity of the recapitalized company but sought to avoid "control" of the bank holding company were obligated to enter into passivity commitments. In many cases these were directed at mitigating Federal Reserve concerns about joint action among investors, as well as the assertion of control by any particular investor individually. Most experienced bank investors have come to view passivity commitments as a customary part of any significant, but non-controlling investment in a bank, and one that is

consistent with their business intent and fund considerations in any case. Control issues (and others, including stock exchange shareholder approval requirements and Hart-Scott-Rodino Act requirements) may also be addressed through carefully structuring an investment in classes of voting and non-voting securities, as was done in transactions including Warburg Pincus/Mellon, Warburg Pincus/Webster Financial, West Coast Bancorp, Warburg Pincus/National Penn and many others. As a general matter, the Federal Reserve has taken the position that non-voting securities that are convertible into voting securities should be deemed to be voting securities for purposes of a control analysis if the holder has the ability to immediately convert the securities into voting securities or has the ability to transfer the convertible securities to third parties.

If a private equity fund were to acquire a controlling stake in a bank, it would first need to register as a bank holding company with the Federal Reserve. As a bank holding company, it would be subject to regular inspections as well as risk-based capital adequacy regulations on a consolidated basis. Furthermore, a private equity fund that acquires control of a bank would be required to limit its activities to financial services, which several funds have done in recent years. In the past, in a few relatively isolated examples, this limitation could be addressed through the use of an alternative investment vehicle — *i.e.*, a separate fund established for the sole purpose of holding a particular financial services investment — but only if special separations were put in place to ensure that the control and operation of the fund are effectively partitioned from other funds sponsored by the same private equity firm that hold investments in non-financial businesses. With the elimination of the OTS, however, such alternative investment vehicle structures no longer provide a means for private equity funds to control depository institutions without registering as a bank holding company.

## B. Other Investment Vehicles — "Blind Pools"

In addition to the challenge presented by regulatory hurdles, private equity firms have also faced increased competition in bidding for failed and open banks from other non-bank investors, including investment vehicles referred to as "blind pools." Blind pools raise money from a group of disparate investors who do not have control over the management of the firm or its acquisitions. The management team is also typically granted broad discretion under the terms of the offering and chartering documents to undertake the company's stated acquisition objectives without the need for further shareholder approval, subject to using some portion of the net proceeds of the offering in an acquisition of or investment in a banking institution within a specified time period. Another common feature is the requirement for the vehicle to file a resale or IPO registration statement within a specified period of time after a qualifying acquisition.

The first of these blind pool offerings was announced in October 2009 by National Bank Holdings Corp., a newly formed corporation led by former Citizens Financial Group banking executives, which raised gross proceeds of $1.15 billion through the sale of common stock in a private placement to over 70 non-control institutional investors, with FBR Capital Markets acting as placement agent. National Bank Holdings announced that it anticipated becoming a bank holding company and using the proceeds of the private placement to build a community banking franchise through a combination of acquisitions and organic growth. Under the terms of the offering and its chartering documents, National Bank Holdings was required to use at least 25% of the net proceeds of the offering in an acquisition of or investment in a U.S. banking institution within 24 months. In early November 2009, Deutsche Bank AG successfully raised

$370 million for Bond Street Holdings LLC, a blind pool which announced plans to invest in troubled banks and become a bank holding company. Bond Street is managed by a former North Fork Bank executive and a former New York state superintendent of banks. In mid-December 2009, another new blind pool, NAFH (now Capital Bank Financial Corp.), raised $632.5 million for investments in the U.S. banking industry. Capital Bank includes a management team made up of several former Bank of America executives. In early November 2010, Community Bancorp LLC (now Cadence Bancorp), a blind pool led by the former chairman and chief executive officer of JPMorgan Chase and the former chief executive officer and president of Amegy Bank, announced that it had raised $1 billion to buy failing or collapsed banks. By the end of 2010, at least 15 blind pools had successfully raised at least $8 billion. In 2012, Capital Bank Financial and National Bank Holdings each completed an IPO.

Blind pools have been active bidders in FDIC auctions and for failing or troubled open banks. National Bank Holdings acquired Bank Midwest (an open bank) and Hillcrest Bank, Bank of Choice and Community Banks of Colorado (FDIC-assisted transactions); NAFH recapitalized TIB Financial (an open bank), Capital Bank (an open bank) and Green Bankshares, acquired MetroBank of Dade County, Turnberry Bank and First National Bank of the South (FDIC-assisted transactions); Bond Street Holdings acquired Peninsula Bank, Florida Community and Premier American (FDIC-assisted transactions); and Community Bancorp acquired Superior Bank (an FDIC-assisted transaction), Cadence Bank (an open bank) and Encore Bank (an open bank).

The FDIC has said that it is interested in increasing the competition for failing banks and is welcoming of new investment vehicles so long as the structures and organizations satisfy regulatory requirements. In guidance issued by the FDIC in early 2010, the FDIC expressed a preference for ownership structures with at least some large shareholders, each with a greater than 5% voting stake, and stated that it will presume concerted action among investors who hold less than 5% voting stakes where they hold more than two-thirds of the total voting power of the structure in the aggregate. This presumption may be rebutted if there is sufficient evidence that the investors are not in fact acting in concert.

### C. White Squire Minority Investments and Recapitalizations

In its conventional usage in the takeover defense lexicon, a white squire investment was one where a friendly private equity firm or other party made a significant minority investment in a company that helped it ward off unwanted advances from a potential hostile acquirer. During the course of the financial crisis, the term gained a new meaning as these significant equity investments became instrumental in helping financial institutions ward off the much more pressing threats of regulatory and capital difficulties, troubled status and in some cases the looming specter of failure. White squire investments since the financial crisis by financial institutions have been limited, with Bank of America’s August 2007 investment in Countrywide Financial and the investments by Warren Buffett’s Berkshire Hathaway in Bank of America and Goldman Sachs providing more recent examples.

### 1. Business Considerations

White squire investments can often serve to enhance the stability of a company's capital base for a sufficient period of time to allow the company to pursue its business/strategic plan. Recently, the investments have been used by financial institutions to improve their regulatory capital ratios and, in particular, their Tier 1 Common capital ratios. Target companies and their boards should also carefully analyze the proposed structure of any potential private equity or other private investor transaction. This is important to ensure that a deal, once signed, gets prompt regulatory clearance and that, after the deal closes, the company remains in compliance with all applicable capital and other regulatory standards. In addition, since private equity and private investor acquisition agreements often contain looser closing conditions and/or less favorable enforcement provisions than those common to strategic transactions, a seller must carefully assess the likelihood that a deal, once announced, will close on the agreed terms. These are issues that in a strategic context may not rise to the level of being part of the basic initial business handshake, but in this context they may be important enough to deal with up front before too much deal momentum builds. If management of the target or other insiders are part of the buy-out group, then so-called "self-dealing" issues will also be presented that must be addressed through an appropriate mechanism.

A company's ability to structure a significant equity investment may be facilitated by the availability to the company in its certificate of incorporation of "blank check" preferred stock, which can be issued without a state law requirement for shareholder approval in series with terms approved by the board after negotiation with the investors. (The issuance of preferred stock that is convertible into common stock may still require shareholder approval under stock exchange listing rules.) Where time is of the essence, convertible preferred stock may be structured as a non-voting security to navigate shareholder approval and regulatory requirements to permit a simultaneous sign-and-close transaction. Although many investment forms are possible, the desire for Tier 1 capital treatment (particularly in the context of the more restrictive Basel III rules) places practical limits on the types of securities that can be issued and their terms. For example, new issuances of cumulative preferred stock are no longer treated as Tier 1 capital. And as discussed earlier in this section, the Federal Reserve staff expressed concerns about the "reset" or "clawback" provisions of certain capital raising transactions in 2008 that were intended to qualify for Tier 1 treatment. Capital requirements will also be relevant in non-bank acquisitions as well and in all instances the capital structure must be sufficiently stable to support rating agency considerations and permit ready access to funding on a going-forward basis.

The financial terms of any proposed private placement should be carefully reviewed by the board, with the assistance of management and the company's financial and legal advisors. The private placement should be structured, where possible, in such a way as to rebut any argument that the issuance of the securities will effect a change of control of the company. This will generally be the case in most minority equity investments in banks and thrifts, since the investors generally will not wish to acquire control from a regulatory perspective. Blind pool transactions, such as the investments in TIB Financial and Capital Bank by NAFH (which are discussed below), are an exception to this generalization, as these vehicles are typically structured as bank holding companies; a number of private equity firms also have funds that were specifically created to be bank holding companies. Change of control transactions could raise more challenging valuation and fairness issues, and the impact on existing contracts and

compensation arrangements must be considered. The private placement terms should be reviewed carefully for terms that might restrict the board's ability to pursue other financial alternatives, such as growth through acquisitions, sale of assets, sale of the entire company or raising additional capital, or that might restrict the board's ability to respond to future business, financial or takeover-related developments.

Accounting and tax considerations must also be carefully examined to ensure if possible that the investment does not trigger a change of ownership under Section 382 of the Code.

The stock purchase agreement to be entered into between the issuing company and the investors would contain, among other things, provisions regarding voting, restrictions on share transfers, registration rights, board representation and other governance agreements, limitations on ownership and other standstill provisions. A significant minority investment is usually accompanied by a standstill agreement that sets forth restrictions on the investor's ability to acquire additional voting securities or to sell voting securities, particularly pursuant to a tender offer or merger. Limitations on the permissible conduct of the investor, including on the scope of the investor's voting rights, may also be imposed by the bank regulators.

### 2. Recapitalization Transactions

Since the financial crisis, numerous private minority investments and recapitalizations have helped stabilize troubled banks. The spate of private investments was characterized by substantial capital infusions (in some cases, several times market capitalization) into banks with strong, established management teams, attractive franchises and more clearly delimited problems in their loan portfolios. Two early examples in 2009 demonstrated an innovative and practical approach by financial institutions, investors and regulators alike and blazed a trail for other banks to follow in later years. The first of these investments was Warburg Pincus's $115 million minority investment in Webster Financial in late July 2009, and the second was West Coast Bancorp's $155 million private placement to over 20 separate investors, including Michael F. Price, Castle Creek Capital and the Glick family in October 2009. Another example of an innovative recapitalization addressing thorny timing and approval requirements was the Knight Capital private placement of cumulative convertible preferred stock, discussed in detail earlier in this chapter.

The Warburg Pincus investment in Webster Financial was structured to maximize speed and minimize uncertainty by addressing regulatory and shareholder approval hurdles before the full investment resulting in Warburg Pincus holding just under 24% of Webster's voting stock (and just under 17% of total equity) could be made in its final form. The investment was made in two stages. Approximately $40 million was funded immediately upon signing in return for common stock and warrants (exercisable for a combination of common stock and preferred stock or, following shareholder approval, common stock) giving Warburg Pincus ownership of approximately 5.9% of Webster's voting stock. The $75 million balance of the investment was made following receipt of antitrust and federal bank regulatory approvals in return for additional shares of common stock, non-voting perpetual participating preferred stock and warrants, and Warburg Pincus also received a board seat and board observer at that time. The preferred stock mandatorily converted into common stock upon Webster Financial shareholder approval. The investment also included measures to compensate the investor if shareholder approval had not

been obtained in a timely manner, including, among others, an additional 8% non-cumulative dividend payable on the preferred stock.

The investment by a group of private investors in West Coast Bancorp was structured to maximize speed and to immediately address the cease-and-desist order requiring West Coast Bank to enhance its regulatory capital levels. The entire $155 million was funded immediately upon signing in return for shares of mandatorily convertible cumulative participating preferred stock and, in the case of four of the investors, warrants exercisable for preferred stock. Upon receipt of shareholder approval, the preferred stock received by the investors mandatorily converted to common stock (other than the Series A preferred stock held by certain investors which was structured to mandatorily convert to common stock when transferred to a third party in a widely dispersed offering). The investment included measures to compensate the investor if shareholder approval had not been obtained in a timely manner, including an additional 15% cumulative dividend payable on the preferred stock and additional warrants exercisable for shares of the preferred stock if the necessary shareholder approvals were not received by a certain date.

The investment was structured such that no investor would hold in excess of 9.9% of West Coast Bancorp's voting stock or in excess of 14% of total equity (as determined under the Federal Reserve's methodology). Two of the investors received the right to each designate one member of West Coast Bancorp's board of directors and the right to send an observer when the director was not present, and two other investors received the right to each designate one board observer. While the investment was structured such that no regulatory approvals were required, discussions were held with the Federal Reserve prior to the investment regarding the structure of the proposed investment and the permissibility of the investment under the Federal Reserve's practice and policies relating to non-controlling investments in bank holding companies. The West Coast Bancorp recapitalization resulted in the new investors owning over 80% of West Coast Bancorp after the closing of the investments. West Coast Bancorp also conducted a $10 million rights offering that allowed the pre-investment stockholders to purchase additional shares at the same price that the investors had purchased shares.

Several prominent recapitalizations of bank holding companies by private equity funds and other private investors (including "blind pools") built on the precedents of 2009, such as the $500 million investment in Pacific Capital by Ford Financial Fund; the $730 million recapitalization of Sterling Financial anchored by $171 million investments by each of TH Lee and Warburg Pincus with investments by 30 other accredited investors; the $460 million recapitalization of Opus Bank (formerly Bay Cities National Bank) led by Elliott Management Corporation, Fortress Investment Group, Starwood Capital Group and Stephen H. Gordon with approximately 25 other institutions and accredited investors; the $60 million investment in First PacTrust by TCW, COR Capital and other accredited investors; and the $175 million investment in TIB Financial by NAFH. Additional recapitalizations include the $181 million investment in Capital Bank by NAFH, and the $325 million investment in Central Pacific anchored by $98 million investments by each of The Carlyle Group and Anchorage Capital Group, the $217 million investment in Green Bankshares by NAFH and the $100 million recapitalization of SWS Group by Oak Hill and Hilltop Holdings.

Each of these recapitalization transactions, along with a number of other transactions proposed or considered by regional or community banks facing significant asset challenges, was designed to navigate a maze of obstacles, including those posed by more senior pieces of the capital structure. Many of them involved a period of months between signing and closing and were subject to numerous contingencies. A number of these financial institutions had issued TARP preferred stock, subsequently were unable (or not allowed) to pay the dividends and found both these securities and their accrued and unpaid dividends a significant obstacle to attracting new common equity necessary to address capital issues and, in many cases, salvage any value for any of the institutions' equity and subordinated debt holders.

The closings of the 22.6% investments by each of Warburg Pincus and TH Lee in Sterling were conditioned on the exchange of Sterling's TARP preferred stock for common stock and the amendment of the exercise price for the TARP warrants. The transaction was structured to avoid a shareholder vote condition through the issuance to Warburg Pincus of a combination of common stock, warrants and preferred stock that is convertible upon the receipt of shareholder approval following the closing (and includes a cumulative cash dividend at a per annum rate of 15% if shareholder approval is not received by 120 days after the closing). The Pacific Capital transaction was conditioned on exchanging the company's TARP preferred stock and warrants for common stock at a discount, and completion of tender offers at specified success levels for Pacific Capital's trust preferred securities and subordinated debt instruments (although it should be noted that the investor waived these conditions in significant part). The investment was also subject to Pacific Capital's receipt of approval from NASDAQ to rely on the financial viability shareholder approval exemption set forth in Rule 5635(f). The investment was made through a combination of common stock and mandatorily convertible preferred stock that converted upon receipt of post-closing shareholder approval of an amendment to the company's charter to increase the amount of authorized common stock. The investment closed four months after the announcement. The investors agreed to conduct a rights offering for up to 20% of the pro forma fully diluted equity following the closing of the investment.

Balance sheet management has been a defining feature of many bank recapitalizations. Accomplishing the balance sheet management objectives requires some time and risk on the part of the financial institution and some recapitalizations have fallen apart prior to completion, but in the successful cases the regulators, investors and customers of the banking franchises seeking capital have applauded the investment by the private investors and have allowed the bank time to satisfy the conditions to closing the investment. One recapitalization that took a creative approach to achieving the necessary balance sheet management objectives that would enable the investors to be willing to invest in the bank was NAFH's investment in TIB Financial. As a condition to the investment, TIB Financial was required to repay or redeem its TARP preferred stock and warrants, but because TIB Financial was deferring dividends on its trust preferred securities, the terms of the trust preferred securities prohibited it from directly repurchasing the preferred stock and warrants issued to the Treasury. In order to address this issue, NAFH purchased TIB Financial's TARP securities directly from the Treasury and reduced the purchase price by a like amount for its investment in TIB Financial.

The Central Pacific and Capital Bank recapitalizations involved many of the same features seen in the Sterling and Pacific Capital investments. The investment by The Carlyle Group and Anchorage Capital Group in Central Pacific was conditioned on exchanging the

company's TARP preferred stock for common stock and amending the TARP warrant on specified terms and on the receipt of approval from the NYSE to rely on the financial viability shareholder approval exemption. Carlyle and Anchorage's 24.9% investments took the form of common stock only. NAFH's investment in Capital Bank was subject to the repurchase or redemption of the company's TARP preferred stock and warrant at a discount and was also subject to shareholder approval. In addition to providing for a rights offering to existing shareholders following the closing, the transaction also included a new feature that allowed the investors and the company to bridge a valuation gap by providing for the issuance to existing shareholders of contingent value rights prior to closing that entitle the shareholders to receive cash (subject to a cap) at the end of a five-year period based on the credit performance of Capital Bank's existing loan portfolio. Contingent value rights and other techniques that can be used to bridge valuation gaps relating to the future performance of bank assets are discussed in more detail in Chapter 6.

As discussed earlier in this chapter, one issue that many smaller and regional banks face in attempting to recapitalize is that some issued trust preferred securities into pools or CDO structures, which can present unique problems beyond the challenges inherent in any repurchase and may make it difficult or impossible to even find counterparties that are willing or able to negotiate.

### 3. Investments to Facilitate Acquisitions

Private equity and other private investors have also looked for opportunities to invest in a bank in order to partner with that bank in anticipation of an immediate acquisition opportunity. One prominent example was the $500 million private investment in East West Bancorp in November 2009 in connection with East West's acquisition of failed United Commercial Bank. The private placement was comprised of investments from existing stockholders of East West and a $131 million investment by Corsair Capital LLC. East West issued a combination of common stock and preferred stock that mandatorily converts into common stock upon stockholder approval and expiration or termination of certain antitrust waiting periods. After giving effect to the private placement, no stockholder owned in excess of 10% of the outstanding common stock of East West. Following on this approach, certain other banks have used partnerships with private equity and other private investors to take advantage of more receptive capital markets and investor appetite to be in a position to play in potential consolidation opportunities. In Florida, Seacoast completed a recapitalization in 2010, led by CapGen Financial, consisting of a $50 million non-contingent capital infusion to provide capital for the existing bank and a larger $200 million contingent capital raise conditioned upon Seacoast's completion of an assisted acquisition within specified parameters. Ultimately, Seacoast did not prevail in the FDIC auction and returned the contingent portion of the capital raise. Shortly thereafter, Doral Financial undertook a similar capital raise, with $180 million of permanent capital and an additional $420 million of capital contingent upon its success in the FDIC's Puerto Rico bank seizures, but, like Seacoast, Doral ultimately did not prevail. Popular, however, did successfully complete a significantly oversubscribed $1.15 billion public equity capital raise in April of 2010 to permit its acquisition of Western Bank's $10.85 billion in assets in the largest bank failure of the year. A more recent example of a private investment in connection with a bank acquisition is Warburg Pincus' $400 million equity investment in Banc of California, which

was completed in November 2023 in connection with the merger of Banc of California with PacWest Bancorp.

## IV. OTHER CAPITAL STRATEGIES

### A. Exchange Offers, Private Exchanges and Issuer Tender Offers

In some cases, balance sheet, income statement, regulatory capital and ratings agency issues can be addressed not only by raising new capital but by shifting existing debt and equity capital between different categories — examples include swapping debt for debt, debt for equity, trust preferred securities for equity and preferred equity for common equity. Sometimes this is referred to as liability or balance sheet management, and it has been a key component of the capital plans executed by financial institutions in recent years and has also been a prominent feature of many bank recapitalizations.

Exchange offers, in particular, have been used by many financial institutions to increase the common equity component of their regulatory capital and have also been used by other companies to de-leverage and extend the weighted-average maturity of their outstanding debt. Citigroup completed a public exchange offer in which holders tendered approximately $20 billion in aggregate liquidation value of publicly held convertible and non-convertible preferred and trust preferred securities in exchange for common stock, and completed exchanges where the U.S. government exchanged $12.5 billion in aggregate liquidation preference of preferred securities for interim securities and approximately $27 billion in aggregate liquidation preference of preferred stock for an equal liquidation amount of new trust preferred securities. These exchanges helped Citigroup to increase its Tier 1 Common by $64 billion and its tangible common equity by $60 billion.

Many other financial institutions, including Bank of America, KeyCorp, Fifth Third and Webster Financial also completed public exchange offers. These transactions were prompted by a desire to reduce fixed dividend obligations, to raise Tier 1 Common following the release of the SCAP stress test results in 2009, and by enhanced market and rating agency focus on tangible common equity ratios. If an exchange offer is designed to create regulatory capital to meet the requirements to be a bank holding company under the Bank Holding Company Act and a security other than common stock is being offered, a company and its advisors should carefully review the new debt and/or equity securities being offered to make sure the securities will in fact achieve the desired result, including qualifying as Tier 1 or Tier 2 capital (as applicable) under the Bank Holding Company Act and not exceeding regulatory limits on the types of securities composing an institution's overall regulatory capital.

In any event, a company should carefully review its existing debt agreements and other material contracts to determine whether the issuance of new and/or additional debt or equity pursuant to the exchange offer is a breach of any such agreement, or would cause the acceleration of the maturity of any obligations under any such agreement (as well as any cross-default provisions in other instruments).

Both debt-for-debt and debt-for-equity exchange offers are subject to the anti-fraud provisions of Regulation 14E under the Exchange Act. An exchange offer or tender offer for a

debt security is exempt from Regulation 14D under the Exchange Act, whereas a tender for a registered equity security generally is not. Regulation 14D imposes disclosure requirements, as well as limitations with respect to the timing and duration of the offer, offeree withdrawal rights, proration of purchases, equal treatment of offerees and other anti-discrimination requirements.

Issuer tender offers with respect to equity securities of the issuer are subject to Rule 13e-4 under the Exchange Act, which contains many of the same limitations and requirements as Regulation 14D, and all issuer tender offers are subject to Regulation 14E. Regulation 14E subjects the issuer to certain anti-fraud restrictions and requires the issuer to keep the offer open for a minimum 20-business day period, but does not contain the other detailed rules of Regulation 14D. As a result, a tender or exchange offer for a debt security generally gives the issuer more flexibility with respect to key terms of the offer, including pricing, timing and offeree withdrawal rights and also gives the issuer the ability to make the offer to a limited group of security holders, which can be particularly helpful where time is of the essence.

In an exchange offer where existing securities of an issuer are exchanged for new securities of that issuer, the exchange offer will need to either be registered under the Securities Act or be subject to an exemption from the registration requirements of the Securities Act. Registering an exchange offer involves filing a registration statement with the SEC on Form S-4 which must be declared effective by the SEC before the exchange offer may be completed. The content of the registration statement is substantially similar to the information that is required to be filed with the SEC in a Schedule TO (which must be filed in any public exchange offer that is subject to Rule 13e-4 or Regulation 14D). In some situations, issuers can also consider the exemption from registration under Section 3(a)(9) of the Securities Act, for "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." The SEC staff has taken the position that securities exchanged for other securities of an issuer pursuant to Section 3(a)(9) generally receive the character of the exchanged securities for purposes of the Securities Act, so if the initial securities being exchanged were sold pursuant to a registered transaction under the Securities Act, then the securities received in the exchange should be freely tradable. The SEC staff has also taken the position that Section 3(a)(9) applies to the exchange of a "downstream" guaranteed security (*i.e.*, a security issued by a subsidiary but guaranteed by the parent). In such a case, a parent can exchange the subsidiary security for a newly issued security of the parent, despite the lack of continuity of issuer. In mid-January 2010, the SEC issued a no-action letter expanding the scope of permitted reliance on Section 3(a)(9) to a situation where a parent issues a new parent security in exchange for an outstanding parent security that has one or more "upstream" guarantees from the parent's wholly owned subsidiaries.

During 2009, South Financial, KeyCorp, Webster Financial, Fifth Third, Bank of America and Regions Financial all conducted public exchange offers that relied on the exemption under Section 3(a)(9). Issuers should be aware that relying on this exemption from registration strictly limits the communications that officers, directors and employees of the issuer and its outside advisors can have with security holders. In general, only the issuer can discuss the substance and merits of the offer with security holders and solicit participation in the offer. Advisors can freely consult with the issuer, but when it comes to communicating with holders, generally can assist only on mechanical aspects of the transaction and should not receive

compensation contingent upon the success of the offering. Issuers should therefore consult with their advisors to make sure they understand what constitutes permissible activities.

Some issuers (including Huntington and Bank of America in 2009) also rely on the exemption from registration under Section 3(a)(9) of the Securities Act to conduct private exchanges with security holders that are not tender offers and thus are not subject to Rule 13e-4 or Regulation 14D or Regulation 14E. The primary advantage of private exchanges is that they can be completed very quickly, whereas a public exchange offer must generally be left open for at least 20 business days and can subject an issuer to market swings, although in 2015 the SEC issued new guidance permitting abbreviated five business-day issuer tender offers for an entire class of non-convertible debt securities in certain circumstances.

Private exchanges can only be done on a limited basis and only to the extent that they would not be considered, individually or in the aggregate, to be a "tender offer." While the term "tender offer" is not defined by statute or SEC regulation, the analysis of whether an offer constitutes a tender offer usually centers on the eight-factor test from the case of *Wellman* v. *Dickinson*, which sets forth the characteristics of a tender offer: (1) an active and widespread solicitation is made of public shareholders for the shares of an issuer; (2) a solicitation is made for a substantial percentage of the issuer's securities; (3) the offer to purchase is made at a premium over the prevailing market price; (4) the terms of the offer are firm rather than negotiable; (5) the offer is contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased; (6) the offer is open only for a limited period of time; (7) the offeree is subjected to pressure to sell his or her security; and (8) public announcements of a purchasing program concerning the target issuer precede or accompany a rapid accumulation of large amounts of the target issuer's securities. To be classified as a tender offer, an offer need not meet all or even a majority of the above factors, and different courts or regulators may give different weight to one or more of the factors set forth above. Issuers who are considering conducting private exchanges should consult with their legal advisors to make sure that they do not risk an exchange or series of exchanges being deemed a tender offer that should have complied with the tender offer rules and regulations.

The best approach to pricing an exchange offer will depend on the circumstances, and there are a great variety of methods available to the issuer. Among the choices is whether to fix a price in advance (either as a number or a formula) or use a Dutch auction mechanism. In debt-for-debt offers, price fine-tuning can be taken further by, for example, establishing priority tiers among different classes of notes as to whether or how much they will be cut back in favor of other classes in the event of over-subscription. In addition, participants may be offered a mix of consideration, including cash, common or preferred equity, and secured, senior or subordinated notes. This consideration may also be offered on an election basis with participants being allowed to elect a single form of consideration or a "mixed" election of different forms of consideration, subject to proration in each case.

In addition, in pricing the exchange offer, issuers should be aware of the investor base that holds the existing security and their likely receptivity for the new security that the issuer is proposing to exchange. For example, the buyers of trust preferred securities are not customarily investors who purchase common stock, and, in fact, some of these holders are not permitted to hold common stock by virtue of their investment guidelines or other rules or regulations. Thus,

in an exchange offer of common stock for publicly held trust preferred securities, one might expect that holders of trust preferred securities would sell shares of the common stock short before the exchange closes and cover their short positions with the shares received in the exchange. Depending on the extent of the shorting activities, this could put pressure on the common stock price and also lead to suboptimal pricing of the exchange offer. In order to address this asymmetry, in June 2009, Huntington launched a public equity offering and contemporaneously launched a cash tender offer for its outstanding trust preferred securities. The tender offer was conditioned on a successful equity offering and the proceeds of the equity offering were used to purchase the validly tendered trust preferred securities. This allowed Huntington to maximize the pricing of both the equity offering and the trust preferred tender offer by selling shares of common stock to investors who were interested in buying and holding Huntington's common stock and offering cash to the trust preferred holders who preferred cash to common shares. The equity offering closed successfully, Huntington used the proceeds to purchase the validly tendered trust preferred securities, and after the offering closed, Huntington retired the trust preferred securities which it had purchased in the tender offer. TARP participants need the prior consent of the Treasury to effect any redemptions of trust preferred securities for cash, and Federal Reserve regulatory approval is usually required for bank holding companies to redeem trust preferred securities. When trust preferred securities are in a dividend deferral period, the terms of the security may restrict redemptions or repurchases.

The tax consequences of an exchange offer to both the issuer and the security holders merit careful consideration. An exchange of notes or stock for existing notes may result in taxable cancellation of indebtedness income to the issuer and gain or loss to the holder. Debt-for-debt and debt-for-equity exchanges can, however, be structured to be tax-free for participating holders if the existing notes and, in the case of a debt-for-debt exchange, the new notes, are "securities" for federal income tax purposes. An exchange offer can also have consequences for non-participating holders in the event that the terms of the existing debt are significantly modified. Any exchange offer should be structured in light of the particular tax circumstances of the issuer and the business objectives of the exchange offer.

Issuers may limit the exchange offer to "qualified institutional buyers" ("QIBs") and "non-U.S. Persons" in order to qualify for the private placement exemption from registration under the securities laws. The main advantage of a private placement is speed — an important consideration given the state of today's capital markets. The offer should be carefully structured so that only QIBs and "non-U.S. Persons" are solicited, and the issuer should be sure to receive "eligibility letters" from each person choosing to participate in the offer to assure compliance with the Securities Act.

Notes purchased by QIBs under Rule 144A are "restricted securities" for purposes of the Securities Act, however, and can only be traded among institutional investors in the Rule 144A market (and must be carried as "restricted" and remain subject to resale limitations). Thus, in order to create liquidity for the purchasers of the new notes, notes sold in 144A offerings are typically entitled to post-closing registration rights, which may include a commitment from the issuer to commence a further registered exchange offer to exchange the new notes purchased in the exchange for substantially identical notes registered under the Securities Act within a specified time frame or to file a shelf registration statement covering the new notes issued in the exchange.

Exchange offers are useful as one element of an issuer's multi-pronged recapitalization and restructuring plan. Careful consideration must be paid to the accuracy of the disclosure in these situations to accurately capture the other elements of the recapitalization, material recent developments and risks to successfully carrying out the various aspects of the restructuring plan.

## B. Restructurings

Restructurings — which generally involve a combination of the various capital strategies outlined in this chapter, as well as basic redefinition of core businesses, reevaluation of strategic goals, cost-cutting initiatives and major asset sales — have often been viewed as a key to survival in the financial industry. Higher expenses, shrinking margins and slower earnings growth have, from time to time, led to business restructurings that allow institutions to streamline their operations and reduce costs, shed unprofitable businesses and reallocate resources to those businesses generating the highest returns on equity. Most troubled non-financial businesses conduct major restructurings in (or against the backdrop of) bankruptcy reorganization. However, in the financial industry, anything that suggests insolvency may be the death knell for any company that depends on demand deposits, commercial paper, redeemable securities or other short-term funding. Thus, major restructurings will often occur as a means of saving financial companies from bankruptcy under the careful scrutiny of regulators and are often accompanied by a change in senior management.

Prominent examples of restructurings in the financial services industry as a result of the financial crisis include the reorganization of Citigroup into two separate businesses, Citicorp and Citi Holdings, the restructuring of AIG, the sales by Bank of America of non-core businesses and assets, and the restructuring of several large European financial institutions. Citi's restructuring, which was first announced in January 2009, was intended to draw a dividing line between Citigroup's core assets and its non-core or troubled assets, so that Citigroup could focus on improving the performance of its core businesses and realizing value through winding down or selling its non-core or troubled assets, and it led, in part, to the Morgan Stanley Smith Barney venture and the partial IPO of Primerica and contemporaneous sale of a minority stake in Primerica to Warburg Pincus. AIG's restructuring plan involved retaining its U.S. property and casualty and foreign general insurance businesses and a continuing ownership interest in certain of its foreign life insurance operations, while exploring disposition opportunities for its remaining businesses, including through, among others, the $20.5 billion partial IPO of AIA Group Ltd. and additional sales of over $20 billion in AIA shares, and the divestitures of Transatlantic Holdings and International Lease Finance Corporation. Since the financial crisis, Bank of America has undertaken a review of its businesses with respect to whether they fit with the bank's strategic goals and has disposed of many assets and businesses not viewed as core to its business, including Columbia Asset Management, First Republic, Balboa Insurance, and its interest in Santander Mexico, the sale of most of its stake in BlackRock, the sale of most of its stake in China Construction Bank, the sale of its HCA shares back to HCA, the sale of assets of BAC Field Services Corporation and the sale of numerous branches in certain geographic areas. In Europe, regulators have required some of the large financial institutions that received significant aid during the financial crisis to restructure and dispose of assets, including ING Groep NV, Lloyds Banking Group, Royal Bank of Scotland and AIB. In AIB's case, the disposition included the sale of its stake in Poland's Bank Zachodni WBK to Banco Santander, and, as discussed above, the creative disposition of its minority interest in the highly regarded

M&T through a public offering of notes that were exchangeable for shares of common stock of M&T, subject to AIB shareholder approval.

# CHAPTER 6.

## SPECIAL ISSUES IN ACQUISITIONS OF NON-BANK FINANCIAL INSTITUTIONS

Acquisitions of non-bank businesses by banks and other financial institutions have been significant over the last decade, although the nature of the activity has fluctuated over time and has encompassed a wide variety of transactions. Securities firms, asset management, insurance companies and hedge funds have all been a source of deal activity in prior years, as has the consumer finance space. In recent years, transactions involving companies specializing in financial technology — more commonly referred to as "fintech" — and, in particular, payment technologies, have become increasingly notable on the non-bank financial institution acquisition landscape. Cryptoasset-related acquisition activity, which reached an all-time high in early 2022, continued its decline in 2023 following a pronounced market downturn and a number of abandoned transactions (particularly de-SPAC mergers) and high profile collapses, including of FTX, BlockFi, Celsius, Voyager and Genesis. However, in January 2024, the SEC announced the approval for listing and trading of a number of spot bitcoin exchange-traded products. It remains to be seen when and to what extent crypto M&A will rebound after these developments. Major recent transactions involving non-bank financial institutions or businesses have included: Nasdaq's acquisition of Adenza; Fidelity National Information Services Inc.'s pending sale of a majority stake in Worldpay Inc. to funds managed by GTCR, following Fidelity National's acquisition of Worldpay in 2019; Intercontinental Exchange's acquisition of Black Knight; Visa's acquisition of Pismo; Square's acquisition of Afterpay; SoFi's acquisition of Technisys, UBS's proposed and then abandoned acquisition of Wealthfront, Paypal's acquisition of Paidy; Mastercard's acquisition of the account-to-account payments business of Nets; Goldman Sachs' pending sale of GreenSky to a consortium led by Sixth Street, following Goldman Sachs' acquisition of GreenSky in 2022; Morgan Stanley's acquisition of E*TRADE Financial Corporation; the merger of Charles Schwab and TD Ameritrade; Fiserv Inc.'s acquisition of First Data Corp.; and the merger of Global Payments Inc. and Total System Services Inc. and subsequent transactions by Global Payments, including its acquisition of EVO Payments.

To many non-bank financial services firms, banks have often been perceived as among their most attractive acquirers. Banks that managed their credit portfolios carefully over the past few years, including through the Covid-19 pandemic, remain among the strongest, best-capitalized competitors in the financial institutions industry, with relatively high market capitalizations and cutting-edge technology. Banks that are looking to build and expand their investment banking and asset management franchises, in particular, are often viewed as the perfect place to turn for the management team of a regional or boutique securities firm. The managers and owners of such firms can be compensated for the value of the franchise that they have helped build, while finding an attractive home with strong capital and customer relationships to help their business grow further.

Banks that are looking to expand their technological capabilities and talent base are attractive acquirers of fintech firms, though many of those firms are more focused on equity investment rounds and strategic partnerships than on pursuing a sale, particularly in light of the impressive rise in fintech valuations over the past few years. In 2023, fintech firms experienced a substantial shrinking of both valuations and funding, even though fintech funding continued to represent a significant portion of overall startup funding. For example, global fintech funding

amounted to $29 billion in the first nine months of 2023, down from $54 billion in the first nine months of 2022. Certain high-profile devaluations in recent years, particularly in the payments space, highlight the pressures such companies faced in 2022: in June 2022, Klarna closed an $800 million funding round at a $6.7 billion valuation, an 85% decline from the $45.6 billion valuation it reached a year prior, and Stripe saw its valuation reduced in July 2022 and January 2023 due to 409A valuations, and again in March 2023 with a Series I funding round, resulting in an overall decline of over 40% since its peak. Fewer fintech unicorns (companies with a valuation over $1 billion) were also made in 2023: only eight were made in 2023, compared to 69 new fintech unicorns in 2022 and 166 in 2021. U.S. banks continue to back equity investments in fintech startups, with the most active U.S. banks in such space Goldman Sachs, Citigroup and JPMorgan Chase & Co. Since 2010, Goldman Sachs and Citigroup alone have participated in over 200 fintech deals.

In addition, banks and financial services companies are acquiring fintech firms at an increasing pace in recent years, as banks seek to accelerate their technological capabilities (including through the use of distributed ledger technology), leverage innovative models developed by fintech firms and, more recently, capitalize on deflated valuations. Examples of recent acquisitions include Goldman Sachs' acquisitions of GreenSky, which it has subsequently agreed to sell to a consortium led by Sixth Street, NextCapital, Final and Clarity Money; J.P. Morgan's acquisition of Renovite and a controlling interest in Viva Wallet; PNC's acquisitions of Linga and Tempus Technologies; Huntington National Bank's acquisition of Torana; Mastercard's acquisitions of Aiia, Finicity and the account-to-account payments business of Nets; Bank of America's acquisition of Axia Technologies; Fifth Third Bank's acquisitions of Big Data Healthcare and Provide; Royal Bank of Scotland's acquisition of Free Agent; BBVA's acquisition of the digital banking startup Simple; and Visa's acquisition of Pismo. Visa's proposed, but abandoned, acquisition of Plaid for $5.3 billion in cash provides a stark demonstration that these transactions are not without regulatory risk. The proposed acquisition, announced in January 2020, was terminated one year later after the U.S. Department of Justice filed an antitrust lawsuit seeking to enjoin the transaction. As these transactions continue to grow in prominence, scope and purchase price, potential antitrust scrutiny is likely to increase. Furthermore, as fintechs continue to integrate with traditional banking operations, bank regulators could focus greater attention on IT risks regarding information security, resilience and customer protection, as demonstrated by the U.S. Comptroller of the Currency's public comments in late 2022 that banks and tech firms, in an effort to provide a seamless customer experience, are teaming up in ways that make it more difficult for regulators to distinguish the line between the bank and the tech firm.

Formerly, significant regulatory barriers impeded the full integration of the banking, securities and insurance industries, although there has long been plenty of room to maneuver in moving towards cross-sector integration. The modernization of financial services legislation removed the bulk of any residual regulatory inefficiencies and legal impediments affecting the ability of bank holding companies to combine with investment banks and insurance companies. Although the Dodd-Frank Act introduced some new restrictions, their impact has not been as severe as some industry observers had initially speculated. Rating agency pressures, increased government regulation, more restrictive access to commercial paper markets, high funding costs, asset quality concerns, capital requirements, as well as competition from banks and industrial companies with significant balance sheets and lower funding costs, have all helped drive

consolidation. Consolidation is likely to be more significant among small and mid-sized firms free from the increased regulatory scrutiny given to large, systemically important institutions.

This chapter addresses selected issues that arise in the acquisition of a non-bank financial institution, whether by a bank or non-bank acquirer. Section I addresses certain issues applicable to many acquisitions of "people" businesses (such as securities firms and investment advisors) generally and Sections II and III address specific issues in acquisitions of securities firms and asset management firms. Sections IV and V address insurance company acquisitions and credit card portfolio acquisitions. Many of the general observations applicable to bank M&A activity are also applicable in the context of acquisitions of non-bank financial institutions. Significant differences occur in acquisitions of non- or less-regulated financial institutions, where the possible absence of a long regulatory approval process permits a broader range of acquisition techniques and a much faster timetable, including through the use of a tender offer structure, which is discussed in Section VI.

# I. SPECIAL CONSIDERATIONS FOR PEOPLE BUSINESSES

Acquisitions of securities firms, investment advisory companies and other people businesses are unique in that these acquisitions are first and foremost acquisitions of human capital. These companies have at various times attracted considerable acquirer interest as commercial banks (both domestic and foreign), other securities firms and investment advisors and other financial service providers have sought to gain cross-selling opportunities and access to the specialized knowledge, experience and client base of these professionals. The buying and selling of businesses where the main assets walk out the door every night can be a challenging process. Deal terms and documentation must be tailored to the unique circumstances of each transaction. In addition to the challenging social issues presented, complex tax, accounting and regulatory issues must also be resolved as deals are structured to accommodate the sometimes divergent interests of acquirers and sellers. Often, transactions involve multiparty negotiations among the acquirer, seller and individual employees of the acquired firm, further complicating the process.

## A. Negotiating the Deal

### 1. Negotiating the Key Deal Terms

Acquisitions of securities firms and investment advisors, in particular, require delicate negotiations among the most senior personnel of the acquirer and seller. As significant as the key deal terms is the need for the key personnel to get to know and understand each other well to ensure that the initial courtship will continue to mature into a happy, long-term relationship. While outside advisors can play a useful role in setting the parameters of the discourse (including identifying potential key legal or regulatory risks that may not be known or apparent to the principals), successful transactions will require active negotiations and advance integration planning among the principals.

Once an agreement is reached concerning the broad strategic vision and economic terms for the acquisition, the difficult work of structuring and documenting the terms of the acquisition and ongoing management and employment arrangements begins. Agreements on broad

principles can often unwind as the parties confront the devil in the details. Accordingly, when agreements on the broad terms of the transaction are reached, it is often useful to memorialize them in a term sheet or memorandum of understanding to narrow the realm of potential issues for dispute in crafting the definitive documentation. Sensitivity to key social issues is critical; they can often play as important a role as the main economic terms of the transaction.

Where a parent company is selling a subsidiary business whose employees are among its key assets, it will be necessary for the parent to allow potential acquirers to work closely with the key personnel of its subsidiary in structuring post-acquisition management and employment arrangements. A parent company must be careful, however, to make sure that value that is properly attributed to the equity ownership in the business is not transferred to the key personnel of the business in this process. Careful attention should be paid to the negotiation and enforcement of non-disclosure agreements, in particular any non-solicitation provisions contained within, which typically establish the guidelines for direct communication between the acquirer and target personnel. A parent company must also monitor diligence discussions between key personnel of the business to be transferred and the potential acquirer, since the parent company's interests may diverge from those of its employees who would be transferred to the potential acquirer. While this consideration is present in many M&A transactions, it is particularly acute in the context of advisory or investment management deals, and in some cases fintech deals, where the prized asset is the business' personnel.

### 2. Due Diligence

A number of broker-dealers and investment advisors have faced expensive and embarrassing compliance problems and trading irregularities over the years, with more recent examples including the LIBOR manipulation scandal, "rogue" trader problems, and violations of disclosure and conflict-of-interest rules. The Volcker Rule has increased compliance costs and risks at bank-affiliated broker-dealers and investment advisors exponentially. No acquisition should be pursued without a careful due diligence investigation. A careful investigation does not necessarily mean a lengthy investigation involving large due diligence teams. Indeed, large teams can be counterproductive, and key due diligence concerns can be overlooked because no individual gains a sufficiently clear picture of the total firm.

Due diligence should begin with a small team of senior managers that meet with the senior officials of the target to discuss legal, regulatory, compliance and risk management issues. Outside assistance should be used where the target is engaged in businesses unfamiliar to the acquirer. A primary goal of these sessions should be to obtain a solid understanding of the strength of the target company's risk management and compliance programs. In addition to reviewing legal and compliance concerns, acquirers will also wish to focus on systems integration issues. The due diligence period can also be used to begin to determine how the compliance policies and procedures of subsidiaries with overlapping operations will be integrated. In the acquisition of a fintech firm or any other company where technology is a key asset (or the only asset), detailed intellectual property due diligence should be conducted to understand the rights that the target company — and founders, employees and business partners — have and do not have in the relevant platforms and assets. Other traditional areas of due diligence (*e.g.*, confirming future earnings capability, confirming the absence of undisclosed liabilities, estimating potential cost savings and synergies, examining contracts for change-of-

control or exclusive/preferred dealing provisions and technology and systems matters) are equally important. An acquirer's regulators will often want to understand, and gain comfort from, the careful and robust due diligence process undertaken, including planning for a smooth integration. Public company acquirers will wish to consider in advance the need to integrate the target within the acquirer's internal control over financial reporting, particularly in the case of acquisitions of private companies that may not have had the same degree of focus on internal controls as their public peers, and, if not already created, should consider requiring the target to generate audited financials prior to signing. Temporary relief from public company internal control requirements, however, is available in connection with acquisitions, although the public company must disclose any determination to exclude the target from the scope of the public company's internal control review, and must also make other required disclosures regarding the acquired company and the significance of the acquired company to the acquirer's financial reports. Depending on the significance of the target company relative to the acquirer (measured based on various calculations prescribed by the SEC), a public company acquirer may also be required to file audited financial statements of the target company and pro forma combined financial statements. If representations and warranties insurance is being obtained in connection with the transaction, the underwriting process will place additional importance on performing robust diligence to obtain the desired coverage, particularly in areas where insurers are inclined to provide exceptions to the policy (such as technology, intellectual property and tax).

### 3. Key Considerations in Definitive Acquisition Agreements

A basic definitive agreement for an acquisition should not be difficult to negotiate. In most instances, it will be a fairly straightforward stock or asset purchase agreement or merger agreement, depending upon the structure of the transaction. In many investment advisory and securities firm transactions, there will generally be few assets on the books of the target, and an acquisition will in substance be an acquisition of goodwill, client relationships and people. The target will normally want to make sure that market-related changes in the price of trading or investment portfolios or accounting-related changes in the book value of those portfolios do not create an "out" for the acquirer under the definitive documentation.

In some private transactions, the purchase price will be based upon an assumed closing date net worth or working capital amount and the price will be adjusted to reflect any divergence from the agreed-upon amount as reflected on the closing date balance sheet. It is also not unusual for there to be post-closing indemnity obligations in such transactions (usually limited in length and amount and, sometimes, in scope) to protect the acquirer against losses arising from breaches of representations attributable to pre-closing periods and breaches of covenants attributable to pre- and post-closing periods. While a strong indemnity from the seller is always helpful in mitigating risk, buyers often insist on the indemnity to be backstopped in some way, such as including an escrow, purchase price holdback or letter-of-credit, particularly where the creditworthiness of the seller is in question or where collectability from the seller is uncertain due to jurisdictional issues. Sellers, however, need to be mindful of the balance sheet impact that such structures would have, given fair-value accounting standards applicable to such transactions. Where there may be concerns of creditworthiness, structural protections in an asset purchase transaction can insulate acquirers from undesired liabilities. In addition, the rise and rapid expansion of the representations and warranties insurance market has led to buyers more frequently turning to insurance as a backstop to, and in many cases a substitute for, a traditional

indemnity and escrow structure to protect against liabilities arising out of a target's pre-closing breaches of representations.

Covenants addressing post-signing operational and management matters help protect the acquirer against changes in the business between signing and closing. Such covenants should be tailored to fit with the business agreement concerning the degree of autonomy that the target company will retain following the acquisition. Covenants also should protect the acquirer against intrinsic changes to the business that would have an adverse consequence for the acquirer (*e.g.*, in the case of an acquisition by a bank holding company, covenants should protect the acquirer from the entry by the target into new businesses that would not be permissible for the bank holding company acquirer to conduct following the acquisition). On the other hand, it will often be appropriate for the acquirer to bear the risk of adverse extrinsic changes such as general economic or securities markets declines.

Closing conditions are usually comparable to other transactions, although they may also contain additional requirements, especially for investment management businesses, where it is not unusual to condition the closing on the delivery of a minimum percentage of client consents to the acquisition (typically measured in terms of assets under management or revenue run-rate, and which may take the form of a negative consent for advisory contracts with non-fund clients). The closing in a people-intensive acquisition, such as a securities, investment advisory or fintech firm, will frequently also be conditioned upon the continued employment of all or a certain percentage of specified key personnel of the target company and the implementation of any other special employee arrangements. In that regard, it will often be preferable from both the buy side and the sell side to enter into employment agreements with key personnel simultaneously with entering into the merger or purchase agreement, and then requiring continued employment and absence of actions that would give rise to a termination for "cause" under those agreements as of the closing date. Closing conditions may be tailored to the circumstances, however, where extraordinary circumstances exist. In some of the distressed or discounted transactions in 2008, the parties acknowledged the unusual conditions and terms under which the deals were reached by, for example, limiting the application of material adverse effect clauses for closing purposes or including post-signing due diligence periods. During the Covid-19 pandemic, it was common to include exceptions to the material adverse effect standard and interim operating covenants for effects of the Covid-19 pandemic and governmental action in response to the pandemic, particularly in light of Delaware case law arising out of the early days of the pandemic, though more recent practice has leaned toward limiting these carveouts following multi-year emergence of "ordinary course" business practices during the pandemic.

### 4. Allocating Value Between Shareholders and Employees

In people-intensive businesses, such as broker-dealers and investment advisors, or businesses where the original founders are still employees but hold meaningful equity stakes, such as many early stage fintech firms, there will often be a tension between amounts paid in consideration for the target's equity and amounts allocated to employees through employment agreements and other retention arrangements. However, the allocation of the purchase price consideration between the shareholders and the employees of the acquired business can have significant tax and accounting consequences — even where the employees and shareholders are

the same individuals. Allocating the consideration where the employees and shareholders are not the same presents obvious further complications.

In many instances where employee shareholders are selling their own business, the acquirer will want to condition some of the purchase price consideration on the continued employment of key personnel in the business, particularly where the key employees are owners who receive substantial consideration for their interests. However, employee shareholders will want to ensure that the purchase price for the business will be treated for tax purposes as capital and not ordinary income (and may also wish to achieve a tax-free exchange of their shares for acquirer stock). Achieving the objectives of both the acquirer and sellers requires careful planning, as conditioning the right to receive the purchase consideration on continued employment in some cases may result in a portion of the purchase consideration being deemed compensation and taxed as ordinary income. Striking the correct balance from the tax, social, economic and other perspectives between the value paid for the capital or goodwill of the business and the ongoing compensation of employee shareholders by means of employment agreements or other retention programs requires both complex planning and good business judgment. A variety of structural mechanisms, with varying trade-offs, exist for bridging this gap:

- *The Restricted Stock Structure*. To ensure that employee shareholders do not walk out the door the day after the acquisition is closed, the acquirer can issue restricted shares that will be forfeited if the recipient does not remain in the acquired company's employment for a specified period of years. Restricted shares commonly vest over time in tranches (similar to the vesting schedules associated with employee stock options). A significant drawback, however, of the restricted stock structure is that the fair market value of the shares will be taxable to the recipient as ordinary income upon the vesting of such shares (unless the recipient makes an election under Section 83(b) of the Code, in which case the excess of the fair market value of such shares over the amount (if any) paid by the recipient will be taxed as ordinary income at the time of receipt, with any subsequent appreciation taxed at capital gain rates). Since the acquirer will get a corresponding tax deduction, the acquirer may be able and willing to gross-up the selling shareholders for some or all of the adverse tax impact, although acquirers are often reluctant to do so. Restricted stock will also have an adverse accounting impact on the acquirer, since the value of the restricted shares will be charged against income over the period in which the shares vest.

- *Earn-Outs*. With an earn-out structure, the acquirer and seller can avoid the adverse tax and accounting consequences of the restricted stock structure. Shares can be issued or the cash consideration paid in the acquisition subject to meeting specified future performance hurdles. If structured properly, the consideration should be treated as capital and not ordinary income, and, in a tax-free exchange, the exchange of shares by the selling shareholders should be treated as a valid tax-free exchange. In addition, the selling shareholders may be able to use the "installment method" of tax reporting and defer taxation of any earn-out payments until receipt. Earn-outs can also be structured to mitigate the adverse impact on future earnings. A significant drawback of an earn-out structure, of course, is the fact that the purchase price is contingent on the future performance of the target business. Selling shareholders

often may not wish to assume that risk, as future performance is not fully within their control, although the risk can sometimes be mitigated by the negotiation of detailed covenants regarding the acquirer's post-closing operation of and investment in the target business. Also, in order to achieve the desired tax treatment (and to avoid a potentially unexpected earnings charge), the parties generally will not be able to make the payment of the earn-out amounts contingent upon the employee shareholder remaining an employee of the acquirer (although it may be possible to defer payment of the earn-out amount to a future period in the event that the target business fails to meet agreed upon levels of retention among different groupings of employees following the closing). Earn-outs with terms greater than five years may not comply with Section 409A of the Internal Revenue Code.

- *Profits Interests*. One earn-out alternative that has been used successfully in recent years has involved the issuance of "profits interests" in an entity classified as a partnership for U.S. federal income tax purposes to employees where the value of the interests depends upon the future earnings of the acquired company. With careful planning and coordination with accountants and tax counsel, this structure should enable the employees to treat their gains from a future sale of such interests as capital gains. The structure generally involves converting the target business into a limited liability company formed by the acquirer in return for one or more classes of interests (and cash) and awarding (or selling) management one or more classes of "profits interests." The limited liability company agreement details the division of profits among the different classes of interests. Ultimately, the primary value of the interests will be realized when the acquirer exercises call rights provided under the limited liability company agreement for a call price that should approximate both the fair market value of the interests and the agreed upon economics. Receipt of the full profits participation will generally depend upon continued employment, with the limited liability company having the right to repurchase interests held by departing employees for a low price (generally the amount paid for the interests) or declare such interests to have been forfeited. The limited liability company documentation would also include restrictions on competition and the solicitation of clients and employees during employment and following repurchase of the interests, and can also address other matters, such as the degree of operational freedom to be given to target management. From a practical perspective, this structure is likely to be most effective in transactions where the acquired business will be operated substantially autonomously by the officers of the acquired entity. However, this structure has tax and accounting advantages relative to incentive compensation arrangements, and the ability to tie participation to continued employment, as well as the ability to distribute interests in a way that matches the expected future contributions of the acquired employees rather than the ownership structure of the acquired company (which may primarily reflect historical rather than expected employee contributions), can give this structure an advantage over a traditional earn-out structure.

- *Unrestricted Shares Combined with Liquidated Damages*. One creative structure is the combination of a tax-free reorganization involving the issuance of unrestricted shares tied to the execution of long-term employment agreements containing liquidated damages provisions by key employee shareholders. The liquidated

damages are expressed as a sum certain that decreases over the term of the employment agreement (*e.g.*, cash damages if the employee leaves without "good reason" or is terminated for "cause" during the first year of the employment term, declining ratably to zero by the end of the term of employment, which is typically three to five years). The acquirer then takes a pledge of a portion of the shares issued as acquisition consideration to secure the liquidated damages claim under the employment agreements. Shares are released from the pledge over time as the employee serves out his or her employment term. In order for the transaction to constitute a tax-free reorganization within the meaning of Section 368 of the Code, it is crucial that the selling shareholders have unlimited upside and downside in the stock (to the extent tax-free reorganization treatment depends on such stock being treated as stock consideration). Thus, the liquidated damages may not fluctuate with the value of the stock issued and must constitute full recourse obligations of the selling shareholders. It is also possible to use this structure in a taxable transaction where the consideration involves a mix of cash and stock and the stock is pledged as described above to secure liquidated damages. While such a transaction is not tax free, it should be consistent with the treatment of the purchase consideration as capital and not ordinary income (excluding possibly the time value benefit of the accelerated payments that are tied to continued employment). In some circumstances, it may even be possible to use liquidated damages in an all-cash transaction. From the acquirer's perspective, the liquidated damages structure is not without risk, since liquidated damages clauses are subject to challenge and, if found to be punitive in nature, can be held to be unenforceable. In addition, acquirers should pay careful consideration to any potential accounting implications of utilizing a liquidated damages structure.

- *Retention Pools and Other Golden Handcuffs*. In light of the adverse tax and accounting consequences of restricted stock and the drawbacks of the alternative structures addressed above, it may be preferable to split the payment consideration of the transaction into a portion of stock consideration that is paid on an unrestricted tax-free basis and a pool of cash consideration that is paid out as compensation on a post-closing schedule tied to the retention of key personnel. As mentioned above in the context of restricted stock, since the cash component will be tax deductible to the acquirer, the acquirer should be able to justify a larger retention pool as measured by value when compared to alternative tax-free considerations.

### 5. Regulatory Restrictions on Compensatory Arrangements

Developments over the past decade have chipped away at the flexibility of companies to design and implement compensation arrangements in the ordinary course, including because of the influence of proxy advisors and, in the bank space in particular, increased regulatory focus. The elimination of "golden parachute" excise tax gross-ups and single-trigger vesting, challenges to the enforceability of non-compete provisions, the increasing prevalence of equity awards that are performance-based and deferred and mandatory "say on golden parachute" votes in merger proxy statements can result in a range of potential consequences that deal makers must think through and plan for in advance of signing.

In 2016, several federal bank regulatory bodies and the SEC re-proposed rules under Section 956 of the Dodd-Frank Act to prohibit incentive-based compensation arrangements that encourage inappropriate risks at covered financial institutions. The proposed rules would have applied to a range of companies and, among other things, prohibited establishing incentive-based compensation arrangements that encourage inappropriate risk by providing covered persons with excessive compensation, fees or benefits that could lead to material financial loss, and, in some cases, annual reporting requirements, policy and procedure requirements, and specific (and increasingly prescriptive) requirements relating to compensation deferrals, forfeitures, downward adjustments and clawbacks. These rules have not yet been adopted as of December 31, 2023. However, following the sudden collapse of Silicon Valley Bank and other regional bank failures in 2023, and following pleas from a number of reform advocates and lawmakers, in June 2023, the SEC publicly placed the unfinished Dodd-Frank executive compensation rule on its short-term agenda.

### 6. Contingent Value Rights

Where target stockholders are particularly concerned about the value of acquirer securities received as consideration, the parties can employ a contingent value right ("CVR") to provide some assurance of that value over some post-closing period of time. This kind of CVR, often called a "price-protection" CVR, typically provides a payout equal to the amount (if any) by which the specified target price exceeds the actual price of the reference security at maturity. Price-protection CVRs typically also include a floor price, which caps the potential pay-out under the CVR if the market value of the reference shares drops below the floor, functioning in the same manner as a collar or a cap in the case of floating exchange ratios. CVRs can also be used in other contexts, especially where the parties are unable to reach agreement as to the valuation of a specific asset, liability or contingency, including, for example, the magnitude of losses in a portfolio of assets or the outcome of a significant litigation. A CVR of this type, often called an "event-driven" CVR, may be used to bridge a valuation gap between the two parties and to increase deal certainty by allowing the parties to close the deal without the contingency having been resolved. Event-driven CVRs typically provide holders with payments when certain events resolving the contingency occur, or when specific goals, usually related to the performance of the acquired business, are met.

In most cases, CVRs are memorialized in a separate agreement, which usually calls for a trustee or rights agent to act on behalf of the holders. At maturity, CVRs may be payable in cash or acquirer securities or, in some cases, a combination of the two at the option of the acquirer. Acquirers may also negotiate for the option of extending the maturity of the CVRs, typically in exchange for an increase in the target price. Targets may seek to have the acquirer make CVRs transferrable (in which case the CVRs generally also have to be registered under the Securities Act) and, in some cases, to list them on a stock exchange. Buyers, and sometimes targets, looking to maximize speed and limit SEC review, often seek to make CVRs nontransferable so as to avoid the need to register them under the Securities Act.

Parties considering the employment of CVRs also need to be aware of potential pitfalls. CVRs are highly-structured instruments with many variables, and their negotiation and implementation can introduce significant additional complexity to a deal, including the tracking of, and payment to, CVR holders years into the future. While CVRs may be useful tools in

bridging valuation gaps and overcoming disagreements, there is also a possibility that they create their own valuation issues and increase the potential for dispute during negotiations. Moreover, CVRs remain outstanding and often impose restrictions on the actions of the acquirer long after closing, including operating restrictions with respect to the acquired business. CVRs could become the source of litigation, particularly where great care was not taken to anticipate potential misalignments between the interests of the acquirer and the CVR holders. Finally, CVRs are subject to a host of additional securities law, accounting and tax considerations, and parties contemplating their use should seek legal, financial, accounting and tax advice.

### 7. Tax Structures

As an alternative to a straight stock purchase or merger transaction, some transactions not involving actual sales of assets have nevertheless been structured as taxable asset purchases for tax purposes. Where the acquired company is a pass-through entity for tax purposes (*i.e.*, partnerships, S corporations or limited liability companies), there is only one layer of tax imposed on such transactions. Moreover, because most of the purchase price in such transactions is allocable to goodwill, most of the sellers' gain is capital. As a result, for most non-corporate sellers that have owned their stake in the business for more than 12 months, most of the gain on the sale will be taxed at long-term capital gain rates. Transactions involving sales of 80% or greater owned corporate subsidiaries are also frequently structured as asset sales for tax purposes. In each case, the acquirer will be able to amortize goodwill (as well as most other identified intangibles) for income tax purposes over a fixed period.

### 8. Non-Competition and Non-Solicitation Agreements

A critical component of any acquisition agreement relating to an investment banking or investment advisory business will be the terms of non-competition and non-solicitation (of both employees and clients) agreements by the selling shareholders and target employees. To preserve the goodwill of the acquired business, the acquirer will want to ensure that the sellers, and any target employees who terminate their employment following the acquisition, will be subject to appropriately tailored restrictions on competition and solicitation. It is wise to review any applicable state statutes to assure that the non-competition restrictions comply with affirmative requirements and exclude any specific prohibitions in the statute. Since over-reaching non-competition provisions may not be enforceable under New York law (as is common in other jurisdictions), a measured, balanced approach is best. Particular care must be taken in California, where a 2008 California Supreme Court decision, *Edwards* v. *Arthur Andersen LLP*, 189 P.3d 285 (Cal. August 7, 2008), held that employee non-compete agreements violate California law, unless they fall within one of three narrow statutory exceptions (one of which exempts non-compete agreements in connection with sale or dissolution). Furthermore, in 2017, California adopted California Labor Code Section 925, which purports to invalidate non-California choice of law and forum selection provisions in employment agreements for employees who primarily reside and work in California. It is also advisable to clarify that the non-competition provisions are being agreed to by the sellers in their role as shareholders, and not as employees, as some states view non-competition provisions as legitimate only in the sales context (and even in the sales context, non-competition provisions must still be reasonable). Clearly indicating the consideration being provided in exchange for the non-competition agreement may also be advisable, depending on the circumstances. In addition, in January 2023,

the Federal Trade Commission proposed rules that would prohibit all employee non-compete provisions, with limited exceptions for sellers of a business entity and substantial owners, which could have far-reaching implications across a wide variety of issues. These rules have not yet become effective as of December 31, 2023.

Agreements prohibiting the solicitation of employees are often under-emphasized, but can be just as important as the basic non-competition agreement, particularly in the context of an investment banking or investment advisory business target. Since it is unrealistic to believe that one can forever prevent a terminated employee from working in direct competition with the target firm, it is important to make sure that a departing employee cannot take other employees with him or her. Such mass exoduses are, unfortunately, not uncommon in past advisory and investment management acquisitions.

Strict confidentiality requirements are also important to protect the trade secrets and client information of a target. Restrictions on the solicitation of specific clients or the use of customer information can serve as a more narrow, and hence enforceable, version of a general non-competition agreement. For instance, California courts have recognized that a provision restricting the use of customer information obtained through the time and effort of an employer are permissible despite California's general policy against enforcement of non-competition provisions. *See Wanke, Indus. Commercial, Residential, Inc*. v. *Superior Court*, 209 Cal. App. 4th 1151 (2012). However, courts in three recent cases interpreting California law invalidated non-solicitation provisions in employment contracts, therefore heightening uncertainty regarding enforceability of these provisions. *See WeRide Corp.* v. *Huang*, 379 F.Supp.3d 834 (N.D. Cal. 2019); *Barker* v. *Insight Global, LLC*, 2019 WL 176260 (N.D. Cal. Jan. 11, 2019); *AMN Healthcare, Inc.* v. *Aya Healthcare Services, Inc.*, 28 Cal. App. 5th 923 (2018). An important exception to this potential unenforceability is a non-solicit provision entered into in connection with the sale of a business. *See Blue Mountain Enters., LLC* v. *Owen*, 74 Cal.App.5th 537 (2022). In the end, no degree of protection will be foolproof, and acquirers will have to assume some degree of risk and responsibility that the goodwill and personnel they are paying for will stay with the acquired business. Sellers are often more willing to agree to a long-term or indefinite restriction on using the confidential information of the target to compete with the acquirer than a more limited non-compete; however, the utility of a confidentiality restriction as a proxy for a non-compete may be limited in industries where human capital is more important than particular trade secrets or contact information.

### 9. Maintaining Autonomy After the Acquisition

Successful securities and investment advisory firms have generally attained success as a result of the well-tuned working relationship that exists among the highly talented members of the firm. In acquisitions of these firms or any other people sensitive business, acquirers will often wish to preserve the pre-acquisition working environment that enabled such talent to flourish, and sellers will often condition their willingness to sell on the promise of future autonomy. Autonomy issues will assume even greater importance in transactions involving back-end, performance-based deal consideration (*i.e.*, earn-outs) because the sellers will want to be comfortable that they will have the opportunity to achieve performance hurdles and receive the maximum payments available under the earn-out.

Promises of autonomy and the realization of post-acquisition autonomy are not always one and the same. Accordingly, acquirer and seller alike are well advised to address key operational, management and "social" issues in advance to avoid later conflicts and disputes. Since the departure of key personnel after the closing can have a serious financial impact on both acquirer and seller, the parties should plan as best they can to create a working environment that will minimize the risk of such departures. In this process, the parties will need to determine which promises are meant to be precatory and which are meant to give rise to financial consequences (such as the acceleration of earn-out payments or lapse of the obligation to pay liquidated damages) if breached and who will be responsible for enforcing such promises (such as a committee of legacy directors or an outside entity appointed by target shareholders).

In general, it will be best not to overcomplicate matters or to try to draft for every conceivable set of circumstances that could arise following an acquisition. No set of narrow rules will work as a template for managing an ongoing and evolving business. Broad principles and trust, combined with some bright line standards on compensation, reporting lines, employee authority and employer commitment to the business, must generally suffice.

Some things will change after an acquisition. Perhaps the most important is the need to ensure that the newly acquired business is appropriately integrated into the acquirer's internal audit and compliance structures. Over the years, billion-dollar-plus settlements of allegedly illegal practices, similarly large losses attributed to rogue traders and the associated heightened focus on internal controls and risk management, not to mention a rapidly evolving legal and regulatory environment for securities firms, investment advisors and others, have shown that no financial institution can afford to give complete autonomy to its investment or advisory professionals.

## B. The Regulatory Approval Process

In some cases, particularly in high-profile transactions, it may be best to approach the regulators just prior to executing a definitive agreement to alert them to the proposed transaction. Banking regulators have emphasized the need to advise them of any material acquisitions in advance. However, detailed discussions concerning the regulatory issues raised by a given transaction are generally not required in advance of the announcement, unless there is likely to be a significant concern regarding the permissibility of the transaction generally (such as an acquisition of a non-bank affiliated entity by a bank subject to Volcker Rule and other restrictions on permitted activities) or the specific resolution of other issues is critical to the fundamental economics of the transaction. One area not to overlook in the acquisition of smaller people-intensive businesses by banks is ensuring that the target does not engage in activities that are not permissible for a bank. For instance, an investment advisor might acquire equity interests in client businesses as a form of compensation or engage in certain other ancillary non-financial activities that may not be permissible for a regulated bank. The acquirer will also wish to approach the Financial Industry Regulatory Authority ("FINRA") promptly upon announcement (if not prior to announcement) if the acquirer or an affiliate will become a member of FINRA for the first time as a result of the proposed acquisition. In some cases, it may be possible to ensure in advance that an acquisition of assets and entities comprising non-permissible activities for a bank or that run into other restrictions can be structured to make the activities permissible for the acquirer. However, this requires careful advance planning and may be subject to prior approval

of the applicable banking agency. Transactions that do not require prior bank regulatory approval will be subject to the notification and waiting period requirements under the Hart-Scott-Rodino Act if certain jurisdictional requirements are met relating to the size of the parties and the size of the transaction, as discussed in more detail in Chapter 9.

### C. Post-Acquisition Organizational Considerations

Non-bank acquisitions also raise issues concerning the best post-acquisition organizational structure. Most financial institutions are giving careful consideration to the best means of organizing their various activities. Organizational structure can have significant tax, regulatory, cost and funding consequences.

The most basic issue for a bank holding company to consider is whether the non-bank activity is best housed within a subsidiary bank (or a bank's operating subsidiary) or in a non-bank holding company subsidiary. To the extent the activity will rely on core deposit funding, housing it outside of a bank subsidiary will be difficult, if not impossible, due to the strict limitations on affiliate transactions under Section 23A of the Federal Reserve Act. Even where core deposit funding is not essential, acquirers should recognize that funding activities at the holding company level will be closely scrutinized by the Federal Reserve, which disfavors a heavy reliance on commercial paper funding.

Some activities are not permissible at the bank level, and obtaining limited purpose exceptions has become increasingly challenging for national banks. Hybrid structures have also been used where specialized banks are established to conduct a given non-bank activity. A number of institutions have looked to a thrift structure to house their mortgage company or trust activities and various full- and limited-purpose banking charters have been used for credit card and trust operations. Using a bank charter has certain funding advantages and benefits regarding the export of interest rates and fees, but may subject consumer finance activities to stricter regulatory standards and Community Reinvestment Act ("CRA") obligations, although this regulatory gulf between banks and non-banks has narrowed with the ascendance of the Consumer Financial Protection Bureau's ("CFPB") oversight of non-bank consumer finance as well as with the ability, granted by Dodd-Frank, of the Financial Stability Oversight Council to designate certain non-bank financial companies for supervision by the Federal Reserve if they are predominantly engaged in financial activities. Complex issues can also arise regarding the integration of marketing activities between bank and non-bank subsidiaries, including the different treatment of banks and non-banks under the anti-tying rules, and the use of loan production offices in lieu of, or in addition to, the bank's basic branch network.

Most importantly, any bank holding company seeking to expand into a new non-bank business, or to substantially increase the scope of activities of an existing business, must give careful attention to the compliance and internal control needs of the new business. Non-banking businesses, especially brokerage and asset management businesses, are subject to a broad range of bank and non-bank regulations, and a significant commitment is necessary to ensure that a proper compliance program is put in place. This commitment should begin at the outset during the pre-acquisition due diligence investigation. There are a number of examples over the past years where an acquirer has suffered a costly black eye for compliance problems that have arisen in a newly-acquired non-bank business. Education from the highest level of the organization

(including at the board level) on down will help to ensure that the risks associated with such new ventures are well understood and a prudent compliance and risk management system has been established to keep track of evolving standards.

Financial institutions should also be aware that acquisitions by a depository institution of non-bank assets or liabilities may necessitate a Bank Merger Act application, even in situations involving internal corporate restructurings.

## II. ACQUISITIONS OF SECURITIES FIRMS

### A. Acquisition Activity

Over the last few years, there have been a substantial number of acquisitions by banks of non-bank financial services firms, as well as significant consolidation between securities firms themselves, as a result of the importance of product scope and scale of operations in the highly competitive global arena for financial services. These transactions have included Morgan Stanley's acquisition of E*TRADE Financial Corporation; the merger of Charles Schwab and TD Ameritrade; TD Ameritrade's acquisition of Scottrade; Hellman and Friedman's acquisition of Financial Engines; Virtu Financial's acquisitions of KCG Holdings and Investment Technology Group, Inc.; and the acquisition of FBR & Co. by B. Riley Financial.

### B. Overview of Applicable Laws and Regulations

The range of federal and state laws and regulations applicable to securities firms is far-reaching. Potential acquirers of such firms will need to examine closely the specific laws and regulations applicable to a target in the context of that firm's business and the acquirer's plans for such business on a transaction-by-transaction basis. Several features of the legal regime applicable to securities firms, however, are relevant to nearly all acquisitions of such firms. A general appreciation of these common features can help acquirers anticipate and address specific issues and processes associated with acquiring securities firms.

The central feature of federal and state regulation of securities firms is the requirement that such firms be registered as broker-dealers. Under Section 15(a)(1) of the Exchange Act, it is unlawful for any broker or dealer to effect any transactions of any nonexempt security unless such broker or dealer is registered with the SEC. State laws similarly have registration requirements, and broker-dealers must register in states in which they do business unless an exemption is available, generally based on the institutional nature of the customers. Most large broker-dealers are registered in every state. There are very few exemptions from the federal registration requirement. The Jump Start Our Business Startup ("JOBS") Act created two limited exemptions from the requirement to register with the SEC as a broker-dealer: (i) intermediaries that maintain platforms to facilitate private placements pursuant to Rule 506 of Regulation D need not register with the SEC, but are not necessarily exempt from state regulation; and (ii) entities that act as "Funding Portals" registered as such with the SEC under the JOBS Act's crowdfunding provisions (for which applicable FINRA rules were approved by the SEC in 2016).

Potential acquirers should note that, although the Exchange Act and the SEC rules thereunder have established a system of regulation of broker-dealers that is directed primarily at

conventional securities brokerage businesses, the SEC has, through a series of no-action letters, interpreted the term "broker" to include professionals that limit their business solely to the provision of M&A advice. The SEC has stated that "a professional who brings together potential buyers and sellers and advises the parties on questions of value, plays an integral role in negotiating the transaction or provides other services designed to facilitate the transaction, may be deemed to be a broker." *International Business Exchange Corp.*, SEC No-Action Ltr. (available Dec. 12, 1986). Transaction-based compensation received by a provider of M&A advice has been considered by the SEC to be a hallmark of broker-dealer activity requiring registration. In 2014, the SEC eased the regulatory burden for certain M&A advisors facilitating transactions solely with respect to private companies (even if receiving transaction-based compensation). *Faith Colish, Esq. et al.*, SEC No-Action Ltr. (available Jan.31, 2014, revised Feb. 4, 2014) (the "2014 No-Action Letter"). Registration of such M&A advisors is not required if the conditions of the no-action position are met, including: (i) the transaction may not involve the public offering of securities; (ii) the buyer must control (presumed at 25% ownership) and actively operate the acquired company (via executive positions or directorships); (iii) the M&A advisor may not provide financing (directly or through affiliates) for the transaction (but may assist in obtaining financing from third parties); and (iv) the M&A advisor may not bind a party to the transaction or have custody, control or possession of securities in connection with the transaction (which would preclude a PE or VC fund from relying on the no-action letter).

Effective March 29, 2023, the Exchange Act was amended to provide for an express exemption from registration for "M&A brokers" as part of the Consolidated Appropriations Act, 2023. This new exception is more limited than the relief described in the 2014 No-Action Letter. For example, the new statutory exception is limited to transactions involving a change of control over "eligible privately held companies", while the 2014 No-Action Letter relief was broader. An "eligible privately held company" is one that must (i) not have any class of securities registered with the SEC pursuant to Exchange Act Section 12 or subject to Exchange Act Section 15(d)'s filing obligations and (ii) in the fiscal year prior to the engagement of the M&A broker, have (a) earnings of less than $25 million before interest, taxes, depreciation, and amortization, and/or (b) gross revenues of less than $250 million. Furthermore, the statutory exemption provides for a list of activities which would preclude the M&A broker from taking advantage of the exemption, including (i) directly or indirectly, receiving, holding, transmitting, or having custody of funds or securities of the parties in connection with the transaction; (ii) directly, or indirectly through any of its affiliates, providing financing to a party to the transaction; (iii) assisting in the formation of a buyer group to acquire the eligible privately held company; and (iv) binding a party to a transfer of ownership of an eligible privately held company. On the same day that the new statutory exemption became effective, the SEC withdrew the 2014 No-Action Letter. Importantly, the new statutory exemption does not preempt states from instituting broker registration or other requirements. Various state securities laws may come into play and may require state registrations, even for companies engaged solely in providing M&A advice. Acquirers seeking to enter the relatively specialized M&A advisory business will need to become familiar with the broker-dealer registration system.

The SEC has delegated oversight of broker-dealer registration to FINRA and, pursuant to Section 15(b)(8) of the Exchange Act, every registered broker or dealer (with certain limited exceptions) must either be a member of a national securities association registered under Section 15A (which currently includes only FINRA) or effect transactions solely on a national securities

exchange of which they are a member. Accordingly, securities firms will typically be subject to FINRA's rules as well as those promulgated by the SEC. In addition, securities exchanges and other regulatory authorities, such as the Commodity Futures Trading Commission, impose their own regulations on member firms.

Initial application for registration as a broker-dealer with the SEC and most states is made by filing a Uniform Application for Broker-Dealer Registration on Form BD through the Web Central Registration Depository ("CRD"), a centralized filing system operated by FINRA on behalf of itself, the SEC and the state securities agencies. Each registered broker-dealer must update the information in its Form BD by filing amendments through the Web CRD. Broker-dealer registration requirements of the states vary by state, but often involve the submission of additional information directly with the state before registration will be effected.

The process of becoming a member firm of FINRA requires that the applicant furnish to the FINRA Membership Application Program group via an electronic filing system a comprehensive new member application which includes, among other materials, (1) a description of business activities in which the firm intends to engage, management and operational experience and appropriate registration of the firm's key personnel, the firm's ownership structure, a description of the firm's physical and communication facilities (including systems for financial and other recordkeeping) and plans for financing the firm's brokerage operations, (2) a copy of written supervisory and compliance procedures to be adopted by the firm and (3) other documentation demonstrating the firm's ability to comply with applicable laws and regulations and FINRA membership standards, as set forth in NASD Rule 1014. Once the review process, including satisfaction of any additional requests FINRA may have, is completed, the senior management of the applicant firm must participate in a pre-membership interview process. FINRA will then notify the applicant firm of whether its application has been granted, denied or granted subject to restrictions. The firm must enter into a membership agreement with FINRA, which will enumerate any restrictions on its operations.

If a broker-dealer is to become a member of an exchange, it must undergo a similar process with the exchange. Some of the documentation typically required by the exchanges parallels that required by FINRA, and many exchanges have delegated their membership process to the FINRA administration, but each exchange has its own regulations with respect to qualification and registration of associated persons of the firm, and with respect to financial and operations matters related to the firm that must be complied with.

**C. Acquisition Issues**

The panoply of laws and regulations governing registered broker-dealers raises several issues in the context of acquisitions of securities firms (whether such acquisition is direct or an acquisition of the parent of a broker-dealer — the discussion below is directed at the direct acquisition of a broker-dealer but applies equally to the acquisition of a broker-dealer holding company). First, as a matter of due diligence, the acquirer should review the firm's broker-dealer memberships and registrations with FINRA, the relevant securities exchanges and the states to ensure that such memberships and registrations are current. This review can be done quickly by examining the firm's registrations through the FINRA BrokerCheck program. Further, in addition to the "compliance with laws" representation that an acquirer would typically

obtain in an acquisition agreement with respect to the securities firm to be acquired, the acquirer should also obtain a more specific representation stating explicitly that the firm is a member of FINRA and any exchanges on which it conducts business and is registered with the securities agency of any state in which the firm's activities require it to be so registered, and that such memberships and registrations are in full force and effect.

In the course of its due diligence, the acquirer should also examine closely the firm's FINRA Membership Agreement to determine which restrictions, limitations and obligations are applicable to the target's broker-dealer registration. The FINRA Membership Agreement typically enumerates the permitted business activities of the target securities firm, and the acquirer should ensure that the actual business of such firm comports with the permitted set of activities. The FINRA Membership Agreement may set forth net capital and financial reporting requirements as well, and the acquirer should request and review the firm's financial reports submitted to FINRA to ensure compliance. The acquirer may seek further comfort through an explicit reference in the acquisition agreement to the FINRA Membership Agreement in the typical litany of laws and regulations with respect to which the target securities firm will represent it complies. Due diligence should also cover recent regulatory examinations and communications from regulators, reports filed with FINRA and other regulators, and the firm's compliance and supervisory program, its risk management practices and its AML program. NASD Rule 1017 requires notice and approval of a change of control of a target securities firm which is a member of FINRA. In addition, the FINRA Membership Agreement will often contain a provision requiring notice to FINRA of a change of control of the broker-dealer. In light of these requirements, the acquirer and the target firm should consider at what point in the development of the transaction they will inform FINRA of the potential change-of-control. A telephone call by the parties to the firm's FINRA Coordinator immediately prior to or after execution of the definitive acquisition agreement may be useful in some instances to alert FINRA of the transaction.

Subsequent to execution of the acquisition agreement, it may be helpful for the acquirer and the target to discuss with FINRA's Membership Application Program Group what information should be included in the notice and approval request (typically referred to as a Continuing Membership Application (CMA)). The CMA is filed with the Membership Application Program via an electronic filing system. The CMA requires information relating to (1) the acquisition, including the corporate ownership structure following consummation, financing of the acquisition and resolutions authorizing the acquisition, (2) formation documentation with respect to any new holding companies of the target, (3) the impact of the acquisition on the target, including any changes to its supervisory structure, business activities, operational capabilities and capitalization and (4) continued compliance with FINRA's standards for admission set forth in NASD Rule 1014(a). Information regarding other changes occurring at the target as a result of the acquisition, such as changes in business lines or other operational changes, may be required as well. After submission of the CMA, FINRA may require additional information regarding the proposed acquisition. The acquirer and the target should be prepared to respond promptly to any such requests in an effort to obtain FINRA's approval of the proposed transaction as quickly as possible. While the approval process can take up to six months, so long as the CMA relates only to a change in control or ownership and does not address approval of a material change in the target's business, FINRA rules permit the parties to close the acquisition 30 days after filing a substantially complete CMA, but FINRA may impose

interim restrictions on the operations of the broker-dealer pending final FINRA action. FINRA has a Fast Track Review Process for acquisitions that FINRA determines to be low-risk, low-complexity and require little additional information beyond the initial CMA filing. If FINRA (with the firm's agreement) puts the CMA under its Fast Track program, final approval can be obtained within weeks rather than months. FINRA's review of CMAs is quite extensive, although the contours of the review will depend substantially on the specific aspects of each transaction.

If the senior management of the target is expected to change significantly, FINRA may want individual managers to undergo its formal interview process. Consequently, acquirers that intend to install new personnel in the senior management positions of the target should recognize that each such person must be appropriately registered and have relevant management experience, and that FINRA may compel such personnel to undergo an interview process, which may prolong the period until FINRA approval is obtained.

Acquirers should examine the statutory provisions of each state in which the target is registered to determine the precise notice requirements applicable in the context of the proposed acquisition. Most states merely require notice of the acquisition after its consummation (by the filing of a Form BD amendment), although a small group of states (and the membership of this group is continually evolving) have minimum statutory pre-consummation notice periods. The acquirer and the target should prepare a form of notice letter to states where pre-consummation notice is required in connection with the proposed acquisition, explaining the transaction and the identity of the new owners. Other changes to the target, such as a name change, often require additional filings with the states.

FINRA and the state securities agencies will both require that the target securities firm file an amendment to its Form BD to reflect the change of control and the new management and ownership of the firm, which will also satisfy continuing SEC registration requirements. This amendment is filed through the Web CRD following consummation of the acquisition.

The acquirer will also want to continue the target's stock exchange memberships. If the target is a member of the NYSE, the acquirer will need to file the appropriate form as an approved person of the member firm. If the target merges into another entity in the acquisition, a new member firm application may be required. If operational aspects of the target will change as a result of the acquisition, such as where two broker-dealers are being merged, the NYSE will likely also conduct an on-site examination of the resulting firm, and will be particularly interested in issues such as systems integration. FINRA handles regulation of member firms on behalf of the NYSE as well as several other exchanges. The target firm's FINRA Coordinator will inform the acquirer and the target what information is expected to be filed with respect to the proposed acquisition (in addition to the CMA). Exchanges operated separately from FINRA may require separate notice.

## III. ACQUISITIONS OF FINANCIAL ADVISORY AND INVESTMENT MANAGEMENT BUSINESSES

Investment advisors and asset managers have long been frequent M&A targets, and the asset management industry has witnessed a number of deal announcements in recent years.

Notable recent transactions include T. Rowe Price's acquisition of Oak Hill Advisors; Goldman Sachs' acquisition of NN Investment Partners; AllianceBernstein's acquisition of CarVal Investors; the acquisition of Focus Financial Partners by Clayton, Dubilier & Rice and Stone Point Capital; Morgan Stanley's acquisitions of Eaton Vance Corp., Hyas Group and Cook Street Consulting; Franklin Resources' acquisitions of Lexington Partners and Legg Mason; Brookfield Asset Management Inc.'s acquisition of Oaktree Capital Group; Hellman and Friedman's acquisition of Financial Engines and the proposed acquisition of Fortress Investment Group by Mubadala and Fortress management. A range of forces, including overcapacity, margin pressures, competition, active fund product offerings pressured by exchange traded funds, technology advances, the desire to build out product offerings and regulatory developments in the U.S. and abroad, will all help keep investment advisor and asset management M&A active in the future.

Investment advisor mergers and acquisitions raise a number of unique issues and demand an understanding of the unique elements of the advisory business. In addition, as an increasing number of diversified financial companies acquire or develop *de novo* investment advisory businesses, management of those companies must be cognizant of the special issues that mergers of investment advisor parents may raise. Such mergers raise not only the traditional set of corporate, banking and securities law issues applicable to such mergers, but also a number of issues unique to the asset management and mutual fund industry.

**A. Retention of Clients; Pricing Formulas**

Acquirers of investment advisors must enter the process with the knowledge that an advisor's primary assets are its people and its advisory relationships. Like demand deposits, the relationships may be terminated by clients with very limited (if any) prior notice. Minimizing client run-off, satisfying existing clients' concerns about the transaction and devising acquisition and pricing structures that protect the acquirer while motivating the seller will be primary concerns.

Many acquisition agreements contain client consent closing conditions expressed in terms of permitted percentage changes in revenue run-rates or assets under management between a pre-signing date and the closing date. This condition is sometimes paired with a purchase price reduction that applies below a specified run-rate or assets under management threshold, where the threshold for adjusting the purchase price is set at a certain percentage change in revenue run-rate or assets under management and the closing condition is set at a lower percentage threshold. This combination is sometimes used as a means of resolving the conflict between the seller's need for certainty of closing and the acquirer's level of acceptable loss of client accounts. In non-public transactions, a portion of the purchase price can be withheld until following any required post-closing client consent period (including to adjust for fund holder consents obtained during the 150-day period provided for under Rule 15a-4 of the Investment Company Act), although this option is more likely to be desirable from the acquirer's perspective in transactions where the value of the registered fund business is secondary to the value of the non-registered fund business.

## B. Regulatory Considerations and Due Diligence

Acquirers must have a basic knowledge of the special legal and regulatory requirements triggered by the federal statutory scheme governing advisors — in particular, the Investment Advisers Act (the "IAA") and the Investment Company Act (the "ICA"). In addition, investment advisor acquisitions may raise special considerations based on the acquirer's own regulatory situation. Finally, due diligence must be carefully undertaken, especially in light of SEC scrutiny of advisors' conflict-of-interest, trading and related policies. Diligence should include particular focus on issues raised by the SEC (including any SEC examination letters and the target's responsive letters), FINRA (if the firm is also a registered broker-dealer) or, if the advisor is not registered with the SEC and is registered with any states, any state attorneys general with respect to the target. In particular, if the target is a registered broker-dealer, the acquirer should ask about the target's response to FINRA's recent industry-wide inquiries into conflict-of-interest policies requirements as well as any material requests from FINRA arising from its authority, under FINRA Rule 8210, to inspect any documents in a broker-dealer's or its affiliate's "possession, custody or control."

### 1. "Assignment" of Mutual Fund Investment Advisory Contracts

Section 15(a) of the ICA requires that every investment advisory contract with a mutual fund or other registered investment company provide "in substance, for its automatic termination in the event of its assignment." The purpose of Section 15(a) is to prevent "trafficking" in investment advisory contracts (*i.e.*, the sale of the advisor's fiduciary office).

"Assignment" is defined in Section 2(a)(4) of the ICA to include: "any direct or indirect transfer . . . of a contract . . . or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor." While ICA Rule 2a-6 provides that a "transaction which does not result in a change of *actual* control of management of the investment adviser to, or principal underwriter of, an investment company is not an assignment" (emphasis added), Section 2(a)(9) sets forth a presumption that "control" exists where a person owns directly or through controlled companies 25% or more of the voting securities of the company.

As a result, the acquisition of an investment advisor with mutual fund clients, regardless of deal format, usually results in a deemed assignment of its investment advisory contracts to the new owner. Likewise, where the parent of an investment advisor is acquired in a merger, Section 15(a) could be viewed as being triggered, regardless of the size of the investment advisor relative to the parent company. Similarly, where two parent companies merge and there is no clear "acquirer" (as in mergers of equals), a conservative reading of the ICA would suggest that *both* companies treat the parent merger as a "change-of-control" under Section 15(a) for their investment advisor subsidiaries. However, the SEC has given a degree of no-action relief where the parent holding companies of investment advisors merged and where ownership of the merging firms before the merger, and of the combined firm after the merger, was widely dispersed in the public without large controlling shareholders either surrendering or gaining control, where no advisor subsidiary was itself being merged out of existence, sold or spun-off, and where no advisory contract was being transferred as a result of the merger. *Dean Witter Discover & Co.*; *Morgan Stanley Group Inc.*, SEC No-Action Ltr. (available April 18, 1997). Thus, in the case of certain stock-for-stock mergers of publicly held parent companies that have

investment advisor subsidiaries, no assignment (for purposes of the ICA or the IAA) of investment advisory contracts between an advisory subsidiary and a fund or other advisory client may be deemed to occur as a result of the parent company merger.

The SEC has also provided some limited guidance in no-action letters regarding when a minority investment in an investment advisor results in a deemed assignment of investment advisory contracts, which is helpful to investors, often private equity, seeking to acquire significant non-controlling interests in investment advisors. As noted above, Section 2(a)(9) provides that a change of control (and hence an assignment) is presumed when more than 25% of the voting securities are acquired. Section 2(a)(9) also provides that an acquisition of less than 25% is presumed not to be a change of control, although both of these presumptions can be overcome with evidence of actual control being transferred. In *American Century Cos., Inc.*, SEC No-Action Ltr. (available December 23, 1997), the SEC found that J.P. Morgan's acquisition of almost half of the economic interest of a family-controlled investment advisor would not constitute a change of control, since J.P. Morgan was only acquiring up to approximately 12% of the total voting power of the company (with the family retaining a controlling stake), it was only acquiring 2 of 10 board seats, and was obtaining a set of veto rights designed not to give J.P. Morgan the right to direct "day-to-day management." Parties seeking to make a minority investment in an investment advisor should carefully examine the structure of their investment relative to *American Century* and other applicable precedents to minimize the chance of triggering an automatic termination of the target's advisory contracts.

Because of Section 15(a) of the ICA, an investment advisor cannot continue to advise a mutual fund after a change of control unless a new advisory contract is approved by the fund's board and shareholders, subject to a limited exception for shareholder consents obtained following completion of the transaction pursuant to Rule 15a-4 under the ICA, as discussed below.

Given the necessity of obtaining approval from the directors of the relevant registered investment companies, the seller should take special care when informing them of the transaction and seeking their approval of a new investment advisory contract. The seller, often in conjunction with the acquirer, must first determine the appropriate time to inform the investment company directors of an impending change of control and, in making such determination, should weigh several transaction-specific factors, including the need for confidentiality and the reputation and financial strength of the acquirer.

Since Section 15(c) of the ICA imposes on fund directors the duty to request, and on advisors the duty to provide, all information that may reasonably be necessary to evaluate an investment advisory contract, the seller and acquirer should assure directors that they will provide all such information.

Obtaining fund shareholder approval for assignment of investment advisory contracts will often take as long as, or longer than, obtaining any necessary target shareholder approval. As described below, proxy materials for soliciting such approval will be relatively simple and easy to draft, file and clear with the SEC; however, the process of obtaining a shareholder vote from mutual fund investors can be more difficult than obtaining a shareholder vote from public companies, as most mutual fund investors are individuals who tend to manage their money in a

passive manner. A good proxy solicitor with the ability to mount an effective telephone campaign is critical if shareholder approvals are needed in a short time frame.

### 2. Fund Mergers

When two existing investment advisors merge — or when two companies with subsidiary asset managers merge — the combined company may desire to combine the mutual fund complexes advised by the two merging companies. This will often involve mergers between the mutual funds themselves, as well as between the investment advisors. This complex fund merger process will also generally require approval of the shareholders of the funds.

Among other things, fund shareholders may need to approve any or all of the following:

- the fund mergers under the state law pursuant to which the funds are organized (*e.g.*, corporate or trust law);
- appointment of new fund directors, which often may apply to two or more merging funds where the resulting fund board combines members from each of the merging funds;
- new investment advisory contracts with the surviving investment advisor; and
- new distribution agreements with the designated distributor.

Because the expenses associated with obtaining shareholder approval of the fund mergers can sometimes be allocated to the funds on the basis that fund mergers increase efficiency and reduce fund expenses, obtaining Section 15(a) approval and fund merger approvals at the same set of shareholders' meetings presents a savings opportunity for the funds. While this would marginally increase the complexity and cost of requisite proxy materials, the savings resulting from avoiding an extra set of shareholder meetings for the affected funds, as well as an extra set of proxy materials, should, in most instances, outweigh confusion or delay caused by added complexity.

In many cases, merging parent companies will not know prior to entering into a merger agreement which funds will be combined, which funds will survive, which advisors will be selected and so on. Those matters are generally determined as part of the integration process that follows announcement of the parent merger and sometimes the process does not begin until closing of the parent merger. In addition, advisors may be loath to announce fund mergers until major contingencies to the parent merger have been eliminated (*i.e.*, after requisite parent shareholder and regulatory approvals are obtained). As a result, it may be difficult or impossible both to obtain Section 15(a) and fund merger approvals at the same set of shareholders meetings. It may be difficult even to obtain the requisite Section 15(a) approval prior to the completion of the parent merger. Thus, the merger parties may need to look to the exemptions available under Section 15(a) in order to complete the closing of the parent company merger.

### 3. Exemptions Under Section 15(a)

If shareholder approval of a new advisory contract cannot be obtained prior to closing, relief is available under Rule 15a-4 under the ICA. Relief may also be available from the SEC for an interim period under certain situations pursuant to the SEC's exemptive authority under Section 6(c) of the ICA, although there are likely to be few situations in which companies will not be able to obtain relief under Rule 15a-4 given the flexibility of that rule.

Rule 15a-4 requires that the board (including a majority of the disinterested directors) of the advisory client approve an interim advisory contract prior to the completion of the merger or other business combination transaction. In addition, the investment advisory client's board must determine that the scope and quality of services to be provided to the fund under the interim contract will be at least equivalent to the scope and quality of services under the prior contract, and the interim contract must contain the same terms and conditions as the previous contract (other than the effective date, the termination date and the provisions required by Rule 15a-4) and be terminable by the client's board on no more than 10 days' written notice. Assuming appropriate director approval, Rule 15a-4 permits shareholder approval to be obtained after completion of the change-of-control transaction as long as it is obtained within 150 days of that date (the maximum duration of the interim advisory contract).

Rule 15a-4 provides that the compensation to be received under an interim advisory contract cannot exceed the compensation that would have been received under the previous contract. Rule 15a-4 also requires compensation earned under the contract to be held in an interest-bearing escrow account, with the compensation (plus earned interest) to be paid to the advisor upon approval of a new contract with the advisor by the advisory client's shareholders. If the shareholders do not approve a new contract, the advisor may be paid from the escrow account an amount equal to the lesser of costs incurred in performing the interim contract (plus interest earned on that amount) and the total amount held in escrow (including earned interest) — but note the restrictions on funds bearing costs and expenses in connection with the sale of an investment advisor discussed below in part 6.

### 4. "Assignment" of Other Investment Advisory Contracts

Unlike advisory contracts with registered investment fund clients, advisory contracts with non-fund (including unregistered private funds) clients are not required to terminate automatically upon assignment, but Section 205(a) of the IAA provides that no investment advisory contract may be entered into if such contract fails to provide that no assignment of the investment advisory contract may be made by the investment advisor without the consent of the client. Failure to obtain client consent for the assignment of a non-fund contract may constitute a breach of the contract and a violation of the antifraud provisions of the IAA. However, so long as the contract does not expressly require written consent to an assignment, the SEC Staff has allowed advisors to obtain "negative consent" from non-fund clients. *See Templeton Investment Counsel Limited*, SEC No-Action Ltr. (available January 2, 1986). That is, advisors may assume from clients' continued receipt of advisory services after appropriate notice of the facts relating to the assignment that the client consents to the assignment.

In order to make such negative consent effective, an advisor must inform the client specifically that the acquirer will continue the services for a specified period and that continued acceptance without objection will be regarded as the client's consent. In theory, the need for the client to "accept the services" of the new advisor means that negative consent can only be obtained after the change of control, underlining the risk to the acquirer of client runoff. However, many, if not most, advisory agreements can be terminated on relatively short notice — so, even if negative consent could be obtained prior to closing the transaction, the risk of post-closing client runoff would remain. Accordingly, in some respects, the client consent process (both affirmative consent and negative consent) can be viewed as a "market check" with respect to potential near-term client retention/runoff, and thus a negative consent process that deems negative consent effective (for contractual closing purposes) at a time on or before the closing can be a reasonable approach for both acquirer and seller.

#### 5. "Assignment" of Distribution Arrangements

As with advisory contracts, Section 15 of the ICA provides that underwriting and distribution agreements with an investment company terminate automatically upon assignment. New agreements must be approved by a fund's board but, unlike advisory agreements, do not need to be approved by a fund's shareholders.

Under Rule 12b-1 of the ICA, subject to compliance with requirements designed to minimize potential conflicts of interest, open-end funds may pay the expenses of distributing their own shares. In addition, agreements between funds and distributors relating to these arrangements must provide for automatic termination if they are assigned. Rule 12b-1, however, does not require the agreement itself to terminate upon assignment.

#### 6. Section 15(f) "Safe Harbor" Requirements

As a general rule, fiduciaries — including corporate directors, trustees and investment advisors — may not "sell" their "office" for personal gain. By attempting to sell the right to act as fiduciary, a fiduciary may be viewed as placing his or her interests before the client. In *Rosenfeld* v. *Black*, 445 F.2d 1337 (2d Cir. 1971), *cert. dismissed*, 409 U.S. 802 (1972), the court held that an investment advisor, as a fiduciary, may not profit from its sale. Under the principle of *Rosenfeld*, an investment advisor and its shareholders may be liable to an investment company client and its shareholders for any profits arising out of the sale of the advisor.

Not all courts agreed with the *Rosenfeld* decision. Nevertheless, Congress in 1975, at the behest of the mutual fund industry, enacted a safe harbor to address the risk. The safe harbor is contained in Section 15(f) of the ICA, which permits investment advisors and their shareholders to retain profits arising from a change of control if certain conditions are met. Among other things:

- for at least three years after the sale, at least 75% of the investment company client's directors must be independent of the advisor's old and new owners. While the acquirer is not wholly foreclosed from participating in the selection of independent directors, care must be taken that the acquirer does not unduly influence the process. Section 16 of the ICA further requires that any board vacancy occurring in connection

with compliance with the Section 15(f) independence requirements generally may be filled only by a person "selected and proposed" by a majority of the independent directors and elected by the shareholders; and

- there must be no "unfair burden" imposed on any investment company client as a result of the acquisition. An "unfair burden" includes any arrangement during the two-year period following the sale under which the advisor or any of its "interested persons" receives any compensation (1) in connection with the purchase or sale of securities or assets to, from or on behalf of the investment company, other than *bona fide* ordinary compensation to the principal underwriter, or (2) from the fund or its shareholders other than for *bona fide* investment advisory or other services.

The SEC has indicated that if the investment company bears any costs caused by the sale of an investment advisor — including expenses of a special shareholders meeting — such costs may constitute an "unfair burden." *See* ICA Rel. No. 10809 (Aug. 6, 1979). Furthermore, acquirers should take great care not to produce analyses relating to an acquisition, such as plans to raise fees or cut services, that can potentially damage their case in litigation over compliance with Section 15(f) "undue burden" requirements.

## C. Fund Disclosure Documents and SEC Filings

Once a sale agreement is entered into, it usually will be necessary to "sticker" or amend the prospectuses of funds served by the advisor involved to disclose the possible change of control. Similarly, if the seller is a publicly owned company, public announcement of the sale will be required, and the acquirer may also wish or be required to make a similar announcement.

Proxy materials for funds advised by the target must be prepared in connection with the approval of new advisory agreements. The proxy statement should describe the transaction, provide adequate information about the acquirer and explain that existing advisory contracts will terminate at closing. Generally, it should also:

- describe the terms of the new advisory agreement, including any material differences from the old agreements;

- give the reasons why fund directors recommend approval of the new agreement; and

- address the availability of Section 15(f) protection for the transaction.

An investment advisor's Form ADV must be amended "promptly" to disclose changes in the advisor's controlling shareholders and owners of 5% or more of the company.

A successor to an investment advisor may operate temporarily under its predecessor's registration if it files its own complete application for registration on Form ADV within 30 days of the succession. A successor is an unregistered entity that assumes and continues the business of a registered advisor, which then ceases its advisory activities.

### D. Broker-Dealer Issues

If the acquirer is not a registered broker-dealer, consideration should be given to whether the acquirer needs to register as such in order to carry out the target advisor's business. While contractual or other arrangements can be made to address the need for broker-dealer registration, such arrangements should be undertaken with care. If the acquirer is a broker-dealer or is affiliated with a broker-dealer, the acquirer should be aware of provisions that prohibit or place limitations on transactions between an investment company and its affiliates.

The ICA prohibits a broker-dealer from entering into principal transactions with an affiliated fund, prohibits joint transactions between a fund and its affiliates, regulates brokerage transactions between a fund and an affiliated broker and prohibits a fund from purchasing securities underwritten by an affiliated broker-dealer, except under certain conditions. ICA §§ 17(a), 17(d), 17(e), and 10(f). A broker affiliated with an investment advisor also may be subject to the IAA when it enters into advisory contracts with non-fund clients.

In addition, the impact of the risk assessment rules on an acquisition by a broker-dealer under the Exchange Act should be considered. Certain reporting and recordkeeping obligations may be imposed on the broker-dealer and its affiliates. Finally, amendments to the relevant Form BD are required if the advisor is a registered broker-dealer.

### E. Due Diligence Issues

Because of the extent and complexity of the applicable regulation of investment advisors and their investment company clients, due diligence by an acquirer of an investment advisor often focuses to a large extent on legal matters. In particular, legal issues arise with respect to tax qualification of fund clients, ERISA issues, litigation, blue sky and foreign regulatory qualifications, ICA, IAA and FINRA (for advisors that are registered broker-dealers) compliance (including review of compliance manuals) and audit reports, intellectual property issues, credit agreements, and track record compliance with the Global Investment Performance Standards of the CFA Institute.

## IV. ACQUISITIONS OF INSURANCE COMPANIES

As with other financial institutions, the pressure on insurance companies to perform has increased, leading to a number of significant restructurings and consolidations. In the last several years, there have been a number of notable proposed corporate mergers and restructurings in the U.S. insurance industry. However, notable transactions have faced resistance from antitrust authorities and were ultimately abandoned, and other proposed transactions involving foreign acquirers have faced similar challenges.

Large strategic combinations between ACE Limited and The Chubb Corporation, Cigna and Anthem, Aetna and Humana and Aon and Willis Towers Watson were announced in recent years, though only the ACE/Chubb transaction was completed, with the Cigna/Anthem and Aetna/Humana transactions abandoned in 2017 and the Aon/Willis Towers Watson transaction abandoned in July 2021, in each case, following antitrust challenges. Cigna and Express Scripts completed its combination with Express Scripts in December 2018 in the wake of Cigna/Anthem and Aetna/Humana. Nevertheless, the antitrust enforcement environment remains uncertain.

Recent transactions involving both a U.S. and non-U.S. based insurer include RenaissanceRe's acquisition of AIG's treaty reinsurance business, including Validus Re; Covéa Mutual Group Insurance Company's acquisition of PartnerRe; Chubb's acquisition of Cigna's personal accident, supplemental health and life insurance business in seven Asia-Pacific markets; AXA's acquisition of XL Group; the acquisition of Jardine Lloyd Thompson by March & McLennan Inc.; the acquisition of Fidelity & Guaranty Life by Anbang Insurance Group Co., Ltd. of China; and Symentra Financial Corporation's acquisition of Sumitomo Life Insurance Company of Japan.

A notable amount of other insurance M&A activity has involved private equity buyers and sellers, including KKR's acquisition of the Global Atlantic Financial Group; Warburg Pincus's acquisition of K2 Insurance Services; Carlyle Group's acquisition of NSM Insurance Group; Third Point Reinsurance's acquisition of Sirius International Insurance; the take-private transaction of AmTrust Financial by an investment group led by Stone Point Capital; Apollo's acquisitions of Aspen Insurance and Athene Holding; Hellman & Friedman's acquisition of insurance broker Hub International Ltd. from its previous private equity owners Apax Partners and Morgan Stanley Principal Investments; and Athene Holding's (an affiliate of Apollo) acquisition of insurer Aviva USA.

Other recent transactions have included Prosperity Life Group's pending acquisition of National Western Life Group; Liberty Mutual's acquisition of State Auto; Centene's acquisitions of WellCare Health Plans and Magellan Health; Allstate's acquisition of National General Holdings; and Fidelity National Financial's acquisition of FGL Holdings.

One particularly notable insurance industry transaction during the financial crisis — though by its nature a very unique transaction — was the federal government's bailout and *de facto* nationalization of AIG in 2008. AIG's obligation to divest assets in order to repay the federal government resulted in a number of transactions headlined by MetLife's purchase of AIG's American Life Insurance ("ALICO") subsidiary (following on the heels of AIG's terminated sale of AIA to Prudential), AIG's sale of two of its life insurance units in Japan to Prudential and AIG's agreement to sell up to 90% of its airplane leasing unit to a Chinese investor group.

## A. Regulatory Issues and the Role of State Insurance Authorities

Regulation of the insurance industry has long been and continues to be primarily the responsibility of state authorities, rather than the federal government, although the scope of federal regulation of some large insurers has expanded in the wake of Dodd-Frank. Under the McCarran-Ferguson Act, 15 U.S.C. § 1011 *et seq.*, state insurance laws are specifically protected from being preempted by federal law, and federal laws regulating the "business of insurance" are made applicable only to the extent that such business is not regulated by state law. In addition, under Dodd-Frank, insurance companies found to be systemically important to the Financial Stability Oversight Counsel can be subjected to the supervision of the Federal Reserve as with other systemically important non-bank financial institutions ("SIFI"). To date, of the four entities that had been designated for supervision by the Federal Reserve as SIFIs, all had insurance activities — American International Group, General Electric Capital Corporation and, in controversial decisions, Prudential Financial and MetLife. However, all four of these entities

have since been de-designated as SIFIs (including one, Metlife, which was de-designated through successful litigation). Moreover, the FSOC's focus, when making these designations, on aggregate counterparty exposure and the ability of customers to theoretically surrender all of their life and annuity policies at once, raises the prospect of other large insurers being designated SIFIs in the future.

SIFIs will be subject to enhanced oversight by the Federal Reserve as if they were bank holding companies, including higher liquidity and capital requirements, regular stress tests, enhanced risk management, the creation of living wills, and early remediation efforts at the first sign of financial distress. While the Federal Reserve has yet to implement regulations fully defining the scope of its supervisory powers (only the stress test rules have become final to date), the prudential and reporting standards it does adopt may be more stringent than existing state regulations and could impact large-scale consolidation activity and potentially encourage breakups within the insurance sector. In 2017, MetLife completed the spin-off Brighthouse Financial, its U.S. life insurance and annuity business, in large part due to anticipated higher capital requirements as a result of MetLife's designation as a SIFI.

In addition, prior to 2019, the international Financial Stability Board had adopted a set of policy recommendations relating to recovery and resolution planning, group-wide supervision and higher capital requirements that would apply to institutions designated as "globally systemically important insurers" ("GSIIs") (none of which would have legal effect unless and until implemented by the applicable U.S. regulatory agencies). The Financial Stability Board had designated three U.S.-based insurers, AIG, Prudential and MetLife, as GSIIs. In 2017 and 2018, the Financial Stability Board, in consultation with the International Association of Insurance Supervisors and national authorities announced that it had decided not to publish a new list of globally systemically important insurers, and the International Association of Insurance Supervisors adopted its Holistic Framework for Systemic Risk in the Insurance Sector in November 2019. Following the adoption of the Holistic Framework, the Financial Stability Board decided to suspend GSII identification as of the beginning of 2020, and, in December 2022, to discontinue GSII identification, based on the initial years of implementation of the Holistic Framework.

State insurance commissioners have extensive powers, and directly influence consolidation activity. Good relations with state regulators are crucial, for not only do regulators scrutinize restructuring plans and acquisition proposals, but, as discussed below, insurance companies facing hostile takeovers can often seek assistance from state insurance regulators as a shield against such actions.

As with state corporate and blue sky codes, state insurance statutes are generally similar and closely track one another in many respects. Individual issues, however, are often addressed differently. State statutes governing insurance companies reflect many of the same concerns as those regulating banking institutions, but also focus on rate regulation and similar customer-oriented matters. While as noted above some federalization of insurance regulation for the largest insurance companies has begun, because there is no federal fund equivalent to the FDIC to back up claims against insurance companies, the insurance industry has generally not faced the kind of taxpayer-driven federal regulation embodied in the FIRREA and the FDICIA. State insurance regulators tend to be more powerful and independent than some of their banking or

securities counterparts, and will often be very proactive in pushing unhealthy insurance companies towards restructurings or sales before a collapse is imminent. In addition, lack of a federal structure has meant that insurance holding companies are less subject to the equivalent of the various provisions that apply to bank holding companies — including the "source of strength" doctrine, the cross-guarantee provisions of FDICIA or the requirement of capital plan guarantees in FDICIA. State insurance regulators have the power to regulate any insurance company doing business within the state, foreign or domestic, but may choose to regulate in-state and out-of-state insurers differently (for example, by only permitting in-state companies to offer certain types of insurance).

Insurance authorities generally represent both the state and policy holders, and are generally obliged to protect the latter from abuses and defaults by insurance companies. State authorities often possess wide discretionary powers, allowing them to determine the rules by which the insurance industry may function in the state, including through acquisition, to ensure compliance with those restrictions and to monitor and investigate the practices of insurers.

Of course, acquisitions of insurance companies still fall within the purview of antitrust authorities at the federal level. The proposed $47 billion acquisition of Cigna by Anthem, announced in June 2015 and the proposed $37 billion merger between Aetna and Humana that was announced the next month were each abandoned in 2017 as a result of antitrust challenges, though Cigna completed its $67 billion acquisition of Express Scripts in 2018. More recently, the proposed $30 billion merger of Aon and Willis Towers Watson, announced in March 2020, was abandoned in July 2021 as a result of an antitrust challenge from the U.S. Department of Justice.

### 1. Control Regulations Applicable to Insurance Deals

Most states regulate acquisitions of "control" over insurance companies by statute that generally require an acquirer to disclose certain information to the state regulatory authority and to obtain prior approval from the authority. The statutes generally apply only to domestic insurers (*i.e.*, insurers incorporated in that state), although some statutes apply to certain other insurance companies as well.

"Control" under these statutes is generally presumed to exist in most states if an acquirer acquires direct or indirect ownership, control or voting power over a specified threshold of voting securities. New York, like most states, sets the threshold at 10% (*see* N.Y. Ins. Law § 1501(a)(2)); some states set the threshold lower or higher.

The acquisition of a multistate insurance holding company thus must generally be conditioned on the receipt of multiple state approvals and will be subject to possible delay by the procedures established under multiple state statutes. State authorities are required to consider applications using a variety of discretionary factors described below.

*The Approval Process*. Taking New York as an example, acquirers are generally prohibited from taking "control" of an insurer incorporated in New York, by purchase of its securities or otherwise, unless it gives the insurer 20 days' prior written notice and receives prior approval from the New York Superintendent of Financial Services. N.Y. Ins. Law § 1506(a).

The Superintendent must disapprove the proposed acquisition if he or she determines, after notice and an opportunity to be heard, that such action is reasonably necessary to protect the interests of the people of New York State.

Most state statutes specify information to be included in a control application and a time period for applications to be processed. However, as with federal bank regulatory approvals, many states also permit regulatory authorities to request additional information and extend the processing period. In some states, approval by the target's shareholders will be required before the state commissioner will grant state approval for such a transaction.

After the filing is complete, a public hearing is usually held by the regulatory agency, at which time the appropriateness of the merger or consolidation agreement is considered. In some states, the commissioner decides without a hearing, except in the case of contested expedited approval situations. At the hearing, the companies involved in the agreement may be allowed to present oral and written statements.

*Approval Criteria*. Generally, the most important issues on which regulators focus in considering whether to grant approval for an insurance company acquisition is whether the acquirer has sufficient capital and management expertise to operate the target in the public interest. Often attention is placed on the quantity of capital reserves, which may indicate prospects for long-term survival.

The grounds articulated in many insurance statutes are substantially similar. In California, for example, the commissioner may disapprove an insurance company merger if the following conditions are found:

- after the change of control the domestic insurer could not satisfy the requirements for the issuance of a license to write the line or lines of insurance for which it is presently licensed;

- the purchases, exchanges, mergers or other acquisitions of control would substantially lessen competition in insurance in California or create a monopoly therein;

- the financial condition of an acquirer is such that it might jeopardize the financial stability of the insurer or prejudice the interests of its policyholders;

- the plans or proposals where the acquirer has to liquidate the insurer, to sell its assets, merge it with any person or make other major changes in its business or corporate structure or management are not fair and reasonable to policyholders; or

- the competence, experience and integrity of those persons who would control the operation of the insurer indicate that it would not be in the interest of policyholders or the public to permit them to do so. Cal. Ins. Code § 1215.2.

A number of other major states, including Illinois and Texas, have similar standards for approving insurance company mergers.

Sufficient capital resources are often essential to the success of any application submitted for approval. The California Commissioner rejected the application of AXA, a French insurance group, to acquire control of Farmer's Group in 1990 because it was felt that the resulting company would have been too highly leveraged. Often, whether the resources of the resultant company will be adequate is central to the question of whether the interests of policyholders will be adequately served. State regulators have also held up approval because of more directly customer-focused concerns. For example, in 2004 the California Commissioner held up approval of the $16 billion merger between Anthem and WellPoint until the companies agreed to invest approximately $265 million towards health services in California. More recently, out of concern that private equity acquisitions of annuity providers could place policyholders at risk, the New York State Superintendent of Financial Services demanded certain special conditions for the approval of Guggenheim's acquisition of Sun Life's annuity business and Apollo's acquisition of Aviva's annuity business. These "heightened protections" included higher capital standards, a backstop trust account and a requirement to bring certain material operational changes to the Superintendent for approval.

Generally, deference to the insurance commissioner is limited to the "business of insurance." Within this context, commissioners act as they see fit to maintain the health of the industry. In a number of instances, however, attempts of a commissioner to block a takeover bid were held to interfere unduly with the federal securities laws or the Commerce Clause of the U.S. Constitution. In one case, the court held that, while the Insurance Commissioner could regulate insurance business, he could not interfere with shareholders' abilities to vote their shares. *Liberty National Life Insurance Co.* v. *Huddleston*, No. 3:90-0368, slip op. at 2 (M.D. Tenn. May 1, 1990), *aff'd*, No. 90-5598 (6th Cir. May 2, 1990) (motion to stay denied). *See also Alleghany Corp.* v. *Pomeroy*, 700 F. Supp. 460 (D.N.D. 1988) (enjoining North Dakota commissions from blocking acquisition of St. Paul Companies Inc.), *rev'd* 898 F.2d 1314 (8th Cir. 1990) (reversing on procedural grounds). *But see Hoylake Investments Ltd.* v. *Washburn*, 723 F. Supp. 42 (N.D. Ill. Oct. 4, 1989), which holds that, even absent protection of the McCarran-Ferguson Act, which gives states the ability to regulate the "business of insurance," the Illinois insurance statute was a proper exercise of the state's power to "regulate domestic corporations."

Insurance acquisitions will also be subject to antitrust review under the Hart-Scott-Rodino Act. Historically, few substantive antitrust issues were typically raised in the insurance context. As discussed above, however, a recent spate of failed large insurance mergers, as well as increased antitrust scrutiny in M&A deals generally, have caused uncertainty regarding regulatory approvals in pending and future insurance deals.

### 2. Timing Considerations and Deal Structure

Timing issues may directly determine the structure of a transaction. In some limited circumstances, it may be possible to structure a transaction so as not to require prior approval in a particular state, most notably in the case of certain "white squire" investments. This kind of strategy may be particularly beneficial when time is of the essence or a "lockup" of the transaction is desired, and the deal will not survive the delays inherent in the regulatory process. In CNA's acquisition of Continental, CNA purchased securities representing 19.9% of the outstanding equity of Continental upon the execution of its merger agreement with Continental.

This structure was required by Continental, which was in need of capital and was terminating a "white squire" investment transaction with IP Partners in order to enter into an agreement with CNA. CNA was able to purchase these securities by limiting the voting rights associated with the securities to 10% until such time as all necessary regulatory approvals were obtained, and taking part of the investment in the form of synthetically convertible preferred stock. Also, tender and exchange offers, which can be completed on a more rapid basis than a merger, are likely to be more useful in the insurance industry than in the banking industry where regulatory delays are generally longer.

In some states, the recapitalization of a holding company generally does not require approval by the insurance commissioner. This recapitalization could take place in a number of ways, including the adoption of a plan involving the combination of increased leverage with a significant cash distribution to shareholders. If the recapitalization is material, however, an obligation to report information about the adjusted capital structure may be triggered. In some states, the recapitalization of a holding company will require approval if the recapitalization involves the issuance of securities that results in a change of control of the holding company.

In New York, as in many states, special provision is made for those situations where an accelerated approval process may be necessary. Expedited approval is allowed for mergers between domestic mutual property/casualty insurance companies if such action is in the best interests of the policyholders, as determined by the superintendent, and subject to the superintendent's final approval. N.Y. Ins. Law § 7107. However, if within 30 days of receiving the required notice, at least 5% of the policyholders of either company file objections with the superintendent, a hearing must be convened, at which point the superintendent will take these opinions into account when making his or her final determination.

**3. Use of Non-voting Stock**

Note that non-voting stock can be used creatively to provide funding in advance of insurance regulatory approvals. In the fall of 2001, following September 11, there was a huge deficit of capital in the global reinsurance market. Two private equity firms, Warburg Pincus and Hellman & Friedman, sought to invest in the reinsurance market by acquiring a majority interest in a reinsurer, Arch Capital Group Ltd.

As noted above, state insurance laws generally require prior approval to acquire 10% or more of an insurer's voting securities. This approval process can take months. Also, in this case, because the two firms wanted to acquire more than 50% of Arch, the transaction was also subject to approval by the Arch shareholders.

To address the immediate need for capital, Warburg Pincus and Hellman & Friedman invested a combined $750 million in Arch in exchange for warrants and convertible preference securities with voting rights that were capped at 9.9% until all required shareholder and regulatory approvals were obtained. Using such preference securities enabled the firms to invest in Arch as soon as the papers were signed without waiting for regulatory approval. The documents were prepared and the deal closed and funded in about a week.

Unlike the bank regulators, the state insurance departments effectively permitted the two investors to hold non-voting securities that were convertible into over 50% of the common stock of the insurance company and represented over 50% of the company's total equity. One helpful aspect was that, as an anti-takeover device, the company had a provision in its by-laws that no shareholder could hold 10% or more of the voting power unless the by-laws were amended by shareholder vote.

## B. Special Deal Issues

### 1. Troubled Acquisitions

In the past, several insurance company deals have involved "healthy" acquirers and "unhealthy" targets. In climates of increased competition, this route has often been the only choice available. Regulators generally have raised no objections to such transactions. Such was the case in the merger of CIC into Cigna. By letting Cigna shoulder the burdens of CIC's business, state regulators were protected from covering the potential downside themselves.

In some cases, such an acquisition may simply accelerate the death of a failing insurance company. In 1994, Zurich Insurance Co. acquired policies with annual premiums of about $1 billion from Home Holdings. Part of the deal stipulated that Home Holdings would stop issuing new policies after the deal closed, although it would continue to service its already existing policies.

There have also been instances of "white squire" investments, in which a minority investment is made in the company to prevent a hostile takeover. These types of acquisitions can turn the fortunes of the weaker company around sharply. For example, after investing $200 million into troubled insurance broker Alexander & Alexander Services Inc., AIG saw the value of its investment rise over 28% in only two weeks. Primerica's decision to invest $722.5 million in Travelers in 1992, which gave it a 27% share in the company, also sent Travelers' stock surging to new highs.

In 2007, in the midst of the subprime and liquidity crises, monoline insurance companies engaged in the financial guaranty business experienced extreme financial duress, prompting these companies to look to non-traditional sources of capital. In December 2007, Warburg Pincus agreed to commit to invest up to $1 billion in MBIA Inc. through a direct purchase of MBIA common stock and a backstop for a shareholder rights offering. Warburg Pincus's investment was structured as an initial investment of $500 million in MBIA through the acquisition of 16.1 million shares of common stock at a 3% premium-to-market to be followed by a shareholder rights offering of up to $500 million that Warburg Pincus would backstop. Warburg Pincus also received warrants to purchase 8.7 million shares of MBIA common stock and "B" warrants, which, upon obtaining MBIA shareholder and other approvals, became exercisable for an additional 7.4 million shares. MBIA ultimately did not conduct the rights offering, opting instead to do a public offering of $750 million in common stock, which Warburg Pincus agreed to backstop by purchasing up to $750 million of convertible participating preferred stock. After launch, the offering was upsized to $1.1 billion with Warburg Pincus purchasing $300 million of the common stock offered; the backstop was not used.

In 2008, the federal government rescued AIG after collateral demands exceeded AIG's available liquidity. The New York Federal Reserve initially agreed to provide a two-year $85 billion secured revolving credit facility at a punitive interest rate with the hope that AIG would pay down the facility using the proceeds of asset sales. In connection with the extension of credit, the U.S. government was to receive a 79.9% equity interest in AIG. The New York Fed subsequently undertook additional measures including additional secured borrowing facilities, a $40 billion preferred stock investment directly in AIG, a purchase of certain troubled mortgage-related assets (up to $22.5 billion) and certain collateralized debt obligations (up to $30 billion) on which AIG had written credit default swaps, and a reduction of the $85 billion credit facility to $60 billion, with an extended term of five years and a lower interest rate.

### 2. Restructuring Multi-Line Companies

Another type of transaction is the restructuring of multi-line insurance companies, often by splitting them into two or more "pure plays." For example, in 2000, Aetna sold its financial services and international operations to ING Group and spun-off its domestic health insurance business to its shareholders. In 1995, Cigna split itself into two companies, one managing its property and casualty operations, and the other managing its "run-off" operations (predominantly asbestos and environmental claims). In 1994, Lincoln National sold off Emphesys Financial, a managed care insurance firm, through a subsidiary IPO, following the lead of Transamerica, which in 1993 discontinued its property and casualty insurance line by selling a majority share in the subsidiary through a $1 billion IPO, the largest ever by a U.S. insurance or financial services company at that time. Both Lincoln National and Transamerica reduced their investments to minority stakes, and used the capital to invest in their core businesses, pay down debt and/or repurchase common stock.

### 3. Hostile Acquisitions

The insurance industry has not been immune to hostile acquisition attempts, with AIG's successful unsolicited bid for American General being a prominent example. However, regulatory defenses can prove to be even more fatal than in the banking arena, and hostile bids for insurance companies have also failed because of basic corporate law defenses (rights plans, staggered boards and the like), successful proxy fights and the apparent ability and willingness of potential white knights to step forward. Few such bids have succeeded, although some have pushed targets into a transaction with a third party. *See* Chapter 3.

*Regulatory Defenses*. In a string of hostile acquisition attempts in the late 1980s, state insurance commissioners were strong allies of their regulated targets. In 1990, state insurance commissioners denied approval for hostile bids by AXA for Farmers Insurance and Alleghany in its attempt to acquire a controlling position in The St. Paul Companies. The California Insurance Department's blocking of AXA's bid for Farmers in turn caused Hoylake Investment to drop its attempted hostile takeover of Farmers's parent company, B.A.T. Industries.

Regulatory defenses have not always been successful in themselves. Torchmark's bid for American General, implemented by nominating five persons for the 15-person American General board, was allowed to proceed, despite state regulatory resistance. Several state insurance commissioners advised Torchmark that its solicitation did or could violate prior approval

requirements under state law. The staff of the New York Insurance Department informed Torchmark that it would be in willful violation of state laws, but did not take action. In Tennessee, the insurance commissioner issued a cease and desist order against Torchmark's proxy solicitation, but a federal district court issued a temporary restraining order to bar enforcement of the cease and desist order. *Liberty National Life Insurance Co.* v. *Huddleston*, *supra*. Still, after American General let it be known that it would put itself up for sale, Torchmark lost its proxy fight and, following an auction process run by American General, Torchmark eventually terminated its bid.

Since the Torchmark fight, however, many states have amended their statutes to make them less susceptible to court challenges, and litigation involving hostile bids for insurance companies has resulted in several pro-regulatory rulings. For example, Alleghany's challenge to state holding company laws (allowing states in which an insurer or its affiliates are "domiciled" the right to veto an acquisition of 10% or more of the stock of the insurance company or its parent) was rejected. Regulatory actions stymied the two hostile bids, and a third (B.A.T. Industries' bid for Farmers) was transformed into a friendly merger following regulatory resistance.

*Significant Hostile Bids*. In 2021, Chubb made a series of public unsolicited proposals to acquire The Hartford, the highest of which would have valued The Hartford at approximately $25 billion and all of which were publicly rejected by The Hartford. In April 2021, Chubb announced that it was abandoning its pursuit of the transaction. In late December 2022, Elliott Management launched an unsolicited bid to acquire American Equity Investment Life Holding Company, which was rejected by the company the same day. Anthem's initial approach to Cigna in the summer of 2015 was a public unsolicited proposal, which noted that Anthem had been engaged with Cigna to explore a potential combination for nearly a year and that Anthem was making its proposal public following what it viewed as Cigna's refusal to reasonably negotiate. Anthem and Cigna entered into a definitive agreement just one month after the public proposal, although the transaction was abandoned during 2017 following antitrust challenges. During 2011, several suitors waged a prolonged battle for reinsurer Transatlantic Holdings, including a hostile bid by Validus Holdings. Validus dropped its bid when Transatlantic agreed to be acquired by Alleghany for $3.4 billion. In 2001, AIG, assisted by its own strong stock price and a negative market reaction to the announced merger of American General and U.K. insurer Prudential plc, succeeded in derailing the Prudential transaction, and entering into a friendly transaction pursuant to which AIG acquired American General. In 1998, Nationwide Mutual succeeded in its $1.5 billion unsolicited takeover offer for Allied Group and Cendant's hostile bid for American Bankers Insurance broke up a negotiated deal with AIG. Ultimately, Cendant was forced to agree to terminate its acquisition agreement with American Bankers when an accounting scandal decimated its stock price. American Bankers was ultimately acquired by Fortis. Back in 1994, GE Capital relied on a proxy contest as part of a hostile bid for Kemper by nominating four persons for election to Kemper's board. GE Capital's attempt pushed Kemper into the arms of Conseco, which submitted an offer worth $3.25 billion in cash and stock valued at $67 per share. Ultimately, Conseco, after cutting its price, was forced to drop its offer for lack of adequate financing. As shareholder pressure for a deal continued to mount, and with the prospect of GE Capital renewing its bid, Kemper agreed to be acquired by Zurich Insurance. American General's $2.6 billion effort to purchase Unitrin in 1994 fell through after Unitrin successfully defended its stock buyback program, under which it would buy up to $15 million of

its shares, against a legal challenge brought by American General under Delaware corporate law. *See* Chapter 3 for a further discussion of notable hostile transactions.

### 4. Mergers of Mutual Companies

Mergers have proven to be an attractive way for mutual companies to obtain the capital that is increasingly necessary to survive in the financial industry. Mergers may be structured to expand an insurer into more profitable markets, or to cut costs by streamlining and eliminating duplicated services and jobs.

In 1992, the first merger of major mutual life insurance companies took place, between Phoenix Mutual Life Insurance Company and Home Life Insurance Company, resulting in the creation of the 12th largest mutual life insurance company in the United States, ranking among the nation's 30 largest insurers, with assets of almost $16 billion, and capital of nearly $600 million. In 1996, Metropolitan Life and New England Mutual Life merged in order to expand sales at New England Life by increasing their financial strength and ratings. Another mutual merger, the consolidation of Massachusetts Mutual and Connecticut Mutual, was aimed at strengthening the financial standing of Connecticut Mutual, specifically through cost-cutting and the elimination of duplicate services. In 2012 Nationwide Mutual Insurance merged with Harleysville Mutual Insurance in a $834 million transaction billed as a way for both companies to gain expanded geographic and product breadth.

## V. CREDIT CARD PORTFOLIO ACQUISITIONS

The monoline credit card business has substantially consolidated, with a number of banks having sold their credit card businesses to a handful of acquisitive firms, including Citigroup, Bank of America, MBNA (prior to its acquisition), JPMorgan, Capital One, PNC and American Express. Thinning margins, asset quality concerns, consumer-focused regulatory scrutiny, increased competition and expanding marketing budgets intensified the pressure to consolidate in order to achieve economies of scale. Large issuers have taken advantage of economies of scale to drive growth through analytics-driven marketing strategies.

Notable credit card portfolio transactions announced in recent years included Capital One's acquisition of REI's co-branded consumer credit card accounts from U.S. Bank in connection with Capital One's entry into a new exclusive credit card program agreement with REI, Capital One's acquisition of BJ's Wholesale Club co-branded consumer and small business credit card accounts from Comenity Capital Bank in connection with Capital One's entry into a new exclusive credit card program agreement with BJ's Wholesale Club, Capital One's acquisition of existing Walmart private label and co-branded credit card receivables from Synchrony Bank in connection with Capital One's entry into a new exclusive credit card program agreement with Walmart; Goldman Sachs' acquisition of General Motors credit card receivables from Capital One in connection with Goldman Sachs' entry into a new exclusive credit card program agreement with General Motors; Barclays' acquisition of existing U.S. co-branded and private label credit card receivables from Synchrony issued in partnership with The Gap, Inc.; Capital One's acquisition of existing Williams Sonoma private label and co-branded credit card receivables from Comenity Bank in connection with Capital One's entry into a new exclusive credit card program agreement with Williams Sonoma; Capital One's acquisition of

Cabela's credit card portfolio in connection with the sale of Cabela's to Bass Pro Shops; the purchase by Citigroup of the Costco credit card portfolio from American Express; Target Corporation's and Nordstrom's sale of their respective consumer credit card portfolios to TD Bank; Scotiabank's acquisition of JPMorgan's Sears Canada credit card portfolio; Capital One's acquisition of HSBC's $30 billion U.S. credit card business (consisting largely of private label and co-branded cards), as well as Capital One's subsequent sale of pieces of this portfolio — its Bon-Ton private label portfolio to World Financial Network and its Best Buy private label and co-branded portfolio to Citigroup; and KeyBank's acquisition of Key-branded credit card assets from Elan Financial Services Inc.

Like other asset sales, transactions involving card portfolios can be complex. A full understanding of the assets and liabilities being transferred and of the appropriate allocation of risk among the parties is required. In addition, because holders of a seller's cards will often have deposit, loan, asset management or other relationships with the seller and because the seller's retail network will continue to be a fertile source of prospective card accounts, the parties to a portfolio transaction will often have an ongoing commercial relationship that will need to be delineated, including provisions relating to commissions, exclusivity, cooperation, logistics, non-competition and trademark licensing. Additionally, the transfer of the infrastructure supporting the portfolio itself raises logistical issues often dealt with through interim servicing agreements. Highlighted below are some of the issues to consider in structuring a purchase or sale of a credit card portfolio.

## A. Due Diligence

Increased consumer-centric regulatory scrutiny, both at the state and federal level, as well as concerns regarding asset quality warrant an increased focus on due diligence. Due diligence is particularly important where the acquirer wishes to acquire only selected accounts meeting certain risk parameters. For example, an acquirer may only be interested in acquiring the seller's premium credit portfolio. An acquirer will want to have a thorough understanding of the quality of the portfolio and the seller's approval standards, credit scoring methods and statistical modeling, as well as loan loss reserving and other accounting policies. In the context of a portfolio consisting of "private label" or "co-branded" cards, both acquirer and seller must be attentive to the agreements governing the various private label and co-brand programs and the consent, termination and other rights of the counterparties to those agreements; and such transactions often require a tri-partite negotiation between account owner, acquirer, and branded partner. When the operating platform that services and supports the portfolio is included in the transactions, the parties will want to carefully review and plan for the separation of those assets and any interim servicing arrangements that will need to be provided. The acquirer should also scrutinize the target's marketing practices and product terms, including ancillary debt protection products and other so-called "enhancement services" and "add-on products" and the marketing thereof in light of increased focus by the CFPB, state attorneys general and other governmental bodies on consumer finance practices, including consent orders applicable to a number of large issuers. In the wake of the Covid-19 pandemic, the acquirer will also want to know about the portfolio's recent performance and whether the target has provided any Covid-19 related hardship or other relief to cardholders.

## B. Acquisition Agreement

Although not a substitute for thorough due diligence, the acquisition agreement can provide some additional comfort regarding credit quality concerns. A credit card portfolio sale is generally structured as a purchase of assets and assumption of liabilities (either through an outright transfer to the acquirer or through contribution to a joint venture). By inserting adequate representations and warranties regarding the nature and credit quality of the credit card accounts being purchased that are linked to an effective indemnity, acquirers can gain further comfort that they are purchasing assets that meet desired risk profiles.

Key representations and warranties will include those relating to compliance with consumer protection, privacy and other laws (including the Credit CARD Act of 2009), in light of the large potential exposure and reputational issues that may result from regulatory investigations or from class-action litigation. Representations ensuring that the list of borrowers for the accounts being sold have not been shared with a competing credit card issuer are also important. With respect to the credit card accounts being transferred, representations to be given by the seller may include representations that:

- the accounts are legal, valid and binding obligations of the obligors in the full amount set forth on the selling bank's books and are enforceable against the obligors;

- the accounts are governed by account agreements and other documentation, true and correct forms of which have been provided to the acquirer; and

- all account applications, related disclosures and account terms, as well as the seller's marketing, solicitation, servicing and credit evaluation practices, comply with applicable law and card association rules.

For sales of "private label" or "co-branded" portfolios, seller representations and warranties can also provide some comfort regarding the nature and quality of the existing relationships with the partners and the ability to transfer the programs to the acquirer. The acquisition agreement can also include a framework for the seller and acquirer to cooperate to obtain the consents of the third-party partners if they are in fact necessary prior to closing.

As with many asset acquisitions, the scope of "assumed liabilities" and "excluded liabilities" is often more important from a risk management perspective than the seller's representations and warranties. The reason for this is twofold. First, an acquirer's right to recover for breaches of most representations and warranties usually only remain in effect for a set period of time (generally one to two years) and are limited by a specified deductible and cap (each generally some percentage of the purchase price or premium on the receivables). In contrast, an acquirer can generally recover from the seller for any losses arising from excluded liabilities indefinitely and without dollar limitations. Second, a more aggressive regulatory climate focused on consumer lending practices emanating from the CFPB, federal banking agencies and various state attorneys general means that activities once thought to be permissible can become "deceptive" or "illegal" overnight. Assuming the practices targeted were conducted by both seller and acquirer, it can become contentious and difficult to determine how to allocate the cost of responding to and remediating newly illegal practices. This is true even if the seller

and acquirer have agreed to a standard “our watch/your watch” apportionment of liabilities, as regulators may not clearly apportion sanctions between current and prior owners. As a result, parties negotiating an acquisition agreement should consider including more precise and detailed procedures for apportioning litigation and compliance-related liabilities beyond standard “our watch/your watch” language. To the extent that securitizations are being transferred as part of the sale of an overall portfolio, there are additional considerations. Representations and warranties that no pay-out events or servicer defaults have occurred may be prudent. In addition, due to the many steps involved, transferring securitizations can be time-consuming. Hence, it may be desirable to structure the transaction with two closings. In the first closing, the acquirer would acquire the seller’s unsecuritized credit card accounts. In the second closing, the acquirer would acquire the securitized accounts. The use of two closings can ensure that the timing of the transfer of the securitizations does not unnecessarily impede the overall transaction.

In credit card transactions where the seller is exiting the credit card business by effectively “outsourcing” it to the acquirer through an agent bank agreement (which is discussed below), the acquirer may also have the opportunity to hire certain of the seller’s employees who are employed in the credit card business. In that instance, an acquirer may covenant in the acquisition agreement to interview these employees and to use its reasonable efforts to offer employment to them. In these cases, the acquirer will often agree to offer to employees who transfer from the seller to the acquirer benefits that are no less favorable in the aggregate than other similarly situated employees of the acquirer. Less common are covenants (more frequently found when a legal entity is being acquired) where the acquirer agrees to offer to transferred employees the same level of benefits that they enjoyed as employees of the seller for at least a transition period. Moreover, the acquirer may agree to recognize the length of service of the transferred employees with the seller for purposes of determining eligibility, vesting and level of benefits under the acquirer’s benefit plans. However, in these arrangements, the acquirer will frequently wish to preserve its rights to terminate any transferred employees and to make clear that the seller retains all liability for benefit claims incurred by transferred employees while employed by the seller.

Finally, where a seller divests only part of its credit card business, the parties must pay close attention to the same non-competition and non-solicitation considerations that arise in the agent banking context and that are discussed below.

### C. Agent Bank Agreement

In transactions involving the sale of an entire credit card business rather than simply a sale of a particular portfolio, the seller typically enters into an “agent bank agreement” with the acquirer in addition to a purchase and sale agreement (or, if the seller is not primarily a banking institution, a “co-branding” or “private label” agreement). The agent bank agreement allows the seller to continue to offer branded cards to its customers without having to incur the obligation of servicing those accounts. Under the terms of the agent bank agreement, the acquirer agrees to issue credit cards bearing the seller’s brand and the seller agrees to market the acquirer’s cards to its customers on an exclusive basis. Sometimes, the seller receives commission payments tied to measures such as credit transaction volume or number of new accounts. By their terms, these arrangements frequently last five to seven years or longer, so close attention should be paid to ensure that a workable framework — not unlike a joint venture — is established. In addition,

these arrangements often contemplate a repurchase right for the seller of some or all of the receivables at the end of the term, so it is critical for the parties to address the repurchase triggers and terms as well as whether the acquirer will retain any customer data or other rights, with the view of facilitating future partnering transactions for the seller.

Furthermore, since these agreements are exclusive, this framework should reasonably anticipate potential complications such as a change of control of either the seller or acquirer, which could well raise sensitive competitive concerns. Unanticipated change-of-control scenarios can arise and can be difficult to resolve if not provided for in the agent bank agreement. For example, agent bank agreements often provide that any banks acquired by the seller or its affiliates become subject to the agent bank agreement. Accordingly, if the seller were to acquire, or become affiliated with, a small bank, the acquired bank would also become subject to the agent bank agreement. That is, the acquired bank would cease to issue credit cards and transfer its credit card portfolio to the acquirer. The acquired bank would also commence offering to its customers credit cards issued by the acquirer under the existing agent bank agreement. The parties should also include appropriate prohibitions on acquirer's rights to sell receivables and should address acquirer change-of-control scenarios and termination or other rights that would be triggered by such events.

However, sometimes left unaddressed in agent bank agreements are the scenarios where a seller, subject to an agent bank agreement, is acquired by a larger banking organization (or a smaller bank in a reverse merger) or enters into a merger of equals. These and other scenarios should be addressed. Different outcomes may be warranted in each case. Under certain circumstances, it may make sense for the agent bank agreement to terminate and for the party being acquired or merging to pay to the other party a termination fee representing some measure of the acquirer's expected economics for the remaining term of the agreement. Alternatively, the agent bank agreement could provide that, in the event that the seller acquires or merges with another banking organization that is a credit card issuer, the acquirer has a right of first refusal to purchase the credit card business. In the event that the acquirer declines, the agreement can further provide that the credit card portfolio be divested.

An additional consideration for both the acquirer and the seller is whether it would be desirable to have different outcomes depending on the identity of the acquirer or the merger partner. As an example, a seller should consider whether it would be desirable to continue the agent bank agreement if the acquirer were acquired by a chief competitor of the seller, and vice versa. In that instance, the party not being acquired may wish to terminate the agent bank arrangement rather than cede some control of its credit card program to a close rival.

In negotiating these change-of-control provisions, consideration should also be given as to the appropriate outcome if an acquired bank, acquirer or merger partner is already subject to an agent bank agreement but with a different acquirer. Because agent bank agreements generally require that a seller market to its customers credit cards issued by the acquirer on an exclusive basis, a merger of two banks that results in competing agent bank agreements can present difficult conflicts if not carved out from non-compete provisions.

The importance of these provisions was highlighted in connection with the purchase by First USA of Wachovia's credit card receivables in 2001. The portfolio had an aggregate

principal amount of approximately $8 billion and represented approximately 2.8 million customer accounts. One week after the transaction was announced, Wachovia announced that it had agreed to merge with First Union. First Union had sold its credit card business to MBNA the previous year and had entered into an agent bank agreement with it.

The challenges of reconciling the two agent bank agreements ultimately resulted in an announcement by Wachovia and First USA that they had decided to end their agent bank relationship. In addition, First USA announced it would sell back to Wachovia approximately $1.3 billion of consumer credit card receivables of customers who also have a Wachovia retail banking relationship. First USA stated that it would retain approximately $6.2 billion in receivables of cardholders who were not otherwise customers of Wachovia's retail bank. Wachovia also agreed to pay First USA a $350 million termination fee as well as to reimburse First USA for the premium paid for the repurchased receivables and the conversion costs related to the repurchase.

Another critical issue arising in connection with the negotiation of agent bank agreements is the scope of the non-compete covenant. The selling bank typically covenants that it will not engage in the business of issuing credit cards for the duration of the agent bank agreement in order not to compete with the acquirer. Care must be exercised to ensure that the non-compete does not unnecessarily limit the selling bank from acquiring or being acquired by another entity that engages or may wish to engage in the credit card business. The non-compete should also address the extent to which the selling bank may offer new or existing financial products that may have some of the characteristics of credit cards, or from soliciting cardholders to purchase non-card financial products and services from the selling bank. The parties may also decide to give the acquirer a right of first offer or right of first refusal with respect to some categories of new products.

Customer non-solicitation covenants are equally important. Under these provisions, the acquirer agrees not to market or solicit the seller's customers for any financial products or services other than credit cards or other agreed products bearing the seller's brand and issued under the agent bank agreement. Exceptions may include solicitation incidental to marketing campaigns targeted at the general public.

In this regard, both parties should ensure that the agent bank agreement provides an effective process for the development of a mutually satisfactory marketing plan. This may be done, for example, by providing in the agreement for the formation of a marketing coordination group consisting of representatives from both the seller and acquirer that would lead the development of a marketing plan. This group would then meet on a regular basis to update the marketing plan. Depending on the respective leverage and needs of the parties, the responsibility of this group can also be expanded to include approval of business plans, servicing standards and other significant aspects of the relationship.

Finally, in those transactions where the continuing issuance of credit to the seller's customers, and related service standards, are critical to the seller's remaining business, such as when a retailer "outsources" its credit card business, the seller should also seek protection — sometimes in the form of penalties or termination rights triggered by specified events — to ensure that the interests of the seller and the acquirer are aligned and to minimize the possibility

of damaging the seller's remaining business as a result of tighter credit or lower service standards.

If a seller has sold some, but not all, of its credit card business, in lieu of an agent bank agreement, a seller may request to simply enter into a servicing agreement with the acquirer that will permit the seller to retain its existing credit card accounts and receivables and utilize seller's former infrastructure in support of the retained portfolio for a period of time. Such arrangements are similar to a "reverse" interim servicing agreement, except that they may be relatively long-term as the seller will need support until it can effectively rebuild or outsource alternative infrastructure. Because these servicing agreements are longer-term, sellers may request more detailed and restrictive controls on the acquirer's business than is typical in an interim servicing agreement, such as restrictions on subcontracting and more intrusive quality-control, audit and monitoring provisions. Seller's desire for such provisions can be driven by regulatory guidance on appropriate monitoring of third-party service providers, such as OCC Bulletin 2001-47. Acquirers, reluctant to agree to detailed quality standards and invasive controls on a business they just acquired, will often insist that they not be responsible for failing to provide services to a level of quality not provided by the seller pre-closing and that any operating restriction is narrowly tailored to satisfy applicable regulatory concerns while not unduly burdening acquirer's other businesses.

### D. Other Documentation

The parties also typically enter into an interim processing agreement to govern the conversion of the credit card accounts from the seller's operating system to the acquirer's operating system. In addition, the parties enter into licensing agreements granting the other party the right to use the other's brand names and trademarks largely to facilitate coordinated marketing efforts or until the purchased portfolio can be re-branded.

### E. Closing the Transaction

Once the documentation for a credit card sale has been entered into, the closing process is fairly straightforward. If the transaction does not represent the sale by the selling bank of substantially all of its assets or the transfer of any deposits, there may be no need for any prior bank regulatory approvals. However, a notice may need to be filed under the Hart-Scott-Rodino Act. The bulk of the closing preparation is generally the extensive operational planning that must be done to convert the credit card accounts from the seller's operating platform to the acquirer's operating platform or to transfer the operating platform itself from the seller to the acquirer, which may often involve significant cooperation with third-party service providers. In the sale of co-branded or private-label portfolios, the closing and transition process may also require coordination with the applicable branded partner.

## VI. TENDER AND EXCHANGE OFFER OPTIONS

Unlike most bank acquisitions, which require a lengthy regulatory approval process, many non-bank acquisitions can be completed on an expedited basis. Where no formal regulatory application is required and the consideration offered is cash, a cash tender offer or an exchange offer, which enables the acquirer to complete its acquisition in as few as 20 business

days, may provide attractive alternatives to the more time-consuming merger process that must be used in most bank acquisitions. GE Capital structured its acquisition of Heller Financial as a tender offer. Credit Suisse and Chase also utilized the tender offer structure to complete their respective acquisitions of Donaldson, Lufkin & Jenrette and Hambrecht & Quist, as did Charles Schwab in its acquisition of SoundView. Tender and exchange offer structures are occasionally used in bank acquisitions as well, such as Ford Financial's acquisition of a majority stake in Mechanic's Bank.

Tender and exchange offers are attractive to bidders and target companies alike, because they reduce the risk of non-consummation and enable acquisitions to be completed promptly following the execution of a definitive agreement. No target shareholder vote is required and, due to the short time frame involved, the risk of third-party interlopers is limited. Tender and exchange offers are particularly attractive in situations where limited lockup protections are available.

Tender offer or exchange offer structures are available even where a prompt consummation of the transaction is not envisioned, although most of the benefits of the structure are lost in such circumstances. It is cumbersome, although not impossible, to keep a tender or exchange offer open over a period of several months. If other approvals are required before closing that might result in a lengthy process (such as regulatory approvals or fund shareholder approvals where the target is an asset manager), the tender offer approach may be less attractive. However, potential benefits sometimes include facilitating the acquisition of a substantial (but less than 100%) stake from a large number of shareholders without the need to negotiate with numerous third parties.

Following announcement of a tender or exchange offer, bidders should proceed expeditiously to commence and complete the offer. A host of complex disclosure, procedural and market manipulation rules apply to the conduct of a tender offer and it is advisable to engage an experienced dealer-manager to oversee the offer. The engagement of a dealer-manager is a relatively simple process requiring the execution of a short agreement with the dealer-manager bank and is without many of the complexities of underwriting engagements. It is also advisable to engage expert legal counsel to navigate these complex disclosure and structural requirements.

Registered exchange offers may be commenced upon filing a registration statement and tender offer materials and dissemination to shareholders of a preliminary prospectus and related materials. Prior to 2002, exchange offers could not be commenced until the effectiveness of the registration statement, but now the registration statement need be effective only in order to accept tenders of shares (qualifications under applicable state blue sky laws may also be required).

## A. Elimination of Subsequent Offering Periods and Top-Up Options

"Subsequent offering periods" of up to 20 business days in the aggregate may be made part of the tender or exchange offer as a convenient way of acquiring enough shares to conduct a "short form" merger — without the need for target shareholder approval — under applicable state law, without incremental risk of non-closure to the target, because no withdrawal rights apply during the period. In other words, the acquirer can be assured of completing the

transaction, yet can continue to accept the tender of shares. Subsequent offering periods require that all shares tendered be accepted for purchase promptly upon expiration of the original tender offer period (as it may have been extended). Parties should take care that offering materials sufficiently advise target shareholders of the possibility that a subsequent offering period will be used in order to avoid potentially cumbersome prior notice requirements.

If the tender offer does not result in the acquirer reaching the required threshold for a "short-form" merger under applicable state law, the merger agreement may also include a "top-up" provision permitting the acquirer to purchase newly issued shares directly from the target in order to reach the requisite threshold. Targets occasionally negotiate requirements for the minimum percentage of shares that are required to be tendered for the top-up option to be triggered, and parties need to keep in mind the available headroom in the target's authorized share count under its charter, as well as the stock exchange requirements that an issuance of 20% or more of the outstanding shares requires shareholder approval.

The addition of Section 251(h) to the Delaware General Corporation Law in 2013 has largely decreased the need to utilize subsequent offering periods and top-up options in tender offer acquisitions of Delaware targets. Section 251(h) generally permits, subject to certain conditions, consummation of a merger to acquire all remaining un-tendered shares once the acquirer has accumulated more than a majority of the target's outstanding shares without conducting a target stockholder vote. Previously, an acquirer had to accumulate 90% of the target's outstanding shares to be able to acquire the remaining shares in a short-form merger without a target stockholder vote. Subsequent amendments in 2014, 2016 and 2018 eliminated the requirement for the acquirer to be a disinterested stockholder, made certain other clarifying changes in response to the statute's nuances being tested in practice and applied the "market-out" exception to appraisal rights under Section 262 available to transactions under Section 251(h).

### B. Consideration

There have been a number of financial institutions transactions in which different holders of target common stock have received different consideration for their stock — typically where the target has a controlling or significant shareholder and either that shareholder has special needs regarding the form of consideration or there are constraints on the acquirer's side as to the amount of stock and/or cash consideration that may be provided. The consideration may differ in type (cash vs. securities) or amount, although in most transactions there has been an equalization of the amount of consideration as of some point in time. For instance, in Tyco's acquisition of CIT Group, the significant CIT Group shareholder, Dai-Ichi Kangyo Bank, received a fixed amount in cash for its shares while the public received Tyco common stock, with the public exchange ratio being set to provide a per-share value equal to the cash to be received by Dai-Ichi Kangyo as of the signing of the merger agreement. In Credit Suisse's acquisition of Donaldson, Lufkin & Jenrette, the public received a fixed cash amount per share while AXA, DLJ's controlling shareholder, received the same cash amount for a portion of its shares and Credit Suisse stock for the remainder, again at a fixed exchange ratio set to provide equivalent value to the cash consideration based on Credit Suisse's stock price at signing.

The Credit Suisse/DLJ transaction was structured as a cash tender offer for the public shares, while the Tyco/CIT Group transaction was structured as a merger. In both cases, a

merger agreement covered the acquisition of the public shares, while a separate purchase agreement governed the acquisition of the shares from the major shareholder. When such differential consideration is used and/or separate agreements with certain shareholders are employed, special considerations arise not only under relevant state corporate law but also under the SEC's tender offer rules, and the transaction must be structured with these restrictions in mind. For example, Rule 14d-10 requires that the consideration paid to any shareholder pursuant to a tender offer be the highest consideration paid to any other shareholder during the tender offer. The Ninth Circuit in *Epstein* v. *MCA, Inc.*, 50 F.3d 644 (9th Cir. 1995), refused to confine Rule 14d-10 to payments made "during" a tender offer, although that is what the words of the rule provide. Decisions in some important circuits continue to adhere to a similarly broad reading of Rule 14d-10, while others construe the rule more narrowly. As a result, practitioners must use care in structuring side agreements for particular shareholders in the context of a deal structured to include a tender offer. In the case of Credit Suisse/DLJ, the record was clear as to the intent that the stock consideration be valued the same as the cash consideration in the merger at signing and that AXA would have preferred to receive 100% cash for its shares, as the public had.

For a period of time there was uncertainty regarding the interaction of Rule 14d-10's best price provisions and common-place management compensation and incentive arrangements. Some jurisdictions held that compensation payments made to executives in the context of a deal violated Rule 14d-10. However, in November 2006, the SEC adopted amendments to the tender offer best-price rule to clarify that Rule 14d-10 applies only with respect to the consideration paid for securities tendered in the offer and does not include employee consideration under severance or other employee benefit arrangements. Rule 14d-10 provides a safe harbor in the tender offer context allowing the applicable compensation committee to approve the arrangements and deem them to fall within the meaning of the exception. It is important for the seller and acquirer to understand the consequences of the tender offer structure under the seller's equity compensation plans and change-of-control arrangements, as this structure raises the possibility that the tender offer will close, triggering the vesting of equity awards and other change-of-control provisions, prior to the consummation of the merger, which may give rise to retention issues.

The use of a tender offer structure adds other considerations where a separate agreement is struck with a major shareholder to purchase its shares outside of the offer/merger that will apply to public shareholders. Rule 14e-5 prohibits, in connection with a tender offer for equity securities, from the time of public announcement of the tender offer until it expires, an offeror and certain related persons from directly or indirectly purchasing or arranging to purchase those equity securities other than as part of the tender offer, and applies whether or not the consideration in such outside purchases is identical to that in the tender offer. However, Rule 14e-5 contains an exception for purchases under a contract entered into before public announcement of the tender offer that is "unconditional and binding on both parties" and that is fully disclosed in the tender offer materials. Where a major shareholder's shares will be purchased pursuant to a separate private stock purchase agreement, care must be taken as to how closing conditions are structured in the merger agreement and the separate agreement and otherwise to structure the transaction so as not to run afoul of Rule 14e-5. Notably, Rule 14e-5 does not bar outside purchases during a "subsequent offering period" if the consideration to be paid in the outside purchases is in the same form and amount as that paid in the tender offer.

# CHAPTER 7.

# MERGERS OF EQUALS

Combinations between large companies of comparable size are often referred to generally as "mergers of equals" or "MOEs." Structurally, an MOE can be accomplished by having both companies' stocks surrendered and a new company's stock issued in their place or by having one of the companies issue its stock for its merger partner's stock, often with no control premium being paid to either party's shareholders. And, while the term suggests that both companies are on an equal footing with one another after the deal is complete, in point of fact, other than the size of the parties, the "equality" of the two partners (*e.g.*, post-merger governance and management) varies substantially from transaction to transaction. All-stock MOEs between institutions of similar size with a small premium or no premium for shareholders have been common in financial institution M&A, as exemplified by the $28.3 billion merger of BB&T and SunTrust in 2019, as well as other significant banking transactions since, such as the $5.1 billion merger of Webster and Sterling, the $2.8 billion merger of BancorpSouth and Cadence, and the $3.2 billion merger of South State and CenterState. An MOE is a structure that allows an institution to roughly double in size and use the additional scale to drive cost savings and offset significant fixed costs, including investments in technology and consolidating and making branch delivery systems more efficient, often without a price tag that could otherwise make a transaction prohibitive.

In many MOEs, neither party's shareholders receive a control premium or transfer control. Instead, control remains with the public shareholders as a group. The exchange ratio is set to reflect the relative asset, earnings and capital contributions and market capitalizations of the two merging parties — typically, but not always, resulting in a market-to-market exchange. Premiums to market are also possible but are often relatively modest compared to those seen in outright acquisitions where one party is usually accorded control of the combined entity. Pricing restraint can create a "win-win" situation as a run up in the surviving company's stock on announcement of the deal directly benefits the merged company's shareholders.

MOEs are difficult to negotiate and even harder to execute. Because MOEs generally do not provide shareholders with a control premium, it is usually important that any proposed transaction be structured as a true combination of equals, with shareholders sharing the benefits of the merger proportionately. The appearance, and reality, of balance is critical in such situations. Common goals and a shared vision are key, and cooperation must begin at the highest levels of the institution, where painful decisions frequently must be made.

The successful implementation of an MOE requires careful advanced planning. A positive stock market reaction to the transaction is critical to reduce both parties' vulnerability to shareholder unrest and/or a competing offer following the announcement of the deal. Careful explanation of the financial terms and strategic rationale of the deal, and of management and governance arrangements, is of tremendous importance in assuring that the transaction is ultimately accomplished.

The risks involved in an MOE are graphically illustrated by two 2001 transactions: the break-up of the deal between British insurer Prudential plc and American General, with the

original parties ultimately terminating their merger agreement and American General being acquired by AIG, and the saga of SunTrust's ultimately unsuccessful attempt to break up the announced marriage of First Union and Wachovia. These transactions are discussed in more detail in Chapter 3. A third possible result is that an interloper may succeed at breaking up the original transaction but fail to win the prize for itself, as demonstrated by North Fork's success at stopping the Hubco/Dime merger in 2000, but its failure to accomplish a merger with Dime (which was ultimately acquired by Washington Mutual). Strong market support and a strong business rationale for the merger are needed to assure consummation of the deal, as demonstrated by the different outcomes in the Prudential/American General and First Union/Wachovia deals. Working out management and social issues at the highest levels is also vitally important.

It is important to keep in mind that, as commonly used, the term "merger-of-equals" refers to a range of transaction types between institutions of comparable size. There is no precise definition of the term and it does not describe a distinct legal transaction structure. The term encompasses a wide variety of governance arrangements. Some, like the mergers of Hancock and Whitney in 2011, Firstar and U.S. Bancorp in 2001 and AmSouth Bancorporation and First American Corporation in 2000, involved an institution acquiring another that had similar (or perhaps even slightly larger) size, but for various reasons may not have been as highly valued by the market, and the governance arrangements on their face reflect the essentially "acquisitive" nature of the deal, favoring the buyer to varying degrees. In other transactions, such as the merger of Webster and Sterling in 2022, the merger of South State and CenterState in 2020 and the merger of BB&T and SunTrust in 2019, the merger agreement may contain very detailed provisions regarding power-sharing on the board and the post-closing roles of specific executive officers from each of the parties. In any event, the market will usually make up its own collective mind about who is the "acquirer" in a transaction and may greet governance-sharing plans somewhat skeptically. As a technical matter, federal regulators will also designate one of the merger parties as the acquirer based on their substantive review of the transaction. While the economic impetus of the deal often comes from market and competitive conditions, much of the power-sharing arrangements will depend on the *ex ante* bargaining power of the parties as the merger is negotiated; the final governance terms will reflect what is needed to reach agreement in a particular set of circumstances.

Another significant aspect of some of the large strategic mergers of two strong parties has been a strong commitment to non-shareholder constituencies. A number of these major mergers have included strong commitments and reassurance to communities in terms of maintaining employment levels, charitable giving and locating key businesses in their footprint, as well as top management roles for key executives. Such commitments require thought and care in crafting and strong follow-up and communication after a merger closes; local officials, community groups and the press have focused on these commitments and have been quick to jump on evidence that they believe suggests the parties are not fully honoring them.

## I. THE ADVANTAGES OF AN MOE STRUCTURE

For companies seeking to expand, MOEs can be an attractive avenue for gaining the increased scope of operations needed to remain competitive. MOEs can help enhance shareholder value through merger synergies and can be less costly than high-premium

acquisitions. A low-premium MOE structure may represent the most effective avenue available to a would-be acquirer for a large-scale expansion. On the other hand, such pricing can send a signal that the issuer may not have the firepower to compete with a financially stronger interloper. As a result, a vital part of planning an MOE is to gauge the perception of the parties in the marketplace, the credibility of the parties' story about the deal and the likely scenarios that may develop after announcement. MOEs are thus best executed by parties with strong market credibility.

MOEs are also an attractive alternative for smaller and mid-sized institutions that would not otherwise have the interest, opportunity or financial capability to launch a large-scale expansion program. These institutions must either carve out a successful niche strategy at their then-current scale of operations or give serious consideration to a sale to, or merger with, a larger institution.

An outright sale of an institution is often an unattractive alternative for a variety of business, economic and social reasons. Management and boards properly perceive their duty as managing their institutions for the long-term benefit of their shareholders and other significant constituencies. While some sales can be highly beneficial for shareholders, they typically result in the loss of the institution as an independent presence in its community — which can be especially significant for older, well-established institutions. Shareholders, too, can lose in an outright sale or merger with a larger acquirer by being cashed out of their investment prematurely or being forced to accept an equity security in an institution that is significantly different from the one in which they originally invested. The best business fit for an institution may be combining with a comparably sized local or adjacent market competitor that best complements its operating strengths and long-term business strategy.

In any stock-for-stock merger transaction, the value of the consideration received is highly dependent upon the combined company's future performance. Often, there is no better way to protect the shareholders' investment than to ensure a significant continuing management role for both companies' existing directors and management team. In most of the larger MOEs, there has been substantial balance, if not exact parity, in board representation and in senior executive positions. The 2019 BB&T/SunTrust merger is a good example, with a 50/50 board split, a senior management team equitably divided between the two parties disclosed as part of the initial rollout of the transaction and a transition plan in which BB&T's CEO would remain Chairman and CEO of the combined company for an approximately two-year period, at which point he would transition to Executive Chairman for a one-year period and SunTrust's CEO would become CEO and ultimately, Chairman. MOEs also allow the combined company to leverage the strengths of both management teams using a "best athlete" approach, thus enhancing long-term shareholder value. Many MOEs, especially in-market MOEs, allow the parties to achieve significant cost savings and operational efficiencies, again borrowing the best from both institutions. Assuming a proper exchange ratio is set, MOEs allow for a fair and efficient means for the shareholders of both companies to share in the merger synergies.

MOEs are not right for all companies, and the rationale for any MOE transaction must be carefully considered in advance. Parties to an MOE should expect their transaction to be closely scrutinized by the analyst, investor and acquirer communities, who will eagerly jump at the opportunity to exploit any weakness in the rationale put forward for the proposed deal. Low-

premium MOEs involving a foreign issuer may be further complicated as the price of the issuer's currency may be negatively impacted by low liquidity in U.S. markets and by "flow back" concerns, widely noted in connection with the negative market reaction to Prudential plc's announcement of merger plans for American General (that being said, flow back concerns have been hard to precisely quantify, both in terms of severity and duration of the price effect, and cross-border mergers with strong underlying strategic rationales should likely not be derailed on this basis alone.) Confidentiality during the often tricky stages of negotiating an MOE is absolutely paramount, as the combination of a range of difficult issues to be negotiated, the absence of a substantial takeover premium and (often) the prospect of a potent new competitor being created make such transactions particularly susceptible to dissident shareholder campaigns and competing bids.

## II. RESOLVING THE KEY GOVERNANCE ISSUES

After agreeing on the business goals and means to enhance shareholder value, partners to an MOE must seek to achieve an efficient balance in key management and operational areas. Management compatibility is very important, and MOE agreements are almost always struck at the CEO-to-CEO level.

Key issues to be addressed include:

- the split of the board (sometimes a 50/50 split, although a number of situations have involved a slight majority in favor of one party; agreements concerning committee structure, chairmanship, membership and specified supermajority vote requirements may also be included);

- the split of the Chairman and CEO positions (frequently one party gets the Chairman position (which may be an "Executive Chairman" position) and the other party gets the CEO position, although sometimes the CEO of one party assumes both the Chairman and CEO title while the CEO of the other party may be guaranteed the title after a specified transition period; co-CEO positions, while often unwieldy, are sometimes used; retirement age and use of consulting agreements are often taken into account);

- the selection of the combined senior management team (typically involves retention of executives from both companies; the specific allocation of duties among key management team members is often addressed, sometimes in exacting detail; existing employment arrangements must also be considered; employment contracts often require modifications to protect employee and company interests and to reflect the newly proposed management structure);

- the rationalization of separate corporate cultures (including attitudes toward, and practices regarding, compensation, employee benefit and incentive plans, management styles, business strategy, use of technology, operating priorities, community involvement and reinvestment and future business strategies);

- identification of merger synergies (a fair sharing of the human pain and operational disruptions associated with the proposed merger synergies is important, as is a unified approach to severance arrangements);

- the company's name (any number of options exist, *e.g.*, a new name, a combined name, retention of one of the old names, retention of one name for some operations and the other name for other operations);

- location of corporate headquarters and other key operations (often based on costs and operational considerations, but can be a key social and constituency issue when the institutions are headquartered in different cities or states);

- legal structure of the merger and choice of a surviving entity (the manner in which the merger is structured can affect the public perception as to whether one of the parties is "being acquired"; legal structure can also have important tax, accounting, regulatory and state law consequences, including the required shareholder vote; "newco" structures are sometimes used to avoid having to choose between either of the merging parties or to effect other changes deemed to be desirable going forward, such as a change of domicile); and

- the exchange ratio (the amount of the premium, if any, and how the premium is expressed can have an important impact on the public perception of the transaction; the *pro forma* dividend payout ratio must also be considered; for example, in JPMorgan Chase/Bank One, it was agreed that Bank One could after signing immediately increase its dividend to JPMorgan Chase's level on a *pro forma* basis, and in First Union/Wachovia, SunTrust, as the interloper, made the dividend that Wachovia shareholders would receive a key issue in attacking the First Union/Wachovia transaction).

In most transactions, there is a trade-off among these various key issues, as the parties strive to achieve a mutually acceptable balance of power.

Negotiating a mutually acceptable balance of power is often difficult, and may actually run counter to the long-term objective of ensuring a successful integration of two institutions (which may require the existence of one dominant, visionary force within a company's management and certainty as to "who's in charge" during the critical integration process, both before and after closing). The success or failure of an MOE may depend on the strength of the CEOs who bring the transaction together and their ability to effectively ensure a smooth transition towards a new unified corporate culture. Many will be watching from the outside for signs that the management structure is sufficiently stable and effective to assure that synergies can be realized, and community activists can be expected to look for opportunities to gain concessions on CRA issues. No one or easy formula for success exists. Often, the strength of arrangements protecting governance or succession agreements must be balanced against the need to avoid creating a balkanized organization. Accordingly, each situation must be judged on the basis of individual facts and circumstances, with sensitivity to the personalities involved and their respective talents and weaknesses.

At the outset of any MOE, it is essential to recognize that the best legal protections in the world are inadequate substitutes for a deeply held commitment and trust, based on a potential partner's past performance, behavioral style, reputation and culture. Each organization is unique and differing management styles are common. It is impossible to envision all of the pitfalls and complexities that will arise, so the compatibility of objectives, philosophies and personalities is required.

The discussion and resolution of governance issues should be handled carefully to avoid any actual or perceived conflict of interest. The personal interests of directors or officers must not be put before the interests of the institutions' shareholders, depositors, employees and other important constituencies. Arrangements that ensure that shareholder, employee and community interests are properly protected are legitimate to consider.

Once an agreement is reached concerning the key governance issues, it will be important that appropriate provisions are put in place to ensure that both parties live up to the bargain. Nothing is as certain as the fact that, no matter how close the parties are before the transaction, "things *will* change after the merger." While no set of legal rules can fully protect the parties against changes that occur after a merger, some basic protections should be built into the merger agreement, the key executives' employment agreements and, in some instances, even the new company's charter, by-laws and operational statements. Among other areas that may deserve written protections are: principal executive officer successorship provisions, board successorship provisions (both pre- and post-merger for a specified duration) and any super-majority voting provisions. For example, the combined company may adopt by-laws that govern the succession of one constituent's CEO to CEO of the combined company, the size and composition of the board, the manner in which director vacancies are filled and other social issues, such as the location of the headquarters of the combined company or its key business units. Parties should recognize that all factors should be taken into account, and that overly complicated or elaborate provisions regarding power sharing may be taken by the market as a sign that the two organizations are less likely to meld successfully after the merger. Also, when thinking about amendments to charters and by-laws to become effective upon closing, parties should keep in mind the SEC staff's views regarding "unbundling" of proposals in the proxy statement and consider whether a given structure can be optimized so that the SEC Staff is likely to require fewer separate proposals on the proxy card.

## III. THE MOE MERGER AGREEMENT

The merger agreement for an MOE should be a balanced contract with matching representations, warranties and interim covenants from both parties. MOEs are typically structured as tax-free, stock-for-stock transactions with a fixed exchange ratio without collars or walkaways, and the contract will need to address the standard provisions applicable to stock-for-stock transactions. MOE agreements generally include only limited closing conditions. It is also customary for the agreement to contain a mutual strong no-shop provision and only such fiduciary duty exceptions as required by law.

Rapid execution is crucial in public company transactions generally and assumes even greater importance in the MOE context. Defining the appropriate scope of pre-signing due diligence, and confidentiality in general, is a critical issue, since premature disclosures or leaks

can seriously jeopardize such typically low-premium deals. Each situation must be assessed carefully to achieve the proper balance of pre- and post-signing due diligence and integration planning, and parties should recognize the risks of either too large or too small a pre-signing due diligence process. A model that appears to have worked well in a number of transactions is to conduct a good deal of the "high level" diligence through meetings among a very small group of the most senior executives — the CEOs and, eventually, the CFOs and perhaps the General Counsels, without any outside advisors or accountants. When agreement on the terms of a transaction appears likely, parties then bring in a broader (but still no larger than necessary) group of the senior teams on both sides to conduct intense, face-to-face diligence sessions in key areas (*e.g.*, key business lines, financial/accounting, risk management, regulatory, legal, operations and human resources) over a period of several full days preceding the target date for signing the merger agreement.

Any institution considering a potential MOE transaction should be prepared for a deliberate and painstaking process. MOEs are rarely put together overnight and often involve months, and sometimes years, of preliminary exploratory conversations before getting to the detailed diligence and execution stage. Given the complex business considerations and personality issues presented in an MOE transaction, it is not surprising that many MOE discussions never result in a transaction. In light of this fact, institutions should not place too great a weight on early exploratory meetings, and should be cautious to avoid external leaks and the build-up of internal expectations.

As history has shown, a poorly planned MOE can be a recipe for disaster. When all things fit, however, an MOE can be the most successful form of business combination. Some of the most successful and largest bank holding companies today are the result of successful MOE transactions — and many of the financial institution powerhouses of the future will likely be the result of MOEs yet to be envisioned.

## IV. FIDUCIARY ISSUES AND FAIRNESS OPINIONS IN MERGERS OF EQUALS

MOEs usually do not involve a "sale of control" of either company within the meaning of the applicable case law on directors' fiduciary duties (discussed in Chapter 3); instead, control remains with the public shareholders as a group (absent a controlling shareholder of the post-merger entity). Accordingly, directors have broad discretion under the business judgment rule to pursue an MOE transaction that they deem to be in the best long-term interests of their institution, its shareholders and its other important constituencies, even if they recognize that an alternative sale or merger transaction could deliver a higher premium to their current market value.

MOEs are not comparable to sales of control. An MOE can be fair even though the post-announcement trading value of a company's shares is less than that which could be achieved in a sale transaction. It is prudent, however, for a board, as part of its deliberative process, to consider what alternative business strategies might exist, including an affordability analysis of what potential acquirers could pay in an acquisition context. The Delaware courts, in the *Time/Warner* and *Paramount* decisions and elsewhere, have indicated that directors have wide latitude in pursuing long-term strategic objectives through an MOE or similar strategy that does not involve a sale of control. (Notably, the original Paramount/Viacom merger in 1994 was a

rare example of a purported MOE that actually involved a change of control — since the post-merger entity would be controlled by one individual.) Case law has confirmed that directors will continue to have such wide latitude outside the sale of control context — including confirming the lack of a duty to pursue negotiations of an unsolicited third-party offer — but has emphasized the importance of a process that ensures that directors are well-informed before the agreement is signed and retain reasonable flexibility to stay informed thereafter. (The unusual situation where a party has a controlling shareholder that can single-handedly deliver the required shareholder vote will involve extra considerations under current Delaware law.)

An MOE should be analyzed on its own merits with active board involvement. Detailed presentations should be made to the boards concerning the benefits of the transaction and the plans for integrating the two institutions, ideally over a period of several meetings. A thorough analysis of the strengths and weaknesses of the merging parties, including a critical assessment of the due diligence results and the projections, forecasted synergies and related restructuring changes, is also appropriate. There are far too many examples of failed MOE transactions, and boards considering the benefits of a proposed MOE should carefully consider these lessons of the past. Frequently, a merger partner may be engaged in an entirely different line of business and it is important for a board to gain a comprehensive understanding of that business and the associated risks and opportunities, with which it may not be familiar (including any internal controls, management or compliance issues particular to such businesses). Systems integration issues must also be addressed, as the scale of any needed changes may be massive and successfully navigating them is often a prerequisite to a substantial portion of the planned cost savings.

A fairness opinion is important for both institutions. Fairness opinions in MOE transactions must be carefully crafted to provide clarity as to what is and is not being covered in the opinion. While extensive explanations are not required, or in most instances useful, it is important to avoid the impression that the opinion is attempting to compare the proposed MOE to a sale of control. Careful attention to the proxy statement disclosure relating to the fairness opinion is also important. In situations where competing offers have been received by one or both of the merging parties, care should be taken in crafting the appropriate response and in drafting language for the fairness opinion and the related proxy statement disclosure. Emphasis should be placed on the board's independent business determination that pursuing an MOE as opposed to a sale of the company is the best long-term business strategy for the company.

## V. PROTECTING THE DEAL

MOEs have, in the past, attracted attention from potential interlopers questioning whether there was a way to step forward and acquire one, or in some MOEs even both, of the merger partners. Given the way in which MOEs can instantly reshape the competitive landscape in an industry, such interest is not surprising. However, to date, relatively few U.S. bank or thrift acquirers have been willing to step forward in an active effort to break up an announced deal — and where they have, the results have been mixed. Such bids should be approached on a careful and opportunistic basis. Market perceptions of a relatively weak issuer can help, as can dissatisfied investors.

While no protection is iron-clad, steps can be taken to protect an MOE transaction. First and foremost, it is important to recognize that the period of greatest vulnerability is the period before a deal is signed and announced. Leaks or premature disclosure of MOE negotiations can provide the perfect opening for a would-be acquirer to submit an acquisition proposal designed to derail the MOE talks or pressure one party into a sale or auction. Nothing will kill a low premium MOE faster than a run-up in the stock of one of the merging parties — whether or not the run-up is based on takeover speculation — because no company wants to announce an MOE reflecting an exchange ratio that reflects a substantial discount to market. Keeping the number of involved parties to an absolute minimum and developing a confidentiality protocol — perhaps even a written page of bullet points — may be useful to enforce strict secrecy about a proposed deal. In some cases, outside advisors have been asked to defer bringing on their own external advisors (such as outside counsel), and to specifically identify those within their organization who will be brought into the circle and not to expand that group without prior permission from the client.

Once deals have been announced, most financial institutions continue to be reluctant to step in. A strong and unwavering commitment by both parties to a deal will help discourage interlopers, while any indication of internal dissension will encourage intervention. A strong market rollout and careful strategy for explaining the rationale of a deal to the market is important, as it can be considerably easier to bust up a deal that market analysts dislike than one that they applaud. A prime example of this is the AIG/American General transaction; the market's negative reaction to the Prudential plc/American General deal, together with positive market perception of AIG, was likely a substantial factor in AIG's success in that situation. The CVS/Caremark/Express Scripts battle in 2007 demonstrates the vulnerability that a deal can experience resulting from a weak market rollout. In response to the initially negative market reaction to the CVS/Caremark merger announcement — which called for Caremark shareholders to receive stock of CVS at close to no premium — Express Scripts, a competitor less than half Caremark's size, launched an aggressive part-cash, part-stock counter offer for Caremark.

Despite the highly conditional nature of Express Scripts' bid, the market embraced the competitive battle, pushing higher the shares of both Express Scripts and Caremark in anticipation of a bidding war. Both CVS and Caremark remained firmly committed to their strategic combination and waged an aggressive campaign to gain shareholder support for the CVS deal, which ultimately was approved after Caremark negotiated with CVS to increase its offer through the issuance of a special cash dividend to Caremark's shareholders. The take-away from both the CVS/Caremark and AIG/American General transactions is that great thought and care must be put into the initial marketing of a transaction, the first step of which is to have a strong investor presentation by the two CEOs, as this presentation will set the tone and focus the market on the key merits of the deal. A base of good shareholder and community relations can also be important for deterring interlopers.

Finally, structural protections such as cross-stock options or cash breakup fees and support commitments are both necessary and appropriate. Cross-stock options may be appropriate if the option terms are reasonable and do not deprive shareholders of a fair opportunity to vote on the proposed transaction. As noted in Chapter 4, the use of lockup options has become exceedingly rare, and some have questioned the continued utility of lockup options (as opposed to breakup fees) after the end of pooling many years ago. However, there

still may be an incremental deterrent effect to an acquirer's ability to obtain a significant equity position in a target, and lockup options can be given cash put features, cash floors and value caps that enable them to simulate very closely a cash breakup fee. The justification for strong breakup protection, such as an option, is most robust in the context of a proposed MOE. Since an MOE generally does not involve a sale of control of the company, parties to an MOE should send a strong signal that they have no intention of engaging in a sale of control transaction, even if their MOE transaction is voted down by shareholders.

MOEs require the expenditure of enormous resources to even begin, much less see to fruition, a process that can often take months to complete and that involves substantial monetary and opportunity costs. Cross-stock options or cash breakup fees, relatively robust agreements by both parties not to shop their companies after a deal is announced and an agreement not to terminate a merger agreement in the face of a competing offer, without first giving the shareholders a fair opportunity to vote on the merger, are all proper and appropriate. Under the Delaware merger statute and those of most other common jurisdictions, merger partners can make a binding commitment to bring a deal to a stockholder vote, even in the unlikely circumstance where an interloping bid results in the board withdrawing its recommendation of the MOE transaction. Utilization of a rights plan may also be appropriate in certain circumstances.

# CHAPTER 8.

# THE REGULATORY APPROVAL PROCESS FOR ACQUIRING BANKS AND BANK HOLDING COMPANIES

This chapter provides an overview of the statutory framework governing the acquisition of banking organizations as well as the regulatory approval process for bank holding company acquisitions as set forth in the regulations of the Federal Reserve that are currently in effect.

An acquisition of a bank or bank holding company differs from most other types of acquisitions by virtue of the elaborate system of applicable statutes as well as the extended regulatory approval process. The statutory authority for federal regulation of acquisitions of banks, other insured depository institutions, bank holding companies and other insured depository institution holding companies, and their respective subsidiaries emanates primarily from:

- The Bank Holding Company Act (the "BHC Act"), 12 U.S.C. § 1841 *et seq.*, which regulates acquisitions of control of a bank or bank holding company by a "company," as well as the acquisition of foreign subsidiaries and the commencement or acquisition of companies engaged in non-bank activities by a holding company or non-bank subsidiary. 12 U.S.C. §§ 1842; 1843;
- The Bank Merger Act, 12 U.S.C. § 1828(c), which regulates mergers between insured depository institutions and acquisitions of assets and assumptions of liabilities of one insured depository institution by another;
- The Home Owners' Loan Act, 12 U.S.C. § 1467a *et seq.* ("HOLA"), which regulates acquisitions of control of savings associations and savings and loan holding companies; and
- The Change in Bank Control Act of 1978, 12 U.S.C. § 1817(j) (the "Control Act"), which governs all acquisitions of control of a depository institution or holding company by an individual, a company (other than a bank holding company or savings and loan holding company), other entity or any group of the foregoing. The Control Act and implementing regulations provide that if a proposed acquisition is subject to the application and approval requirements of the BHC Act, HOLA or the Bank Merger Act, then the acquiring person need not comply with the Control Act. 12 U.S.C. § 1817(j)(17).

Each of these statutes and the accompanying regulatory approval process are discussed below. For a summary of the federal regulatory framework applicable to banks and thrifts, as well as a discussion of the applicable supervisory frameworks, please see Annex B.

## I. BANK HOLDING COMPANY ACT CRITERIA

Under the BHC Act, prior approval by the Federal Reserve is required for the direct or indirect acquisition by a "company" of "control" of a bank or of substantially all of the assets of

a bank. Prior Federal Reserve approval also is required under the BHC Act for an existing bank holding company to (a) acquire "direct or indirect ownership or control" of voting shares of a bank or bank holding company if it will own or control 5% or more of any class of voting shares after such acquisition or (b) merge with another bank holding company. 12 U.S.C. § 1842(a). Such approval is not required for the acquisition of additional shares in a bank or bank holding company by a company that already owns or controls a majority of the voting shares prior to such acquisition. 12 U.S.C. § 1842(a)(B); 12 C.F.R. § 225.12(c).

Section 3(c) of the BHC Act, 12 U.S.C. § 1842(c), sets out the criteria that the Federal Reserve must apply in acting upon Section 3 applications. 12 C.F.R. § 225.13. In reviewing the proposed acquisition of a bank or a bank holding company, the Federal Reserve considers the impact of the proposal on:

- competition;
- the financial condition of the parties and the future prospects of the combined company, including whether current and projected capital positions and levels of indebtedness conform to the Federal Reserve's standards and policies;
- the competence, experience and integrity of the officers, directors and principal shareholders of the two parties, including their record of compliance with laws and regulations and history of integrating acquired banking entities into the company and the soundness of the organizations' risk management systems and integration plans;
- the extent to which the proposed transaction would result in greater or more concentrated risks to the stability of the U.S. banking or financial system;
- the effectiveness of the company in combating money laundering activities; and
- the convenience and needs of the communities to be served, including the records of both parties under the Community Reinvestment Act ("CRA") and fair lending and other consumer protection laws.

Interstate transactions must meet the requirements of section 3(d) of the BHC Act; specifically, the following conditions: the acquiring bank holding company is well capitalized and well managed; compliance with state-imposed age limits, if any, subject to limits established under Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("Riegle-Neal"); after the acquisition, the bank holding company will not control more than 10% of the deposits in the United States or more than 30% of the deposits in any one state (subject to certain exceptions); the acquisition complies with any non-discriminatory deposit caps imposed under state law; and the Federal Reserve has taken into account the applicant's record of compliance with federal and state community reinvestment laws. Additionally, after Dodd-Frank, an insured depository institution or its holding company now cannot acquire another financial company if the consolidated liabilities of the acquirer would exceed 10% of the aggregate consolidated liabilities of all financial companies, subject to limited exceptions.

Depending on the size and complexity of the proposal, the approval process can be as short as 30 days or longer than six months. Data released by the Federal Reserve in its June 2023 Semiannual Report on Banking Applications Activity showed that the average processing time for mergers and acquisitions proposals in the first half of 2023 was slightly down from 81 days, for the same period in 2022, to 73 days, primarily as a result of fewer proposals receiving adverse public comments; median processing time remained about the same for the two periods. Nevertheless, there was a significant decrease in the number of proposals that were approved following adverse public comments, with 11 such proposals being approved in the first half of 2022 and only one such proposal being approved in the first half of 2023. 2023 proposals had both an average and median processing time of nearly one year. Moreover, in a decrease from prior years, approved mergers and acquisitions proposals accounted for only 15% of the total approved proposals in the first half of 2023. Given recent issuances and statements by leadership at the FDIC, OCC and the Federal Reserve, it is likely that both approvals and processing times for applications for large mergers and acquisitions proposals will be materially longer for some period of time moving forward. It is not clear at this time whether this will impact transactions of all sizes. As discussed in previous chapters, leadership at the FDIC, OCC and the CFPB have all expressed particular concern about transactions that may potentially impact competition or the financial stability of the financial system. Reflecting these concerns, in March of 2022, the FDIC requested comments on its regulatory framework for bank merger review, asking for input on, among other things, whether the existing framework is too lenient. 12 C.F.R. § 303. Later in the year, in October, the Federal Reserve and the FDIC solicited public comments on proposed rules to address the financial stability of large banks. 87 Fed. Reg. 64170 (Oct. 24, 2022). Though competition and the financial stability of the financial system are both current factors for review under the BHC Act, there have been aggressive calls from both agency and congressional leaders to reevaluate the criteria used to review these factors. Beginning in 2021, some Members of Congress called for a complete moratorium on approving bank merger applications over $100 billion until these issues are resolved. Though review of the bank merger framework is ongoing, it does not appear likely that such a moratorium will be seriously considered. In any case, banking organizations should anticipate longer processing periods with increased scrutiny from all of the agencies.

Although there have been renewed critiques of this approach, the Federal Reserve rarely denies bank holding company applications. Where there are serious concerns, the Federal Reserve communicates them to the applicant bank holding company prior to the application being filed or during the application process. Rather than deny the application, the Federal Reserve will more often encourage the applicant to withdraw or suspend processing the application. In the first half of 2023, 12 merger and acquisition applications (this number includes mergers and acquisitions, branch applications and the Control Act notices) were withdrawn after consultation with Federal Reserve staff due to technical or procedural reasons or because the proposals raised significant issues related to statutory factors for approval. This was a three-fold increase from the number of merger and acquisitions proposals that were withdrawn in the first half of 2022. The Federal Reserve confirmed, in its 2015 order approving M&T's application to acquire Hudson City, its policy of denying an application when material supervisory weaknesses arise after the application is filed and the applicant does not withdraw the application. The Federal Reserve also has emphasized that bank holding companies with material, unresolved supervisory issues should not submit applications for expansionary proposals.

Substantially similar criteria apply to acquisitions of savings associations or industrial loan banks under Sections 4(c)(8) and 4(j) of the BHC Act. Among other things, the Federal Reserve is required by Section 4(j) also to consider whether the transactions can "reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the U.S. banking or financial system." Section 4(j) of the BHC Act, 12 U.S.C. § 1843(j)(2).

The competitive effects criteria under the BHC Act are discussed in this chapter below.

## A. Financial Condition and Future Prospects

The BHC Act provides that, in considering proposed acquisitions of bank shares or assets, "[i]n every case, the Federal Reserve shall take into consideration the financial and managerial resources and future prospects of the company or companies and the banks concerned." 12 U.S.C. § 1842(c). The Federal Reserve's consideration of this factor generally centers around the sufficiency of the resulting company's capital. This analysis turns on the following measures of capital adequacy: (1) whether the resulting company (and its subsidiary insured deposit institutions) will satisfy and sufficiently exceed the Federal Reserve's (and relevant federal bank agency's) published risk-based capital adequacy guidelines and requirements for well-capitalized status (which establish minimum levels of capital that bank holding companies are expected to meet); (2) how the resulting company's capitalization compares to the capitalization of the two combining companies; (3) whether the resulting company's capitalization would be sufficient for the company's risk profile; and (4) how the resulting company's capitalization compares to the capitalization of its peers. In assessing financial condition, the Federal Reserve also considers asset quality, earnings prospects, the impact of the proposed funding of the transaction, and the ability of the organization to absorb the costs of the proposal and the proposed integration of the parties' operations.

Recognizing the significant, unprecedented disruption brought by the Covid-19 pandemic, in 2020 and 2021, the Federal Reserve, along with the OCC and the FDIC, asked merger and acquisition applicants to address how the respective banking organizations had been impacted by the economic environment from an operations, risk management, as well as a capital and liquidity perspective. With higher interest rates and continued market volatility and inflation, the federal banking agencies will continue to expect applicants to address the impacts of the current economic environment and thoroughly discuss any underlying assumptions being made about the economy reflected in *pro forma* and projected financial and capital information in any applications submitted.

### 1. Capital Adequacy Guidelines and Related Measures

The Federal Reserve, together with the other federal banking regulators, has issued risk-based capital rules, which require bank holding companies to maintain certain ratios of qualifying capital to risk-weighted assets.[3] The minimum capital requirements vary depending

[3] The Federal Reserve Board maintains capital guidelines for state member banks, bank holding companies and thrift holding companies and the OCC maintains capital guidelines for national banks and federal thrifts. The FDIC

on the size of the bank holding company and are complex. As a summary, under current rules, qualifying capital includes:

- *Common equity Tier 1 capital*: This category includes only common stock, related surplus, retained earnings and qualified minority investments.

- *Additional Tier 1 capital*: This category includes non-cumulative perpetual preferred stock, certain qualifying minority interests, and for bank holding companies with less than $15 billion in consolidated assets, cumulative perpetual preferred stock and grandfathered trust preferred securities.

- *Tier 2 capital*: This category includes subordinated debt, certain qualifying minority investments, and for bank holding companies with less than $15 billion in consolidated assets, non-qualifying capital instruments issued before May 19, 2010 that exceed 25% of Tier 1. For bank holding companies with $15 billion or more in total consolidated assets, cumulative perpetual preferred stock and grandfathered trust preferred securities qualify as Tier 2 only (and for the largest institutions, only for a limited time).

The full definitions of each capital component and related adjustments are included in subpart C of the Federal Reserve's Regulation Q. 12 C.F.R. § 217 subpart C. Bank holding companies are also required to hold a capital conservation buffer of additional common equity Tier 1 capital of 2.5% to avoid limitations on capital distributions and executive compensation payments. The largest bank holding companies must also hold a countercyclical buffer and possibly an additional surcharge of common equity Tier 1 capital. The full details of the capital conservation and countercyclical buffers are in subpart B of Regulation Q. 12 C.F.R. § 217.11.

The capital rules also include risk weights for credit risks. In calculating "risk-weighted assets," prescribed risk percentages are applied to particular categories of both on- and off-balance sheet assets. These risk weights are codified in the Federal Reserve Board's Regulation Q, and vary depending on the size of the banking organization and different risk categorizes. 12 C.F.R. § 217 subparts D-F.

Regulation Q establishes a series of minimum capital ratios, the calculation of which varies depending on the size and risk categories applicable to the individual banking organization involved. These ratios are summarized below:

| | **Minimum Requirement** | **Well Capitalized Requirement** |
|---|---|---|
| **Common Equity Tier 1 Capital Ratio** | 4.5% | 6.5% |
| **Tier 1 Capital Ratio** | 6% | 8% |

maintains capital guidelines for state non-member banks and state-chartered thrifts. All of these guidelines impose essentially uniform minimum ratios, although there are some minor differences in the way certain ratios are calculated.

| | Minimum Requirement | Well Capitalized Requirement |
|---|---|---|
| **Total Capital Ratio** | 8% | 10% |
| **Leverage Ratio** | 4% | 5% |
| **Supplementary Leverage Ratio (Advanced Approaches Only)** | 3% | |

Importantly for the applications process, the Federal Reserve's risk-based capital rules establish only the minimum levels of capital that bank holding companies must maintain and the Federal Reserve expects bank holding companies to maintain capital well in excess of the ratios required for well-capitalized status, depending on the size, nature and risks of the banking organization. 12 C.F.R. § 217.10(d).

The applicability of the capital rules varies by the size of the banking organization. Smaller bank holding companies are subject to slightly less stringent requirements under the Federal Reserve's Small Bank Holding Company Policy Statement or the Community Bank Leverage Ratio. Large banking organizations are subject to a variety of additional capital requirements, including stress testing, a capital conservation buffer, liquidity coverage ratio, requirements to hold high quality, liquid assets, as well as long-term debt and total loss-absorbing capacity requirements.

The bulk of the new capital rules required by the Dodd-Frank Act became effective in 2015; however, the global capital standards continue to evolve, as do the U.S. banking agencies' related implementations. In July 2023, the Department of Treasury, OCC, Federal Reserve and FDIC proposed a joint rulemaking in connection with the Basel III agreement, also known as the Basel III endgame, that would substantially revise the capital requirements applicable to banking organizations with $100 billion or more in total assets, as well as other banking organizations with significant trading activities. This proposal has been widely criticized as inconsistent with the tailoring efforts. As the banking regulators continue to focus on the appropriate implementation of capital requirements and the impact of tailoring efforts, they also have suggested heightened obligations for banks engaging in acquisitions that approach thresholds requiring additional capital, liquidity, long-term debt, resolution planning and reporting obligations.

### 2. Declines in Capital Strength Resulting from Acquisitions and Mergers

A bank holding company that is contemplating or experiencing significant growth, whether internally or by acquisition, is further expected to maintain strong capital levels substantially above the ratios for well-capitalized status, and its capital ratios should not decline significantly below these strong levels as a result of the acquisition or other expansion. The Federal Reserve has denied an application by a bank holding company on the grounds that it lacked sufficient capital — even though the bank holding company met the requirements to be well capitalized at the time — and any number of other proposals have been withdrawn prior to receiving an official denial. *See Illini Corp.*, 89 Fed. Res. Bull. 85, 86 (2003). In fact, the Federal Reserve staff has come to expect that the capital ratios of applicant bank holding companies well exceed the ratios necessary for "well capitalized" status before and after the

acquisitions. It is particularly important for financial holding companies to remain well capitalized as failure to do so can lead to serious consequences.

Consequently, it is now not uncommon for acquiring financial institutions to raise capital in connection with mergers and acquisitions to raise overall capital ratios or to support future expansion. For example, the 2017 merger of BNC Bancorp and Pinnacle Financial Partners was combined with a $175 million issuance of common stock. This also is an option for smaller financial institutions. In early 2020, the Professional Holding Corp. acquisition of Marquis Bancorp, Inc. included a planned offering of common stock with an aggregate offering price of $74.9 million.

Bank holding company acquirers should consider maintaining a sufficient level of capital above the well-capitalized ratio thresholds to address the company's existing and pro forma risks as the "new normal." Prior to signing a deal, prospective acquirers should consult with banking regulators about capital expectations and be prepared with stress testing results showing the capital impact of the proposed transaction. In the case of a transaction involving a bank holding company subject to the CCAR, parties can expect a delay in processing of the regulatory application if the submission overlaps with the three-month CCAR review process (or the three-month period prior to the commencement of the annual CCAR process) to ensure that the bank holding company receives a non-objection to its submitted capital plan. To the extent the bank holding company's most recent capital plan that received a non-objection under the CCAR process did not cover the proposed transaction, the bank holding company will generally need to submit a revised capital plan reflecting the transaction (including CCAR stress testing analysis) and receive a non-objection in order for regulatory approval to be obtained.

### B. Management Resources

The BHC Act requires the Federal Reserve to take "managerial resources" into account in considering applications for acquisitions. 12 U.S.C. § 1842(c). Applications that have been denied on the grounds of inadequate managerial resources have generally involved attempted acquisitions of relatively small banks by persons with little or no experience in managing a banking business.

Such managerial concerns are not limited to these circumstances, however. As part of the application process, the Federal Reserve staff frequently seeks and obtains detailed information to document an acquirer's managerial resources. Such information often takes the form of strategic and business plans for the combined company, action plans to address deficiencies at the target that were identified in due diligence, planned changes to risk management systems, integration plans and staffing and cost savings projections. In addition, the federal regulators also scrutinize the larger bank holding companies' management, staffing, planning and implementation of acquisitions as part of the examination process. Any adverse exam report findings in this area (including identified "matters requiring immediate attention" or "matters requiring attention") can be expected to impact an applicant during the application process. The Federal Reserve reviews this information to ensure that the managerial resources match up with the size, scope and risks of the pro forma organization. The Federal Reserve's emphasis on managerial strength, robust consolidated risk management policies and procedures, strong integration plans, as well as strong records of compliance with applicable banking, consumer and

money-laundering laws is illustrated by decisions issued in recent years. Some Federal Reserve orders have gone so far as to summarize these policies and specific integration plans. *United Bankshares, Inc.*, 100 Fed. Res. Bull. 1, 13 (2014); *Ameris Bancorp*, 100 Fed. Res. Bull. 1, 1 (2014); *CIT Group, Inc.*, FRB Order No. 2015-20 (July 19, 2015).

Although rare, contested applications present similar, though more heated, issues. In 1989, for example, when NCNB made a public merger proposal to Citizens & Southern, one of the ostensible reasons cited by Citizens & Southern for rejecting the proposal was Citizen & Southern's concern that NCNB's rapid growth might have outstripped NCNB's supply of talented managers. In the 1988 Bank of New York acquisition of Irving, similar concerns were addressed by Bank of New York's commitment to attempt to retain Irving's management personnel by offering contracts to senior personnel and establishing a committee composed of officers from each institution to make staffing decisions. *The Bank of New York Co.*, 74 Fed. Res. Bull. at 266 (1988).

Further, an applicant's future prospects may also be adversely affected by the adversarial nature of a contested application. For example, Irving presented a great deal of evidence suggesting that Bank of New York would be unable to integrate its data systems with Irving's and that Bank of New York's projections of anticipated profits from divestitures of Irving's assets were overly optimistic. On the basis of this evidence, some of which was not available to Bank of New York from public sources, Irving contended that Bank of New York's financial projections were unduly optimistic. *Id.* at 266-67.

In the end, the Federal Reserve rejected Irving's claims on the grounds that Bank of New York's capital commitments and operating plans would leave it with sufficient financial flexibility even if its earnings did not reach projected levels. *Id.* at 267. The General Counsel of the Federal Reserve has indicated that such difficulties arising from the insufficiency of public information can generally "be overcome through a strong capital plan and a proposal with sufficient financial flexibility to account for unanticipated costs or losses." *Contested Acquisitions* at II.B.2. Although this was a contested application, realistic estimates of integration costs and staffing needs, combined with a strong and flexible capital plan, is just as relevant to any proposal.

The Federal Reserve appears to give little weight to allegations, often made in the context of hostile transactions, of securities law violations. In *Suburban Bancorp, Inc.*, 71 Fed. Res. Bull. 581 (1985), for example, the Federal Reserve found that certain alleged securities law violations by the applicant, even if true, did not reflect adversely on management of the applicant, since they did not involve fraud or criminal misconduct. Likewise, it has become commonplace for community groups protesting bank acquisitions to submit compilations of negative news stories about the applicant as evidence of inadequate managerial resources. In these cases, the Federal Reserve has frequently dispensed with such protests. For example, in the Citicorp/Travelers merger, protesters to the application cited a number of lawsuits or administrative actions involving Travelers or its subsidiaries. The Federal Reserve noted that there "have been no adjudications of wrongdoing by Travelers or any of its subsidiaries in any of these matters, and each matter is before a forum that can provide adequate redress if the allegations of wrongdoing can be sustained." *Travelers Group Inc./Citicorp*, 84 Fed. Res. Bull. 985 (1998).

The Federal Reserve also generally has limited its considerations of comments to those factors specified under the BHC Act and have not taken on tangential issues. *See Western Bancshares, Inc.* v. *Board of Governors*, 480 F.2d 749 (10th Cir. 1973). More recently, in its approval of CIT Group's acquisition of OneWest Bank, the Federal Reserve concluded that the statutory factors it is required to consider under the BHC Act were consistent with approval of the proposal despite vigorous opposition by 187 commenters, and noted that commenters' concerns about the racial diversity of OneWest Bank's officers and employees were outside those statutory factors. *CIT Group, Inc.*, FRB Order No. 2015-20 (July 19, 2015). However, the Federal Reserve often will ask applicants for information about allegations concerning such matters, which can delay the processing of an application.

In at least one case prior to the financial crisis, the information from protesters led the Federal Reserve to investigate the allegations and that investigation resulted in a formal enforcement action and civil money penalty. In the current supervisory environment, applicants should expect the Federal Reserve to inquire about the status of any litigation or administrative enforcement actions and the steps that the bank holding company has taken to address each issue raised in such actions. In certain circumstances, the Federal Reserve can also be expected to require a demonstrated strengthening of compliance risk management systems as a predicate to acting on a banking application (with the M&T/Hudson City transaction a notable example). Applicants should satisfactorily address any known deficiencies before filing an acquisition application and proactively address any compliance issues that arise during the application processing period. Material compliance issues that require a lengthy period to resolve, such as often the case with BSA/AML compliance risk management issues, may require an application to be withdrawn. As noted above, the Federal Reserve confirmed, in its 2015 order approving M&T's application to acquire Hudson City, that going forward it will deny an application when material supervisory weaknesses arise after the application is filed and the applicant does not withdraw the application.

## C. Convenience and Needs of the Community

The Federal Reserve is required to take into consideration the "convenience and needs of the community to be served" in approving or rejecting an application under section 3 of the BHC Act. 12 U.S.C. § 1842(c); 12 C.F.R. § 225.13(b)(3). As noted, with respect to an application to acquire a savings association or industrial loan bank under section 4 of the BHC Act, the Federal Reserve must take into consideration whether the transaction can reasonably be expected to produce benefits to the public, such as greater convenience. Considerations related to convenience and needs or public benefits generally relate to the nature, quality and availability of the applicant's actual or planned products and services, including, for example, the availability of new products to the target institution's customers, the hours and locations of operation, interest rates on deposits and size of available loans.

As a practical matter, the Federal Reserve has almost always determined that the general convenience and needs aspects of an application (as opposed to the specific CRA aspects, discussed below) are consistent with approval of the application, even if the applicant plans to offer no new services or products. However, the Federal Reserve currently is requiring applicants to provide more detailed explanations of how the proposed transaction will benefit the communities served by the combined organization and has discussed this factor in recent orders.

The Federal Reserve has found factors such as increases in services, additional products, greater loan limits, increased hours and, in particular, the reopening, or the assumption of the deposits, of a closed institution to be positive factors weighing in favor of approval of an application because of more effective service to the community. *See, e.g.*, *Independent Bank Group, Inc.*, FRB Order No. 2018-11 (May 2, 2018); *Arvest Bank Group, Inc.*, FRB Order No. 2018-09 (Apr. 2, 2018); *First American Bank Corporation*, FRB Order No. 2014-18 (November 13, 2014); *United Bankshares, Inc.*, 100 Fed. Res. Bull. 1, 13 (2014); *One PacificCoast Foundation*, 99 Fed. Res. Bull. 3, 9 (2013); *FirstMerit Corporation*, 99 Fed. Res. Bull. 2, 1 (2013).

Under the BHC Act, the Federal Reserve may approve a transaction with substantial anticompetitive effects if it finds that these effects are clearly outweighed in the public's interest by the probable benefits of the transaction to the convenience and needs of the public. 12 U.S.C. § 1842(c). On rare occasions, the Federal Reserve has done so, generally on the grounds that the financial condition of the acquired institution was so weak that it could not survive absent the acquisition.

### 1. The Community Reinvestment Act

The Federal Reserve generally considers the CRA performance records of the subsidiary insured depository institutions of an applicant and target as part of its consideration of the convenience and needs of the community. The Federal Reserve is also required, under the CRA, 12 U.S.C. §§ 2901-2906, to consider an applicant's record of serving "the credit needs of its entire community, including low- and middle-income neighborhoods, consistent with the safe and sound operation" of the applicant. 12 U.S.C. § 2903(a)(1). The CRA requires the federal banking regulators to "encourage financial institutions to help meet the credit needs of the local communities in which they are chartered" and, to that end, the Federal Reserve is required to take an applicant's CRA record into account under section 3 of the BHC Act. 12 U.S.C. §§ 2901(b), 2902(3)(F), 2903.

As discussed further below, the revised CRA regulations also explicitly reference an institution's compliance with the Fair Housing Act and the Equal Credit Opportunity Act in assessing the institution's CRA performance. The Federal Reserve and OCC have indicated that findings of "unfair, deceptive or abusive acts and practices" ("UDAAP") are relevant to an institution's CRA performance assessment. Fair lending and UDAAP violations have resulted in the CRA ratings of banks and thrifts being lowered. Fair lending compliance was a major enforcement initiative of the Clinton Administration and a significant focus of the Obama Administration. The Trump Administration took a very different approach and worked to limit fair lending actions and policies, most notably at the Consumer Financial Protection Bureau ("CFPB"). Consistent with recent years, the CFPB made five fair lending discrimination referrals to the Department of Justice in 2022. This is significantly lower compared to years prior, with the CFPB making 15 referrals in 2014. As anticipated, the Biden Administration has taken a more active approach with respect to fair lending policies and enforcement, including fair lending enforcement actions against Trustmark National Bank, LendUp Loans, LLC, JPay, LLC, and Nexus Services, Inc. in 2021 and against Townstone Financial Inc. and Washington Federal Bank, N.A. in 2020. In 2022, the CFPB also announced changes to its supervisory operations to address discrimination in consumer finance markets where fair lending laws may not apply, and separately issued an advisory opinion affirming that the Equal Credit Opportunity Act prohibits

discriminatory practices after a customer has received a loan, as well as during the application process itself. In October 2023, the OCC, the Federal Reserve and the FDIC released an interagency final rule to implement the CRA, many provisions of which will take effect on April 1, 2024, with other provisions taking effect on January 1, 2026 and January 1, 2027. The new rule adopts various changes, including four new performance tests for large banks and related tests for intermediate, small and limited purpose banks, clarifications for what constitute community development activities, and the creation of a new public comment process. The CFPB issued a statement in connection with the final rule calling state legislatures to ensure non-bank entities are subject to similar requirements. It is likely that all of the agencies will take a more aggressive stance on fair lending issues as we continue to see shifts in leadership.

By contrast, applications to acquire non-banking subsidiaries under section 4(c)(8) of the BHC Act are generally not subject to CRA review, except that the CRA requires the Federal Reserve to consider the CRA performance records of the relevant insured depository institutions in acquisitions of savings associations or industrial loan banks under section 4(c)(8) of the BHC Act. *See, e.g.*, *Associated Banc-Corp*, FRB Order No. 2018-03 (Jan. 23, 2018); *Midland States Bancorp, Inc.*, 101 Fed. Res. Bull. 1, 23 (2014).

The Federal Reserve will review the CRA records of each of the applicants' subsidiary insured depository institutions, any banks related to the applicant through common ownership or management and the insured depository institutions to be acquired. 12 C.F.R. § 225.13(b)(3). The Federal Reserve's Regulation Y does not provide a safe harbor based on superior CRA ratings. An applicant generally must address all CRA-related allegations in comments submitted on a proposed transaction.

An applicant's CRA record may be the basis for the denial of an application — although denials solely on CRA grounds are rare. The Federal Reserve takes into account both an institution's CRA rating and CRA performance evaluations, as well as its CRA activities since its most recent evaluation, in making its CRA performance determination in connection with an application.

Of the few CRA-based denials of applications, most, if not all, have involved applicants having subsidiaries with low CRA ratings. On the other hand, the Federal Reserve has approved acquisition applications even where the applicant has a low-rated bank, particularly where the low-rated bank is only one of numerous subsidiary banks with stronger ratings. Institutions with low ratings are likely in any event to be required either to improve their CRA record prior to consummation of a proposed transaction or commit to specific remedial actions following consummation.

Although the Federal Reserve has denied an application on CRA grounds in a relatively limited number of cases, other bank holding companies have withdrawn applications because of the possibility or likelihood that they would be denied on CRA grounds. Moreover, community groups and other organizations regularly challenge applications for major acquisitions, especially of banks in large urban areas, on CRA or fair lending grounds. In recent years, some community organizations have protested applications of smaller bank holding companies on CRA grounds with increasing frequency. Following such challenges, application processing has often been significantly delayed. In some cases involving very large banking organizations, the Federal

Reserve has held public meetings to collect information from the public concerning the applicant's CRA record.

Given the limitations placed on "mega-mergers" by Dodd-Frank's amendments to the BHC Act and other relevant statutes, in recent years community groups and other organizations have continued to focus attention on smaller transactions, as well as episodic, larger transactions. These commenters are challenging proposed acquisitions based on the applicant's CRA record but often also on fair lending grounds. The Home Mortgage Disclosure Act ("HMDA") requires that financial institutions with more than $48 million in assets track the disposition of all loan applications as well as loan approvals, and code such data by census tract, income level, race and gender. 12 U.S.C. § 2803. Community groups have used the expanded HMDA data in protests filed against a number of applications, alleging concerns with respect to fair lending compliance or CRA performance. The commenters generally use HMDA to point out lending disparities among different groups of borrowers but without substantiating any discriminatory activity or other violations of fair lending laws.

The Federal Reserve and other federal banking agencies continue to take a heightened interest in the allegations in these comments, although they have recently increased their efficiency in reviewing and approving commented applications. Applications receiving substantive public comments have experienced longer and widely variable processing periods, as well as more aggressive and detailed additional information requests. A portion of this elongated processing time is due to the fact that the Federal Reserve typically asks for detailed information about the bank CRA and fair lending programs, policies and procedures.

These processing delays are highlighted in the Federal Reserve's Semiannual Report on Banking Applications Activity issued in June 2023. The report indicates that in 2022, applications with adverse comments took on average 202 days — over six months — to process for approval, an increase from the average processing time of 160 days in 2021. The Federal Reserve took an average of 232 days to process an application with an adverse comment in 2020 and 143 days in 2019. In the first half of 2023, average processing times for applications with adverse comments rose again to 364 days from 197 in 2022, based on the single approved application noted above. In contrast, the processing period of applications without adverse public comments was up slightly in 2023 but is generally very consistent over time. In 2022, applications without comment took on average about 73 days for approval, compared to 62 days in 2021 and 64 days in 2020. In short, an adverse comment can add many months to the processing time for proposed acquisitions.

In 2018, the Federal Reserve started to take internal measures to shorten processing times on commented applications. For example, the Federal Reserve concluded that one serial commenter's submission was wholly unsubstantiated, previously considered or presented frivolous issues and did not consider it in connection with processing the application in question. Although this was a significant victory for the banking organizations that are plagued by the repeated comments of this individual and the resulting delays in applications processing, this approach will likely not apply to the more sophisticated community groups currently commenting on applications. Further, the Federal Reserve's position on certain commenters does not necessarily translate over to the other banking agencies and their review process. While the Federal Reserve may limit additional questions and try to rely on detailed internal agency

information on the CRA and fair lending programs at each banking organization, the FDIC or OCC may request detailed additional information to address allegations made in the same comment letter.

In any event, it is important that potential applicants carefully analyze their CRA performance and consider compliance records and make any needed improvements prior to seeking approval of a transaction; as a practical matter, enhancements may need to be implemented as long as two or three years in advance of a transaction to maximize the prospect of regulatory approval. Furthermore, in May 2022, the banking agencies issued a joint proposed rulemaking to strengthen and modernize CRA regulations. Institutions with business models that may be impacted by the proposed rulemaking should be prepared to answer questions on how they serve the needs of their communities, including those that are not currently "assessment areas." This area of focus is particularly relevant for digital-first banks with a nationwide footprint, but single assessment area.

In addition, it is critical that applicants respond promptly and aggressively to any comments regarding the institution's CRA record. Applicants should provide the banking agencies with a detailed response that includes specific information about the bank's CRA activities since its last evaluation, as well as detailed information about the banking organization's policies and procedures regarding fair lending, consumer compliance and risk management.

Because such delays may be costly and create the risk that a transaction may not be consummated, acquirers have occasionally negotiated "settlements" with community groups protesting an application. In these settlements, the applicant commits in its application, makes a public community pledge, enters into a community reinvestment agreement with one or more community groups or submits a community reinvestment plan to the relevant federal banking agency(ies), which outline steps to offer additional products and services to low- and middle-income customers and communities, to implement CRA self-evaluation programs or otherwise to enhance its CRA performance record. On occasion, an applicant has simply agreed to fund a specific project proposed by a protesting community group. In exchange, the community group sometimes withdraws its protest.

Both the approaches of settling with a particular activist group and of committing to a program of more general application have met with mixed success. Although some such settlements have successfully resolved community groups' protests, in other instances, banks have entered into deals with one activist group and/or announced extensive low-income lending programs only to see another activist group claim itself free to continue protesting. Moreover, certain activist groups have made statements to the press in the past suggesting that they are no longer willing to enter into or abide by such arrangements. Indeed, one such group even brought a protest in apparent breach of an agreement that it had previously entered into with the bank pursuant to which it had agreed not to protest any application by that bank for a specified period of years in return for a low-income lending commitment by the bank.

Although a refusal to reach an agreement with a particular group may have contributed to the delays involved in certain applications, the Federal Reserve does not require applicants to meet or settle with protesters. A number of bank holding companies, notably Bank of America,

have made large bank acquisitions without entering into settlements with community groups protesting their applications. The Federal Reserve's order validated Bank of America's approach, noting that the Federal Reserve "has consistently found that neither the CRA nor the federal banking agencies' CRA regulations require depository institutions to make pledges or enter into commitments or agreements with any organization." The Federal Reserve has made this same statement in a number of orders approving other banking organizations' proposed transactions. *See, e.g.*, *U.S. Bancorp*, FRB Order No. 2022-22 at 19 n.47 (October 14, 2022); *TriCo Bancshares*, FRB Order No. 2022-09 at 9 n.20 (March 1, 2022); *United Bancshares, Inc.*, FRB Order No. 2017-10 at 12 n.28 (Apr. 6, 2017); *Huntington Bancshares Inc.*, FRB Order No. 2016-13 at 32 n.50 (July 29, 2016); *CIT Group, Inc.*, FRB Order No. 2015-20 at 24 n.54 (July 19, 2015); *Citigroup Inc.*, 88 Fed. Res. Bull. 485 (2002); *Fifth Third Bancorp*, 80 Fed. Res. Bull. 838, 841 (1994).

### 2. Fair Lending and Consumer Compliance

The CRA regulations also explicitly reference an institution's compliance with the Fair Housing Act and the Equal Credit Opportunity Act in assessing the institution's CRA performance. As noted above, fair lending compliance was a major enforcement initiative of the Clinton Administration and the Obama Administration, as well as the Federal Reserve, in reviewing transactions. Although the Trump Administration took a less aggressive approach to fair lending enforcement, this has experienced change under the Biden Administration. Any actual or possible fair lending issues will continue to significantly impact applications processing at all bank regulatory agencies. Additionally, concerns regarding so-called "predatory lending" practices have become a principal area of focus of commenters, as well as federal bank regulators, in evaluating an acquisition proposal. In addition, unresolved UDAAP and SCRA violations have prevented or delayed transactions. Federal bank regulators have heightened their scrutiny of fair lending and other consumer law protections, including with respect to predatory lending. In addition, anti-predatory lending ordinances have been adopted in various cities; in recent years, municipalities including Cook County, Illinois, Los Angeles, Oakland, Baltimore, Miami and Providence have brought suit against financial institutions for alleged predatory lending.

The CFPB adds another layer of complexity to the examination and enforcement authority with respect to fair lending and other consumer protection laws. Under a Biden Administration, the CFPB has actively pursued enforcement actions against financial institutions. In addition, the CFPB is issuing composite consumer compliance ratings, which the banking regulators are taking into account in evaluating applications and, purportedly, in determining CRA performance ratings.

Aside from aggressive enforcement, CFPB amendments to residential mortgage lending regulations, particularly the "Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act" portions of Regulation Z, are affecting review of both CRA and fair lending compliance. Although the CFPB's rule and Dodd-Frank do not prohibit creditors from extending credit to consumers that have the ability to repay but do not satisfy the criteria of a qualified mortgage, indications are that many creditors are seeking to limit their legal risk by offering only qualified mortgages. As such, this rule, which took effect in 2014, together with

other CFPB rulemakings, are reshaping the origination, servicing and securitization of residential mortgages in the U.S.

Federal Reserve orders involving comments on fair lending issues have increased and orders regularly have included a HMDA data analysis, a summary of the banking organizations' fair lending policies and procedures and information about underlying credit decisions. At times, the Federal Reserve specifically requests improvements or follow up reviews for banking organizations to seek more opportunities to meet the credit needs of the communities they serve. *See, e.g.*, *KeyCor*p, 102 Fed. Res. Bull. 5, 1 (2016); *First American Bank Corporation*, 101 Fed. Res. Bull. 1, 1 (2015); *Regions Bank*, 100 Fed. Res. Bull 5, 33 (2014); *Cullen/Frost Bankers, Inc.*, 100 Fed. Res. Bull. 3, 1 (2014); *CIT Group, Inc.*, FRB Order No. 2015-20 (July 19, 2015).

As a result, applications involving these comments have seen longer processing periods, as well as more aggressive and detailed additional information requests from the bank regulators. It is critical that applicants respond promptly and aggressively to any comments regarding the institution's fair lending and consumer protection law compliance record, as noted above, and prophylactically identify and address any deficiencies well in advance of a potential transaction. Applicants should provide the banking agencies with a detailed response that provides context about the data cited by commenters as well as detailed information about the banking organization's policies and procedures around fair lending and consumer compliance issues. Applicants should also stand ready to provide detailed information and data regarding specific credit decisions on loans to applicants of groups that were the subject of the protesters' criticism.

### D. Risks to the Stability of the U.S. Banking or Financial System

Under the Dodd-Frank Act, section 3(c) of the BHC Act now requires the Federal Reserve to take into consideration the "extent to which a proposed acquisition, merger or consolidation would result in greater or more concentrated risks to the stability of the United States banking or financial system." 12 U.S.C. § 1842(c)(7). Section 4(j) of the BHC Act includes a corresponding requirement as part of the assessment of the public benefits of a proposed acquisition of a savings association or industrial loan company. 12 U.S.C. § 1843(j)(2). The Federal Reserve's 2012 approvals of Capital One's application to acquire ING Bank, fsb, *Capital One Financial Corporation*, 98 Fed. Res. Bull. 5, 7 (2012) and PNC's acquisition of RBC Bank (USA), *The PNC Financial Services Group Inc.*, 97 Fed. Res. Bull. 3, 16 (2011), shed important light on how the Federal Reserve will assess this criterion.

The Federal Reserve will consider whether the proposal would result in a material increase in risks to financial stability, assessing the following factors: (1) whether the proposal would result in a material increase in risks to financial stability due to the increase in size of the combining firms; (2) whether the proposal would result in a reduction in the availability of substitute providers for the services offered by the combining firms; (3) the extent of interconnectedness among the combining firms and the rest of the financial system; (4) the extent of cross-border activities of the resulting firms; (5) the extent to which the combining firms contribute to the complexity of the financial system; and (6) the relative degree of difficulty of resolving the resulting firm. These factors generally correspond to the approach that the Basel Committee on Banking Supervision uses to identify systemically important, globally active banking organizations (albeit with certain distinctions; for example, the Federal Reserve

considers broader and somewhat different metrics). This also suggests that the quality of an organization's resolution plan, or "living will," could become relevant in the Federal Reserve's financial stability risk analysis.

The foregoing factors are assessed both individually and in combination, and the Federal Reserve will base assessments on both quantitative factors (using publicly available data compiled through the supervisory process and data obtained through information requests) and qualitative factors. The Federal Reserve may ascribe more or less weight to a particular factor depending on the facts and circumstances. For example, the Federal Reserve has acknowledged that measures of a financial institution's size on a pro forma basis could either understate or overstate risks to financial stability posed by a combination (*e.g.*, a smaller company operating in a critical market for which there is no substitute provider could pose a greater risk than a larger company engaging in non-complex activities for which there are substitute providers). The Federal Reserve also considers countervailing factors, including whether the proposed transaction would provide any stability benefits and whether enhanced prudential standards applicable to the combined company would tend to offset any risks.

The orders approving the Capital One/ING Bank and PNC/RBC Bank (USA) transactions, and transactions since then, indicate that the Federal Reserve will not reject a merger or acquisition based purely on theoretical concerns or on risks below some reasonable threshold. Adverse effects on financial stability must be "significant," and the expected resulting damage must be "material." The impact on the ability of other financial institutions to conduct business or the disruption to credit availability or financial services must be "serious."

Importantly, the Federal Reserve has acknowledged that certain transactions may be presumed not to raise financial stability concerns (absent significant increases in interconnectedness, complexity, cross-border activities or some other factor) — *i.e.*, a proposal that involves an acquisition of less than $10 billion in assets or that would result in a firm with less than $100 billion in total assets or a corporate reorganization. *See, e.g.*, *People's United Financial Inc.*, 103 Fed. Res. Bull. 2, 50 (2017).

As noted above, in late 2021, leaders from the federal banking agencies publicly stated concerns about the current process used by the agencies to review merger applications, including the financial stability factor. Members of Congress requested a moratorium on agency approval of any merger application resulting in a banking organization with over $100 billion in total assets. The concerns expressed by agency leaders and Members of Congress are not solely related to financial stability — they are a blending of a several concerns regarding the impacts of a growing number of larger banking organizations, including on competition, impact on customers and communities and resolvability in the case of another crisis. As review of the bank merger framework is ongoing, it is difficult to anticipate whether this will result in a formal revision of the agencies' presumptions and considerations on financial stability (or any other factor). A broad moratorium as proposed seems unlikely, but at a minimum, banking organizations should expect longer processing times and greater scrutiny on a number of factors, including financial stability. This increased scrutiny will likely increase with the size of the banking organization.

## II. BANK MERGER ACT CRITERIA

The Bank Merger Act provides that no insured bank or other insured depositary institution may merge with, or acquire the assets or assume the liabilities of, another insured depositary institution without the prior written approval of the "responsible agency" and prescribes certain procedures (including procedures for obtaining shareholder approval and for appraisal of shares held by dissenting holders) for such mergers. 12 U.S.C. § 1828(c)(2). Where the acquiring or resulting bank is to be a national bank, a bank chartered in the District of Columbia or a federally chartered savings association, the OCC is the responsible agency; where the acquiring or resulting bank is to be a state-chartered bank that is a member of the Federal Reserve System, the Federal Reserve is the responsible agency; and where the acquiring or resulting bank will be a state-chartered bank that is not a member of the Federal Reserve System or a state-chartered savings association, the FDIC is the responsible agency. In addition, where an uninsured entity is merged or consolidated with an insured depository institution, the FDIC is the responsible agency.

Acquisitions involving an assumption of any FDIC-insured deposits are subject to the Bank Merger Act. In addition, a purchase and assumption transaction involving substantially all the assets and liabilities of a company is subject to the Bank Merger Act, even if no insured deposits are included. In such case, the institution generally would need the prior approval of both the FDIC and its primary federal banking agency. In June of 2023, the Department of Justice signaled that it was working with federal bank regulators on revised guidance for bank merger enforcement, highlighting in particular, that the approach would seek to capture competition more broadly, particularly for large national banks. Nevertheless, the final merger guidelines did not call out specific changes from a bank merger enforcement perspective. As a result and as noted above, the review process may be in flux as the FDIC and other regulators continue to re-evaluate bank merger policy.

The Bank Merger Act provides that the responsible agency may not approve any proposed merger that:

- Would result in a monopoly or would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States; or

- May have the effect in any section of the country of substantially lessening competition, unless the responsible agency finds that the anticompetitive effects of the proposed transaction are clearly outweighed by the convenience and needs of the community to be served.

In addition, the responsible agency is required to take into consideration the financial and managerial resources and future prospects of the existing and proposed institutions and the convenience and needs of the communities to be served. 12 U.S.C. § 1828(c)(5). The responsible agency must also take into consideration the effectiveness of any insured depository institution involved in the proposed merger in combating money laundering activities, including in overseas branches. The Bank Merger Act further requires the responsible agency to consider the extent to which the proposed transaction would result in greater or more concentrated risks to

the stability of the U.S. banking or financial system. Under the CRA, the agencies also must consider the CRA performance records of the institutions involved in the proposal. In addition, interstate bank mergers must meet the requirements of 12 U.S.C. § 1831u, discussed in Annex B. Applying the Bank Merger Act criteria in 2022, the OCC conditionally approved the acquisition by U.S. Bank N.A. of MUFG Union Bank, N.A., requiring, among others, that the resulting bank comply with a consent order applicable to the acquired bank's technology and operations risk management and develop a list and plan for lines of business that could be expeditiously separated in times of stress, in addition other existing divestiture commitments.

The Bank Merger Act standards are substantially the same as those applied to applications under the BHC Act. When the Federal Reserve is the responsible agency, it appears to apply the same criteria in evaluating Bank Merger Act notices that it applies to BHC Act applications.

## III. CONTROL ACT CRITERIA

The Control Act provides that a "person" seeking to effect an acquisition of "control" of a bank or savings and loan holding company or a federally insured depository institution must give prior written notice to the "appropriate federal banking agency." The agency then has a specified period of time to disapprove the acquisition. If not disapproved within that period, the acquisition may be consummated. An acquisition may be made prior to expiration of the period if the agency issues written notice of its intent not to disapprove the acquisition. 12 U.S.C. § 1817(j)(1).

"Person" is defined broadly to include individuals, corporations, partnerships, trusts, associations, joint ventures, pools, syndicates, sole proprietorships, unincorporated organizations or "any other form of entity." 12 U.S.C. § 1817(j)(8)(A). The "appropriate federal banking agency" varies depending on the nature of the target. If a target is a national bank, a bank chartered in the District of Columbia or a federally chartered savings association, the OCC is the appropriate agency; if a target is a bank holding company, a savings and loan holding company, a state-chartered bank that is a member of the Federal Reserve System or a foreign bank or a branch of a foreign bank, the Federal Reserve is the appropriate agency; and if a target is a state-chartered bank that is not a member of the Federal Reserve System or a state-chartered savings association, the FDIC is the appropriate agency. 12 U.S.C. § 1813(q). Please see Annex B for a more detailed description of the current regulatory framework.

The concept of control used in the Control Act differs somewhat from that used in the BHC Act. The Control Act defines "control" as the power, directly or indirectly, to direct the management or policies, or to vote 25% or more of any class of voting securities, of an insured bank. 12 U.S.C. § 1817(j)(8)(B). In addition, the Federal Reserve regulations provide that a person, or group of persons acting in concert, is rebuttably presumed to "control" a bank or holding company under the Control Act if the person or group:

- "Owns, controls, or holds with the power to vote 25% or more of any class of voting securities of the institution"; or

- "Owns, controls or holds with power to vote 10% or more . . . of any class of voting securities of the institution" *and* if (1) the institution's shares are registered pursuant to section 12 of the Exchange Act or (2) no other person would own a greater percent of the institution's outstanding shares.

12 C.F.R. § 225.41(c) and 238.31(c). Similar presumptions are provided under OCC and FDIC regulations. 12 C.F.R. § 5.50(d)(3), 303.4(a). The Federal Reserve regulations also provide that transactions other than those creating these rebuttable presumptions do not result in control for purposes of the Control Act. 12 C.F.R. § 225.41(f) and 238.31(f).

A shareholder who lawfully acquires and maintains control of 10% or more of a class of voting securities pursuant to the Control Act (or in connection with an approved application under the BHC Act or Bank Merger Act) is generally not required to file further notices under the Control Act to acquire additional shares of that class of voting securities. 12 C.F.R. § 225.42(a)(2) and 238.32(a)(2). In cases involving a group acting in concert who received authorization under the Control Act to acquire 10% or more of a class of voting securities, an individual member of the group generally would need to file a prior notice under the Control Act before individually meeting or exceeding the 10% threshold.

Prior notice to and approval of the Federal Reserve of an acquisition or other proposed transaction is not required under the Control Act if the presumption of control is rebutted, but few attempted rebuttals of control presumptions have succeeded. The Federal Reserve will provide an opportunity for the parties to present their views in writing or, if appropriate, orally at an informal conference. 12 C.F.R. § 225.41(g) and 238.31(g).

The appropriate agency may disapprove a proposed acquisition under the Control Act:

- If the acquisition would result in a monopoly or would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States;

- If the acquisition may have the effect in any section of the country of substantially lessening competition, unless the responsible agency finds that the anticompetitive effects of the proposed transaction are clearly outweighed by the convenience and needs of the community to be served;

- If the financial condition of any acquiring person or the future prospects of the bank might jeopardize the bank's financial stability or prejudice the interests of its depositors;

- Based upon the competence, experience or integrity of any acquiring person or of any of the proposed management personnel;

- If any acquiring person neglects, fails or refuses to furnish the appropriate agency all the information required by it; or

- If the acquisition would adversely affect the Deposit Insurance Fund. 12 U.S.C. § 1817(j)(7).

The competitive effects standards set forth in the Control Act are identical to those in the BHC Act. However, the considerations regarding an acquirer's financial condition, competence, experience and integrity, which the responsible agency is authorized to take into account under the Control Act, are worded somewhat less broadly than the inquiry into "financial and managerial resources" authorized by the BHC Act. Moreover, unlike the BHC Act, the Control Act does not authorize the responsible agency to inquire broadly into the convenience and needs of the communities to be served by the post-transaction institution. Under the Control Act, the appropriate agency must affirmatively investigate the competence, experience, integrity and financial ability of each proposed controlling party. The agencies conduct such investigations primarily by evaluating the Interagency Biographical and Financial Report form and a thorough name-check process.

## IV. HOME OWNERS' LOAN ACT

Section 10 of HOLA continues to govern acquisitions of control of both federally and state-chartered savings associations and savings and loan holding companies. 12 U.S.C. § 1467a *et seq*. Specifically, prior Federal Reserve approval is also required under HOLA for an existing savings and loan holding company to (a) acquire "direct or indirect ownership or control" of voting shares of a savings association or savings and loan holding company if it will own or control more than 5% of the voting shares after such acquisition or (b) merge with another savings and loan holding company. 12 U.S.C. § 1467a(e). Any such acquisition, other than an acquisition by a bank holding company, which is exempted from HOLA (such acquisitions require Federal Reserve approval under Section 4 of the BHC Act), must be approved by the Federal Reserve. 12 C.F.R. § 238.11. Prior approval is not required for the acquisition of additional shares in a savings association or savings and loan holding company that is already treated as a subsidiary prior to acquisition of additional shares. 12 C.F.R. § 238.11(c).

Section 10 of HOLA sets out the criteria that the Federal Reserve must apply in acting upon acquisition applications that are similar to the BHC Act. 12 U.S.C. § 1467a(e)(2); 12 C.F.R. § 238.15. In reviewing the proposed acquisition of a savings association or savings and loan holding company, the Federal Reserve considers the impact of the proposal on:

- competition;
- the financial condition of the parties and the future prospects of the combined company, including whether current and projected capital positions and levels of indebtedness conform to the Federal Reserve's standards and policies;
- the competence, experience and integrity of the officers, directors and principal shareholders of the two parties, including their record of compliance with laws and regulations and history of integrating acquired banking entities into the company and the soundness of the organizations' risk management systems and integration plans;

- the extent to which the proposed transaction would result in greater or more concentrated risks to the stability of the U.S. banking or financial system;
- the effectiveness of the company in combating money laundering activities; and
- the convenience and needs of the communities to be served, including the records of both parties under the CRA and fair lending and other consumer protection laws.

The Federal Reserve also takes into considerations assurances given by the company with respect to the conformance of any activities and operations of the banking organization with the requirements of HOLA. A unique holdover from previous Office of Thrift Supervision oversight of savings and loans, the Federal Reserve has a list of actions or violations that would result in presumptive disqualification when considering the competence, experience and integrity of management officials. 12 C.F.R. § 238.15(c). Interstate acquisitions must meet certain requirements. 12 U.S.C. § 1467(a)(e)(3).

Overall, these standards are substantially the same as those applied to applications under the BHC Act. The Federal Reserve appears to apply the same criteria in evaluating applications under HOLA that it applies to BHC Act applications.

## V. ACQUISITIONS BY FOREIGN BANKS AND BANK HOLDING COMPANIES

### A. Capital Adequacy Issues

In considering applications by foreign banks to acquire U.S. banks, the Federal Reserve has looked to whether the capital levels of a foreign bank exceed the minimum levels that would be required under the Basel Capital Accord both before and after the merger. The Federal Reserve also looks to whether a foreign bank's capital levels are considered to be equivalent to the capital levels that would be required of a U.S. banking organization. In doing so, the Federal Reserve will typically consult with a foreign bank's home country supervisor. Another important factor is that the U.S. insured depository institutions controlled by the foreign bank both before and after the merger meet the requirements to be deemed well capitalized. *See, e.g.*, *Royal Bank of* Canada, FRB Order No. 2015-28 (October 7, 2015); Mitsubishi *UFJ Financial Group, Inc.*, 99 Fed. Res. Bull. 1, 1 (2012); *The Toronto-Dominion Bank*, 96 Fed. Res. Bull. B36 (2010); *Allied Irish Bank, p.l.c.*, 95 Fed. Res. Bull. B81 (2009); *Allied Irish Bank, p.l.c.*, 94 Fed. Res. Bull. C11 (2007); *The Industrial Bank of Taiwan Co., Ltd.*, 93 Fed. Res. Bull. C62 (2007). These decisions are in line with the Federal Reserve's longstanding policy that it expects a foreign bank to meet the same general standards of financial strength as domestic bank holding companies and to be able to serve as a source of strength of its U.S. banking operations. The Federal Reserve has occasionally taken into account, on a case-by-case basis, the different regulatory and supervisory requirements, accounting principles, asset quality standards and banking practices and traditions of other countries. For example, the Federal Reserve has indicated a willingness to consider a portion of the unrealized appreciation in a Japanese bank's portfolio of equity securities in a manner consistent with the Basel Committee's risk-based capital framework (*e.g.*, *The Mitsui Taiyo Kobe Bank, Ltd.*, 76 Fed. Res. Bull. 563, 564 (1990)). It is questionable whether the Federal Reserve currently would follow such precedent.

In very limited, older decisions, the Federal Reserve has approved acquisitions by foreign banks which, even after making adjustments to reflect differences in banking and accounting practices, did not meet the minimum capital guidelines for U.S. multinational bank holding companies. Among the factors that the Federal Reserve has considered as mitigating the seriousness of this failure have been the following:

- The proposed transaction would not result in a diminution of the consolidated organization's capital;
- The acquirer would be in compliance with the capital and other financial requirements of banking organizations in its home country;
- The target was strongly capitalized and small in relation to the acquirer;
- The Federal Reserve expected the acquirer to maintain the target among the more strongly capitalized banking organizations of comparable size in the United States;
- The acquirer had recently raised a significant amount of new capital; and
- The proposed acquisition would be financed entirely through the issuance of new common equity so that consummation of the proposal would not diminish the target's capital.

However, the continued precedential value of these orders is questionable. Foreign banking organizations with average U.S. non-branch assets of $50 billion or more must create a separately capitalized U.S. intermediate holding company over all the organization's U.S. bank and non-bank subsidiaries (subject to limited exceptions). 12 C.F.R. part 252, subpart N. Under the Federal Reserve's rules, each such intermediate holding company is subject to similar capital and liquidity requirements that apply to domestic bank holding companies and other enhanced prudential standards and requirements depending on the size of the foreign banking organization and its U.S. operations.

## B. Requirement of Comprehensive Supervision

Under the BHC Act, the Federal Reserve is precluded from approving an application by a foreign bank to acquire a U.S. bank unless the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. Regulation K sets forth the criteria pursuant to which the Federal Reserve determines whether a foreign bank is subject to consolidated home country supervision. In essence, the Federal Reserve must determine that the bank is supervised or regulated in such a manner that its home country supervisor receives sufficient information on the worldwide operations of the bank, including its relationships to any affiliate, to assess the bank's overall financial condition and its compliance with laws and regulations. *See, e.g.*, *Mitsubishi UFJ Financial Group, Inc.*, 99 Fed. Res. Bull. 1, 1 (2012); *Commercial Bank of China Limited et al.*, 98 Fed. Res. Bull. 7, 1 (2012).

Similarly, the BHC Act also requires that the Federal Reserve determine that a foreign bank that is applying to acquire a U.S. bank provide adequate assurances that it will make

available such information on its operations and activities and those of its affiliates as the Federal Reserve deems appropriate to determine and enforce compliance with the BHC Act. To make this determination, the Federal Reserve reviews the restrictions on disclosures in jurisdictions where the foreign bank has material operations and consults with the relevant non-U.S. governmental authorities concerning access to information. The Federal Reserve also expects that the foreign bank commit that it will make available such information on its operations and those of its affiliates that the Federal Reserve deems necessary. The foreign bank must further commit that it will obtain any waivers or exemptions that may be necessary to provide the information.

### C. Interstate Banking Issues

Under Riegle-Neal, foreign banks are generally allowed to engage in interstate banking without being required to establish U.S. bank subsidiaries. Riegle-Neal allows federal or state branches of foreign banks to branch interstate to the same extent as national or state banks, respectively; *provided* that certain criteria are met with respect to authorization by the home country and certain assurances are made by the foreign bank. A U.S. subsidiary bank holding company and a subsidiary U.S. bank of a foreign bank are subject to the same interstate branching rules as other U.S. bank holding companies and banks, respectively.

### D. Government-Owned Foreign Banks

Many foreign banks are government-owned, either directly or through government-owned holding companies. The Federal Reserve has distinguished between investments by foreign governments and investments by foreign government-controlled entities, such as sovereign wealth funds or other instrumentalities engaged in financial, investment or commercial activities. Foreign governments are not treated as “companies” subject to the BHC Act, whereas government-owned entities generally are treated as such “companies.”

In *Banca Commerciale Italiana, S.p.A.*, 68 Fed. Res. Bull. 423 (1982), the Federal Reserve considered the issues presented by foreign government ownership of U.S. banks and specifically the issue of whether Istituto per la Ricostruzione Industriale, a government-owned holding company that controlled Banca Commerciale Italiana, was a “company” within the meaning of the BHC Act. This question was significant because Istituto per la Ricostruzione Industriale held substantial interests in a number of businesses unrelated to banking. If Instituto per la Ricostruzione Industriale were deemed to be a “company,” then its proposed acquisition of LITCO Bancorporation of New York would make it a “bank holding company” and it would be prohibited under the BHC Act from holding these unrelated interests. Although the Federal Reserve expressed the belief in the LITCO Bancorporation opinion that further attention should be given to the policy issues involved in government ownership of multiple banks and commercial-industrial enterprises, it determined to continue its long-standing practice of not applying the BHC Act to government owners. *See also Allied Irish Banks, p.l.c.*, 95 Fed. Res. Bull. B81 (2009) (providing that because the investment in AIB is made and managed by the Irish government, and not through a government-owned or government-controlled company, approval under section 3 of the BHC Act was not required).

Subsequent to the *LITCO Bancorporation* decision, Congress held hearings on the issue of foreign-government ownership of U.S. banks but took no action. In connection with the Federal Reserve's review of Banca Commerciale Italiana's proposed white knight transaction with Irving, however, the Federal Reserve announced that foreign government-owned corporations, such as Istituto per la Ricostruzione Industriale, would be subjected to the BHC Act, notwithstanding the apparent congressional acquiescence to the previous practice of exempting such organizations. The Federal Reserve stated that it would grant a three-year exemption from this new requirement to Istituto per la Ricostruzione Industriale but that at the end of that period the Federal Reserve would review the question of continuing the exemption. If, as a result of this review, the Federal Reserve determined not to continue the exemption, Istituto per la Ricostruzione Industriale would be required either to divest Irving Bank or to divest all of its nonconforming non-banking activities in the United States and abroad. Moreover, this limited exemption would be subject to a number of conditions, including (1) restrictions on Irving Bank's transactions with Istituto per la Ricostruzione Industriale, the Republic of Italy and any company or entity owned by either of them and (2) a requirement that Irving Bank raise its capital position to a level at least as strong as the average for domestic banking organizations of comparable size and thereafter maintain its capital at that level and that Istituto per la Ricostruzione Industriale and Banca Commerciale Italiana provide Irving Bank with the necessary capital support to enable it to comply with this requirement. Letter from William W. Wiles, Secretary of the Federal Reserve, to Patricia S. Skigen, dated Aug. 19, 1988. The imposition of these requirements, which the Republic of Italy considered an affront to its sovereignty, caused Banca Commerciale Italiana to withdraw its offer to acquire Irving Bank.

More recently, the Federal Reserve has determined that sovereign wealth funds or other corporate entities controlled by a foreign government were companies for purposes of the BHC Act. For example, UK Financial Investments Limited ("UKFI") had to obtain Federal Reserve approval to become a bank holding company pursuant to section 3 of the BHC Act in order to acquire an indirect controlling interest in the U.S. bank subsidiaries of The Royal Bank of Scotland Group plc, even though UKFI was formed to manage the government's shareholdings in U.K. banking organizations that subscribed to the government's recapitalization fund. *See* Letter from Robert deV. Frierson to Arthur S. Long (Nov. 26, 2008). The Federal Reserve, however, exercised authority under section 4(c)(9) of the BHC Act (discussed in detail below) to exempt UKFI from the non-banking restrictions of the BHC Act. This exemption was subject to certain limitations designed to minimize the potential for conflicts of interest, competitive advantages, concentration of resources and unsound banking practices. The Federal Reserve also exempted UKFI from certain reporting, filing and capital requirements, subject to certain limitations. *Id. See also Commercial Bank of China Limited et al.*, 98 Fed. Res. Bull. 7, 1 (2012) (order approving application of Commercial Bank of China Limited ("CIBC") and two government-controlled companies controlling CIBC to become bank holding companies); *China Investment Corporation*, 96 Fed. Res. Bull. B31 (2010) (Federal Reserve order approving the application of China Investment Corporation, a sovereign wealth fund controlled by the government of the People's Republic of China to acquire up to 10% of the voting shares of Morgan Stanley, pursuant to section 3 of the BHC Act).

## E. Non-Banking Activities of Foreign Banks

Section 8(a) of the International Banking Act of 1978 ("IBA") subjects a "foreign bank" that maintains a branch or agency in the U.S. to the limitations imposed by the BHC Act on non-banking activities of bank holding companies. 12 U.S.C. § 3106. The term "foreign bank" includes any bank organized under the laws of a foreign country, Puerto Rico, Guam, American Samoa, the Virgin Islands or any territory of the United States. 12 U.S.C. § 3101(7). All non-banking activities engaged in by a foreign bank that had a branch or agency in the United States on September 17, 1978, are grandfathered under the IBA, although the Federal Reserve has the authority to terminate these grandfather rights "to prevent undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices in the United States." *Id.*

A foreign bank that did not have a branch or agency in the U.S. on September 17, 1978, including a foreign bank that owned a U.S. subsidiary bank on such date, does not qualify for grandfather rights under the IBA. Staff Opinion of Sept. 17, 1979, Fed. Res. Reg. Serv. ¶ 3-741. The grandfather rights are lost if the foreign bank acquires a U.S. subsidiary bank. 12 U.S.C. § 3106(c)(2).

Grandfathered foreign banks and their grandfathered non-banking affiliates are not permitted to make new acquisitions of non-banking businesses except to the same extent that a U.S. bank holding company would be allowed to do so. 12 U.S.C. § 3106(a). There is an exception to this rule, however, in the case of a grandfathered affiliate "engaged in the business of underwriting, distributing, or otherwise buying or selling stocks, bonds, and other securities in the United States" if the affiliate is not more than 45% owned by a foreign bank or a group of foreign banks and no more than 20% of the directors and 20% of the executive officers of the affiliate are affiliated with any foreign bank; such an affiliate is permitted to make additional acquisitions and to commence new activities. 12 U.S.C. § 3106(c).

Under the Gramm-Leach-Bliley Act, a grandfathered foreign bank that becomes a financial holding company forfeits its grandfather rights, but only with respect to financial activities. Grandfather rights relating to non-financial activities would remain intact. The Act also authorizes the Federal Reserve to impose on foreign banks that did not become financial holding companies within two years of the date of enactment of the Gramm-Leach-Bliley Act the same restrictions and requirements on their financial activities as are applicable to financial holding companies.

Section 2(h)(2) of the BHC Act provides that most of the non-banking restrictions of section 4 do not apply to shares of any company organized under the laws of a foreign country that is principally engaged in business outside the United States if such shares are held by a bank holding company that is organized under the laws of a foreign country and is principally engaged in the banking business outside the United States. 12 U.S.C. § 1841(h)(2). The Federal Reserve's regulations implementing this exemption, 12 C.F.R. § 211.23(f), are available only to foreign banks that are "qualified foreign banking organizations." To be a qualified banking organization, a foreign bank must meet at least two of the following requirements: (1) banking assets held outside the United States exceed total worldwide non-banking assets; (2) revenues derived from the business of banking outside the United States exceed total revenues derived

from its worldwide non-banking activities; or (3) net income derived from the business of banking outside the United States exceeds total net income derived from its worldwide non-banking business. In addition, the foreign bank must meet at least two of the following requirements: (1) banking assets held outside the U.S. exceed banking assets held in the United States; (2) revenues derived from the business of banking outside the United States exceed revenues derived from the business of banking in the United States; or (3) net income derived from the business of banking outside the United States exceeds net income derived from the business of banking in the United States. A qualifying banking organization may:

- Engage in activities of any kind outside the United States;

- Engage directly in activities in the United States that are incidental to its activities outside the United States;

- Own or control voting stock of a company which is not engaged in any activities in the United States other than those that are incidental to the foreign or international business of such company; and

- Own or control voting stock of a company that (1) conducts the greater part of its business outside the United States, (2) is not engaged in underwriting, selling or distributing securities, (3) conducts activities in the United States of the same kind as or related to its foreign activities and (4) with certain exceptions, does not engage in banking or financial operations in the United States or in non-banking businesses which are permitted for U.S. bank holding companies.

Section 4(c)(9) of the BHC Act provides that the non-banking prohibitions of section 4 do not apply to the activities of a foreign company that conducts the greater part of its business outside the United States if the Federal Reserve, by regulation or order, determines that the exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest. 12 U.S.C. § 1843(c)(9). The Federal Reserve has granted exemptions under section 4(c)(9) sparingly, with the Federal Reserve's inquiry generally focusing on the issue of whether the exemption would give the foreign company a competitive advantage over domestic banking organizations.

## CHAPTER 9.

## ANTITRUST CONSIDERATIONS

### I. 2023 DEVELOPMENTS

The Federal Reserve Board (the "Federal Reserve" or "FRB") and the Department of Justice (the "DOJ") reviewed only a few mergers in 2023 and in reviewing those mergers, both continued to apply their standard assumptions.

The Federal Reserve's and the DOJ's standard assumptions are largely based on joint bank merger review guidelines issued by the two agencies twenty-six years ago (1995 *Bank Merger Competitive Review* Guidelines). Some updates to those guidelines were issued in 2014, when the Federal Reserve and the DOJ jointly released an online guide with FAQs providing insight as to how they were analyzing the competitive effects of mergers and acquisitions (the 2014 Guide). However, based on claims by industry participants that the 1995 Guidelines do not reflect present-day market realities and trends, the banking agencies and DOJ again sought comments for possible revisions. In September 2020, the DOJ solicited comments and feedback on those 1995 Guidelines.[4] Many industry participants and interested parties, including our firm, provided comments. *See*, *e.g.*, https://www.justice.gov/atr/page/file/1330316/download.[5]

Suggested revisions included raising the HHI thresholds from 1800/200 — possibly to 2500/250; and incorporating certain of the DOJ's long-standing practices including using the "2% test" for determining inclusion of thrift and credit union deposits in the Division's analysis of small business banking; and using Community Reinvestment Act ("CRA") small business loan origination data for evaluating competition for small business lending. In contrast, other proposals suggest tightening HHI thresholds or a moratorium on acquisitions above a size threshold (suggesting $100 billion).

The DOJ solicited further comments for possible revisions of the 1995 Guidelines in February 2022. This time the DOJ sought comments on:

- To what extent should the Division's competitive scrutiny of bank mergers apply standards, and incorporate factors, beyond those applicable to other industries solely under Section 7 of the Clayton Act?

- In so doing, (1) what factors should the Division consider, (2) how should those factors be incorporated into the Division's competitive review process, and (3) what additional remedies should the Division consider obtaining?

- What additional information and data should banks submit with their bank merger application to facilitate the competitive review?

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[4] https://www.justice.gov/opa/pr/antitrust-division-seeks-public-comments-updating-bank-merger-review-analysis.

[5] David S. Neill, Damian G. Didden and Christina C. Ma, The Banking Law Journal, Revising the Bank Merger Guidelines – Part I (January 2021) & Part II (February 2021).

- The Division often considers the FDIC's Summary of Deposits, and the Federal Financial Institutions Examination Council's ("FFIEC") CRA data during the review of a bank merger application. Should the data submission requirements for these sources be updated — and in what way — to assist the competitive review of bank mergers? What additional information and data should the banking agencies collect on a routine basis to better analyze the competitive effects of bank mergers?

- Whether and how internet-only banks (*i.e.*, banks with no, or an extremely limited, physical branch network) factor into bank merger competitive review.

In 2021, President Biden encouraged the DOJ and regulatory agencies review their current practices and "adopt a plan … for the revitalization of merger oversight" by the end of 2022. (*See* Executive Order on Promoting Competition in the American Economy, July 9, 2021, at https://www.whitehouse.gov/briefing-room/presidential-actions/2021/07/09/executive-order-on-promoting-competition-in-the-american-economy/.) In furtherance thereof, officials from the DOJ and banking regulatory agencies are considering other possible revisions to merger analysis, including bank merger analysis.

On June 20, 2023, Assistant Attorney General Jonathan Kanter gave a speech highlighting significant potential shifts in how the DOJ will approach bank mergers. Many interpreted his speech to mean that the long-anticipated revisions to the Guidelines would issue imminently, but there has been no such release to date and no new official guidance forthcoming. Kanter's speech was long on generalities and short on specifics, but he mentioned that DOJ merger analysis would focus on new factors such as increased risk of coordinated effects and "multi-market contacts" and whether a transaction may exclude potential rivals such as Fintechs. However, Kanter gave no insight into how DOJ would weigh or assess these factors. Perhaps most surprisingly, Kanter indicated that DOJ would no longer play an active role in identifying and assessing potential remedies. If true, this would decrease transparency and could create additional risk for merging parties who craft a settlement with bank regulators that might not ultimately pass muster with DOJ — a situation exacerbated by DOJ having a statutory automatic stay in the courts to prevent closing while its complaint is pending. There were no corresponding indications from bank regulators about any new methodologies for merger reviews, suggesting that there may be increased division between DOJ and bank regulators on how to conduct merger reviews. This division may be what is preventing issuance of new Guidelines.

There were very few bank merger approvals by the FRB in 2023. The merger of Bank of Montreal and BankWest was approved in January 2023. The parties overlapped in seven markets and there were no divestitures required. The merger of R. Dean Phillips Bank Trust and Northeast Missouri Bancshares Inc. was approved in September 2023 with no divestitures despite an overlap in a Louisiana market that nominally exceeded guidelines. The FRB concluded that branch and depositor locations as well as commuting patterns suggested that the merging parties were not close competitors. Finally, LINKBANCORP, Inc. was approved to acquire Partners Bancorp in November 2023 — the parties overlapped only in Philadelphia with no competitive issues. The DOJ did not issue any press releases in 2023 regarding bank merger reviews, continuing a trend from 2022.

## II. STATUTORY FRAMEWORK AND BACKGROUND

The Bank Holding Company Act provides that the Federal Reserve may not approve an acquisition which:

- Would result in a monopoly in, or furtherance of, a combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the U.S.; or

- May have the effect in any section of the country of substantially lessening competition, unless the Federal Reserve finds that the anticompetitive effects of the transaction are clearly outweighed by the convenience and needs of the communities to be served.

The BHC Act standards mirror those of Section 2 of the Sherman Act and Section 7 of the Clayton Act. As such, the courts have held that the Federal Reserve must follow the standards established under those Acts (*e.g.*, *County National Bancorp.* v. *Board of Governors*, 654 F.2d 1253 (8th Cir. 1981)).

Under the BHC Act, during the Federal Reserve's review of an acquisition, the DOJ also has an opportunity to evaluate the competitive issues raised by the proposed transaction and may submit its comments to the Federal Reserve. If the Federal Reserve approves the acquisition, the BHC Act provides that the transaction may not be consummated for 30 days (or 15 days if the DOJ has not submitted adverse comments with respect to competitive factors), during which time the DOJ may challenge the transaction in federal district court. If the DOJ decides to challenge the transaction, the DOJ is entitled to an automatic stay of the transaction upon the filing of its antitrust complaint. *See* 12 U.S.C. § 1828(c)(7)(A). The stay may be lifted only after a *de novo* trial on the merits or if the district court otherwise determines that the stay is unwarranted.

Evaluating the antitrust implications raised by in-market bank acquisitions can be a complex task because the Federal Reserve and the DOJ use different analytical methodologies and focus on different competitive concerns. In 2014, the Federal Reserve and the DOJ jointly released an online guide — called FAQs — providing updated information regarding how they analyze the competitive effects of mergers and acquisitions. The guide (hereinafter, the "2014 Guide"), provides the most comprehensive update of the Federal Reserve's and DOJ's standards and processes for reviewing bank mergers since the issuance of the Bank Merger Competitive Review in 1995 (see below). Most notable among the differences in methodology employed by the Federal Reserve and DOJ is the definition of the relevant product market used by the two agencies. While the Federal Reserve continues to invoke the "cluster" of banking services market definition adopted by the Supreme Court more than 50 years ago, the DOJ evaluates disaggregated product markets including, among others, small-business lending and middle-market lending, in addition to retail banking services. In the 2014 Guide, the DOJ reaffirmed its focus on small business products in its competitive review. In certain circumstances, these differences can lead to conflicting outcomes at the two agencies with respect to whether a particular transaction raises antitrust concerns, and the level of divestiture required to resolve those concerns.

## III. METHODOLOGY USED BY THE FEDERAL RESERVE BOARD

According to the Bank Merger Competitive Review Guidelines issued jointly by the Federal Reserve and the DOJ, the primary tool for evaluating the antitrust implications raised by a bank merger is to measure the effect of the proposed merger on the concentration levels within locally limited geographic markets. *See* Bank Merger Competitive Review, www.usdoj.gov/atr/public/guidelines/6472.htm (the "*Competitive Review Guidelines*").

### A. Geographic Market Definition

The Federal Reserve staff has delegated the task of geographic market definition to the 12 Federal Reserve Banks. Most of the Federal Reserve Banks have pre-defined the geographic markets that they will apply to proposed mergers and have posted the market definitions on their respective Internet websites, or will otherwise make them available upon request. (Links to existing banking market definitions can be found at https://www.federalreserve.gov/supervisionreg/afi/market_info.htm). One significant exception is the Federal Reserve Bank of San Francisco. Because of the large size of this Federal Reserve Bank's territory (covering Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah and Washington), the San Francisco Federal Reserve Bank has chosen to define geographic markets only when merger applications are proposed that actually affect its district. The San Francisco Federal Reserve Bank's website, however, provides an extensive list of markets it has defined in recent merger transactions. *See Banking Markets in the Twelfth Federal Reserve District* (May 2019), *available at* https://www.frbsf.org/banking/files/marketdef-May-2019.pdf ("FRBSF Banking Markets"). The St. Louis Federal Reserve Bank has created a searchable database of all market definitions for all the Reserve Banks. *See* http://cassidi.stlouisfed.org/markets/. The Federal Reserve Bank in the district in which the applicant's headquarters is located can redefine the geographic market at any time, including in the midst of its review of an application. If a market has not been previously defined, it behooves the merging parties to present evidence to the Federal Reserve Bank supporting a geographic market definition in its application. Generally, market definitions will be re-evaluated in any potentially controversial transaction.

Previously, most Federal Reserve Banks commenced their analysis by using the Rand McNally Areas ("RMAs") that existed for all of the major U.S. urban centers in the *Rand McNally Commercial Atlas & Marketing Guide* (Rand McNally). In 2010, Rand McNally discontinued updating the definitions of RMAs, and since then the Federal Reserve Banks appear to be gradually changing the descriptions of their markets to counties, towns, or census divisions, rather than RMAs.[6] However, the approach used by Rand McNally to define RMAs is indicative of the approaches taken by the Federal Reserve Banks to define their own banking markets and, with additional refining, can be used as a starting point for any current analysis. In addition, according to the 2014 Guide, the Federal Reserve will use metropolitan statistical areas ("MSAs") or rural counties, multiple MSAs or rural counties, or parts of MSAs or rural counties to define the geographic market. (FAQ No. 13).

[6] Only 14 markets are still defined by RMAs.

According to Rand McNally, "[t]here are two basic criteria that determine inclusion within an RMA. In general, an area must have (1) at least 70 people per square mile and (2) at least 20% of the labor force must commute to the central urban areas of the RMA." The RMA commuting calculation was performed using individual census tracts rather than entire counties. As a result, RMAs tended to be significantly smaller than the corresponding Metropolitan Statistical Areas ("MSAs") defined by the U.S. Office of Management and Budget (and used extensively by the Census Bureau), which are generally comprised of complete counties. RMAs had been drawn for all areas with populations of at least 50,000 as well as for some smaller urban areas that comprise the central cities of MSAs. The Federal Reserve endorsed the use of RMAs for market definition by the Federal Reserve Banks.

Unlike the other Federal Reserve Banks, the San Francisco Federal Reserve Bank's website provides a detailed explanation of its methodology for defining markets, which may be taken as a reasonable summary of the methodology underlying most of the other Federal Reserve Banks' pre-defined markets, determined at a Census County Division level. As the website description is not dissimilar to the prior RMA-based methodology it is still useful to describe the historical use of RMAs in geographic definition. Indeed, the San Francisco Federal Reserve Bank acknowledges that "[n]o geographic market boundaries significantly changed as a result of the restatement of banking markets in terms of CCDs." (FRBSF Banking Markets, at n.1).

Historically, the San Francisco Federal Reserve Bank would sometimes enlarge RMA markets to include adjacent areas that did not appear to be self-sufficient in terms of retail, commercial, health and government services. Areas that appeared to receive most of their broadcast and print media from the neighboring RMA were also likely to be added to the RMA market. In rural markets for which there are no RMAs, the San Francisco Federal Reserve Bank grouped local communities together based on its own evaluation of the following factors, each of which measures economic interaction:

- Commuting data;
- Highway traffic volume statistics;
- Interconnecting highways and other transportation assets; and
- Reliance on one community's retail, government, health, educational or transportation services (such as regional malls, local government seats, colleges and universities, and major hospitals).

The 2014 Guide also clarifies that the Federal Reserve considers "commuting patterns, shopping patterns, interviews with local government and business leaders, and surveys of local households or small businesses" to define its geographic banking markets.

Factors indicating that two areas might *not* be economically integrated would include geographic barriers that impede or delay travel between the areas, such as bodies of water, mountain ranges or inadequate roads. *See, e.g.*, *Community Bankshares, Inc.*, 93 Fed. Res. Bull. C59 (2007) (parties failed to convince the Federal Reserve Board to redefine the Cortez, Colorado banking market to include La Plata County, Colorado, where Durango is located,

because of, among other things, the presence of a mountain pass between Cortez and Durango, making commutation between those cities difficult during the winter months).

As localized as the Federal Reserve Banks' predefined markets are, in some sense they are larger than would be suggested by the formulation expressed in *United States* v. *Philadelphia National Bank*, 374 U.S. 321 (1963). In particular, the markets are not drawn so that an individual customer at one end of a market would need to consider banks at the opposite end of the market to be practical alternatives. Rather, it is assumed that the economic integration of the market will transmit banking competition via a "chain reaction" effect. The Federal Reserve has echoed this concept: "Competing banks need not serve the same set of customers in order to affect or be affected by pricing and product decisions by each other or other banks because factors indicating economic integration transmit competitive forces over larger areas." *See, e.g.*, *Chemical Banking Corp.*, 82 Fed. Res. Bull. 239, 241 (1996).

The parties may attempt to persuade the Federal Reserve Banks that their pre-defined geographic markets should be amended to reflect new growth or other developments. *First York Ban Corp.*, 88 Fed. Res. Bull. 251, 252 (2002) (redefining the York, Nebraska banking market to include the towns of Polk and Stromsburg in Nebraska). Since many Federal Reserve Banks will redefine markets only after on-site visits and/or surveys, arguments to change geographic markets will usually delay the application by several weeks or more. Indeed, when there is a challenge to a Federal Reserve Bank's geographic market definition, it typically requires review at the Federal Reserve Board level. To help minimize processing delay, it is important to discuss a market redefinition proposal with, and provide supporting information to, the relevant Federal Reserve staff before or soon after an application is submitted.

Arguments to redefine the Federal Reserve Banks' markets will seldom succeed unless the applicant can point to new information that indicates the current definition is outdated. The Federal Reserve will consider certain types of data before making a decision on the redefinition, such as advertisements for banking services and competitive information from interviews of banking organizations throughout the proposed geographic market. One of the most fruitful avenues is to review recent commuting data, as market definitions may be based on older commutation data and older census results. Commuting data are now gathered on a rolling-basis as part of the American Community Survey and Longitudinal Employer-Household Dynamics databases and released by the Census (*see* https://www.census.gov/topics/employment/commuting/guidance/flows.html; https://www.census.gov/programs-surveys/acs; https://lehd.ces.census.gov/data/#lodes and https://lehd.ces.census.gov/). The Federal Reserve Banks are typically receptive to market revisions based on such updated commuting data. Where the evidence shows little commuting between the existing geographic market or portions thereof and the place sought to be included in the geographic market, arguments to redefine the geographic market will likely be unsuccessful. *See Community Bankshares, Inc.*, 93 Fed. Res. Bull. C59 (2007) ("The rate of commuting between Montezuma and La Plata Counties remains low at approximately 7 percent of residents."); *Glacier Bancorp*, 92 Fed. Res. Bull. C167 (2006) (the Federal Reserve rejected the argument that the Montana banking market should be expanded to include the Great Falls banking market based on, among other things, the fact that there was "little commuting between Great Falls and Lewistown" (which is within the Montana banking market)).

Even when a pre-defined banking market is based on the most recent census commuting data, such data may nonetheless be outdated, depending upon the vintage of the commuting data being used. However, even without new commuting data, applicants may be able to show that since the last census a community has experienced dramatic population growth and that commercial and residential development and/or new traffic arteries have bridged previously existing gaps between communities. Other types of evidence that may be persuasive to the Federal Reserve Banks are the factors (discussed above) used by the Federal Reserve Banks to define markets in the first instance, namely:

- Surveys conducted by the applicants or by third parties showing solicitation of local businesses by banks from other areas, or current usage by local residents of banks in other areas;

- Unique facilities in one community, such as regional malls, healthcare facilities, educational facilities or transportation assets, that draw residents from other areas;

- Common broadcast and print media sources (especially those used by banks for advertising) and common telephone directories;

- Travel time studies and surveys showing the local perceptions of the costs and ease of travel between communities; and

- Evidence that the pricing of bank products in one community is influenced by competitors in other communities.

Typically, once a geographic market has been determined, the Federal Reserve evaluates only the entirety of the market. However, on occasion, the Federal Reserve has considered the distribution of the merging banks' banking activity within the market and the directionality of economic ties in assessing the extent of the competitive effects across an entire market. *See Magnolia Banking Corporation*, FRB Order No. 2019-15 (Oct. 11, 2019) (In the Hope, Arkansas, banking market, "the branch locations and commuting patterns of consumers within the market suggest that Farmers Bank and Prescott do not compete as closely with each other as they do with other competitors"); *First Farmers Bank & Trust*, FRB Order No. 2015-06 (February 17, 2015) ("The geographic locations of the applicant and target in the market also suggest that HHI calculations likely overstate the competitive effects of the proposal. FFBT's branches are located in Paris Township, which is located in the more populated, southern portion of the county where a significant majority of the market's banking activity is centered. In contrast, Chrisman only operates in Ross Township, which is in the less populated, northern part of the county. Although the northern and southern parts of Edgar County are included in the same banking market, only a small number of Edgar County residents regularly commute between the two townships."); *River Valley Bancorp*, FRB Order No. 2012-10 (October 17, 2012) (all banking activity by the target is in the northernmost part of the market while the acquirer is in the southern portion and economic ties flow only from the north to the south). A review of the distribution of branches within a market has historically been more typical of the DOJ than the Federal Reserve.

## B. Product Market Definition

The Federal Reserve has stated consistently in its decisions and reaffirmed in the 2014 Guide that in evaluating bank mergers the relevant product market is the traditional "cluster" of commercial banking services which was delineated by the Supreme Court more than 50 years ago in *United States* v. *Philadelphia National Bank*, 374 U.S. 321, 359-62 (1963). Market shares in this cluster product market are approximated on the basis of deposits held by banks and thrifts — and currently, by certain credit unions — in the relevant market.

Under the Federal Reserve's traditional approach, thrifts are initially included in the market at 50% of their deposits for purposes of calculating the Herfindahl-Hirschman Index (HHI) (computed by summing the squares of the market shares of each of the institutions in the market). Where it can be shown that the thrifts in a particular market are unusually active commercial lenders, the Federal Reserve may give those thrifts more weight (*i.e.*, more than 50% of deposits) in its analysis. *See, e.g.*, *BB&T Corporation*, FRB Order No. 2019-16 (Nov. 19, 2019) (weighting the deposits of certain thrifts at 100% in several markets); *First Horizon National Corporation*, FRB Order No. 2017-29 (Oct. 30, 2017) (weighing the deposits of one thrift at 100% when such thrift had a ratio of C&I loans to total assets of 9.6%); *Huntington Bancshares Incorporated*, 102 Fed. Res. Bull. 5, 20 (2016) (weighting the deposits of various thrifts at 100% in several markets); *First Farmers Bank & Trust*, FRB Order No. 2015-06 (February 17, 2015) (weighting the deposits of one savings bank at 100% because its C&I loans to assets ratio is comparable to that of commercial banks in the Edgar County banking market); *see also* FAQ No. 5, *available at* http://www.justice.gov/atr/public/guidelines/308893.pdf.

While historically the Federal Reserve did not include the deposits of credit unions in its analysis (because credit unions were not regarded as competitors), the Federal Reserve has now determined that certain credit unions, like thrifts, should be included in the analysis at 50% of deposits. The current practice to include credit unions in the structural analysis follows years of a slowly building acceptance that credit unions do in fact compete. Moreover, the recently revised delegation rules now provide delegated authority to the Reserve Banks to review applications if the resulting HHI screens are less than or equal to the 1800/200 safe harbor, and the resulting market share is less than 35%, based on the deposits of banks, thrifts *and now credit unions* (that meet certain criteria).

Credit unions will now be included in the analysis at 50% of deposits if the credit union (1) has a broad membership, open to a large portion of the population; (2) has "street level" branches accessible to the general public; and (3) provides products and services that are increasingly competitive with bank products and services. *See, e.g.*, *Huntington Bancshares Incorporated*, FRB Order No. 2021-07 (May 25, 2021) (For example, in the Alpena, Michigan, Banking Market, the Federal Reserve found that six credit unions met those criteria and weighted their deposits at 50%; in the Ludington, Michigan, banking market, four credit unions were weighted at 50%; and in the Traverse City, Michigan, banking market, six credit unions were weighted at 50%); *First Horizon National Corporation*, FRB Order No. 2020-01 (June 15, 2020) (including one credit union in the Marathon banking market); *BB&T Corporation*, FRB Order No. 2019-16 (Nov. 19, 2019) (So called "qualifying credit unions" given 50% weighting in numerous markets); *Magnolia Banking Corporation*, FRB Order No. 2019-15 (Oct. 11, 2019) (same). Since credit unions do not report deposits at a branch level, it is unclear how the credit

union deposits are allocated to the market by the Federal Reserve but one method of doing so is to allocate the deposits equally across all of a credit union's branches unless evidence suggests some other methodology should be used.

We note that the Federal Reserve in one decision weighted the deposits of a significant credit union based on actual membership in a banking market rather than its having a field of membership that covers all, or almost all, of a market's population. In connection with First Citizens BancShares' acquisition of Entegra Financial Corp., the Federal Reserve included the deposits of North Carolina State Employees Credit Union ("SECU") at 50% in four different local banking markets in analyzing the competitive effects of the merger. SECU is the second largest credit union in the U.S., and between 12% and 28% of the residents of four local markets were actual members of SECU. *First Citizens BancShares, Inc.*, FRB Order No. 2019-17 (Dec. 16, 2019). Unlike the Federal Reserve, merging parties do not have access to actual membership data.

It is also possible for deposits of a credit union to be included at 100% given significant evidence of broad services provided to businesses, including commercial lending. Generally the commercial lending of the credit union must be comparable to the lending of banks in the market — the same standard held for including thrifts at 100%.

In the past, when the a credit union did not meet all three of the criteria set out above, the Federal Reserve would consider the credit union's presence as a mitigating factor but it would not weight its deposits at 50%. (*See, e.g.*, *Robertson Holding Company, L.P.*, FRB Order No. 2017-36 (Dec. 15, 2017).) Thus, the First Citizens/Entegra decision marks a change from prior practice, but it might have limited application — that is, limited to only a small number of the country's largest credit unions. Second, as noted above, parties likely cannot access publicly the information about actual membership relied on by the Federal Reserve. Nonetheless, parties might identify large credit unions in their merger applications seeking increased competitive consequences for them even if the large credit union on its face does not meet the three criteria for 50% deposit inclusion.

In calculating market shares, the Federal Reserve also will discount certain special purpose banking organizations, such as credit card banks or internet banks, resulting in higher concentration levels than would otherwise be apparent from the deposit data. In the past, the Federal Reserve has not explicitly described these adjustments in its decisions; rather, the effect is manifested implicitly from the HHI levels reported in the Federal Reserve's decisions and can have significant impacts in markets where credit card banks are concentrated. *See, e.g.*, *WSFS Financial Corporation*, FRB Order No. 2021-14 (Dec. 17, 2021) ("Because several depository institutions centrally book out-of-market deposits in the Wilmington market, these data may overstate the level of concentration in the Wilmington market and understate the competitive effects of the transaction."). *The PNC Financial Services Group, Inc.*, 94 Fed. Res. Bull. C38 (2008) (stated HHI level for the Wilmington, DE market could only result from the exclusion of several large credit card banks). The 2014 Guide explicitly states that such specialty banks will not be included in local market share calculations. *See* FAQ No. 25, *available at* www.justice.gov/atr/public/guidelines/308893.pdf.

Under the Federal Reserve's traditional analysis, an acquisition will not raise competitive problems unless the post-merger HHI is above 1800 and the increase in the HHI resulting from the acquisition is more than 200 points. In 1997, there was some discussion among Federal Reserve officials about raising the safe harbor thresholds to 2200/250 (and some commenters in response to the DOJ's recent solicitation of comments regarding possible revisions to the *Competitive Review Guidelines* have so suggested), but the safe harbor thresholds were never officially changed and today remain at 1800/200.

The Federal Reserve has on occasion expressed concerns about mergers that result in market structures heavily skewed toward the leading firm in the market. For instance, in its decision denying a merger application in *Banc Security Corporation*, 83 Fed. Res. Bull. 122 (1997), the Federal Reserve stated that "[t]he degree of disparity between the market shares of Banc Security [49.2%] and its [12 remaining] competitors significantly reduces the mitigating effect of the number of remaining competitors and would permit Banc Security to maintain a dominant market position despite the presence of firms that may have overall greater organizational resources." *See also The PNC Financial Services Group*, 95 Fed. Res. Bull. B11 (2008) ("Merger proposals involving the largest depository institutions in markets structured like the Pittsburgh market warrant close review due to the[ir] size . . . relative to other market competitors."); *First Busey Corp.*, 93 Fed. Res. Bull. C90 (2007) ("The Board has previously recognized that merger proposals involving the largest depository institutions in markets structured like the Champaign-Urbana market warrant close review due to the size of those institutions relative to other market competitors.").

In a related policy, the *Competitive Review Guidelines* indicates that mergers resulting in the leading firm holding in excess of 35% of a market's deposits may raise additional competitive concerns at the Federal Reserve, even where HHI thresholds are not otherwise exceeded. *See Competitive Review Guidelines*, at n.1, *available at* http://www.usdoj.gov/atr/public/guidelines/6472.htm. The Federal Reserve continues to scrutinize mergers that involve resultant market shares in excess of 35%, even if the safe harbors based on HHI concentration levels have not been exceeded. For example, in reviewing Central Bancompany, Inc.'s acquisition of Bank Star One, where the resultant combined market share was 48.7% but the HHI increase was 92 points to 2,645, the Federal Reserve undertook an analysis of mitigating factors, although it determined ultimately that the transaction would not have significantly adverse effects on competition. Its conclusion was based on the fact that Central would face competition from 23 other depository institutions (one of which would control 9% and two others which would control 6% of the market's deposits), the fact that certain out-of-market deposits attributable to a large class action settlement booked in the market were excludable, credit union competition, and an examination of actual pricing data. *Central Bancompany, Inc.*, FRB Order No. 2017-03 (Feb. 8, 2017); *see also Advent Bank Group, Inc.*, FRB Order No. 2018-09 (April 2, 2018) (despite not breaching the HHI safe harbor, the Federal Reserve undertook a full analysis of the Fayetteville/Rogers Arkansas banking market because the combined market share of the merging banks would be exceed 35%; parties were not required to divest in the market even though the combined market share would be 50.2% because there were 40 other competitors remaining).

In contrast, a merger between two firms in highly skewed markets involving a few dominant banks, where neither of the merging parties is the market leader, often can proceed

even with breaches of the HHI safe harbor levels on the ground that the merger is creating more significant competition against the dominant players in the market. *See Farmers Bank of Northern Missouri*, FRB Order No. 2015-32 (Nov. 13, 2015) ("The proposed transaction would reduce the dominance of Bethany Bankshares by creating a competitor that, while still sizably smaller than the largest competitor in the market, is better situated to compete in the market and is only marginally larger than the firm that is currently the second largest in the market.").

While this section has addressed the methodology of the Federal Reserve, the other national banking regulators — the OCC and the FDIC — perform similar analyses and also receive competitive impact statements from the DOJ.

## IV. METHODOLOGY USED BY THE DEPARTMENT OF JUSTICE

The DOJ has an opportunity to submit comments to the Federal Reserve, the OCC, or the FDIC on the competitive effects of proposed bank mergers.[7] In addition, the DOJ may challenge a proposed merger in federal district court within 30 days after the merger has been approved by the Federal Reserve (or 15 days, if the DOJ failed previously to submit adverse comments to the Federal Reserve). Throughout most of the 1980s, the DOJ was relatively inactive with respect to bank mergers and generally acquiesced in the Federal Reserve's decisions. Beginning in 1990 and continuing today, however, the DOJ has implemented a more proactive enforcement policy, in some cases by seeking and obtaining divestitures above and beyond those required by the Federal Reserve. As part of this proactive enforcement policy, the DOJ established in its competitive factors letters and competitive impact statements new methodologies and product market definitions that departed significantly from the Federal Reserve's traditional approach. In many respects, the details of the DOJ's analysis afforded by the early 1990s' enforcement actions are still instructive in underscoring the differences between the DOJ and the Federal Reserve.

### A. DOJ Challenges in the Early 1990s

In December 1990, the DOJ challenged the acquisition of First Interstate of Hawaii, Inc. by First Hawaiian, Inc., after the acquisition had been approved, subject to certain divestitures, by the Federal Reserve. The DOJ alleged that the divestiture provisions in the Federal Reserve's order were inadequate to safeguard competition in several relevant geographic markets in Hawaii. The suit was settled after the merging parties agreed to a more stringent divestiture plan proposed by the DOJ.

The most significant aspect of the DOJ's action in the First Hawaiian matter was the narrow product market definition adopted. The DOJ's Complaint and the Competitive Impact Statement accompanying the proposed Final Judgment defined a relevant product market for "business banking services" consisting of transaction account deposits and commercial loans. Small and medium-sized commercial customers requiring these services allegedly would have

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[7] In the case of failed banks acquired out of FDIC receivership, the Bank Merger Act permits the relevant banking regulatory agency to approve acquisitions without seeking a competitive factors report from the DOJ and to permit consummation of the acquisitions without observing any waiting period — effectively freezing the DOJ out of the merger review process.

been injured as a result of the acquisition because there were few other entities providing the business banking services which these customers demand.

In particular, the DOJ claimed that thrifts were limited by law in the extent to which they could make commercial loans, and that the capital requirements imposed by the FIRREA significantly impaired the ability of thrifts to provide business banking services. The DOJ also cited state law limitations on the powers of credit unions as impediments to those entities' attempts to compete in the relevant product market. Finally, prohibitions against interstate banking in Hawaii made new entry unlikely to occur. Thus, the DOJ's narrowed product market definition effectively excluded thrifts and credit unions from the relevant market entirely.

In 1991, the DOJ employed a similar analysis in challenging Fleet/Norstar's acquisition of Bank of New England assets from the FDIC. By way of background, Bank of New England and its affiliate banks, Connecticut Bank & Trust, and Maine National Bank, failed and were closed down by the OCC, and the FDIC was appointed receiver in January 1991. In April 1991, the FDIC approved the bid of Fleet/Norstar to acquire the three banks. The DOJ reviewed the acquisition, and rejected the parties' failing firm defense, finding that "because there were less anti-competitive alternatives to the acquisition of the failed Bank of New England, the 'failing firm' defense was not appropriate." *See Bank Merger Analysis and the New Merger Guidelines: The View from the Department of Justice*, Remarks of Janusz A. Ordover, then Deputy Assistant Attorney General for Economics and Margaret E. Guerin-Calvert, Assistant Chief, Economic Regulatory Section, Antitrust Division, before the Federal Reserve Bank of Chicago at 24 (May 8, 1992). Moreover, despite the fact that the New England economy was in a tailspin at the time, the DOJ rigidly applied substantive standards concerning competition between banks and thrifts. According to the DOJ's Competitive Impact Statement, thrifts in the markets in question had largely ceased to offer business banking services to small and medium-sized businesses. Moreover, the DOJ concluded that new entry was unlikely to occur in these New England markets, notwithstanding interstate banking.

The DOJ's review of several transactions in 1992 and 1993 — BankAmerica Corporation's acquisition of Security Pacific Corporation; Society Corporation's acquisition of Ameritrust Corporation; the acquisition of Bank Shares, Inc. by First Bank System, Inc. (FBS); and the acquisition by Texas Commerce Bancshares ("TCB") of three bridge banks created by the FDIC out of the assets of the failed First City Bank System — marked even more significant departures from the antitrust standards and analytical methods used by the Federal Reserve for most of the previous decade. The BankAmerica and TCB transactions represented especially aggressive applications of the DOJ's newly defined product market — business banking services for small and medium-sized businesses. As was the case in the First Hawaiian and Fleet/Norstar matters, the DOJ alleged such a product market in an attempt to exclude thrift institutions from the competitive analysis. In the BankAmerica and TCB transactions, the DOJ was more aggressive in its market definition suggesting that even certain small commercial banks should not be included in the market since small commercial banks may not be able to meet the lending and cash management needs of medium-sized businesses. In the TCB acquisition, the DOJ again rejected the "failing firm" defense because it had understood "there were additional bids above liquidation value for each of the Beaumont and Midland branch banks, and some of those bids would therefore constitute less anticompetitive alternatives to selling those bridge banks to

TCB." *U.S.* v. *Texas Commerce Bancshares, Inc.*, No. 3-93CV0294-G (N.D. Tex. March 8, 1993) (Competitive Impact Statement, at 17 and n.16).

The FBS and Society transactions were also significant due to the DOJ's rejection of the Federal Reserve's geographic market definitions. With respect to the Society transaction, in particular, the DOJ rejected the Cleveland-area market, as defined by the Federal Reserve Bank of Cleveland, and instead focused on smaller county markets within the Cleveland area where market concentration levels were considerably higher and, therefore, more problematic, than in the larger area defined by the Cleveland Federal Reserve Bank. The DOJ claimed that such narrow geographic markets corresponded more closely to the realities of its newly defined product market for small business banking services.

## B. The 1995 "Bank Merger Competitive Review" Guidelines

The enforcement actions by the DOJ in the early 1990s injected a great deal of uncertainty into the process of predicting whether a bank merger would raise antitrust issues. In 1995, however, the DOJ and the Federal Reserve jointly issued *Competitive Review Guidelines*. In the *Competitive Review Guidelines*, the DOJ stated that it would generally employ the 1800/200 HHI threshold to all of the product markets it analyzes. Notably, the DOJ has since then approved a number of transactions that substantially exceeded the 1800/200 threshold. The *Competitive Review Guidelines* further hinted at more flexibility on the part of the DOJ by listing possible mitigating factors that merger applicants may wish to discuss. Such factors include evidence that geographic market definitions are outdated; evidence that a party's competitive significance is overstated by market share statistics, including owing to the fact that the institution may be a weakened competitor due to economic conditions; evidence of recent entry or expansion; and evidence of actual competition for business lending from thrifts, credit unions, non-bank institutions and out-of-market institutions.

While throughout the early 1990s the DOJ was rigidly applying the criteria needed to satisfy the failing firm defense, evidenced by the Fleet/Norstar/Bank of New England and TCB/New City Bank transactions, the DOJ in its *Competitive Review Guidelines* did acknowledge, and provide for, a weakened firm defense. In particular, those *Guidelines* explicitly note that parties may provide "evidence that a particular institution's market share overstates or understates its competitive significance (such as evidence that an institution is rapidly gaining or losing market share or that the institution is not competitively viable or is operating under regulatory restrictions on its activities)." The DOJ's public statements have further acknowledged the mitigating significance of a financially weakened banking competitor. In particular, DOJ officials have stated that "the financial health of the acquired firm is relevant to the competitive analysis . . . in terms of measuring the competitive significance of a firm. . . . For example, in banking . . . poor financial condition of the bank, while short of actual failure, may in some circumstances signal a bank that is a substantially weaker competitive influence in the market. Where factually supported, such evidence will be taken into account in the analysis of the possible competitive effects of the merger." *See Bank Merger Analysis and the New Guidelines: The View from the Department of Justice*, Remarks of Janusz A. Ordover, then Deputy Assistant Attorney General for Economics and Margaret E. Guerin-Calvert, Assistant Chief, Economic Regulatory Section, Antitrust Division, before the Federal Reserve Bank of Chicago at 23 (May 8, 1992).

The *Competitive Review Guidelines*, and the 2014 Guide, continue to stress the DOJ's belief that separate product markets exist with respect to small business and middle-market lending.

## C. DOJ Policies

Certain policies employed by the DOJ are not reflected in, and in some respects deviate from, the *Competitive Review Guidelines*. Adding another layer of complexity and uncertainty to the bank merger process, these DOJ policies can significantly affect the quantity and quality of the branch divestitures required to resolve antitrust concerns and should be anticipated by merger applicants to the extent possible.

### 1. Geographic and Product Market Definition

The DOJ often defines narrower markets than the Federal Reserve. As a starting point, the DOJ initially considers counties or possibly portions of counties in determining the market definition to apply in a particular merger.[8] Because the Federal Reserve regards the relevant product market as a cluster of products and services, it generally assesses the competitive effects of a bank merger for the cluster within a relevant geographic market. In contrast, the geographic markets defined by the DOJ may differ depending upon the relevant product market at issue. In the vast majority of deals, the DOJ has focused on two separate relevant product markets: (1) retail banking; and (2) small business banking, and the geographic market corresponding to each relevant product market may differ.

For retail banking, the DOJ generally regards the product market to be equivalent to the Federal Reserve-defined market, unless there is some topographical reason for a smaller geographic market. With regard to small business banking, the DOJ may regard the geographic market to be smaller than the Federal Reserve-defined market if it believes small businesses would not travel as far as retail customers for banking products. The DOJ will narrow the geographic market to the county or a portions of the county, depending upon what the evidence reveals. Recently, the DOJ has considered cash-based small businesses as a distinct subset of the small business market presuming these businesses require more frequent interactions with a local branch than other businesses. DOJ relies heavily on interviews with customers, competitors, and the merging parties to determine geographic market definitions. Parties should be prepared to look separately at all counties within a Federal Reserve defined market to see if such potential markets might cause concentration issues.

When relevant to a particular merger, the DOJ may also focus on middle-market banking as a separate product market and will define a different geographic market, which may be larger than the other two markets (discussed in Section IV.C.5 below).

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[8] Historically the DOJ initially considered RMA markets due to the narrower focus on business services in the RMA market definition. RMAs are discussed in the *Competitive Review Guidelines*. However, the DOJ has not acknowledged an RMA market definition in recent years.

### 2. The 2% Test

For purposes of identifying the competitors that would be taken into account in analyzing small business banking, since 1995, the DOJ has applied a loan-to-asset test in its competitive analysis of bank mergers — a test not described in the 1995 *Competitive Review Guidelines* but is discussed in FAQ No. 31 of the 2014 Guide. This loan-to-asset test is based on the ratio of an institution's total C&I loans to total assets — with 2% being the threshold — and is applied to commercial banks, thrifts, credit unions, and the subsidiaries of bank holding companies. Any institution (bank, thrift or credit union) that fails to meet the 2% C&I loan to asset threshold is *entirely* excluded from the DOJ's analysis of *deposit* market concentration. Banks and thrifts exceeding the 2% threshold are generally included in the analysis at 100% of their deposits. Credit unions appear to be held to a higher — unquantified — standard for inclusion.

The differences between the DOJ's 2% test and the Federal Reserve's methodology can have important consequences for merger analysis. First, the DOJ's test results in an "all or nothing" determination as to the inclusion or exclusion of an institution in the market, whereas the Federal Reserve's test includes all thrift institutions in the market at a minimum of 50% of deposits regardless of the thrift's loan-to-asset ratio. This is consistent with the Federal Reserve's "cluster of banking products" approach. Second, the DOJ applies its 2% test to individual subsidiaries, without regard to the institution's parent relationship. Thus, the DOJ would exclude a thrift which failed the 2% test even if that thrift were owned by a large commercial bank holding company. The Federal Reserve, by contrast, automatically includes at 100% of deposits any thrift that is owned by a bank holding company. In certain markets, these differing assumptions can substantially affect the market shares of the merging parties and the *divestiture levels required* to remedy antitrust concerns.

Evaluating an institution's proclivity to make small business loans on the basis of an arbitrary ratio of *total* C&I loans to assets has obvious limitations and is arguably unnecessary in view of the availability of more direct measures of small business loan competition. In particular, geographically coded small business loan origination data is available under the Community Reinvestment Act ("CRA"). Since 1995, the call report instructions have required banks and thrifts to report information for small business loans outstanding in addition to total outstanding C&I loans. Using either of the foregoing databases, it is possible to construct estimated market share tables for small business loans. Indeed, the *Competitive Review Guidelines* describes a method for estimating such market share tables by weighting call report data for small business loans according to each lender's share of local market deposits. The CRA loan origination data, which are based on loan customer locations, may be even more accurate than the call report data if adjusted to account for the competitive presence of small banks and thrifts not required to report under the CRA.[9]

[9] Some flaws of the CRA data collection process can lead DOJ to discount market shares in its analysis. CRA includes both commercial & industrial and commercial real estate loans and the DOJ is primarily concerned with only the commercial & industrial product. Not all lenders report CRA loans and estimated lending by non-reporters is often skewed by commercial real estate lending. DOJ adjusts shares to exclude credit card lenders and the smallest loan sizes. And, finally, CRA data is publicly reported at a county level which may not correspond with the geographic market definition used for the small business market.

It should be noted that a merger applicant can attempt to overcome the DOJ's presumption to apply the 2% test to particular competitors in a market. The merger applicant may submit evidence that a competitor plans to initiate or expand its C&I lending, including interviews with the competitor's management; evidence showing that the competitor has recently hired commercial loan officers; and evidence that the competitor is attempting to expand capital and lending limits. Of course, such evidence can seldom be obtained by merger applicants prior to the public announcement of the merger — assuming such evidence can be obtained at all from the parties' competitors. Moreover, interviewing the management of dozens of competing institutions in a large metropolitan market is a time-consuming and expensive task. Finally, the merger applicant can submit CRA data to show actual lending in a market. Note that while the latter evidence is helpful, the DOJ has stated that evidence of low CRA loans alone will not necessarily refute the results of the 2% test. The DOJ may also consider other characteristics it believes are necessary to serve businesses, such as ATM networks, online and mobile banking systems, branch distribution, perception of customers/competitors, and the disposition of management to discount the deposits of any institution.

The 2% test also explains why the DOJ generally does not include credit unions as competitors in its small business banking analysis. Credit unions have limited commercial lending authority, although they can make small business loans to their members, known as member business loans. Over the past 10 to 15 years, the DOJ has become more sympathetic to arguments about credit unions where there is evidence that the credit union is making C&I member business loans well in excess of 2% of its total assets. This evidence should include staffing and servicing by the credit union itself rather than outsourcing originations and processing to service groups. Other factors that will lead the DOJ to treat the credit union as a competitor include the presence of street level branches, memberships open to all or virtually all of a market's residents and a line of products and services similar to those offered by banks.

The DOJ has stated that upon a showing of evidence that the credit union is a comparable competitor to a bank in a market, the DOJ will include the credit union's deposits at 100%. In 2011, the DOJ did just that. In approving Berkshire Hills Bancorp's acquisition of Legacy Bancorp, the DOJ treated one local credit union as a full-fledged competitor and weighted that credit union's deposits at 100%. *See* News Release, *Justice Department Reaches Agreement with Berkshire Hills Bancorp and Legacy Bancorp on Divestitures*, May 18, 2011, *available at* http://www.justice.gov/atr/public/press_releases/2011/271411.htm. The credit union at issue was the largest financial institution in the market, had open membership and operated street level branches. In addition, the credit union competed with the parties for business lending and business services, with about 8% of its assets devoted to member business loans. In FAQ No. 32 of the 2014 Guide, the DOJ has reaffirmed that it may include the deposits of a credit union in the HHI analysis if it meets the same criteria as required by the Federal Reserve and if it is shown to be an active commercial lender. However, the DOJ further stated that if there is no reliable branch level data for the credit union, it may be treated as a mitigating factor in evaluating the transaction rather than given explicit deposit weighting.

### 3. Skewed Market Structures

Like the Federal Reserve, the staff of the DOJ has expressed concern about mergers that result in tiered or skewed market structures — even where the mergers do not otherwise exceed

the HHI thresholds as applied to banking. Like the DOJ's 2% test, this "market tiering" concern was not set forth in the *Competitive Review Guidelines*.

In a 1996 speech given by Constance Robinson, then the Director of Operations of the DOJ's Antitrust Division, Robinson stated that the DOJ "will take a hard look at certain increasingly concentrating regions and markets, especially where a merger would leave a metropolitan area with one or two dominant firms and a fringe of small independent banks which may not be able to compete significantly for small and medium-sized loans." *Bank Mergers and Antitrust*, Address by Constance K. Robinson before the 31st Annual Banking Law Institute, at 7, Washington, D.C. (May 30, 1996). The tiered market concern has been raised by the DOJ staff in a handful of bank mergers of which we are aware.

The DOJ's tiered market concern is notable for several reasons. First, as Robinson's speech indicates, there are no bright-line tests which merger applicants can apply to determine whether their merger will trigger antitrust concerns. Correspondingly, there are no bright-line divestiture remedies which merger applicants can predict or propose as a means to ameliorate the concern.

Moreover, the tiered market concern appears to render moot the HHI concentration thresholds in the *Competitive Review Guidelines*. Since the squaring of the market shares has the intended effect of giving disproportionate weight to the largest competitors, the HHI is designed inherently to reflect the tiering or skewing of a market's structure that may result from a merger. Accordingly, the HHI thresholds in the *Competitive Review Guidelines* should already reflect acceptable levels of market concentration as well as market tiering or skewing. It is difficult to understand why the DOJ must apply an additional — and undefined — market structure test which appears to supplant the clear and predictable test of the *Competitive Review Guidelines*.

#### 4. Deposit Reallocation and Split Relationships

Another analytical technique occasionally used by the DOJ is to request that the parties reallocate their commercial deposit accounts to branches based on the location of the customer in relation to the branches at issue. Deposit reallocation originated with the Fleet/Shawmut merger in 1995 and was proposed by the parties there as a means to address the overstatement of the parties' respective market shares in certain markets. The parties in that transaction argued that the branch-by-branch Summary of Deposit information reported to the FDIC did not reflect actual customer relationships at branches because of organizational decisions made by each of the parties to book certain commercial relationships at their respective headquarters' locations rather than at individual branches.

The DOJ accepted the proposed deposit reallocation in the Fleet/Shawmut transaction as being consistent with the DOJ's suggestion in the *Competitive Review Guidelines* that merger applicants should attempt to allocate their small business loans to geographic markets based on customer zip codes. The DOJ staff further believed that if loans and deposits were allocated using the same zip code methodology, in the event of a divestiture, there would be less chance of splitting the loan and deposit accounts of a single customer among two or more branches. Avoiding split relationships was viewed by the staff as crucial to ensuring the effectiveness and

viability of branch divestitures, on the theory that split customers would be less likely to stay at divestiture branches.

Because of the foregoing concerns, the DOJ has applied deposit reallocation to other proposed bank mergers. When the DOJ believes divestitures may be necessary, it has requested that the merger applicants allocate commercial deposits and commercial loans to branches according to customer zip code or some other methodology. The DOJ also has based its divestiture analysis — both in terms of the size of divestiture and the individual branches selected for divestiture — on the deposit and loan reallocation.

The DOJ's policies regarding deposit reallocation and split relationships have four important implications for merger applicants. First, merger applicants should be aware that the deposit reallocation procedure may increase or decrease the parties' deposit market shares in certain markets from what would otherwise be indicated by the FDIC Summary of Deposit data. While the procedure may reduce concentration in markets where the parties are headquartered, it may correspondingly increase concentration in other, non-headquarters markets. The deviation from the Summary of Deposit estimates will depend on the extent to which the merging parties have centralized the booking of commercial relationships in their respective headquarters offices.

Second, if requested by the DOJ to perform such an allocation, the parties must be careful to select a realistic and defensible methodology, since the selection of divestiture branches will likely be heavily influenced by the results of the allocation. In other words, the parties may have to "live with" the results of the deposit and loan reallocation.

Third, assuming the parties have a significant number of branches in the affected markets, the process can be time-consuming, and it is recommended that it be done early in process so as to avoid delay in the time for the DOJ to perform its divestiture analysis.

Fourth, notwithstanding the logical appeal of reallocating accounts according to customer zip code, the staff of the Federal Reserve continues to rely on Summary of Deposit data for its analysis. The Federal Reserve's resistance to deposit reallocation in part stems from the staff's view that all of the other competitors in the market would need to engage in a similar deposit reallocation in order for the methodology to be consistently applied. This issue, however, is not likely to be of concern unless there are several other large, multi-market or multi-state institutions in the market. In such situations, the DOJ has issued Civil Investigative Demands ("CIDs") to such large competitors, requesting zip-coded deposit and loan information.

Whatever the reason for the Federal Reserve's resistance to reallocation, its refusal to adopt the concept can lead to divestiture results that conflict with those of the DOJ. Unless other mitigating factors are present that ameliorate one or the other agency's concerns, parties theoretically can find themselves over-divesting in various markets to reach the "highest common denominator" of divestiture as between the DOJ and the Federal Reserve. Note that the deposits to be divested for both the DOJ and Federal Reserve would be the allocated deposits.

### 5. Middle-Market Banking

Going back as far as the 1990s, the DOJ has raised concerns about the impact of bank mergers on middle-market banking. Middle-market concerns are difficult to predict and can result in very substantial divestitures.

The DOJ expressed middle-market banking concerns in 1991-1992 with respect to the BankAmerica/Security Pacific transaction and in 1993 with respect to the Texas Commerce transactions. Those transactions, however, also posed problems in small business lending that would have required sizable divestitures even in the absence of middle-market concerns. In several other matters, the DOJ investigated middle-market issues, but concluded that the transactions would not adversely affect competition in that market.

For example, in its evaluation of the merger of First Bank System, Inc. and Bank Shares Inc. (May 1993), the DOJ was concerned with small business lending in the Rochester, Minnesota area but indicated no concern with respect to middle-market lending in the same market, presumably because middle-market firms there were found not to be locally limited with respect to their access to credit. 79 Fed. Res. Bull. 50 (1993). In its evaluation of the acquisition of Ameritrust Corporation by Society Corporation, the DOJ noted that "[m]edium-sized businesses [in Cleveland, Ohio] appear to be able to obtain loans from institutions in Detroit and Pittsburgh as well as locally." U.S. Dep't of Justice, Competitive Factors Letter, February 6, 1992, at 2. In this regard, it should be noted that Pittsburgh and Detroit are located 137 and 181 road miles, respectively, from Cleveland.

In her 1996 speech cited above, then-DOJ Director of Operations, Constance Robinson, stated that the DOJ was "increasingly evaluating the potential effects of bank mergers on middle-market banking customers." That focus was evident in the DOJ's competitive review of the Bank of Boston/BayBanks merger. In that transaction, the parties agreed to divest $860 million in deposits to assuage DOJ concerns focused largely on middle-market competition. Significantly, the Federal Reserve staff perceived no competitive issues with respect to the transaction.

As noted above, the existence of middle-market issues is difficult for merger applicants to predict, largely because there is little publicly available information regarding middle-market lending. The call report instructions for reporting an institution's loans mentioned above in Section IV.C.1. relate only to smaller loan categories, in size ranges of $1 million or less. The DOJ, meanwhile, often defines middle-market lending generally as consisting of loans in the $1 million to $5 million or $1 million to $10 million size range with some adjustment to reflect the specific activities of the parties involved. As technologies allow larger loans to be handled through automated processes, the definition of middle market may now exceed $10 million. In addition, call report data does not show loans originated by the loan production offices of out-of-state banks.

Compounding the problem is the uncertainty as to the scope of the relevant geographic market for middle-market lending. While the DOJ has acknowledged in some matters that middle-market lending can be carried on from cities hundreds of miles from the local geographic market in question (*e.g.*, Society/Ameritrust), there are no clear geographic market definitions of

the type available for conventional bank merger analysis, though it is generally accepted to be broader than most Federal Reserve-defined banking markets — possibly at the state or multi-state level.[10]

Merger applicants can attempt to predict the existence of middle-market concerns in several ways. One method is to construct estimated local market share tables for each call report size category of small business loan (*i.e.*, $0 to $100,000, $100,000 to $250,000 and $250,000 to $1 million) and try to determine if there is a trend toward increasing concentration as the loan size increases. The DOJ sometimes will extrapolate that if such a trend exists among these smaller C&I loans, the trend will continue into the larger middle-market loan categories, raising cause for concern.

Oftentimes, merging parties will have previously performed, or purchased from third parties, market surveys of middle-market businesses. These pre-existing surveys are almost never performed with antitrust principles in mind and often characterize market definitions and market conditions in language that is likely to confuse the antitrust analysis. Merger applicants should, nevertheless, ascertain as early as possible in the process whether they possess such surveys because the DOJ routinely requests that such documents be produced during the course of the investigation. The parties may wish to design and conduct a new survey to counteract poorly phrased or confusing conclusions in pre-existing surveys.

When analyzing middle-market issues, the DOJ often excludes small commercial banks from the competitive analysis. As Robinson explained in her speech, "banks that can offer services to small businesses may not be able to offer the necessary services to middle-market businesses, in part because of regulatory or in-house lending limits." The DOJ has not provided any more public guidance as to the minimum size required for a bank to be included in the middle market, but transaction experience over the past few years suggests that a bank must have $1 billion or more in deposits to have the "critical mass" for inclusion in the DOJ's definition of middle-market competition. Smaller banks will very likely be excluded from the DOJ's competitive analysis.

The $1 billion threshold is also factored into the DOJ's divestiture analysis. In order to ameliorate a middle-market concern, the DOJ is likely to require that a $1 billion competitor be created in the market — either a new entity, or a slightly smaller in-market competitor who can be bulked up to the $1 billion critical mass threshold by acquiring a smaller divestiture from the merging parties. The latter solution was accepted by the DOJ as a remedy in the Bank of Boston/BayBanks transaction.

Significantly, new divestiture methods were devised in 1998 in the NationsBank/Bank America and Banc One/First Chicago NBD transactions to resolve competitive concerns with respect to middle-market lending. Under the previous methodology, the DOJ required merger applicants to assign middle-market customers to bank branches based on geographic proximity and to divest customers that had been assigned to the particular branches chosen for divestiture.

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[10] *See* https://www.federalreserve.gov//econres/notes/feds-notes/are-there-competitive-concerns-in-middle-market-lending-20200810.htm

Thereafter, in public remarks, the DOJ officials expressed doubts that this branch-based method for divesting middle-market customers had been truly effective in the past.

The approach to middle-market divestitures — employed for the first time in 1998 — recognizes that middle-market customers are not branch-dependent. Accordingly, the divestiture of such customers has been uncoupled from the process of selecting divestiture branches. Instead, selected groups of middle-market relationship managers at the divesting bank are offered employment at the divestiture buyer, and all of the loan and deposit accounts for which those relationship managers are responsible are divested to the buyer. This approach was again followed in the merger of Fleet Financial Group and BankBoston Corporation in 1999. In addition to requiring Fleet to divest 306 branch offices with approximately $13.2 billion in deposits, the DOJ also required Fleet to offer the primary purchaser the opportunity to hire middle-market relationship managers and to purchase middle-market loans (and associated deposit accounts) in certain specified markets. This approach was also followed in the merger of Firstar Corporation and U.S. Bancorp in 2001. There, in addition to requiring the parties to divest 13 branches with $756 million in deposits, the parties also had to divest $180 million in middle-market loans and offer the purchaser the opportunity to hire middle-market relationship managers to manage the loan portfolio. Similarly, in the 2008 PNC/National City merger, the DOJ required the divestiture of nearly half of National City's middle market business in the Pittsburgh market and nearly all of its middle market business in the Erie market and offer the purchaser the opportunity to hire personnel who manage those middle market customers.

This approach substantially reduces the usual burden of requiring the merging parties to match middle-market customers to particular branches. Moreover, the new approach will minimize the disruption associated with divesting customer relationships since the managers who are most familiar with the customers will shepherd them through the divestiture process. Because of the obvious merits of this approach, it won approval from the DOJ, as well as from divestiture buyers.

It should be noted that in the three cases where this approach has been used, the merger proponents were not required to include the divestiture of the loan officers in question in the divestiture commitment typically imposed by the Federal Reserve. Unlike the DOJ, the Federal Reserve does not separately evaluate competitive issues with respect to middle-market lending and would likely find it difficult to subject the employment of particular individuals to a trusteeship requirement. Thus far, the differences between the Federal Reserve and the DOJ regarding this new approach to middle-market divestitures have not created any problems.

## V. OTHER FEDERAL RESERVE AND DOJ SUBSTANTIVE CONSIDERATIONS

### A. Headquarters Deposit Adjustments

The Federal Reserve and the DOJ rely on the Summary of Deposit branch data in assessing the competitive impact of bank mergers. Summary of Deposit data, while generally useful as an indicator of a bank's competitive significance in a market, may significantly overstate the competitive position of a bank when the bank has a headquarters or regional headquarters branch in the market or even a branch that is significantly larger than any other branch in a market. Though the Federal Reserve is aware that financial institutions "book"

certain types of deposits to their headquarters branches for administrative purposes, the Federal Reserve has historically resisted excluding any deposits from headquarters branches because of the staff's view that there would have to be a similar exclusion of other similar deposits from all relevant competitors in the market. Despite this long-standing resistance to engaging in any exclusion of deposits as reported in the Summary of Deposit data, starting in 2000, the Federal Reserve began allowing mergers to be consummated with no divestitures in a local market when the parties were able to come forward with evidence that convinced the Federal Reserve that certain deposits were not local deposits and should be excluded from computing concentration levels in the local market. In the 2014 Guide, the Federal Reserve acknowledged that it would make adjustments for centrally booked — headquarters — deposits when presented with sufficient supporting evidence.

The Federal Reserve's initial consideration of, and limited acceptance of, arguments about headquarters deposits as a mitigating factor occurred in 2000 when it reviewed the First Security and Zions Bancorporation merger. In the Federal Reserve's order approving the First Security/Zions merger (86 Fed. Res. Bull. 122 (2000)), the Federal Reserve noted that, because of "unique circumstances," it was willing to discount certain deposits that were subject to legal or other restrictions that constrain the parties' ability to use the deposits to support their general banking activities. The particular deposits identified by the Federal Reserve were non-Utah government and municipality deposits, deposits in escrow accounts for mortgages made outside Utah, and deposits in correspondent banking accounts with institutions outside Utah. For each of the above-mentioned deposit types, First Security and Zions were limited by law, contract, or duration of relationship in their ability to *use the deposits* for any activities other than supporting the deposit account. Moreover, the Federal Reserve noted that the "comparability problem is less severe in this case than in past cases reviewed by the Federal Reserve because First Security and Zions were the only two large banking organizations headquartered in the Salt Lake market that appear to have generated significant out-of-market deposits." After the Federal Reserve's approval, the merger collapsed for business reasons and First Security entered into a merger agreement with Wells Fargo.

The Federal Reserve's 2004 order approving JPMorgan Chase's merger with Bank One Corporation (90 Fed. Res. Bull. 352 (Sept. 2004)) broadened somewhat the circumstances under which it would exclude headquarters deposits from the market share calculations. In that case, the Summary of Deposit data suggested that the merger in the Houston banking market would substantially exceed the agencies' safe harbor thresholds. JPMorgan Chase held 41.6% of total deposits in Houston, and Bank One was fourth in the market with deposits representing 5.5% of the total. Based on the Summary of Deposit analysis, the merger would have caused the HHI to increase by 459 points to 2,421 — indicating a potential billion-dollar deposit divestiture to bring the merger below safe harbor levels. The Federal Reserve, however, agreed with JPMorgan Chase and Bank One that a true assessment of the competitive landscape in Houston should exclude a large amount of deposits held in JPMorgan Chase's Houston headquarters. The Federal Reserve found that approximately two-thirds of the deposits held by JPMorgan Chase in Houston were booked in its main Houston branch and were associated with various JPMorgan Chase business lines that are "national or international in nature" — including JPMorgan Chase's national treasury and securities services, investment banking and mortgage escrow businesses. Of the $21.9 billion in deposits associated with national businesses, less than 5% were held in accounts of customers whose addresses were in the Houston banking market.

JPMorgan Chase represented that almost half of these deposits were not, as a practical matter, available to fund lending by JPMorgan Chase in the Houston market. In this regard, the Federal Reserve noted that JPMorgan Chase's Houston loan-to-deposit ratio was "by far the lowest" for JPMorgan Chase in any Texas banking market.

The Federal Reserve employed several checks and balances to determine whether an exclusion of deposits was warranted. The Federal Reserve examined several alternative measures of concentration in the Houston banking market, including HHIs based on number of branches and the dollar amount of small business loan originations and mortgage loan originations. These alternative measures of concentration yielded post-merger HHIs and HHI increases that were well within guidelines levels for each alternative measure. In addition, the Federal Reserve looked at deposit pricing data and found that the data indicated no significant interest rate deviations in Houston relative to other Texas banking markets, or for JPMorgan Chase relative to its competitors in Houston, that would indicate JPMorgan Chase enjoyed deposit pricing power in the Houston market. Finally, JPMorgan Chase's explanation to the Federal Reserve of its reasons for booking the national deposits in Houston satisfied the Federal Reserve that the decisions were "unrelated to JPMorgan Chase's efforts to compete in Houston."

After considering these factors, the Federal Reserve concluded that the Summary of Deposit "data substantially overstate[d] the effective presence of JPMorgan Chase in the Houston banking market and thus overstate[d] the competitive effect" of the merger in that market. The Federal Reserve then considered the structural effects of the merger after adjusting Houston deposits to exclude the portion of the national business deposits in the main Houston branch attributable to customers with no presence in the Houston market. The Federal Reserve approximated the amount of Houston deposits of JPMorgan Chase competitors attributable to their corresponding national businesses and analyzed the merger's competitive impact excluding those deposits as well. The Federal Reserve noted that it has made such adjustments "only in rare situations in which evidence supported a finding that the excluded deposits were not, as a legal matter, available for use in the market, and data were available to make comparable adjustments to the market shares for all other market participants." Finally, the Federal Reserve noted that the Houston market is attractive for entry by out-of-market competitors.

In 2008, the Federal Reserve again considered and applied a headquarters deposit adjustment in connection with its review of Bank of America's acquisition of Countrywide Financial and PNC's acquisition of National City.

In the Bank of America/Countrywide Financial deal, the merging parties competed in two banking markets, Washington, D.C. and Fort Worth, Texas. While the deposit market shares were well within the HHI safe harbors in the Washington D.C. market, the HHIs were well in excess of the safe harbors in the Fort Worth market. Countrywide Financial was the largest bank in the market, controlling nearly 77% of the deposits. Following a detailed review of Countrywide Financial's deposits at its headquarters branch in that market, the Federal Reserve determined that Countrywide Financial's deposit market share was overstated because of the presence of several categories of non-local deposits. First, the Federal Reserve noted that the branch was not a conventional retail branch in that it was in an office building where Countrywide Financial maintained its national mortgage processing operations and had only one teller window, which accepted cash, but directed customers to an ATM for cash withdrawals.

Second, the Federal Reserve noted that almost all deposits booked at the branch came from escrow deposits, brokered deposits, deposits related to mortgage operations, commercial deposits from title insurance and investment companies throughout the country, and deposits forwarded to the branch from drop-boxes in Countrywide Financial's national network of non-banking offices. Third, the national business-line deposits had been maintained in Alexandria, Virginia but were moved to Fort Worth to take advantage of lower state franchise taxes. Ultimately, the Federal Reserve determined that less than 1% of the deposits were from accounts of customers with addresses in the Fort Worth market. After making the adjustment to account for the non-local deposits, the Federal Reserve determined that consummation of the merger would not have a significant adverse effect on competition. *See Bank of America Corporation*, 94 Fed. Res. Bull. C59 (2008).

In the PNC/National City deal, the merging parties competed in 10 banking markets, although the safe harbor was exceeded only in five markets. In one banking market, Pittsburgh, the merging parties ranked first and second and all other competitors had significantly smaller market shares. The parties argued that because PNC maintained a headquarters branch in the market, PNC deposits booked to the market significantly overstated PNC's competitive presence and certain such deposits should be excluded. In particular, PNC argued that $17 billion in deposits, such as government deposits, out of market escrow deposits, correspondent banking deposits, wholesale CDs, broker-dealer trust accounts and certain corporate deposits, were not local deposits. The Federal Reserve reiterated the limited grounds on which it would consider excluding deposits: (1) where deposits were not legally available for use in that market; (2) where data were available to make comparable adjustments to the market shares for all other market participants; and (3) where there is strong evidence that an institution moved its national business line deposits to a particular branch for business reasons unrelated to its efforts to compete in that market and did not use those deposits to enhance its competitive position in that market or to manipulate Summary of Deposit data. *See The PNC Financial Services Group*, 95 Fed. Res. Bull. B1 (2008). PNC demonstrated sufficiently that (1) its national CDs and broker-dealer trust accounts were maintained at the headquarters for administrative reasons, (2) certain deposits were not legally or practically available for loans in the market, and (3) it did not move the deposits to Pittsburgh to manipulate Summary of Deposit data. While the parties were required to make a divestiture in the Pittsburgh market, the amount of the divestiture was much less than it would have been if the agencies had not made a headquarters adjustment.

In 2016, in connection with Huntington Bancshares' acquisition of FirstMerit Corporation, the Federal Reserve also permitted the exclusion of out of market deposits booked to the parties' headquarters branches upon a showing that there were legal constraints on the use of such deposits and that comparable adjustments can be made for others. *Huntington Bancshares Incorporated*, 102 Fed. Res. Bull. 5, 20 (2016). In 2017, the Federal Reserve again excluded certain non-market deposits booked at an institution's headquarters' branches on that same basis. *Central Bancompany, Inc.* (cited above) (excluding deposits generated from a large class action settlement that were held in escrow for payment to consumers throughout the U.S.). In 2019, the Federal Reserve excluded "tribal deposits in the market that are subject to legal or other restrictions on the organization's ability to lend on such deposits." *First Citizens BancShares, Inc.*, FRB Order No. 2019-17 (Dec. 16, 2019).

Both the DOJ and the Federal Reserve now recognize that extraordinarily large regional or headquarters branches may contain non-local deposits that are subject to the type of legal or other restrictions discussed above, and both may request detailed information on the types of deposits booked at those branches even when arguments have not been made for such exclusions.

## B. Minority Acquisitions

Minority acquisitions can raise unique competitive issues when the acquiring person and the target compete. As a general matter when analyzing the effects of a minority acquisition, antitrust regulators will examine how the transaction will impact the incentives of the transaction parties with respect to future competition, whether the transaction gives the acquiring person the ability to influence or control the competitive decisions of the target, and whether the transaction can facilitate the exchange of competitively sensitive information among competitors. In a straight-out merger, these issues do not exist because there is no continued competition between the acquiring person and the target following the merger. In partial ownership transactions, the regulators will endeavor to determine whether the acquirer will obtain *de facto* control or influence over the target, and if so, the analysis employed will be akin to that applied in a merger between the two firms, *i.e.*, the agencies will look at overlaps between the two firms as if the two firms were merging their operations.

Partial ownership acquisitions can also present unique complications at the remedial stage. If the parties have an anticompetitive overlap, antitrust regulators generally prefer structural relief (*e.g.*, a divestiture) to address competitive concerns. However, except in cases raising very serious antitrust concerns, the remedy for competitive problems in partial ownership acquisitions generally has been something less than structural divestiture. The agencies have allowed partial ownership acquisitions to proceed with conduct restrictions that sterilize the influence the acquirer would otherwise have or that protect the confidential information of the acquired firm and its customers. Examples of such restrictions include requiring the acquiring person to relinquish its rights to have a board representative or to exercise certain vetoes, and imposing firewalls to prevent the exchange of competitively sensitive non-public information.

In connection with minority investments in bank holding companies or banks, the Federal Reserve follows this course:

> One company need not acquire control of another company to lessen competition between them substantially and [the Federal Reserve] has recognized that a significant reduction in competition can result from the sharing of non-public financial information between two organizations that are not under common control. In each case, the Federal Reserve analyzes the specific facts to determine whether the minority investment in a competitor would result in significant adverse competitive effects in a banking market.

*Southern BancShares Inc.*, 95 Fed. Res. Bull. B64 (2009); *accord Sumitomo Mitsui Financial Group, Inc.*, FRB Order No. 2012-11 (October 31, 2012) (FRB undertakes full analysis of overlaps as if it were an acquisition of control). In circumstances where the acquiring bank and the target bank have overlapping operations, and where such overlaps result in concentration levels in excess of the safe harbor levels, the Federal Reserve has required the

acquiring person to enter into passivity commitments. For example, First Citizens BancShares and Carter Bank & Trust entered into an agreement in which First Citizens would increase its ownership from 4.9% to 9.0% of the shares of Carter Bank & Trust. First Citizens and Carter overlapped in numerous markets, although the concentration levels exceeded the safe harbors specified in the guidelines in only four markets. The Federal Reserve ultimately approved the merger without a divestiture because First Citizens had committed "not to acquire, or seek to acquire, any confidential or non-public financial information about or from Carter." Moreover, the Federal Reserve found "there are no officer or director interlocks between the institutions through which First Citizens could acquire confidential or other non-public information about Carter." "These limitations restricting First Citizens' access to confidential information, when combined with the other restrictions on First Citizens' ability to exercise a controlling influence over Carter Bank, significantly reduce the potential that First Citizens may engage in anti-competitive or collusive behavior in any relevant banking market." *See First Citizens Bancshares, Inc.*, FRB Order No. 2017-01 (Jan. 11, 2017) (passivity commitments in Appendix A); *accord Southern BancShares Inc.*, 95 Fed. Res. Bull. B64 (2009); *Sumitomo Mitsui Financial Group, Inc.*, FRB Order No. 2012-11 (October 31, 2012); *City Holding Company*, 96 Fed. Res. Bull. B21 (2010).

**C. Internet Deposits**

Bank merger analyses, regardless of whether they are undertaken by the Federal Reserve or the DOJ, do not take into consideration the competitive presence of online banking. The analyses are based on deposits booked at branches, which have a physical presence, and as physical locations, each branch is mapped into local banking markets. An online bank likely has one headquarters branch where it books all online deposits regardless of where the deposit accountholder lives. Even banks that have physical branches but also take online deposits nationwide may book those nationwide online deposits at a regional headquarters branch rather than in the branches in which the online accountholder resides. The true location of an online deposit holder is not taken into account in by the agencies. In situations where a traditional bank involved in a merger has established a separate cyber branch for Summary of Deposits reporting, the DOJ and Federal Reserve have considered evaluating these deposits similar to headquarters adjustments. This allows for exclusions to a given market, but does not reflect lending into that market by other online lenders. Local competitive analyses thus overstate the competitive presence of branch-based deposits.

We understand that the agencies acknowledge the presence of online deposits but they do not include such deposits in their analyses due to the lack of evidence of the online account holder's domicile. Given the increasing prevalence of online banking, the authors believe there should be some quantitative consideration of online deposits in merger analysis, such as, for example, raising the safe harbor concentration levels proportionately to account for the amount of such deposits compared to actual branch based deposits. At a minimum, parties should engage the regulators in discussions about these issues in order to propel regulators to find a workable solution to address the realities of modern banking. This issue is one of those raised by the DOJ in its recent requests for comments.

There were two transactions in 2020 where the Federal Reserve addressed online banking but primarily in the context of a merger with an online competitor: TD/Schwab and Morgan Stanley/E*Trade.

TD, through its bank subsidiaries, operated approximately 1,220 retail branch locations in fifteen states and the District of Columbia. Schwab also competed for deposits via its online platform. The Federal Reserve acknowledged that competition, but noted that there was unlikely to be any concentration in any localized geographic market. The Federal Reserve found that, based on the size of the organizations, the large number of internet-based competitors, and the diffuse geographic nature of TD's and Schwab's internet deposits, the proposed transaction would not adversely affect competition. *See The Toronto-Dominion Bank*, FRB Order No. 2020-04 (Sept. 30, 2020).

With regard to Morgan Stanley's acquisition of E*Trade, neither operated retail branches. However, both offered online banking products and services. While the Federal Reserve acknowledged that both might compete in local markets, it stated that "[B]oth organizations receive deposits from across the country, making it unlikely that either organization holds a high concentration of deposits in any local market. Based on the size of the organizations, the large number of internet-based competitors, and the widely dispersed geographic origins of Morgan Stanley's and E*Trade's internet deposits." Accordingly it found no material adverse competitive impact. *See Morgan Stanley*, FRB Order 2020-05 (Sept. 30, 2020).

In 2022, the merger between First Internet Bancorp ("FIB") and First Century Bancorp was terminated by the parties after First Century raised its asking price while awaiting for regulatory approval. This was a relatively small transaction with no deposit overlaps in any market, but the Federal Reserve order approving the transaction without antitrust conditions noted that FIB serves the nation "digitally" and the Federal Reserve did not undertake any local market analysis. It is hard to extrapolate any meaningful policy guidance from this small transaction, but it is perhaps noteworthy that the Federal Reserve did not deem it worthwhile to discern any competitive pressure between FIB's internet model and First Century's more traditional banking structure. *See First Internet Bancorp*, FRB Order 2022-12 (April 29, 2022).

## VI. FEDERAL RESERVE BOARD AND DEPARTMENT OF JUSTICE POLICY REGARDING DIVESTITURES

A variety of qualitative divestiture policies adopted by the Federal Reserve and the DOJ can significantly impact the financial and operational value of proposed banking acquisitions/mergers. These policies affect the duration of the application process, the selection of the particular branches to be divested and the selection of the buyers for those branches.

### A. Timing and Delay: Procedural Considerations

Parties to a bank merger often view delay in consummating the merger as imposing a significant opportunity cost in the sense that merger synergies are deferred until consummation. When the acquisition involves a troubled bank, speed is of the essence. It should be noted that since the mid-1990s, the DOJ staff became considerably more flexible with respect to requiring merger applicants to reach an "agreement in principle" with the DOJ as to overall divestiture

levels before the filing of the merger application with the Federal Reserve. Prior to 1995, the DOJ staff took the view that merger applicants should reach an "agreement in principle" with the DOJ as to the approximate magnitude of curative divestitures *before* the parties formally filed their merger application with the relevant banking agency and thereby started the running of the statutory waiting period. This policy, in effect, required the parties to submit a draft of their Competitive Memorandum to the DOJ and allow *several weeks* for review and negotiation before filing the merger application. The DOJ adopted this policy because the banking agencies would sometimes approve transactions pursuant to the BHC Act statutory time periods even if the DOJ had not completed its investigation or reached an agreement with the applicant as to divestitures. Under the post-approval statutory waiting periods of the banking statutes, the DOJ had only a limited 30-day window after banking agency approval in which to bring suit, or the DOJ would forfeit its rights to challenge the combination. *See* 12 U.S.C. § 1849. Reacting to these timing considerations, the DOJ would obtain a commitment from applicants to defer the filing of their bank agency applications (and thus not start the statutory 91-day clock) rather than issue very burdensome Civil Investigative Demands ("CIDs") for documents and data if the applicants did not agree to delay their filings.

In addition, if the DOJ sought divestiture relief in excess of that required by the reviewing federal banking agency, the DOJ would require the merger applicant to enter into a separate consent decree subject to Antitrust Penalties and Procedures Act — also known as the Tunney Act — review in a federal district court. *See* 15 U.S.C. § 16(b)-(h). The Tunney Act provides that DOJ settlements must be approved by a federal district court after a public notice and comment procedure. The DOJ must provide information to the federal district court responsible for approving the settlement, and to the public, so that the court can make an informed determination, taking into account comments from interested members of the public, of whether to accept or reject the settlement as in the public interest. The Tunney Act was a "government in the sunshine" provision, enacted to eliminate so-called "judicial rubber stamping" of DOJ settlements. *See also* Section VI.A.5. Tunney Act proceedings sometimes provided additional forums for CRA protestors to voice their opposition to transactions.

The DOJ and the legal staffs of the federal bank regulatory agencies reached informal agreements in 1995 that substantially ameliorated the delays and burdens associated with the pre-1995 regime. Under these agreements — which are still in effect today — the DOJ staff will advise their federal bank agency counterparts whether the DOJ perceives significant competitive issues with a transaction within 30 days of the filing of the application. If the DOJ perceives significant competitive issues requiring lengthy investigation, the federal banking agency will typically not deem the merger application to be complete and will ask the applicant for more information. Such a pronouncement has the effect of stopping the statutory 91-day clock and relieving the time pressure on the DOJ. As part of this process, the DOJ will also seek to arrive at a divestiture settlement with the applicant in the form of a simplified letter agreement. This settlement is then embodied in the merger applicant's divestiture commitment to the reviewing federal banking agency. As a result, no separate consent decree or Tunney Act review is required.

Interagency coordination has worked well since 1995, and the DOJ has generally been able to resolve its concerns concurrently with the Federal Reserve's consideration of the application. Depending on the applicant's strategy, the applicant may wish to submit a draft of

its Competitive Memorandum to the staffs of both the DOJ and the Federal Reserve at least a week or two before filing the merger application. Providing such a draft is a courtesy to the agency staffs, and may also enable the parties to obtain early feedback about additional markets of concern, possible market redefinition being considered by the DOJ (or the relevant Federal Reserve Bank) that the parties may not have expected, and additional arguments that should be added to the final Competitive Memorandum. While there is no obligation to do so, the parties may also want to consider a pre-filing meeting with the staff of both agencies. In this regard, the bank merger process is considerably less adversarial than the competitive review of mergers in other industries under the Hart-Scott-Rodino Act.

Certain other procedural steps (discussed below) can accelerate the resolution of antitrust concerns at the DOJ:

**1. Early Triage of Geographic Markets**

Where the merging parties overlap in numerous geographic markets, the parties should quickly determine which markets are worth fighting for and which are not. In particular, they should identify the markets which pose the largest potential divestitures, the markets which appear to evidence the most promising mitigating factors, and the markets in which small divestitures will resolve antitrust issues for which there are otherwise few defenses. Based on this triage analysis of overlap markets, the parties should consider apprising the staffs of the Federal Reserve and the DOJ early in the process (within one or two weeks of announcing the transaction) of the markets in which the parties will simply divest down to safe harbor levels.

This approach has several advantages. First, it will help to allay concerns among the DOJ staff about the amount of time they will need to conduct their investigation of the merger; otherwise, the DOJ staff may demand that the parties agree to delay the filing of their Federal Reserve application until the DOJ staff has had several weeks to review a draft of the parties' Competitive Memorandum. The DOJ staff may allow the parties to forego, or at least reduce, the compilation of branch data for geographic markets in which an overlap will be eliminated or reduced to safe harbor levels by divestiture. Eliminating unimportant market overlaps early in the process will also minimize the "multiple market" concerns that were raised by the Federal Reserve in the Federal Reserve's decision in the NationsBank/Barnett merger described above. Finally, early triage will enable the parties to focus their own resources on minimizing divestitures in key markets where mitigating-factors arguments are likely to yield the greatest benefits. These benefits must be weighed, however, against the fact that, in some matters, such early engagement may provide the agencies a "roadmap" to seeking remedies that might not otherwise be required.

**2. Begin Compiling Branch Data Immediately**

The DOJ staff has developed an extensive data request that focuses on the branch operations of the parties in markets where significant divestitures are likely. Described in more detail below, the branch data request is intended to allow the DOJ staff to evaluate whether the divestiture package ultimately proposed by the parties will meet the qualitative criteria imposed by the DOJ. The staff will not act on the parties' divestiture proposal until the parties supply the requested data. Experienced antitrust counsel can provide clients with models of the DOJ's

request (which has not changed significantly in the past few years), and clients should begin compiling these data without waiting for the DOJ staff to issue the request.

### 3. Begin Immediately Assembling a Divestiture Package that Meets the DOJ's Qualitative Criteria

Using reasonable best efforts to assemble a package of divestiture branches that complies with the DOJ's *qualitative* criteria will dramatically accelerate the DOJ's review.

These qualitative criteria are described below in great detail, but one should be noted here — the DOJ strongly prefers that branches selected for divestiture should be chosen exclusively from the party whose name is leaving the market, even if that party is technically the acquiring entity. In the past, if the parties committed up front to comply with this criterion, the DOJ staff would not require that the non-divesting party comply with the branch data request described above. This concession consequently saved considerable time and burden. In 2009, the DOJ departed from this policy and has required both parties to comply with the request regardless of up-front commitments. The DOJ has offered no rationale for this policy shift.

### 4. Choose a Divestiture Buyer Likely to Be Acceptable to the DOJ as Early in the Process as Possible

In the past, if the parties were able to identify a potential divestiture buyer at the time they presented their proposal to the DOJ staff, they were sometimes able to accelerate the DOJ's review of the parties' proposal. In particular, where a large divestiture in a metropolitan market was at issue, the potential buyer could, in effect, endorse the quality of the branches selected by the merging parties for divestiture. More recently, the DOJ has favored the conduct of auctions after the DOJ has preliminarily approved the branch package.

It should be cautioned that a buyer, once selected, may later attempt to use the DOJ staff to extract concessions from the merging parties, such as additional or different branches. Moreover, since the parties cannot sign a definitive divestiture contract with the buyer until final approval is received from the DOJ's front office (usually forthcoming only at the end of the Federal Reserve's review period), the buyer may feel empowered to seek other last-minute modifications in the divestiture contract. The front office may disagree with the conclusions of the DOJ staff and thus independently require changes to the anticipated divestiture portfolio. These pitfalls in the divestiture process are perhaps the inevitable result of the involvement of government agencies in what is otherwise a business negotiation.

### 5. Method of Settlement

Under long-standing policy, the DOJ expected the parties to incorporate all components of their final agreement with the DOJ as part of the parties' Supplemental Divestiture Commitment which must be submitted to the Federal Reserve before the Federal Reserve reviews the merger application. Thus, the parties' Divestiture Commitments to the Federal Reserve generally mirrored the divestiture commitments contained in the letter agreement with the DOJ. Most parties to a merger prefer this form of settlement with the DOJ as compared to entering into a separate consent decree with the DOJ. Consent decrees are subject to a federal court proceeding under the Tunney Act, during which interested parties may file objections to

the terms of the decree. Tunney Act proceedings can thus provide CRA protestants and other adverse parties with an avenue for complaint and delay.

Today, the DOJ appears to require more than a mirroring of divestiture commitments. The DOJ currently requires that the parties' Divestiture Commitments to the Federal Reserve expressly state that they will comply with the divestiture commitments made to the Department of Justice in the letter agreement. We understand that this requirement stems from the DOJ's concerns about the enforceability of its letter agreements following the consummation of the merger. Recent Federal Reserve Divestiture Commitments or applicant side letters to the Federal Reserve include the statement required by the DOJ.

In its most recent settlement agreements, the DOJ also reserved the right to enforce the provisions of the letter agreement independently and required the parties to agree to reimburse the DOJ for the fees and expenses of its attorneys and other costs if necessary to do so. Agreements may also include limitations relating to the future sale or closure of branches in the markets where divestitures were required, or more broadly in certain overlap states. These terms can significantly delay and/or reduce anticipated branch consolidation cost savings.

### 6. Executed Divestiture Contracts Required Before Consummation

The DOJ requires an executed contract with a divestiture buyer to be submitted to it, and the Federal Reserve requires a commitment after Federal Reserve approval but before the merger is consummated. Both agencies also require that the sale of the divestiture branches be consummated within six months after the consummation of the merger. After that time, the divestiture branches must be transferred to a trustee who is directed to sell them without regard to price.

Exceptions to the foregoing policy were made during the financial crisis. In connection with the Federal Reserve's review of the Wells Fargo/Wachovia and PNC/National City mergers in late 2008, both agencies allowed the parties to consummate first and find divestiture buyers afterwards. In those mergers, the Federal Reserve gave the parties 60 days following consummation to enter into divestiture contracts, although the Federal Reserve continued to require that the divestitures be completed within six months of consummation. Owing to the extraordinarily tight capital markets condition confronting potential divestiture purchasers in both transactions, the Federal Reserve (with the consent of the DOJ) granted extensions of the 60-day time period to accommodate these divestiture buyers dealing with difficult capital markets as well as branch conversion constraints. In 2010, the Federal Reserve returned to its policy of requiring executed divestiture contracts prior to the closing of the merger, even in troubled bank transactions. *See The Toronto-Dominion Bank*, 96 Fed. Res. Bull. B36 (2010).

### 7. No "Double Conversions" of Divestiture Branches

The DOJ letter of agreement prohibits the double conversion of divestiture branches — *i.e.*, parties are prohibited from converting such branches first from the target bank's core processing system to the acquiring institution's system and later to the divestiture buyer's system. Instead, the DOJ requires that divestiture branches should convert only once, directly from the target bank's system to the divestiture buyer's system, so as to minimize any

discontinuity in the customers' experience that might cause run-off at the divestiture branches. The DOJ staff amended its standard form letter agreement to explicitly require "that the conversion of the Divestiture Branch customer relationships to the Divestiture Buyer will be completed prior to, or contemporaneously with, the conversion of the other assets and liabilities that will be acquired as part of the subject transaction."

The impact of this requirement is more salient in branch sale transactions than in whole bank or holding company mergers. In a typical branch sale, the parties will schedule the consummation of the sale to occur simultaneously with systems conversion of the branches. If the transaction entails a divestiture of one or more of those branches to a third party, the DOJ's double-conversion prohibition effectively mandates that the consummation (and accompanying conversion) of the main transaction be delayed until the divestiture buyer is also ready to close on its acquisition and convert the divestiture branches. This effectively negates the 180-day period after closing of the main deal that acquirers otherwise had to consummate divestitures. In the context of holding company mergers, this double-conversion prohibition will have little or no impact on timing since acquirers often wait some months after consummation to convert the systems of the target bank subsidiary in any event, and they usually prefer to coordinate that conversion with divestiture buyers.

#### 8. Operate Branch as the Target Has in the Past

Prior to the divestiture, the DOJ requires that the parties agree that between the consummation of the acquisition and the divestiture of the branches, the parties will operate the divestiture branches in a manner similar to the manner in which the target operated them. The DOJ also explicitly requires the parties to commit not to take any action that would impede in any way the operation of the branches to be divested. Finally, the DOJ prohibits the parties from reacquiring any branches to be divested within a specified period of time.

### B. Divestiture Branch Selection

The Federal Reserve staff generally does not become involved in the branch-by-branch details of the parties' divestiture proposal, so long as the deposit totals offered for divestiture are sufficient to reduce market concentration to acceptable levels.

The DOJ, on the other hand, continues to employ several policies regarding branch selection which can significantly impact the synergies to be achieved by the merger. Fulfilling these policy preferences can also entail procedural delay, since the parties can sometimes negotiate with the DOJ staff to select a package of suitable branches only to have that package second-guessed by the DOJ front office. Moreover, as noted above, in order to implement these policies, the DOJ will request from the parties a great deal of information concerning all of the parties' branches in the affected markets.

#### 1. The DOJ's Information Request

As noted, the merging parties may wish to begin assembling the information likely to be requested by the DOJ without waiting for the DOJ to issue the data request. The information requested may include the following for each of the parties' branches in each divestiture market whether or not those particular branches are proposed for divestiture: the type of branch (free-

standing or in-store); its hours of operation; numbers of drive-up windows, ATMs, and night depository drops and their respective transaction volumes; number and volume of loans by type (C&I, commercial real estate, consumer, or agricultural); the deposits in the branch (Summary of Deposits and commercial); and details on ownership or lease conditions for the property. In addition, the DOJ will request written descriptions of policies and procedures on booking loans and deposits; definitions of small business and middle market customers; and organization charts. Loan officers serving the issue markets will be identified with descriptions of their existing portfolio and geographic territory. The DOJ will interview customers of the bank and will request lists identifying the largest customers in each product area of concern. The DOJ will also ask for retail and commercial deposits and loans (number and volume) by customer by zip code for each branch in certain geographic markets. The commercial products will be separated by size of the customer (for example, annual revenues under $1 million or $1 million to $10 million) and by size of loan (generally originations under $100,000; $100,000 to $250,000; and $250,000 to $1 million). Finally, the DOJ will request many types of documents relating to competition and strategic planning.[11]

As more banks carry out their commercial lending activities from centralized offices rather than from traditional bank branches, an additional factual issue will arise in the structuring of divestiture proposals. The merging parties will be required to propose to the DOJ some method of allocating commercial loans held in the central office (usually the state or regional headquarters branch) to the divestiture branches. This procedure may involve some method of matching the loans to the branches holding the loan customers' deposit accounts, and/or matching the loans to branches in the zip code nearest to the customers' locations. Special care must also be taken to avoid splitting loan relationships of individual customers between divestiture branches and retained branches. On occasion, parties may also be required to offer for employment by divestiture buyers the relationship managers who are primarily responsible for the divested loans.

### 2. The DOJ's Preference that Divestiture Branches Be Chosen from the Party Whose Name Is Leaving the Market

With the foregoing information, the DOJ will evaluate whether the parties' divestiture proposal conforms with several of the DOJ's branch selection criteria. First, the DOJ generally prefers that, all else being equal, divestiture branches be chosen from among those of the party whose name is leaving the market.

The DOJ believes that a divestiture buyer will have a better chance of retaining its newly acquired customers and deposits if those customers were formerly associated with branches of the bank whose name is disappearing in the merger. If only branches of the surviving bank are to be divested, the DOJ's runoff theory would presumably require that the merging parties divest a larger amount of deposits in the relevant market than would otherwise be the case to account for the higher levels of expected run-off from the divestiture branches after they are acquired by the divestiture buyer. In the case of a merger where the name of the merged enterprise will be

[11] The Federal Reserve also will likely issue an information request. Generally, these requests are tailored to the transaction so advance preparation is unnecessary.

different from the names of either of the merging parties, the DOJ has shown more flexibility with respect to mixing branches from both parties.

The DOJ's preference that branches of the disappearing party be divested can significantly impact merger planning and merger synergies. For instance, if that party's branches on average happen to be physically larger or underutilized as compared with the other party's branches, they may be better suited to receive additional customers after neighboring branches are closed or consolidated. Thus, occasions can arise where the DOJ's branch selection preference will result in the divestiture of branches that are uniquely valuable to the merging parties, thereby depriving them of some of the cost savings and consolidation opportunities which motivated the merger in the first place.

In theory, the DOJ's branch selection concerns should be unwarranted, and would not seem to justify the DOJ's regulation of the divestiture process. Assuming the DOJ is correct that post divestiture runoff will be greater at branches which were formerly part of the surviving party's network, the divestiture buyer will presumably be aware of this likelihood and will accordingly pay a smaller consideration for the branches in question. The marketplace incentives of the merging parties to maximize the price obtained for the divested branches should therefore result in the same outcome as the DOJ would seek. The authors are not certain if the DOJ has accepted this argument, but the authors note that recently the DOJ has accepted a few branch divestitures from the acquiring institution in certain circumstances.

### 3. Branches in Small Business Areas

The DOJ has a strong preference that divestitures be comprised of branches showing high levels of business activity (such as business deposits, C&I loan volume, night depository drops), and/or branches which are located in areas where small businesses are concentrated. The DOJ is sometimes so concerned that a divestiture package should include branches covering areas of small business activity that it will sacrifice broader geographic coverage and/or coverage of residential neighborhoods within a relevant geographic market. The DOJ's desire to cover all areas of small business activity may also result in a greater number of branches being divested than the deposit divestiture calculations for the market would indicate.

In some respects, the DOJ's desire to cover every area of small business activity within a given geographic market is inconsistent with the theoretical basis on which that relevant geographic market was defined in the first instance. As a matter of antitrust theory, a relevant geographic market should be defined as the smallest area in which to evaluate the competitive effects of a proposed merger, and should reflect the economic realities of how price competition is transmitted through the marketplace. If the geographic market has been defined correctly as a matter of economic reality and antitrust theory, there is no theoretical basis for analyzing competition in yet smaller geographic areas within the defined market. The DOJ sometimes appears to lose sight of this basic premise of market definition when evaluating divestiture proposals.

One exception to the foregoing branch selection criteria is the DOJ's reluctance to accept for divestiture branches which were recently acquired from thrift institutions. Even if such branches meet other criteria (*i.e.*, they are now branches of the bank being acquired and are

located in small business areas), former thrift branches are seldom acceptable to the DOJ as divestiture branches. Similarly, supermarket branches are almost never acceptable as divestiture branches.

### 4. Countervailing Considerations

Overcoming the foregoing branch selection criteria at the DOJ is very difficult even where the DOJ's selection preferences will cause the merging parties to forego significant consolidation opportunities. In order to overcome the DOJ's selection, the parties must present specific evidence on a branch-by-branch basis to illustrate the consolidation and cost savings opportunities at issue, and the competitive sufficiency of the parties' proposed alternatives. Alternatively, the parties may have to agree to higher levels of deposit divestitures in non-conforming branches to offset the DOJ's expectations that greater deposit runoff will occur from those branches after divestiture.

## C. Selecting Divestiture Buyers

Both the Federal Reserve staff and the DOJ staff will evaluate whether potential buyers of divestiture branches are suitable competitive replacements for the acquired bank. Several considerations will be important to one or both of the agencies, including whether the buyer is an out-of-market entity or an in-market competitor, whether the divestiture branches in a given market are sold to one buyer or split up among several different buyers, and whether the buyer is a commercial bank, a savings bank, a savings and loan or a start-up investor group.

### 1. Out-of-Market Versus In-Market Buyers

Based purely on a mathematical calculation of the HHI, the sale of a divestiture package to an out-of-market competitor will result in lower market concentration after all of the transactions are consummated. This results from the simple fact that the sale of the divestiture package to an in-market competitor will itself cause an increase in the HHI above the level that would otherwise result after the divestiture.

Notwithstanding the foregoing, neither the DOJ nor the Federal Reserve absolutely prohibits the sale of divestiture branches to in-market entities. The Federal Reserve, for instance, is sometimes concerned that the post-merger market structure will be heavily skewed toward the merged institution. An example of such a market structure would be where the leading firm has a market share that is twice or more than that of the next largest competitor. In these circumstances, the Federal Reserve staff may acquiesce or even prefer that a divestiture package be sold to an in-market competitor in order to create a stronger number two company and a less lopsided market structure.

Similarly, like the Federal Reserve, the DOJ may find it appropriate to create a strong second institution in a market. In addition, the DOJ has occasionally indicated a preference that an institution which already has some familiarity with the geographic market at issue be selected as the divestiture buyer.

### 2. One Buyer or Multiple Buyers

Based on a purely mathematical calculation of the HHI, splitting a divestiture package among a number of buyers will result in lower concentration than selling the same package to a single buyer. In spite of this, neither the Federal Reserve staff nor the DOJ staff is likely to prefer that parties split the divestiture among numerous buyers. Indeed, in many circumstances, the agencies will not permit such splitting.

The concern with splitting divestiture packages is related to the agencies' desire to avoid creating a skewed market structure with an ineffective fringe of very small competitors. Both agencies would prefer that the divested entity have the "critical mass" necessary to have a competitive impact on the market. Where the merger raises competitive issues with respect to so-called "middle-market" lending (*i.e.*, commercial lending to firms having revenues in the $10 million to $100 million range — though this range varies depending upon the activities of the merging parties), "critical mass" may be defined as a bank having in excess of $1 billion in deposits.

The DOJ is more insistent than the Federal Reserve that divestiture packages within particular markets not be split among numerous buyers. This preference for a single buyer can often dictate the DOJ's selection of the divestiture branches and the pattern of geographic coverage, with the DOJ selecting branches that comprise a single, integrated network within the affected market. Where the divestiture in a market is very large (*i.e.*, in excess of $1 billion), the DOJ may entertain joint or consortium bids by two parties acting in concert. Such bids, however, must encompass the entire package and the DOJ must be apprised of which branches will be acquired by which of the joint bidders.

On occasion, the DOJ's one-buyer policy can extend beyond individual geographic markets and encompass multiple, adjacent local markets. In these cases, the DOJ will require that divestitures in several such adjacent markets be sold as a package to a single buyer. In the Fleet Financial/BankBoston merger, the DOJ applied its one-buyer policy to encompass not only adjacent markets but to encompass an entire region. There, the DOJ indicated a very strong preference that the divestitures in Connecticut, Massachusetts and Rhode Island be sold to a single buyer. To our knowledge, this is the most far-reaching extension of the DOJ's single-buyer preference.

### 3. Commercial Banks, Thrifts and Investor Groups as Buyers

Another consideration affecting the acceptability of a divestiture buyer is whether the buyer is a commercial bank, a savings bank, a thrift or an investor group. Both the Federal Reserve and the DOJ prefer commercial bank buyers. Generally, if the thrift does not meet the DOJ's 2% test, the DOJ will reject it as an acceptable buyer, unless the parties can demonstrate that the thrift is a new, significant entrant in commercial lending. In the Fleet Financial/Summit merger in 2001, the parties were permitted to sell the divestiture package to a thrift that did not pass the 2% test, but only after proving to the DOJ, through documentation and interviews with the thrift's management and lending personnel, that the thrift had recently adopted a strategy to enter this market and had actually entered the non-real estate commercial lending market. As of now, no credit union has been an acceptable buyer.

Private investor group buyers pose special problems for both agencies. Proving these groups to be acceptable buyers can require more time and documented evidence as to the bank management experience of the individuals involved, the capital resources available to the group, the group's business plan (especially its plans regarding commercial lending), and the type of charter the group intends to obtain. The identity of the investors in the group can also raise issues — first as to whether any of those investors are other in-market banks which may themselves pose antitrust concerns, and second, as to whether any of those investors will have ownership positions in the group large enough to create issues of "control" under the BHC Act.

### 4. Seller Financing of Divestitures

One issue that is sometimes raised when an investor group is selected as the divestiture buyer is whether the group may obtain financing (whether a loan or an equity investment) from the merging parties. In general, the DOJ will strongly resist any such financing or equity relationship between seller and buyer of the divestiture branches and requires the parties to commit in the letter agreement that they will not have any such relationships. Even the granting to the seller of warrants on the divestiture buyer's stock is likely to be rejected by the DOJ unless the ownership interest at issue is *de minimis* and sterilized of any voting rights.

As mentioned in the introductory paragraph, the agencies did allow some limited seller financing in connection with the PNC/National City merger in 2008. Owing to severe capital market conditions facing potential divestiture buyers, the agencies permitted certain limited seller debt and equity financing in connection with one of the divesture buyers, subject to strict passivity and information firewall commitments, a prohibition against PNC's exercising any acquired voting rights, and a one-year cap on PNC's ownership of the shares.

## D. Other Considerations and Policies

In addition to the foregoing, merging parties should be aware of certain other divestiture policies.

### 1. Lease Covenant Restrictions on Closed Offices Are Prohibited

At the time of the Firstar/U.S. Bancorp merger, the DOJ began requiring merging parties to include within their Divestiture Commitments an agreement that the parties give competing commercial banks a right of first refusal for the acquisition of branches that were to be closed as a result of the merger. In that deal, the parties were required, "for a period of three months prior to selecting a buyer or lessor for a branch closed as a result of the subject transaction, [to] issue a notice on a weekly or biweekly basis in a relevant industry publication(s), . . . for the sale or lease of the branch." This commitment typically applied to all branches closed in any of the local markets in which the parties are required to divest branches. The commitment further required the parties, during the above-mentioned notice period, to "accept offers from commercial banks that are equivalent to, or better than, offers from non-bank bidders, and will give interested banks an opportunity to meet or exceed outstanding offers from non-bank bidders." The commitment further required that the parties agree not to impose any conditions in deeds or lease agreements that would preclude the future use of any of the closed branches by a commercial bank.

The DOJ expanded this to require merging parties to sell closed branches to commercial banks, except as expressly permitted by the DOJ. The most recent DOJ agreements apply this requirement for three years from consummation of the transaction and expand the requirement to any branch in broader geographic markets (not just the markets with concentration issues). Moreover, the parties are obligated to notify the DOJ of such branch closing and to advertise the sale or lease of the branch in relevant industry publications.

### 2. No Solicitation of Former Customers

Although not required to be included in the Divestiture Commitments, the DOJ's letter of agreement in general prohibits any attempt by the merging parties during the pendency of the divestiture to encourage the switching of customers away from divestiture branches to retained branches. The DOJ has further indicated that it is sometimes opposed to any attempt by the merging parties to solicit former customers at divestiture branches until at least six months after the divestiture has been consummated.

## VII. STATE ATTORNEYS GENERAL INVOLVEMENT

State Attorneys General are involved in reviewing transactions affecting their respective states. Typically, they enter into agreements with the merging parties which permit the DOJ and the Attorneys General to share data and information provided by the parties in response to the DOJ's requests for information. The parties will usually enter into separate confidentiality agreements with the State Attorneys General. As a result of these sharing agreements, the Attorneys General are involved (or have the opportunity to become involved) in all stages of review, including determinations regarding gross divestitures, branch selection and often purchaser suitability.

In larger mergers extending across multiple states, the Attorneys General of multiple states are likely to be involved in the review process, with each state having its own — sometimes conflicting — view of antitrust principles to be applied in analyzing the competitive impact of a merger. In the Fleet/BankBoston merger, one State Attorney General threatened to block the merger, even after the DOJ, the Federal Reserve and the other relevant State Attorneys General had approved the transaction. The important point here is that mergers have become more politicized, with State Attorneys General taking positions in some cases that are inconsistent with the positions taken by the federal regulatory agencies. Although substantial arguments exist suggesting that State Attorneys General do not have standing under the BHC Act to challenge mergers in *de novo* court proceedings, merging parties are seldom willing to risk the delay and costs that would result from litigating this issue.

## VIII. POTENTIAL COMPETITION

During the 1980s, the Federal Reserve proposed and later withdrew guidelines for evaluating the effects of market-extension mergers on potential competition. In its statement withdrawing the guidelines, the Federal Reserve stated that the powers of thrift institutions had been greatly expanded and that barriers to intrastate and interstate geographic expansion by banks had been greatly relaxed in recent years such that the Federal Reserve's proposed guidelines were likely to be applicable "if at all, in only a very few banking markets." 53 Fed.

Reg. 21,462 (1988). The Federal Reserve went on to state that it will apply the standards enunciated by the courts, and that it will also seek guidance from the DOJ's Horizontal Merger Guidelines as they relate to potential competition. Since the Federal Reserve has not denied an acquisition on potential competition grounds, to our knowledge, in the past two decades, potential competition is unlikely to present an issue in most transactions.

The DOJ has not indicated any interest in potential competition theories in connection with its review of bank mergers, not because it agreed with the Federal Reserve that entry restrictions have been relaxed, but because it believed that entry into banking markets was very difficult. The DOJ's Competitive Factors Letters and court pleadings with respect to the challenged transactions described above allege that entry into commercial banking in large cities was very expensive and time consuming because of the need to establish a significant branch network. In view of its stated position that entering banking markets *de novo* was very difficult, the DOJ is unlikely to challenge a transaction on the theory that one of the merging parties would have entered the other party's markets *de novo* but for the proposed merger.

## IX. NON-BANK ACQUISITIONS

### A. Thrift Acquisitions

As a result of the divergence between the merger review methodologies employed by the Federal Reserve and the DOJ, thrift acquisitions by commercial banks pose a unique set of antitrust issues. When it analyzes acquisitions of thrifts by commercial banks, the Federal Reserve creates separate market share tables for the pre-merger and post-merger markets. In keeping with the Federal Reserve's methodology as applied to mergers between commercial banks, the pre-merger HHI for the market is generally calculated with all of the thrifts in the market — including the thrift to be acquired — included at 50% of their deposits. For the post-merger HHI, the Federal Reserve includes the acquired thrift, together with the acquiring commercial bank, at 100% of deposits, while all other thrifts in the market continue to be included at only 50% of their deposits. If the thrift to be acquired is already a subsidiary of a bank holding company, it will be weighted at 100% of deposits before the merger. *See Barnett Banks, Inc.*, 83 Fed. Res. Bull. 916 (1997). If the thrift to be acquired is similar to a commercial bank in terms of its commercial lending and business banking activities, the Federal Reserve has typically weighted its deposits at 100% before and after the merger like a commercial bank. *See Chemical Financial Corporation*, FRB Order No. 2014-16 (September 30, 2014). Surprisingly, in the 2018 acquisition of Bank Mutual Corporation (a commercially active federal savings bank) by Associated Banc-Corp, the Federal Reserve initially weighted the thrift's deposits at 50% before the merger and only included the analysis with 100% weighting for one market that warranted special scrutiny. *See Associated Banc-Corp*, FRB Order No. 2018-03 (January 23, 2018). Generally the Federal Reserve's Orders only discuss adjustments to its baseline approach to deposit share calculations where the *prima facie* analysis indicates a potential issue.

Also, when a commercially active thrift was the acquirer, the Federal Reserve historically weighted its deposits 100% both before and after the merger. *See River Valley Bancorp*, FRB Order No. 2012-10 (October 17, 2012).

The rationale for increasing to 100% the level of inclusion of the acquired thrift's deposits is that the acquired thrift, subsequent to its acquisition, will have access to the resources and expertise of a commercial bank holding company — even if the acquired thrift continues to operate as a thrift after the acquisition. The increase in the HHI resulting from the acquisition is determined by comparing the pre-merger and post-merger HHIs as calculated above. The Federal Reserve applies to thrift acquisitions the same concentration thresholds as it applies to mergers between commercial banks, namely the 1800/200 test.

Using the foregoing methodology, the Federal Reserve has denied approval or conditioned approval of several acquisitions of thrifts by commercial banks on divestiture requirements. *See, e.g.*, *Mid Am, Inc.*, 79 Fed. Res. Bull. 640 (1993) (divestiture required); *BB&T Financial Corporation*, 79 Fed. Res. Bull. 342 (1993) (divestiture required); *SouthTrust Corporation*, 78 Fed. Res. Bull. 710 (1992) (approval denied); *Norwest Corporation*, 78 Fed. Res. Bull. 452 (1992) (approval denied).

Finally, in the acquisition of a thrift by another thrift, the Federal Reserve weights the deposits of all banks and thrifts in the market at 100%. Rules regarding the weighting of thrift deposits at 100% are also codified within the recent rules regarding delegation of authority. See https://www.govinfo.gov/content/pkg/FR-2019-07-03/pdf/2019-13970.pdf.

While the DOJ has not publicly set forth its antitrust methodology as specifically applied to acquisitions of thrifts by commercial banks, the DOJ's views in this regard may be extrapolated from the standards it has applied to mergers between commercial banks. Ironically, the DOJ's analysis will generally result in a much more lenient policy toward thrift acquisitions as compared with the Federal Reserve's methodology.

This anomalous result derives from the DOJ's inclination to discount the significance of thrifts as competitors in the DOJ's commercial lending product market. As noted above, in several bank merger cases, the DOJ has totally excluded thrift competition from its analysis of the commercial lending market. In order to be consistent with these past actions, therefore, the DOJ must generally conclude that the acquisition of a thrift by a commercial bank may not even result in a competitive overlap as to commercial lending.

In the other product market that the DOJ evaluates — "retail" banking services for consumers — a competitive overlap will arise between the acquiring bank and the acquired thrift. However, the market shares of the merging parties will ordinarily be so diluted by the inclusion of other thrifts, credit unions and non-depository financial service providers that competitive problems are unlikely to be presented.

Thus, while the DOJ has, on occasion, imposed more severe antitrust standards than the Federal Reserve with respect to mergers between commercial banks, the DOJ has taken less action in thrift acquisitions — including transactions that the Federal Reserve has denied on antitrust grounds. Indeed, in the SouthTrust merger (78 Fed. Res. Bull. 710 (1992) (approval denied)), the merging parties were in the anomalous position of advocating (unsuccessfully) to the Federal Reserve that the Federal Reserve should apply the DOJ's antitrust methodology since the transaction "would not diminish commercial lending in the market because [the thrift to be acquired] does not make commercial loans." 78 Fed. Res. Bull. at 713. For a more extensive

discussion of the consequences for thrift acquisitions arising from the divergence between the Federal Reserve and the DOJ, *see* D. Neill, "Fed Antitrust Change Could Boost Thrift Acquisitions by Banks," 12 *Banking Policy Report* No. 17, at 1 (Sept. 6, 1993).

## B. Credit Card Acquisitions

Bank mergers that implicate large credit card operations could be affected by the raft of antitrust litigations and investigations beginning in the 90s and continuing apace even today. These lawsuits continue to challenge various aspects of the payment card industry, commencing in the 90s with the government's lawsuit challenging the governance and membership rules of Visa and MasterCard, followed soon thereafter with the suit by Wal-Mart, among other merchants, challenging the "honor all cards" policies. This early wave of litigation was followed by what may be the most significant wave of investigations and lawsuits involving challenges to interchange fees.

The first major challenge to credit card operations occurred when the government filed a lawsuit challenging the Visa and MasterCard governance and membership rules. The government's complaint alleged two antitrust theories. On the one hand, the complaint alleged that widespread "duality" of membership of banks in both Visa and MasterCard had effectively eliminated competition between those two networks with respect to the provision of network services and the creation of innovative network products. At the same time, the complaint alleged that Visa and MasterCard by-laws that prohibited member banks from issuing cards of other competing networks (such as American Express and Discover) were anticompetitive for being "exclusionary." After a non-jury trial, the district court held in favor of the defendants on the duality claim, but ruled against defendants on the exclusivity claim.[12]

In 2003, the Second Circuit Court of Appeals affirmed the district court's determination that the Visa and MasterCard exclusionary rules violated Section 1 of the Sherman Act. In particular, the Second Circuit held that the exclusivity rules prohibiting banks that issue MasterCard and/or Visa cards from issuing American Express or Discover cards had an adverse effect on competition at the card-network services level, specifically by inhibiting American Express's and Discover Card's ability to compete with Visa and MasterCard.[13]

The second significant challenge involved a private lawsuit commenced by large and small merchants against Visa and MasterCard, alleging that Visa and MasterCard forced retailers to accept debit cards as a condition to being able to accept Visa and MasterCard credit cards (the honor-all-cards policy). This lawsuit was settled in the Spring of 2003. As part of the settlement, Visa and MasterCard agreed, among other things, to pay $3 billion and to discontinue their alleged honor-all-cards policy.

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[12] *United States* v. *Visa U.S.A., Inc.*, 163 F. Supp. 2d 322 (S.D.N.Y. 2001), *modified by* 183 F. Supp. 2d 613 (S.D.N.Y. 2001).

[13] *United States* v. *Visa U.S.A., Inc.*, 344 F.3d 229 (2d Cir. 2003), *cert. denied*, 543 U.S. 811 (2004).

A third wave of governmental investigations and private lawsuits — starting in the early 2000s — may be the most significant.[14] Dozens of lawsuits were commenced on behalf of millions of merchants challenging interchange fees and consolidated in the Eastern District of New York.[15] In these lawsuits, two classes of merchant plaintiffs alleged that the defendants unlawfully fixed the price of credit card interchange fees and other fees charged to merchants for transactions that are processed over the Visa and MasterCard networks. In December 2013, the district court approved a settlement that would have released all claims in exchange for monetary relief of up to $7.25 billion — the largest antitrust cash settlement in history — and injunctive relief relating to future conduct. After objections were raised to the settlement, and further court proceedings and negotiations, Visa and MasterCard announced a new settlement with the monetary relief class in September 2018.

Numerous governmental entities outside the U.S. commenced investigations and/or proceedings concerning interchange fees and many of these are continuing.[16]

In 2010, the DOJ and seven State Attorneys General brought a suit challenging the non-discrimination or anti-steering rules long employed by Amex, Visa and MasterCard.[17] The challenged restrictions prevent merchants who accept a network's cards from steering customers to use other cards that charge lower merchant fees or cheaper forms of payment. Visa and MasterCard settled the lawsuit early on, leaving Amex as the only defendant to litigate the claims. Pursuant to the settlement, MasterCard and Visa agreed to make certain modifications to their rules to specify the ways in which merchants may steer customers to preferred payment forms. In 2015, a federal district court ruled against Amex, finding that the credit card market should be treated as two separate markets — one for merchants and one for cardholders — and that Amex's anti-steering provisions resulted in higher merchant fees by effectively denying merchants the ability to shift business to less expensive cards, thereby denying price competition between Amex and its rival networks.[18] In 2016, in a significant victory for Amex, the U.S. Court of Appeals for the Second Circuit reversed the district court's 2015 decision. The Second Circuit took issue with the district court's focus on the interests of merchants while ignoring the interests of cardholders, an approach that "does not advance overall consumer satisfaction." In the two-sided credit card market, where card networks compete for acceptance by both cardholders and merchants, the merchant fees cannot be considered in isolation. Higher merchant fees may be used to fund increased cardholder rewards — which effectively reduce

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[14] In addition to the litigations identified in the text, class action proceedings were commenced against the card issuers alleging that the card groups conspired to overcharge consumers on foreign currency transactions. *In re Currency Conversion Fee Antitrust Litigation*, Case No. 1:01-MDL-01409 (S.D.N.Y.) (Judge William H. Pauley). In October 2009, the district court approved a $336 million settlement of that litigation.

[15] *See In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation*, 1:05-MD-01720 (E.D.N.Y.) (Judge Gleeson).

[16] According to a report issued by the Federal Reserve Bank of Kansas City, proceedings or investigations into payment card networks' interchange fees or merchant service fees were initiated by 38 countries. Federal Reserve Bank of Kansas City, Interchange Fees and Network Rules: A Shift from Antitrust Litigation to Regulatory Measures in Various Countries, October 2014, *available at* https://www.kansascityfed.org/publicat/PSR/Briefings/psr-briefingoct2014.pdf.

[17] *U.S.* v. *American Express Co., et al.*, Civil Action No. CV-10-4496 (E.D.N.Y. Oct. 4, 2010).

[18] *U.S.* v. *American Express Co.*, 88 F. Supp. 3d (E.D.N.Y. 2015).

prices to cardholders. In turn, increased demand on the cardholder side of the platform expands the value of the card network to the merchant side. The appeals court concluded that plaintiffs had failed to prove that Amex's anti-steering rules had a net adverse effect on a properly defined market that includes both cardholders and merchants.[19]

Several State Attorneys General sought certiorari from the Supreme Court, but the DOJ declined to join. The DOJ ultimately filed an amicus brief strongly criticizing the Second Circuit's decision, but also expressly asking the Supreme Court not to hear the case. Nonetheless, the Supreme Court granted certiorari and ultimately upheld the Second Circuit's decision finding that Amex's anti-steering rules do not violate the antitrust laws.[20]

### C. Other Non-Bank Acquisitions

Most non-bank acquisitions do not raise significant antitrust problems, either because the geographic markets at issue are very expansive and fragmented or because the product markets are characterized by ease of entry. Markets for leasing, factoring and investment advisory services, for instance, will usually be regional or national in nature and are unlikely to present serious issues. Consumer lending activities, while carried out in locally limited geographic markets, rarely present competitive problems because of the myriad of competitors in the market, including banks, thrifts, credit unions and other consumer finance companies. Nonetheless, if there were to be a tightening of consumer credit by banks, this might precipitate antitrust scrutiny going forward.

One example of such scrutiny, leading to a required divestiture, is the acquisition of OneMain Financial Holdings by SpringLeaf Holdings. OneMain and SpringLeaf were the two largest providers of personal installment loans to subprime borrowers. The DOJ and seven state attorneys general filed a complaint alleging that the extension of credit to subprime borrowers was a separate market, it was generally a locally limited market requiring access to a local branch, and the combination of the two largest lenders would substantially lessen competition. As a result, the parties agreed to divest 127 branches with over $600 million in loan receivables. *U.S.* v. *SpringLeaf Holdings, Inc.*, Case 1:15-cv-01992 (D.D.C. filed November 13, 2015) (Competitive Impact Statement), *available at* http://www.justice.gov/opa/file/793141/download.

Mortgage company acquisitions in the past occasionally drew attention from the Federal Reserve because of the locally limited nature of mortgage origination markets. Historically, due to the competition offered by banks and thrifts and the ease of entry which characterized the mortgage market, these transactions have not presented serious antitrust issues.[21] A tightening of mortgage lending criteria during the post-recessionary period might have precipitated antitrust concerns, but such concerns have not materialized. In 2008, the Federal Reserve expanded its review from local mortgage originations to a national market, thus reducing further potential

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[19] *U.S.* v. *American Express Co.*, 838 F.3d 179 (2d Cir. 2016).

[20] *Ohio* v. *American Express Co.*, 138 S.Ct. 2274 (2018).

[21] *See BankAmerica Corporation*, 80 Fed. Res. Bull. 623 (1994) (discussing mortgage origination markets in the context of a thrift acquisition); *First Hawaiian, Inc.*, 79 Fed. Res. Bull. 996 (1993) (same).

concerns associated with mortgage banking operations.[22] The Federal Reserve also has considered appraisal services, community development activities, property appraisal and real estate settlement activities to be local in nature. To date, all of these product markets have been found to be unconcentrated with numerous providers.

The Federal Reserve has found a few national products markets to be moderately concentrated, including credit card issuance and securities services, although to date no mergers in these industries have been precluded.

To date no acquisition of credit unions by a bank or a thrift has been publicly analyzed by the regulators or the DOJ for competitive purposes. Generally these would reduce concentration and are unlikely to raise antitrust concerns.

## X. TRANSACTIONS SUBJECT TO REVIEW UNDER THE HART-SCOTT-RODINO ANTITRUST IMPROVEMENTS ACT OF 1976

Prior to the enactment of the Dodd-Frank Act, there was no dual antitrust review of the same assets in one transaction under different U.S. statutes. Under the new statutory regime, there will be dual review of certain types of transactions and transaction-parties. To show how the new statutory scheme has altered the allocation of authority to review bank mergers and acquisitions as between the BHC Act and the Hart-Scott-Rodino Antitrust Improvements Act of 1976, a brief discussion of the prior structure is useful.

Prior to the enactment of the Gramm-Leach-Bliley Act, most bank acquisitions were subject to review exclusively under the BHC Act. These transactions were exempted from the reporting requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act")[23] under subsections (c)(7) and/or (c)(8) of the HSR Act because they were subject to prior approval of the Federal Reserve or other relevant banking agency.[24] Also at this time, the activities that banking organizations could engage in were very different from what they could engage in after the Gramm-Leach-Bliley Act. During this time period, the Glass-Steagall strictures were in place, which generally prevented banks directly or indirectly from engaging in securities underwriting, distribution and related activities.[25] Banks generally could engage in banking activities and other activities closely related to or incidental to the business of banking. Acquisitions involving banking activities were reviewed under Section 3 of the BHC Act, while

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[22] *See Bank of America Corporation*, 94 Fed. Res. Bull. C81 (2008).

[23] 15 U.S.C. § 18a.

[24] Specifically, subsection (c)(7) of the Hart-Scott-Rodino Act exempts bank mergers and holding company acquisitions "which require agency approval under section 18(c) of the Federal Deposit Insurance Act (12 U.S.C. § 1828(c)), or section 3 of the Bank Holding Company Act (12 U.S.C. § 1842)." Subsection (c)(8) of the Hart-Scott-Rodino Act exempts acquisitions of non-bank companies "which require agency approval under section 4 of the Bank Holding Company Act (12 U.S.C. § 1843) . . . if copies of all information and documentary material filed with any such agency are contemporaneously filed with the FTC and the Assistant Attorney General at least 30 days prior to consummation of the proposed transaction."

[25] June 16, 1933, ch. 89, section 21, 48 Sta. 189.

permissible non-bank activities were reviewed under Section 4(c)(8) of the BHC Act.[26] As mentioned above, to the extent both transactions were subject to prior approval by the banking regulatory agencies they were exempt from HSR Act review (*i.e.*, they were exempt transactions).

With the enactment of the Gramm-Leach-Bliley Act, certain banks electing to become financial holding companies ("FHCs") were permitted to engage in a number of previously prohibited non-bank financial activities, now set forth in Section 4(k) of the BHC Act. All of the newly expanded banking activities — the 4(k)-only activities — are subject to exclusive review by the antitrust agencies (generally the DOJ) under the HSR Act (with certain exceptions set forth in note 22).

Under the Gramm-Leach-Bliley Act, if the transaction or portion of the transaction involves a 4(k) activity or the transaction or a portion of the transaction does not otherwise require bank regulatory agency prior approval, then the transaction or portion of the transaction will be subject to the HSR Act and if the HSR thresholds are met, the parties will need to make HSR Act filings. On April 5, 2000, the Federal Trade Commission (which promulgates regulations under the HSR Act), with the concurrence of the DOJ, issued Formal Interpretation 17, stating that it viewed the amendments of the HSR Act contained in the Gramm-Leach-Bliley Act as confirming its long-standing view that the non-exempt portions of mixed transactions — transactions with exempt and non-exempt portions — are subject to the HSR Act.[27] Formal Interpretation 17 also confirmed that banking organizations can continue to seek prior approval from the relevant bank regulatory agency for the acquisition of non-banking operations (*e.g.*, that are closely relating to banking) under Section 4(c)(8), as long as the parties observe the requirement that copies of the materials filed with the relevant federal banking authorities are contemporaneously filed with the FTC and the DOJ at least 30 days prior to consummation of the merger.[28]

In all of the scenarios described above, no single activity involved in a transaction would be subject to review under more than one statutory scheme. Under the Dodd-Frank Act, there is a set of facts under which a single activity is subject to dual review. While small 4(k) transactions are subject to exclusive HSR review, acquisitions of financial organizations with more than $10 billion in assets are now subject to notification and review under both the HSR Act and the BHC Act.[29] For these transactions involving large entities, the Dodd-Frank Act

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[26] As discussed, these 4(c)(8) activities could be reviewed either under 4(c)(8) of the BHC Act or under the HSR Act, and the parties were permitted to choose the avenue of review. The exception to this is that the acquisition of thrifts by bank holding companies must be reviewed under 4(c)(8) of the BHC Act.

[27] *See* Federal Trade Commission, Premerger Notification: Reporting and Waiting Period Requirements, 65 Fed. Reg. 17,880 (April 5, 2000).

[28] For a more detailed discussion of the applicability of the HSR Act to bank mergers, *see* David S. Neill & Nelson O. Fitts, "Acquisitions of Nonbank Operations in Financial Holding Company Mergers," in The Review of Banking and Financial Services (Vol. 20, No. 3, March 2004); David S. Neill, *New Banking Act Complicates Merger Review*, International Financial Law Review, February 2000, at 13.

[29] Section 163 of the Dodd-Frank Act governs acquisitions of voting shares of a company with $10 billion in total assets by either (1) bank holding companies with $50 billion or more in assets or (2) non-bank financial companies supervised by the Federal Reserve on account of their systemic importance to the U.S. economy. Section 604(e) governs $10 billion acquisitions of 4(k) businesses by financial holding companies. Both sections adopt the notice

requires applicants and the Board to follow the notice provisions of Section 4(j) of the BHC Act that previously applied only to acquisitions involving activities "closely related to banking." The Federal Reserve's review criteria will cover the traditional 4(j) factors — including competitive considerations — as well as the newly mandated evaluation of systemic risk. Thus, large 4(k) transactions are now subject to dual review by the Federal Reserve and the DOJ under two different statutes.

Subjecting a transaction to dual review poses two concerns. The first concern is timing and waiting periods. The BHC Act's notice requirements provide that an application be filed at least 60 calendar days before consummation of the acquisition, although the Federal Reserve may approve transactions to proceed before the expiration of the notice period. The HSR Act, by comparison, has a 30-day initial waiting period which the reviewing antitrust agency may — and frequently does — terminate early. The authors note that the FTC, with the support of the DOJ, suspended "temporarily" the practice of granting early terminations of the HSR waiting period and that suspension has continued on to date. Transactions raising competitive concerns may pose significant timing issues, since each of the foregoing processing periods may be extended by the Federal Reserve and the DOJ, respectively, if those agencies require additional information or documents about competitive issues (or other concerns, in the Federal Reserve's case) or demand divestiture remedies. The Federal Reserve, in particular, has considerable discretion in determining whether notice requirements are met or whether the statutory notice period even begins to run.[30]

The new dual review introduces a second concern as to substantive antitrust analysis. If any given transaction raises competitive concerns, the DOJ and the Federal Reserve could reach different conclusions as to the nature and scope of those concerns and the remedies needed to resolve them. Indeed, such differences seem likely since the DOJ and the Federal Reserve have never before formally coordinated antitrust review or issued joint guidelines for analyzing non-bank acquisitions, and the Federal Reserve has little or no prior experience evaluating competitive effects in the non-bank product lines at issue. In this regard, substantial differences between the DOJ and the Federal Reserve frequently arise under the current dual review system for bank mergers, under which each agency applies its own analytical methodology and focuses on different banking product lines — despite their joint adoption of the *Competitive Review*

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procedures already set forth in Section 4(j) of the BHC Act, and both sections make clear that the new Federal Reserve approval requirements do not exempt such 4(k) acquisitions from the HSR Act.

[30] Under the HSR Act, the DOJ or the FTC may issue a Request for Additional Information and Documentary Material ("Second Request"), extending the waiting period until 30 calendar days after both parties substantially comply with the Second Request (often a three to four-month process). Parties regularly agree to extend the second waiting period by 30 days or more. The BHC Act provides that the Federal Reserve generally must act on an application within 60 days of receiving a "complete notification," but it may extend that period an additional 30 days. In practice, if the Federal Reserve needs more time, it either deems the notification incomplete and requests more information, effectively extending the processing period indefinitely, or seeks an agreement with the notifying party to suspend processing until all information needed for a decision is received. Past practice in the bank merger arena has been for the Federal Reserve (which controls timing of bank merger review using similar procedures) to accommodate DOJ requests for more time to investigate competitive effects. If this practice bleeds over into non-bank mergers, then merger applicants could effectively lose the timing control they otherwise enjoy under the HSR Act, since the Federal Reserve could extend the Bank Holding Company Act waiting period indefinitely at the behest of the antitrust agency. Such an extension could render meaningless the applicants' compliance with the Second Request and the expiration of the HSR waiting period.

*Guidelines* for bank mergers. The current dual review of bank mergers often results in parties divesting assets up to the "greatest common denominator" required to satisfy both the DOJ and the Federal Reserve, and the Dodd-Frank legislation may lead to a similar result for non-bank businesses.

- In addition to subjecting transactions to dual review, the Dodd-Frank Act applies disparate antitrust review procedures for FDIC liquidation transfers depending on whether they are structured as mergers or as asset sales. For merger transactions subject to the HSR Act, the reform act shortens the initial HSR waiting period to 15 calendar days from the normal 30 days.[31] Asset transfers, meanwhile, are addressed in a separate provision that is silent as to antitrust review procedures, but which enables asset transfers by the FDIC to occur "without obtaining any approval, assignment or consent."[32]

- This disparate treatment of mergers and asset transfers appears to accommodate long-standing FTC interpretations of the HSR Act's exemption for "transfers to or from a Federal agency" under Section 7A(c)(4).[33] While the FTC deems asset sales made directly by the FDIC and other federal agencies *entirely exempt* from the HSR Act,[34] the FTC has taken the position that FDIC sales of voting securities of private corporations are not exempt.[35] The latter interpretation is rooted in a 1978 Statement of Basis and Purpose for the original rulemaking process under the HSR Act, which held that "corporations controlled by [the United States and its agencies and political subdivisions] and engaged in commerce are entities, and may be subject to the requirements of the act."[36] Even if that decades-old statement were consistent with the language of the HSR Act — which exempts all "transfers to or from a Federal agency," without regard to form of transaction — the disparate treatment of asset and voting securities transactions is plainly at odds with modern FTC views. In 2005, the FTC expanded a regulatory exemption allowing parties to "look through" corporate forms to determine whether the underlying businesses are exempt from the HSR Act.

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[31] *See* Sections 210(a)(1)(G)(i)(I) and (ii). This shortened waiting period already applies in two other exigent circumstances: cash tender offers and certain acquisitions in bankruptcy. *See* 15 U.S.C. § 18a(b)(1)(B); 11 U.S.C. § 363(b)(2)(B).

[32] *See* Section 210(a)(1)(G)(i)(II).

[33] 15 U.S.C. § 18a(c)(4).

[34] *See* ABA Section of Antitrust Law, *Premerger Notification Practice Manual* (4th ed. 2007), Interp. 11 ("The fact that a government agency, such as the FDIC, is a corporation 'engaged in commerce,' does not change its status as a non-entity for purposes of the Act. The PNO's position is that the FDIC is a federal agency, and therefore, cannot be an entity under Section 801.1(a)(2)."); Interp. 12 ("If the government organization does not meet the criteria for an entity subject to the Act pursuant to Section 801.1(a)(2), the Section 7A(c)(4) exemption applies to all assets transfers to or from it. Any asset transfer, no matter the size of the assets involved, to or from a federal or state agency, as defined by Section 801.1(a)(2), is exempt from the reporting requirements of the Act.").

[35] *See id.*, Interp. 12 ("if a state or federal agency sells voting securities, . . . [t]he transaction will be subject to the Act if the acquired person, the issuer of the voting securities, is an entity under Section 801.1(a)(2) and otherwise subject to the Act.").

[36] 43 Fed. Reg. 33,450, 33,456 (July 31, 1978).

- The Commission has concluded that if the direct acquisition of an asset is already exempt, it appears logical to extend that exemption to an acquisition of voting securities of an issuer or of non-corporate interests in a[n] unincorporated entity whose only holding is that same asset.[37]

- The logic of the FTC's 2004 statement would seem to invalidate its older interpretations and render all FDIC sales exempt under the HSR Act, regardless of form. But even if the FTC declines to reevaluate its historical view (and reconcile it with the more recent HSR rules), the Dodd-Frank Act's shortening of the HSR Act waiting period for mergers from 30 to 15 days will reduce the timing disparity between FDIC merger and asset transactions.

The Dodd-Frank Act's disparate treatment of mergers and asset transfers generated confusion among commentators and within Congress itself. For instance, the American Antitrust Institute voiced concern that the reform act's language enabling FDIC asset transfers "without obtaining approval, assignment or consent" could be interpreted to exempt FDIC asset transfers from the HSR Act — apparently ignoring the fact that such asset sales *have always been exempt*.[38] Rep. John Conyers (Chairman of the House Judiciary Committee and a House conferee on the bill) may have further obscured the new legislation in remarks published in the Congressional Record.[39] Without referencing the language regarding no "approval" or "consent," Rep. Conyers concluded that the bill's silence as to specific review procedures for asset sales would subject those sales to *full* HSR review, denying asset deals even the shortened 15-day waiting period applied to FDIC merger transactions.[40] He admirably went on to encourage the antitrust agencies and the FDIC to establish an "informal arrangement" to expedite the processing of all FDIC liquidation transfers — mergers and asset sales alike. Rep. Conyers's interpretation of the legislation could not be correct, however, unless Congress were to repeal the HSR Act's exemption for federal agency transfers — which the Dodd-Frank Act clearly did not do — or the FTC were to reverse decades of regulatory precedent and untenably claim the FDIC is not a "Federal agency" for purposes of the HSR Act.[41]

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[37] 69 Fed. Reg. 18,686, 18,693 (April 8, 2004). The amended rule is 16 C.F.R. § 802.4(a).

[38] *See* Letter dated May 11, 2010 from the American Antitrust Institute to Hon. Harry Reid, *available at* http://www.antitrustinstitute.org/archives/files/HSR%20Exemptions%20Letter.5.11_051120102213.pdf.

[39] Rep. Conyers's remarks are available at https://www.govinfo.gov/content/pkg/CREC-2010-07-15/html/CREC-2010-07-15-pt1-PgE1347.htm.

[40] Review under the HSR Act technically does not constitute "approval" by the reviewing antitrust agency; the HSR Act merely prevents consummation of the proposed transaction pending the parties' notification and substantial compliance with any Second Request, enabling the agencies to seek an injunction against the transaction if they see fit. Even if the DOJ and the FTC allow an acquisition to proceed, they are not estopped under the Clayton Act from later suing to unwind the transaction.

[41] It should also be noted that subjecting FDIC transfers of *non-bank* assets to HSR waiting periods would contrast sharply with the current procedures applied to FDIC transfers of *banking* assets. Under the Bank Merger Act, federal bank regulators reviewing third-party acquisitions of banking assets held in FDIC receivership may invoke "probable failure" authority to enable immediate consummation of the transactions without waiting for any Justice Department antitrust review. That "probable failure" authority for banking assets appears to remain intact under the

In mergers that are subject to the HSR Act,[42] the parties will be required to submit pre-merger notification and report forms (HSR Form) to the FTC and the DOJ, and observe the HSR Act waiting period requirements before consummating the transaction. The HSR Form requires the parties to submit certain categories of information, including a description and valuation of the transaction, annual reports and consolidated financial statements. The parties are also required to submit revenue information broken down into North American Industrial Classification System ("NAICS") codes, as determined by the Office of Management and Budget, for the most recent year. In addition, the HSR Form requires a list of all controlled (50% or more owned) direct and indirect subsidiaries, minority investments in third-party corporations (ownership of 5% to up to 50% of entities with $10 million or more in total assets) that have operations that overlap with the other merging party, and information concerning third parties that own 5% or more of stock of any controlled corporate entity. The HSR Form also requires information regarding product and geographic market overlaps between the merging parties and a description of prior acquisitions by the acquiring person that related to any product line that currently constitutes an overlap. Of significant note is Item 4(c) of the HSR Form, which requires the submission of "studies, surveys, analyses and reports which were prepared by or for any officer(s) or director(s) . . . for the purpose of evaluating or analyzing the acquisition with respect to market shares, competition, competitors, markets, potential for sales growth or expansion into any product or geographic markets." Item 4(d) requires the submission of similar types of analyses done by third parties (*e.g.*, investment banks), any confidential offering memoranda or the equivalent, and certain synergies analyses.

In addition, the staff of the FTC's Premerger Office has taken the position that the HSR Act will also apply to the acquisition by a banking organization of the voting securities of another banking organization that is of insufficient size to trigger the requirements of the BHC Act (*i.e.*, less than 5%). Thus, if the proposed acquisition is valued at more than the HSR threshold as adjusted annually (*i.e.*, the HSR's "size of transaction" threshold which, effective as of March 6, 2024 will be $119.5 million), but constitutes less than 5% of the outstanding voting securities of the target holding company (the "greater than $50 million (as adjusted), but less than five percent" interpretation), the notification and waiting period requirements of the HSR Act will apply, unless the acquirer can claim another exemption, such as having a passive investment intent. A shareholder who will acquire more than $50 million (as adjusted) worth of outstanding voting securities in connection with the merger may also be required to file an HSR Form, unless the shareholder can claim the passive investment or other exemption.

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reform bill. Thus, were it valid, Rep. Conyers's view of the financial reform legislation would create an anomalous procedural disparity between bank and non-bank asset transfers from FDIC receivership.

[42] Filing thresholds applicable to the HSR Act are revised annually based on changes in the gross national product, and changes become effective 30 days after publication in the Federal Register. Effective March 6, 2024, the HSR Act applies (a) if the parties meet the "size of person" test ($23.9 million and $239 million in assets or revenues, respectively) and the non-exempt business of the acquired party had a fair market value or acquisition price of $119.5 million or more when valued as a stand-alone asset, or (b) if the non-exempt business of the acquired party had a fair market value or acquisition price of $478 million or more, then the "size of person" test is irrelevant. Fair market value is determined in good faith by the board of directors (or its delegee) of the acquiring party. For a complete list of revised thresholds, *see Revised Jurisdictional Thresholds*, *available at* https://www.ftc.gov/legal-library/browse/federal-register-notices/revised-jurisdictional-thresholds-section-7a-clayton-act-11.

The HSR Act applies in two other circumstances: (1) secondary acquisitions; and (2) stock swaps by shareholders.

Where the acquired party holds minority investments (*i.e.*, less than 50% of the voting securities) in other, third-party corporations, the acquiring party may be *required* to file under the Hart-Scott-Rodino Act to make the "secondary acquisition" of those minority holdings if those stakes are valued in excess of $50 million (as adjusted) and the acquirer can claim no other exemption, such as having a passive investment intent while acquiring less than 10% of the voting rights. In a secondary acquisition, the acquirer files a separate HSR Form (and pays a separate fee) to make the indirect acquisition of voting securities of the third-party corporation, and that third-party corporation is required to file a responsive HSR Form within 15 days. A separate waiting period for each secondary acquisition will run concurrently with the waiting period applicable to the primary transaction, and, theoretically, a secondary acquisition could be subject to a Second Request (discussed in note 28 above), even if the primary transaction does not receive such a request.[43]

Shareholders of acquired parties who will acquire more than $50 million (as adjusted) worth of the acquiring party's outstanding voting securities in connection with a transaction (for instance, as the result of a stock swap) may also be required to file an HSR Form, unless the shareholder can claim the passive investment or some other exemption.[44] Since the Premerger Notification Office maintains that shareholders who will serve as directors or officers of the acquiring party or directors of its subsidiaries post-acquisition are not eligible for the passive investment exemption, the "greater than $50 million (as adjusted), less than five percent" interpretation may require many significant shareholders to file.[45]

## XI. MERGER REVIEW BY THE EUROPEAN COMMISSION

In 2001, the European Commission voted to prohibit GE from acquiring Honeywell after a detailed investigation lasting more than six months.[46] The prohibition came notwithstanding the earlier decision by the DOJ not to oppose the transaction. While the decision was eventually overturned on appeal by the European Court of First Instance, it highlights the importance of considering the implications of large transactions on competition globally and in the EU in particular.

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[43] In analyzing potential secondary acquisition filings, note that a target bank is usually not deemed to "hold" the voting securities included in mutual funds that it manages. *See* ABA Section of Antitrust Law, *Premerger Notification Practice Manual*, Interp. 51 (4th ed. 2007). A bank or trust company that administers "collective investment funds" or "common trust funds" within the meaning of 12 C.F.R. § 9.18(a), however, is deemed to "hold" all the assets and voting securities of such funds, and filing obligations may arise as to those voting securities if the HSR Act's other requirements are met. *See* 16 C.F.R. §§ 801.1(c)(3), (6).

[44] 16 C.F.R. §§ 801.2(e) & 802.9.

[45] The investment-only exemption, see 15 U.S.C. § 18a(c)(9) & 16 C.F.R. § 802.9, has been the subject of a number of interpretations by the FTC's Premerger Office as well as several enforcement actions by the Justice Department. Fines and penalties imposed on the party charged with improperly claiming the investment-only exemption have been steep and can be imposed on both entities and individuals. Consequently, FTC Premerger Office interpretations should be consulted before relying on the investment-only exemption.

[46] General Electric/Honeywell, Case No. COMP/M.2220 (July 3, 2001).

The importance of undertaking a global analysis was underscored again in 2012 when the European Commission prohibited the combination of Deutsche Börse and NYSE Euronext after the transaction had received clearance in the United States. Deutsche Börse/ NYSE Euronext, Case No. COMP/M.6166 (February 1, 2012). Unlike GE/Honeywell, however, the disparate outcomes in Europe and the United States were based on differing market facts.

Thus, to avoid delay and possible consummation failure, merging financial institutions should carefully consider the impact that their transactions will have in Europe. Financial institutions need to identify possible competition concerns in advance and understand the likely outcome of any antitrust review by the European Commission.

## A. The Standards for Commission Analysis[47]

The European Commission analyzes mergers and acquisitions in Europe pursuant to Council Regulation ("EC") No. 139/2004 of January 20, 2004 (as amended) on the Control of Concentrations between Undertakings (the "EC Merger Regulation"). The EC Merger Regulation gives the Commission exclusive jurisdiction to assess transactions with a Community dimension (defined in terms of revenue thresholds described in Section XI.C. below). Under the regulations, if a transaction with a Community dimension "would significantly impede effective competition, . . . in particular as a result of the creation or strengthening of a dominant position" (referred to herein as "the SIEC standard") in the European Community, then it is "incompatible with the common market" and must be prohibited.

Pursuant to relevant Guidelines, the Commission measures market concentration using the HHI Index, the same index used under the U.S. Horizontal Merger Guidelines (referred to herein as the "U.S. Guidelines"). The Guidelines also specify that the Commission will consider numerous factors in assessing competitive effects, including merger-related efficiencies. In addition, the EU antitrust authorities, like their counterparts in the U.S., will examine the likely impact of the transaction on competition, considering factors such as the number and size of remaining competitors, the ease and likelihood of entry, and the ability of customers to substitute other products. The authorities will prohibit or require divestitures where there is a serious competition concern, but will allow transactions to proceed without divestitures if they have no or only insignificant competition concerns.

## B. Recent Commission Decisions

To date, few transactions in the financial services industry have raised serious antitrust concerns in Europe. Within the past few years, the only transaction in the industry to be blocked was the 2017 merger between Deutsche Börse and London Stock Exchange, which was blocked principally on the ground that the merger would have created a de facto monopoly in clearing fixed income instruments (*i.e.*, bonds and repurchase agreements). *Deutsche Börse/London Stock Exchange Group*, Case No. COMP/M.7995 (March 29, 2017). The parties had proposed to divest LCH Clearnet SA, London Stock Exchange's clearing house based in France, but the Commission rejected the offer on the ground that it was insufficient to remedy the concern.

[47] With the exit of the United Kingdom from the European Union, there are now 27 member states.

While the Deutsche Börse/London Stock Exchange merger was the only transaction in the financial services industry to be blocked, there have been a few in-depth "second phase" investigations undertaken by the Commission, resulting in approvals only after the parties agreed to certain conditions. *See, e.g.*, *Worldline/Equens/Paysquare*, Case No. COMP/M.7873 (April 20, 2016) (requiring the divestiture of Paysquare's Belgian payment system and the licensing of Worldline's Poseidon software); *Nordic Capital/Intrum Justitia*, Case No. COMP/M.8287 (June 12, 2017) (requiring the divestiture of Nordic Capital's portfolio company's ("Lindorff") credit management services ("CMS") and debt purchasing businesses in various Member States, and Intrum Justitia's CMS and debt purchasing businesses in Norway); London Stock Exchange/Refinitiv, CASE COMP/M.9564 (January 13, 2021) (subject to commitments to divest all of its 99.9% share in Borsa Italiana S.p.A., all of its 99.9% share in Bit Market Services S.p.A. and all of its 100% share in GATELab S.r.L., as well as commitments to provide global OTC IRD clearing services and commitments to provide other data to a suitable purchaser); S&P Global/IHS Market (October 22, 2021) (divestiture of several business lines in commodity price assessments, and several business lines in financial data and infrastructure).

Under Commission procedural rules, approval is permissible within Phase I of the review if the parties commit to remedies addressing competition issues, and in such case Phase I is extended from 25 to 35 business days. In 2020, parties in one financial industry transaction offered remedies in Phase I and received approval in that shorter time period subject to their commitments to divest. Specifically, the Commission approved Worldline's acquisition of Ingenico, both of which were involved in the payments services sector. The investigation focused on competition concerns on the markets for the provision of point-of-sale ("POS") merchant acquiring services and POS terminal provision and management services in Austria, Belgium, and Luxembourg. The parties submitted commitments to divest relevant services in those countries, removing nearly fully the overlap between the parties in those countries. Worldline/ Ingenico, Case No. COMP M.9776, September 30, 2020 (https://ec.europa.eu/commission/presscorner/ detail/en/IP_20_1781).

### C. Commission Decisions in the Industry

In the Föreningssparbanken/SEB Swedish bank merger of 2001, the parties abandoned the transaction after the initiation of a second phase investigation because of competition concerns raised by the European Commission, so the Commission never had an opportunity to issue a decision. And although the prohibition of the Deutsche Börse/NYSE Euronext transaction certainly had a financial services component, as it related to the provision of derivative trading markets in Europe, it did not involve the core financial services of banking and insurance. When it comes to true financial deals involving these core services, these deals rarely are subjected to divestiture requirements. Nonetheless, the numerous Phase I decisions issued by the Commission concerning these core services provide some guidance as to how the Commission analyzes financial services markets.

#### 1. Banking

The Commission divides the services typically supplied by banks into various general product categories, including but not limited to retail banking, corporate banking, financial market services, payment cards, leasing, and investment banking. Retail banking refers to the

provision to households and very small businesses of a cluster of services and products, including deposits, loans and the distribution of mutual funds. *See, e.g.*, *Santander/Bradford & Bingley Assets*, Case No. COMP/M.5363 (December 17, 2008); BNP Paribas/Fortis, Case No. COMP/M.5384 (December 3, 2008). Corporate banking refers to a cluster of services provided to corporate clients, including deposits, lending, factoring, leasing, international payments, letters of credit, and investment banking services such as securities underwriting, asset management and advice concerning mergers and acquisitions. The Commission has also found that it may be appropriate to further narrow the relevant market definition and distinguish between services offered to small- and medium-sized enterprises ("SMEs") and large corporate customers ("LCCs"). *See Banco Santander/Rainbow*, Case No. COMP/M.5948 (October 15, 2010). Some of the Commission's decisions suggest that some of the services within the cluster constitute separate product markets, such as factoring, *see BNP Paribus/Fortis Commercial Finance Holding*, Case No. COMP/M.6244 (September 5, 2011); leasing, *see Volkswagen Financial Services/D'Ieteren/Volkswagen D'Ieteren Finance JV*, Case No. COMP/M.6436 (December 12, 2011); and investment banking, *see BNP Paribas/Fortis*, Case No. COMP/M.5384, at 14 (December 3, 2008) (Investment banking services include M&A advice, IPO advice, and services relating to arranging new issues of stocks and bonds).

Financial market services include but are not limited to trading in equities, bonds and derivatives, foreign exchange and money markets. *See, e.g.*, *RBI/EFG Eurobank*, Case No. COMP/M.6168 (June 29, 2011). With respect to some of these product markets, the Commission has further looked at sub-markets; *e.g.*, in the category of equity derivatives, the Commission has further examined flow equity derivatives, equity financing and corporate derivatives/strategic equity. *See, e.g.*, *BNP Paribas/Royal Bank of Scotland*, Case No. COMP/M.7151 (April 10, 2014); *see also Amundi/Credit Agricole/Pioneer Investments*, Case No. COMP/M.8359 (March 24, 2017). The Commission has also looked at asset management services as a separate product market: which services include (i) the creation, establishment, and marketing of retail pooled funds; (ii) the provision of portfolio management services to pension funds, institutions, international organizations, and private investors; (iii) the provision of transition management services; and (iv) securities lending. *See, e.g.*, *Blackrock/Barclays Global Investors UK Holdings*, Case No. COMP/M.5580 (September 22, 2009). In addition, the Commission has indicated that global custody services and fund administration constitute separate product markets. *See, e.g.*, *State Street/Intesa SanPaolo Servizi/Transazionali/SanPaolo Bank*, Case No. COMP/M.5797 (April 26, 2010).

The Commission looks at the impact of banking transactions on these various services in geographic markets consisting of individual Member States. The Commission generally uses an international geographic market to analyze transactions impacting corporate banking services for large clients or financial market services. *See, e.g.*, *MeritaNordbanken/Unidanmark*, Case No. COMP/M.1910 (April 10, 2000).

In the FöreningsSparbanken/SEB merger, the Commission expressed concern that the merger would diminish competition for banking services provided to households and SMEs, with market shares in the 40% to 60% range. *FöreningsSparbanken/SEB*, Press Release, Case No. COMP/M.2380 (Sept. 19, 2001). The parties concluded that much of the value of the transaction would be lost if they made the divestitures necessary to resolve these concerns and decided instead to abandon the transaction before the completion of the second phase investigation.

In addition, the Commission has accepted divestiture commitments (referred to as "undertakings" in the EU) in banking transactions in order to clear a transaction after the initial investigation. For example, in the merger of Bank Austria and Creditanstalt, the merged entity was required to make certain divestitures in order to eliminate competitive concerns regarding the provision of banking services in Austria. Without the divestitures, the combined firm would have had market shares in excess of 30% for certain retail and corporate banking products. *Bank Austria/Creditanstalt*, Case No. IV/M.873 (March 11, 1997). Similarly, the Commission approved Nordbanken's acquisition of Postgirot after Nordbanken agreed to reduce its stake in Bankgirot to 10%. Without this remedy, the transaction would have given Nordbanken control over both Postgirot and Bankgirot, the two main bank payments systems used by Swedish households to pay electricity, telephone and other bills, with a combined share in excess of 75%. *Nordbanken/Postgirot*, Case No. COMP/M.2567 (Nov. 8, 2001). The Commission accepted divestiture commitments by Fortis N.V. and Fortis S.A., eliminating the need for a second phase investigation, in connection with the acquisition by Fortis, as part of a consortium that included Banco Santander Central Hispano and Royal Bank of Scotland, of certain assets of ABN AMRO. To address Commission concerns regarding commercial banking in the Netherlands and factoring, Fortis agreed to divest (1) the Hollandsche Bank Unie N.V.; (2) corporate client departments serving corporate customers with revenues between 50 million Euro and 1 billion Euro; (3) 13 Advieskantoren, which consisted of commercial banking offices serving SMEs; (4) certain factoring contracts related to the customers of the entities identified previously and ABN AMRO's Dutch factoring subsidiary, IFN Finance BV; and (5) other assets relating to these businesses. In the absence of these divestitures, Fortis would have had market shares in excess of 40% to 50% in commercial banking and of 50% to 60% in factoring in the Netherlands. *Fortis/ABN AMRO Assets*, Case No. COMP/M.4844 (Oct. 3, 2007).

In payment cards, the Commission distinguishes between payment cards issuing and payment cards-related activities, such as merchant acquiring and card processing. With respect to card issuance, the Commission has discussed, although not definitively concluded, that there are separate markets consisting of credit/charge card issuing, universal/special purpose (*e.g.*, store cards) credit card issuing, and corporate vs. personal credit cards. *See, e.g.*, *Barclays Bank/Egg Credit Card Assets*, Case No. COMP/M.6164 (April 18, 2011). The Commission has also considered fuel cards (payment cards for use at fuel stations) as a separate product market. *Kuwait Petroleum BV*, Case No. COMP/M. 7196 (June 11, 2014) (left the decision open as the parties did not raise any serious doubts as to compatibility under any market definition of the matter under consideration). In card processing, the Commission has not yet firmly defined whether the card processing services should be subdivided into issuing processing services and acquiring processing services, but it has acknowledged that there may be appropriate segmentations. In a recent decision, the Commission did not have to decide whether to apply a broad definition or narrower ones because there was no issue in any relevant market. Global Payments and TSYS, Case COMP/ M.9452 (Sept. 16, 2019).

To address Commission concerns regarding (i) the issuing of universal charge/credit cards in Belgium and Luxembourg, and (ii) the supply of card-based consumer credit through revolving credit cards (in both cases the combined shared would be about 40-50%), BNP Paribas made divestiture commitments in order to gain approval of its acquisition of certain Fortis entities in 2008. *BNP Paribas/Fortis*, Case No. COMP/M.5384 (December 3, 2008) (the parties had numerous overlaps in various retail, corporate and other banking products and services, but

the only overlap requiring a divestiture commitment was in the card issuing category and in revolving consumer credit).

### 2. Insurance

The Commission has identified three broad categories of insurance: life, non-life and reinsurance. *See, e.g.*, *Aegon/Santander*, Case No. COMP/M.6848 (April 29, 2013); *Helvetia/Certain parts of Gan Eurocourtage's Marine Insurance Portfolio*, Case No. COMP/M.6694 (September 11, 2012). Life and non-life insurance have been further divided based on the different kinds of risks covered. In defining the relevant product market, the Commission looks at the characteristics, premiums and purposes of the various insurance products to determine the level of substitutability for the consumer between different insurance products. The Commission also looks at the degree of supply-side substitutability between products when defining a product market. *See, e.g.*, *Berkshire Hathaway/Converium/Guam JV*, Case No. COMP/M.3035, at 14-15 (Feb. 28, 2003). In that regard, the Commission has considered further segmentations for life insurance products: pure protection products, savings and investment products, and pension products. *See, e.g.*, *Aviva/Friends Life/Tenet*, Case No. COMP/M.7478, at 4 (March 13, 2015). The Commission has also considered the possibility that personal and commercial policies should be segregated into separate product markets and that distinctions should be made based on whether the customer is an individual or a group. *See id.*

The Commission has separately looked at the market for insurance brokerage services. The Commission considered distinguishing product markets for the distribution of life insurance, non-life insurance and reinsurance because different providers tend to be involved for each type of insurance and the distribution of life insurance in Europe is regulated separately from other types of insurance. As with the insurance itself, a distinction can also be made with respect to the brokerage of personal and commercial non-life insurance. The parallel with actual insurance goes only so far, however. The Commission has suggested that the product markets for brokerage services are broader than for insurance products themselves since clients approach a broker for more than one type of insurance (demand-side substitution) and the same skills can be used by brokers to market different types of insurance (supply-side substitution). *See, e.g.*, *KKR/Willis Corroon*, Case No. IV/M.1280 (October 24, 1998).

When analyzing transactions in the insurance industry, the Commission looks at the competitive impact in nationally defined geographic markets for life and non-life insurance, *See, e.g.*, *Helvetia/Certain Parts of Gan Eurocourtage's Marine Insurance Portfolio*, Case No. COMP/M.6694 (September 11, 2012) (indicating that transport insurance market is wider than national and could be at least EEA-wide), except with respect to the insurance of certain large risks, because of the need for adequate distribution channels. For the insurance of large risks and for reinsurance, the Commission uses an EEA-wide, international or global geographic market to determine a transaction's impact. *See, e.g.*, *Berkshire Hathaway/Munich Re/Gaum*, Case No. COMP/M.5010 (July 14, 2008). The Commission also looks at pension products, and in doing so considers defined benefit products, defined contribution products and accumulation projects, *NN Group/Delta Lloyd*, Case No. COMP/M.8257 (April 7, 2017), and considers vertical relationships between pension products and their distribution to customers, Uniqa/AXA, Case No. COMP/M.9796 (July 29, 2020). There have been few divestitures required by the Commission in insurance transactions. For example, the Commission approved Generali's

acquisition of INA subject to certain divestitures. Without these divestitures, Generali would have been by far the largest player in the Italian life insurance sector, accounting for between 30% and 40% of the market and controlling approximately one quarter of existing bank outlets. After accounting for the divestitures, Generali had a share below 30%. *Generali/INA*, Case No. COMP/M.1712 (January 12, 2000).

In the non-life insurance area, the Commission approved the acquisition of GRE by AXA after the parties agreed during the first phase investigation to a divestiture. The Commission was concerned about competition between AXA and Le Foyer Finance Compagnie Luxembourgeoise S.A., in which GRE had a direct 34.8% interest. The companies were two of only three significant competitors for non-life insurance in Luxembourg. This was true for various types of non-life insurance, including motor, casualty, property, general civil liability, litigation and motor breakdown. AXA agreed to remedy the concern by divesting either portions of its portfolio to a credible competitor or GRE's stake in Le Foyer. *AXA/GRE*, Case No. COMP/M.1453 (April 8, 1999).

In late 2001, the Commission accepted undertakings to resolve competitive concerns with respect to domestic and export credit insurance in the acquisition by Gerling-Konzern Versicherungs-Beteiligungs AG ("Gerling") of NCM Holding N.V. ("NCM"). *Gerling/NCM*, Case No. COMP/M.2602 (Dec. 11, 2001). Although similar to factoring, letters of credit and capital good credit insurance, the Commission determined that these other products were sufficiently distinct and specific as not to be truly competitive, and while the Commission recognized a trend toward internationalization, it focused on national geographic markets. Using these market definitions, the Commission found that the parties had high combined shares (>60%) in several countries (The Netherlands, Denmark, Sweden and Norway). Nonetheless, Gerling was able to avoid divesting NCM's business in Sweden and Norway due to the substantial presence of intermediaries who could facilitate entry by shifting large amounts of business away from the parties. In addition, the Commission concluded that in Sweden the rapid growth in the market made entry even more likely, while in Norway, there were already two significant competitors (>15% share) and a third had just entered. On the other hand, divestiture of NCM's business was necessary in The Netherlands and Denmark, as the market was not growing in these countries and intermediaries did not play a substantial role. In Denmark, the Commission also expressed a vertical concern as NCM had a significant share in the factoring business (>30%) and factoring companies reinsure by buying credit insurance. NCM's factoring competitors (and therefore the Commission) were concerned that the merged entity would foreclose the provision of credit insurance, which would lead to NCM becoming dominant in the factoring business.

A 2006 case in which the Commission required a divestiture highlights how the Commission can define narrow product markets for some lines of insurance. In Talanx Aktiengesellschaft's acquisition of Gerling Versicherungsgruppe, the Commission required the divestiture of parts of the pharmaceutical liability insurance business of Talanx's subsidiary, HDI. *Talanx/Gerling*, Case No. COMP/M.4055 (Apr. 5, 2006). The Commission found that liability insurance for pharmaceutical companies is different from liability insurance for other industries due to the significant liability risks inherent in pharmaceutical products, the large group of potential claimants and the difficulty of risk assessment. The Commission focused on the market for pharmaceutical liability insurance outside the obligatory product liability

insurance in Germany, where HDS and Gerling would have accounted for a 50% to 60% market share. The Commission required HDI to divest the renewal rights associated with this business and transfer certain personnel to enable the divestiture buyer to enter the pharmaceutical liability insurance business and thereby remedy the Commission's competitive concerns.

### 3. Digital Payment Products

The Commission has issued several decisions in the mobile payments area. In doing so, it has loosely defined several relevant markets: (1) retail distribution of mobile wallet services, (2) digital advertising services, (3) data analytics, and (4) ticket storage services. *BNP Paribas Fortis/Belgacom/Belgian Mobile Wallet*, Case No COMP/M.6967 (Oct. 11, 2013); *Telefonica/Caixabank/Banco Santander*, Case No. COMP/M.6956 (Aug. 14, 2013).

## D. The Thresholds for Commission Review

Unlike in the U.S., where individual states can conduct their own separate investigations, the EC Merger Regulation is based on the fundamental principle of the "one-stop-shop." When the EC has jurisdiction to review a transaction, the transaction cannot ordinarily also be reviewed by individual Member States and no separate antitrust notification to these Member States is required.[48] However, not every transaction involving parties with revenue in Europe is subject to Commission Review and when a transaction is not subject to Commission review, antitrust notifications may be required to individual Member States. The EC Merger Regulation requires Commission review only for transactions with a sufficient "Community dimension." There are presently two alternate thresholds for a two-party transaction to have a Community dimension:

- The combined turnover of the parties to the transaction is in excess of 5 billion euros; and each of the parties had community-wide turnover of 250 million euros; or

- The combined turnover of the parties to the transaction is in excess of 2.5 billion euros;

- Each of the parties had community-wide turnover of 100 million euros;

- In each of at least three member states, the combined turnover of the parties is at least 100 million euros; and

[48] Under Article 9 of the Merger Regulation, a transaction that is properly notified to the Commission may nonetheless be "referred" back to a Member State in certain circumstances. Specific time periods for referral and subsequent determinations by the Member State are set forth in the Merger Regulation. Additionally, new provisions of Article 4 of the EC Merger Regulation now permit a party to initiate referral to a Member State where "the concentration may significantly affect competition in a market within a Member State which presents all the characteristics of a distinct market and should therefore be examined, in whole or in part, by that Member State." In 2020, one financial industry transaction was referred by the Commission under Article 4 to the Romanian antitrust regulator. The transaction involved the acquisition of joint control over CIT One SRL by three other banks. The activities and operations of CIT are within Romania and affected one distinct market. Banca Comerciala Romana/Raiffeisen Bank/BRD Société Générale/CIT One, Case No. COMP/M.9625 (March 10, 2020).

- In at least three of the member states that satisfy, each of the parties has turnover of more than 25 million euros.

Under either test, a transaction will not be treated as having a Community dimension if each of the parties to the transaction had more than two-thirds of its Community-wide turnover within one and the same Member State.

Under the merger rules, there is an optional third mechanism for having a transaction reviewed by the Commission. Transactions that require notification in three or more Member States may instead be notified to the Commission, and if no Member State objects, the Commission will review the transaction and the transaction will not need to be notified to the Member States.

The term "turnover" is defined as revenue in the preceding financial year from the sale of products and the provision of services falling within the party's ordinary activities after deducting sales rebates and taxes directly related to the turnover. For insurance companies, turnover comprises the value of gross premiums. For credit and other financial institutions, turnover refers to interest and similar income, income from securities (including participating interests and shares in affiliated companies), commissions receivable, net profit on financial operations and other operating income. While the location of the customer determines the location of the turnover for insurance companies and non-financial institutions, the location of the branch or division that receives the income determines the location of turnover for credit and other financial institutions.

## E. The Procedures for Commission Review

A transaction that meets the Community dimension thresholds must be notified to the European Commission and receive approval prior to consummation. Like the U.S., the EU has no trigger for submission of the notification, apart from the absolute rule that the merger or acquisition cannot be consummated prior to clearance. Parties may now notify their transaction prior to a definitive agreement so long as the parties demonstrate a genuine intention to execute the transaction.

The notification, known as the Form CO, requires a detailed description of the parties, their holdings and the competitive impact of the transaction. It frequently takes the parties weeks to prepare the form and a draft of the form is usually submitted before formal filing for comment from the staff of the Commission.

The assessment of mergers by the European Commission involves a two-stage process. The initial waiting period is 25 working days beginning the day following the receipt of the final version of the notification (as opposed to a draft). During this period, the Commission must determine whether the transaction raises serious doubts as to its compatibility with the common market. The Commission will approve transactions that raise no serious doubts about compatibility at the end of the initial waiting period. When the Commission finds that a transaction does raise serious doubts, the Commission will issue a decision to that effect and initiate a "second phase investigation." Sometimes, the parties to a transaction can avoid a "serious doubts" decision and a second phase investigation by committing during the initial

period to make certain structural changes, such as a divestiture. Under certain infrequent circumstances, the Commission will accept behavioral, rather than structural, commitments. If commitments, called "undertakings" in the EU, are offered during the initial phase, this phase will be extended by ten additional working days under the new merger law.

A second phase investigation lasts an additional 90 days. At the end of this investigation, the Commission must come to a conclusion and issue a decision as to whether the transaction is in fact compatible with the common market. Before reaching a conclusion that a transaction is incompatible with the common market, which would prohibit the parties from consummating the transaction, the Commission must issue a Statement of Objections and allow the parties to the transaction an opportunity to respond. The Commission will also hold a hearing at the request of either the parties to the transaction or interested third parties, if they demonstrate sufficient interest. As during the first phase, the parties may submit undertakings to avoid a decision of incompatibility by eliminating the Commission's concerns. The second phase investigation may be extended an additional 15 working days to 105 working days if the parties offer commitments after the 54th day of the second phase. The second phase also can be extended by 20 working days if requested by the notifying parties, but the request must be made within 15 days of the initiation of a second phase investigation. The Commission also may request an extension of the second phase investigation by up to 20 working days if the parties consent.

Finally, it is worth noting that the Commission has the power to issue questionnaires to the parties to the transaction as well as to third parties in order to obtain information necessary for its investigation. These questionnaires, known as "Article 11 Requests," are issued under Article 11 of the EC Merger Regulation. The EC Merger Regulation enables the Commission to impose significant penalties on anyone who provides incorrect information or fails to respond to an Article 11 Request.[49] The Commission may also suspend the review period where one of the parties fails to comply with an Article 11 request, as occurred during the course of the Commission's investigation into Oracle's acquisition of PeopleSoft.

Under the new merger law, the Commission may also conduct interviews and take depositions to be used as evidence with the deponent's consent.

## F. The Role of Complainants

In both the U.S. and Europe, complainants play an important role in helping competition authorities evaluate corporate transactions. They provide background industry information and notify the reviewing authorities of potential anticompetitive effects. In the U.S., the antitrust authorities pay particularly close attention to complaining customers, but the ultimate decision makers at the agencies will frequently discount the concerns of competitors. The European Commission has shown greater receptivity to competitor complaints, allowing them to play a

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[49] In July 2004, the Commission imposed a €90,000 fine on Tetra Laval. Half of the fine was for supplying incorrect information in its merger notification and half was for supplying incorrect information in response to an Article 11 request in connection with its merger notification. Tetra Laval/Sidel, Case No. COMP/M.3255 (July 7, 2004). While the fine was imposed after May 1, 2004, the violation occurred prior to that date and was subject to a €50,000 maximum per violation. The new Merger Regulation that came into force on May 1 enables the Commission to fine companies up to one percent of their aggregate turnover for supplying incorrect or misleading information.

substantial role in the provision of background information and in outlining possible concerns, and the presence of complaining customers plays a more determinative role in the outcome of a merger investigation by the European Commission.

### G. The Appellate Process

If the Commission prohibits a transaction as incompatible with the common market, the parties may appeal the decision to the European Court of First Instance. In 2002, the court reversed the Commission in all three of the appeals that it decided, and in late 2005, the court reversed the Commission's decision regarding GE/Honeywell. Nonetheless, in all but one of these cases, the reversal was essentially a Pyrrhic victory for the parties as the transaction did not survive the delay associated with the appeal. Indeed, in one of the cases, Airtours, the court took nearly three years to reverse the Commission's prohibition, and in GE/Honeywell, the decision came almost four-and-a-half years after the Commission's decision. In the other two cases, the court took "only" about a year due to the parties use of the court's "fast-track" procedures. Only in Tetra Laval/Sidel have the parties renewed their transaction, receiving Commission approval subject to undertakings. The Commission recognizes the problems associated with prolonged appeals, but to date it has not made any formal proposal to address these problems.

## XII. OTHER FOREIGN ANTITRUST REVIEW

In addition to review in the U.S. and EU, mergers and acquisitions in the financial services industry may be subject to review under the merger laws of other countries. More than 100 countries have enacted merger control laws. Not all countries have enacted suspensory laws, but the substantial majority have. Like the U.S. and the EU, many jurisdictions increasingly are becoming more active and aggressive in their antitrust review. This includes Brazil, Canada, China, India, Japan, Mexico, Russia, South Africa, and South Korea. The U.K., now a standalone jurisdiction following Brexit, should be counted among the more active and aggressive jurisdictions. Some countries that previously had non-suspensory regimes (where parties could close before clearance) recently enacted suspensory laws, such as Chile, Costa Rica and Peru.

Unlike the test for reportability under the HSR Act, most jurisdictions apply a functional control test to determine whether a filing is warranted. As discussed in Section IX above, the HSR Act applies regardless of whether control is being acquired, with certain exceptions (such as deals solely between foreign issuers), as long as the thresholds are met and no other statutory or regulatory exemption applies. In most foreign jurisdictions, reportability is based on the acquisition of control, although control may be defined broadly and the definition differs from jurisdiction to jurisdiction. Thus, control may be deemed to exist by the acquisition of 10% of the securities of a firm under the laws of one jurisdiction while it would only exist with a 50% holding in another jurisdiction. It is also noteworthy that a few jurisdictions' merger control laws may apply to acquisitions below 10%. The tests are fact-based and consequently should be considered on a jurisdiction by jurisdiction basis for each transaction.

Some countries' merger laws are based on monetary thresholds — revenues derived from sales to customers located within the jurisdiction — others are based on market share tests and still others are based on both revenues and assets. Some countries employ a substantive standard

similar to the U.S. SLC standard, while others apply standards more similar to the EU's old "dominance" standard or new SIEC standard. From time to time, governmental authorities focus efforts to attaining convergence and harmonization of merger laws throughout the world, but these efforts wax and wane depending on the political climate and in any event this movement is in its infancy and not likely to yield harmonization anytime in the near future.

Further, similar to the U.S., some countries may allocate antitrust review to their relevant banking or insurance regulatory agency, either alone or with the assistance of antitrust regulators. In such countries, the parties may be required to file a notification addressing both banking and antitrust issues. Other countries, however, may require notification to a banking or insurance regulatory agency and a separate notification to the competition authorities.[50]

In addition, the time for review differs from jurisdiction to jurisdiction. While many jurisdictions have 30-day initial waiting periods, there are a number of significant jurisdictions in Europe and elsewhere that have longer initial waiting periods. Second phase review periods also differ quite significantly from jurisdiction to jurisdiction. The time for review thus must be taken into account by the parties in scheduling the closing of the transaction and in announcing the expected closing to the public.

Given the proliferation of merger control laws and the significant differences in notification procedures, detail required in the notification, and timing of review, it is important that parties assess the applicability of foreign merger control to particular transactions as early on in the deal process as practicable.

[50] In Italy, if a merger involves companies engaged in insurance activities, the parties will prepare a notification for filing with the Italian Competition Authority ("ICA"), and the ICA in turn will seek an opinion of the Italian Insurance Authority ("ISVAP").

## ANNEX A

## FINANCIAL INSTITUTION M&A PREPAREDNESS CHECKLIST

The strong pace of financial institution M&A activity in prior recent years and subsequent slowdown, combined with the rapid changes and competitive pressures facing the financial industry, including the vast economic and social changes resulting from the Covid-19 pandemic, a bank regulatory landscape that has shifted in recent years and could continue to experience significant changes in the future, significant tax law changes and potential future changes, volatile stock markets, rising interest rates, continued inflationary risks and an increasing focus on shareholder activism, requires a proactive approach to M&A planning and preparedness. Failure to plan effectively will result in missed opportunities for would-be acquirers. Failure of a potential target to prepare for a takeover overture exposes the target to potential pressure tactics and reduces the target's ability to control its own destiny and obtain the most favorable possible result in an M&A transaction.

The following checklist sets forth certain planning suggestions for financial institutions to consider as they confront the strategic challenges and opportunities that lay before them. Not all matters in the checklist are appropriate for all companies. Preparing for the array of potential transactions that may present themselves in today's landscape is an art, not a science. Each company should adopt planning tools and techniques that are best suited to its own corporate culture and that are tailored to meet its specific strategic objectives. Most importantly, institutions must remain flexible in order to respond quickly to the ever-changing M&A market and regulatory environment.

### 1. General Takeover Defense Preparedness

Notwithstanding the constant criticism from academics, activists and other so-called governance experts, takeover preparedness continues to be of utmost importance to all financial institutions. As the stock market continues to struggle following the significant gains made during the last few years, and as interest rates continue to rise, the financial services industry will likely continue to experience a period of substantial consolidation. The tax law changes enacted in December 2017 have provided acquirers additional "dry powder," but likely have also resulted in pressure on companies to return "excess" cash to shareholders, demonstrated by recent increases in share repurchases following the passage of the 2017 tax reform. In 2022, further tax law changes were enacted in the Inflation Reduction Act, which included a 15% minimum corporate tax rate and a 1% excise tax on stock repurchases. Nevertheless, the specter of possible hostile overtures, outright hostile and interloping bids and general activist activity will remain, if not increase. It is therefore essential for companies to review their takeover defenses to assure that they are prepared to respond to a takeover bid or proxy fight.

Both traditional bear hug overtures and outright hostile tender or exchange offers have been seen in the financial sector, along with proxy fights, consent solicitations and various forms of shareholder activism (including use of the SEC's proxy rules to pressure financial institutions to dismantle various anti-takeover defenses). Pressure tactics can be expected to remain prevalent and, indeed, to increase.

- Assemble a team to deal with acquisition overtures (two to five key officers and a team of outside advisors — lawyer, investment banker, proxy soliciting firm and public relations firm).

- Review existing rights plan or be prepared to rapidly adopt a rights plan if circumstances warrant.

- Ensure ability to convene a special meeting of the board within 24 to 48 hours where circumstances warrant.

- Review charter provisions, by-laws and applicable state law governing shareholder meetings, nominations, shareholder business and consent solicitations, to assure that they are responsive to recent developments in proxy contests and consent solicitations. Don't be complacent if the company has a staggered board of directors — use the review to understand and, if appropriate, to close any loopholes or workarounds that would allow a bidder to undercut the effectiveness of that structure and achieve a majority of the board in a shorter time.

- Review charter provisions to assure that the company has sufficient authorized shares of common and preferred stock to facilitate acquisitions, equity placements and other strategic transactions.

- Review change-of-control triggers in joint venture agreements and other material contracts.

- Review options under state takeover laws (*e.g.*, "control-share," "fair price" and "constituency" statutes).

- Review change-of-control severance agreements and benefit plan protections.

- Review available transactional defenses (stock buybacks, spin-offs, restructurings).

- Establish procedures for monitoring trading activity and 13D/13G filings to anticipate a potential activist situation.

## 2. Working with Institutional Investors

- Closely monitor the company's shareholder profile, particularly institutional and other large shareholder positions. Remain informed about activist hedge funds and activist institutional investors and about corporate governance and proxy issues.

- Develop a proactive strategy for building cooperative relationships with the company's large institutional shareholders — with an emphasis on access and mutual understanding.

- Consider periodic engagement with significant shareholders in order to stay apprised of shareholder opinions and anticipate any potential takeover overtures.

- Developing relationships with key shareholders through regular engagement on clear days may increase shareholder receptiveness to management views in a contested or otherwise challenging takeover situation.

- In some cases, activist institutions have taken large (arguably controlling) positions in financial institutions. Some institutions seek regulatory approval for large positions, while in the past others have inadvertently crossed the 5% or 10% threshold without regulatory approval.

- Seek the assistance of outside experts in keeping watch on shareholder positions and in assessing the composition of the shareholder base.

- For financial institutions with subsidiaries in the investment management business, be aware of the policies of those subsidiaries with respect to favorite governance proposals of shareholder activists (*e.g.*, shareholder votes on rights plans, removal of staggered boards, by-law amendments).

### 3. General Acquisition Planning and Preparedness

Acquisition planning by potential buyers is equally as important as takeover defense preparedness.

- Review business strategy and identify potential acquisition candidates, including opportunities for expansion through acquisitions of, or joint ventures with, non-bank financial service providers (including companies in the fintech space).

- Maintain relationships with key regional industry participants and competitors, who may in the future ultimately prove to be attractive transaction partners.

- Assemble a team to evaluate acquisition opportunities (key officers and outside advisors), including an experienced due diligence team.

- Develop financial models for evaluating potential bids, the institution's asset portfolio and its ability to pay. The flexibility to adapt to sudden unexpected merger announcements or merger overtures can be critical — merger transactions are frequently "art of the do-able deal."

- Schedule periodic meetings and presentations with legal counsel and financial advisors to familiarize management with the current takeover scene and M&A legal developments.

- Review capital position and alternative means of financing acquisitions and ongoing funding options.

- Consider best location to conduct non-bank activities (*i.e.*, at holding company or subsidiary bank level) and the associated regulatory implications.

- Review acquisition strategies in advance with primary regulators to ensure regulatory support and facilitate the approval process.

- Understand potential regulatory consequences associated with making a significant acquisition, such as the application of certain Dodd-Frank requirements when a deal results in the acquiring bank or bank holding company exceeding $10 billion or $50 billion in total assets (and monitor the likelihood of any potential changes to these thresholds).

- Consider potential antitrust, CRA, deposit cap and other regulatory hurdles. If no election has been made to become a financial holding company under the Gramm-Leach-Bliley Act, a periodic assessment of the pros and cons may be worthwhile. Consider capital levels and CRA efforts in light of the requirements for qualification as financial holding companies and in light of plans to enter or expand certain activities.

- Consider general regulatory compliance and relationships with regulators, and identify and be prepared to address possible deficiencies or risks that could affect the company's acquisition strategy or regulatory status going forward (including in areas such as BSA/AML, fair lending, etc.).

- Understand that deals subject an acquirer to increased scrutiny from the press, bank regulators, the SEC and others. The effective functioning of general compliance and internal controls to minimize any issues is critical.

## 4. Restructuring Opportunities

- Increasing competitive and shareholder pressures have led many financial holding companies to implement significant restructuring transactions.

- Peer comparisons are being used to focus operational efficiency ratios. Major cost-reduction programs have been initiated throughout the industry.

- Asset/line-of-business divestitures, partial subsidiary initial public offerings and spin-offs are being employed as institutions seek to restructure their organizations to maximize shareholder value. These transactions raise complex tax considerations that should also be considered.

- The SEC can be expected to closely scrutinize restructuring charges and substantial support will be required to justify the amount and timing of such charges.

- A number of institutions have been proactive in optimizing their balance sheets by disposing of troubled or under-performing assets. The opportunities and risks presented by such strategies should be regularly evaluated. Structures involving special purpose entities and other complex financings should be carefully considered in light of current events.

## 5. Mergers of Equals

- Mergers of equals ("MOEs") can be an important alternative form of business combination, permitting great strides to be made with a single stroke.

- Early, proactive efforts to pursue MOEs are necessary, as they are generally impossible to implement as a takeover defense.

- MOEs offer an alternative to an outright sale, in which two organizations of roughly equal size can combine their organizations in an effort to provide shareholders with greater long-term value.

- Board composition, executive management, succession and other "social" issues are often key to an MOE's success or failure; these issues can be particularly challenging to address when combining companies with different corporate cultures, and should be discussed early in the negotiation process.

- A variety of contractual and legal structures are available to implement agreements on social issues, although basic trust and common objectives are key.

- MOEs can be fragile. Experience has shown that careful planning is critical to avoid placing one or both parties "in play" prior to the announcement of the transaction and to anticipate possible shareholder concerns. Non-premium mergers not structured as "true" MOEs (*e.g.*, a roughly equal sharing on governance and social issues) will likely be attacked by shareholders, although some transactions with low or even negative premiums have been favorably received by investors.

- Lockup protections are appropriate to protect the transaction once it is announced. The record must show the MOE is not intended to be a sale of either company.

- The expected synergies and other long-term benefits of an MOE may allow it to be considered "fair" even though higher short-term value could be obtained in an outright sale of the company.

- Experience in the banking sector suggests that perhaps the key factor in the ability of an MOE to withstand a competing bid is the resolve and public commitment of both parties to see the transaction through.

## 6. Board Preparation

- Achieving and maintaining a unified board consensus on M&A positions is vital to a successful M&A strategy.

- The full board of directors, including independent directors, should be actively involved in the preparation and implementation of the company's strategic plans.

- Regular presentations should be made by management concerning the institution's progress as measured against the strategic plan.

- Directors should consider periodic presentations by lawyers and investment bankers to familiarize them with current M&A developments and to provide an independent assessment of the company's strategic plans.

- The board should maintain a firm policy of continued independence until such time as it determines that it is in the company's and its shareholders' best interests to seek an acquirer or merger partner.

- Directors should not engage in separate takeover or acquisition discussions and all inquiries should be referred to the CEO for a unified response. Regulation FD has made the adoption of a well-coordinated communications strategy even more critical.

- Stock exchange rules require procedures for handling incoming communications directed at the board or individual directors. Frequently, boards choose to direct the corporate secretary or another appropriate officer to summarize and present these communications at regular board meetings.

- Discuss the importance of independent directors meetings with ISS, Glass Lewis and major shareholders during a proxy contest or hostile tender offer.

- Review corporate governance guidelines and reconstitution of key committees.

## 7. Preparation of CEO and Senior Management

- The CEO should be the sole spokesperson for the company with respect to M&A matters and should be carefully counseled by the board of directors and expert advisors on how to respond to both casual and overt takeover inquiries.

- The CEO should consult periodically with the board to obtain support for responding with a firm "no, thank you" to casual passes and bear hug proposals.

- Exploration by a CEO of a possible sale or strategic merger should generally only begin after consultation with expert advisors and the board.

- The CEO and other senior officers should make sure that in dealing with the analyst and financial community and the media a consistent unified message is delivered. In addition, Regulation FD may force premature disclosure of sensitive topics if care is not taken in communications with analysts, institutional investors and shareholders.

## 8. Responding to Rumors, Press Inquiries and News Reports

- Most bear hug letters do not require public disclosure by the target.

- There is no general duty to respond to rumors.

- The best response to inquiries is usually the following: "*It is the Company's policy not to comment on such matters*." To be most effective, this response must be used consistently.

- It is important that communications with the media and the stock exchanges be centralized and monitored.

- Failure to adhere to a no-comment policy can lead to premature disclosure that places a company "in play."

- Develop strategy for handling press and analyst questions concerning rumors and market speculation.

- Develop approaches to deal with "anti-M&A" securities analysts.

- Concern about coordinated, thoughtful communication should not end once a deal is signed and publicly announced. A company should review its communication policies after a deal, as "business as usual" may no longer be the best route, given possible additional disclosure requirements and the high level of scrutiny afforded to deals by the media, arbitrageurs and other constituencies.

**9. Responding to Public Overtures and Takeover Proposals**

- Do not issue an immediate press release or other public statement (other than a "stop, look and listen" communication in the event of a tender offer).

- In the case of a phone call from a hostile acquirer, do not give any response other than "will call you back." Remember that any statement could be repeated publicly (and possibly taken out of context) at a later time.

- Call a meeting of the company's deal team and legal and financial advisors, and inform the board.

- Determine in consultation with the board and advisors, after due deliberation, whether to meet with the acquirer and whether and how to respond publicly. All communications following a public overture should be carefully considered in advance with the board and expert advisors.

- In a tender offer, a Schedule 14D-9 must be filed with the SEC within 10 business days and must disclose the board's position (favor, oppose or neutral) and reasoning.

**10. No Duty to Sell the Company or Conduct an Auction**

- Target companies have a great deal of latitude in responding to takeover proposals and in structuring the process by which a sale of the company or a merger may occur. Careful planning, with the aid of expert advisors, is extremely important in managing both the buy-side and sell-side M&A processes.

- Management and directors have no absolute legal duty either to explore a proposal to buy the company, to meet with, discuss or negotiate with a potential acquirer, or to accept a bid, even if the proposal offers shareholders a substantial premium over the current market price. Delaware case law is clear that the board has the right to "just say no" under *Time Warner* and the simple refusal to enter into a merger agreement is not a "defensive" action that is subject to the higher judicial scrutiny of the *Unocal* standard.

- Once a determination to seek a merger partner has been made, there is no absolute duty to auction the company. Even in the context of a potential cash sale, *Revlon* and *Paramount* do not require a board to conduct a heated bidding contest before it enters into a merger agreement.

- Once a board has determined to enter into negotiations concerning a sales transaction, there will be a heightened duty to consider *bona fide* proposals from other interested parties; however, the due diligence conditions typically attached to such proposals provide a board with significant latitude in sticking with a "bid in hand."

**11. Employee Issues**

- Review procedures by which compensation arrangements are approved and documented.

- Review change-of-control and other employment contracts and employee benefit plans, including for compliance with Section 409A of the Internal Revenue Code and the applicability of Sections 280G and 4999 of the Internal Revenue Code, and consider the need to address potential Section 280G issues.

- Review triggers and termination provisions in employment agreements, equity-based plans and employee benefit plans. In an environment where a considerable number of transactions are not being completed due to regulatory concerns, review whether early triggers — those triggering acceleration on events before the consummation of a transaction such as shareholder approval — are appropriate.

**12. D&O Indemnification and Insurance**

- Review charter and by-law provisions (if the institution is a bank holding company, at both holding company and bank levels).

- Review D&O insurance coverage. Consider coverage of former directors and officers of acquired companies.

- Charter provisions limiting director and officer liability and authorizing D&O insurance take on added importance in the current environment.

## 13. Watch Future Developments Closely

- Look out for legislation and regulatory changes. Maintain regulatory focus on compliance and conflicts.

- Pay attention to accounting developments, such as FASB guidance on mark- to-market accounting (historical examples including: the elimination of the "fair value rule" that previously marked to market certain financial assets; the switch to purchase only accounting and the revised approach to goodwill and other intangibles under FAS 142 and related pronouncements; SEC guidance on loan loss reserves (SAB 102) and, in particular for active acquirers, scrutiny of merger-related restructuring charges; credit card and subprime lending guidance, including revised capital requirements; treatment of stock options) and implementation of Current Expected Credit Loss (CECL).

- Monitor implementation of recent tax law changes and peer responses.

- Monitor M&A, corporate governance and ESG developments.

- Monitor Federal Reserve and DOJ antitrust positions and policies. Non-bank acquisitions by financial holding companies often implicate the Hart-Scott- Rodino pre-merger clearance process and bring the FTC in as a player. Companies should track the evolving regulatory approach to institutions that have varying degrees of regulatory issues, including the possibility of acquisition moratoria. In addition, monitor developments with the UK's and/or EU's competition authority — experience has shown that they may affect mergers between even two nominally "U.S." companies.

- Monitor developments with respect to the activities of the Committee on Foreign Investment in the United States (CFIUS) and its record of approving transactions, including those relating to the U.S. payments infrastructure and financial system.

- Monitor the importance of CRA and community activists in the M&A process — timing and reputational issues as well as the impact of CRA ratings of bank subsidiaries on the ability to obtain and retain "financial holding company" status. Developments regarding "financial consumer protection" and so- called "predatory lending," at both the state and federal levels, and in particular under the Dodd-Frank ACT, should be monitored by companies with exposure to or a possible interest in consumer lending or the subprime markets.

# ANNEX B

# THE FEDERAL REGULATORY FRAMEWORK

The current federal regulatory framework applicable to banks and thrifts is a complex patchwork, replete with elements old and new. This annex provides an introduction to key aspects of this framework, including a description of available charter authority (and the relative merits of each type of charter), and a discussion of the supervisory framework for prompt corrective action and the taking of enforcement action. For detail regarding the regulatory approval process for bank mergers and acquisitions (and associated strategic considerations), *see* Chapter 9.

## I. OVERVIEW OF DIFFERENT BANKING VEHICLES

The following is an overview of the different types of banking and savings association charters currently available, followed by a summary of the relative merits from a regulatory perspective of owning a bank versus a savings association. As discussed below, the principal types of charters are:

- national banks;
- state-chartered banks;
- federal savings associations;
- state-chartered savings associations; and
- non-bank banks.

### A. National Banks

A national bank is a federally chartered bank whose primary regulator is the OCC. The statutory basis for the national bank charter is the National Bank Act of 1864, the foundation of the "dual-banking system" of national banks co-existing with state-chartered banks that has been a distinctive hallmark of the U.S. financial system at least since the Civil War. Like all federally insured banks, national banks are also subject to regulation by the FDIC. Unlike state-chartered banks (which may or may not be members of the Federal Reserve System), all national banks must be members of the Federal Reserve System. A key advantage of the federal bank charter is that national banks have long enjoyed strong federal preemption from state laws that would otherwise purport to govern the national bank's operations, facilitating these institutions' operation across geographies. Most of the largest banks in the United States (including all four of the so-called "money center banks") are chartered by the OCC. In 2007, the U.S. Supreme Court upheld the OCC's position that federal preemption also applies to operating subsidiaries of national banks.

In 2018, the OCC announced that it would begin accepting applications from financial technology companies to become special purpose national banks. To date, the OCC has not approved any special purpose fintech charters, but the concept has received much attention and

debate over preemption and whether the special purpose charter must satisfy all of the same requirements as a national bank. Under the OCC's proposal, these companies would have the same benefit of preemption as other national banks. Financial technology companies engaged in business such as money transmittal (including bitcoin and other cryptocurrency-related startups) and non-bank lenders often have found it daunting to navigate the panoply of state licensing regimes required in order to operate across state lines. Unsurprisingly, state regulators have expressed concerns about the proposed national fintech charter and the prospective associated limitation of state regulatory authority. Accordingly, the state bank regulators brought suits challenging the OCC's authority to grant such a charter. In 2019, a federal district court in New York ruled that the OCC did not have the authority to issue a special purpose fintech charter under the National Bank Act, but the decision was later reversed by the Second Circuit on procedural grounds.

However, in July 2020, the OCC did grant final approval to Varo Money, Inc., a mobile technology company, to form a full-service *de novo* national bank. As the first fintech company with a full national bank charter, Varo Bank, N.A. and its owners must still comply with all of the activity and ownership limitations applicable to national banks and their holding companies. Overall, technology companies have found these limitations, as well as the requirements of a full service charter, difficult to work within. As noted in Chapter 2, many technology companies have instead found ways to partner with regulated banks to provide innovative technology-based banking solutions. Given the continued legal challenges to the OCC's special purpose charter and, as discussed further below, long held feelings related to commercial companies controlling banks, it is likely that the discussion over fintech company involvement in banking will continue for some time.

In January 2021, the OCC also took an aggressive position by granting conditional approval of the charter conversion application for Anchorage Trust Company to permit it to become a national trust bank. In an accompanying interpretative letter, the OCC's Chief Counsel substantially increased the trust powers of national banks. The interpretation also confirms that national trust banks, operating through a limited purpose charter that does not have deposit insurance, may perform other national bank activities, including accepting certain types of deposits, and that fiduciary activities need not be their primary business activity. This interpretation and approval dramatically increases the attractiveness of this limited purpose charter, particularly for fintech companies interested in cryptocurrency-related activities. However, in April 2022, the OCC issued a consent order to the new Anchorage Digital Bank, noting that the bank failed to meet the BSA/AML requirements set forth under the operating agreement, which was a condition of the approval.

As discussed in Chapter 2, activity at the intersection of fintech and banking continues to be brisk. In January 2022, the Federal Reserve and the OCC approved SoFi Technologies, Inc.'s application to become a bank holding company and control SoFi Bank, National Association. Additionally, a number of digital only and crypto-focused companies applied for banking licenses with varying success. However, the OCC's initiative to create and grant a national non-bank "fintech" charter to non-depository companies seems to have taken a back seat with the new administration. The Acting Comptroller in 2022 and 2023 has continued to take a more cautious approach and did not approve any nonbank fintech charters over the past two years. Coupled with the lengthy application process, the result has been that many fintech companies

are withdrawing applications and considering alternative paths to securing a charter, including through bank acquisition activity.

## B. State-Chartered Banks

A state-chartered bank may be established under the laws of any state. The bank is then subject to supervision and regulation by that state. In addition, all state-chartered banks also have a primary federal regulator. Under current law, if the state-chartered bank opts for membership in the Federal Reserve System, then the Federal Reserve becomes the bank's primary federal regulator. The FDIC is the primary federal regulator of non-member banks. As a practical matter, this means that a state-chartered bank is examined by both its state regulator and its primary federal regulator. In practice, the bank's state regulator and its primary federal regulator generally coordinate and conduct concurrent examinations or they conduct alternate examinations, particularly in cases of community banks that are not experiencing financial or other supervisory difficulties. However, notwithstanding the duplicative regulation, state-chartered banks are attractive vehicles to some because the annual assessments charged by state regulators tend to be lower than those charged to national banks by the OCC. This advantage has been somewhat tempered by Section 318 of the Dodd-Frank Act, as amended by Section 401(c) of the Economic Growth, Regulatory Relief, and Consumer Protection Act, pursuant to which the Federal Reserve is empowered to assess bank holding companies with total assets of $100 billion or more for the cost of examinations and the FDIC is empowered to assess state-chartered banks for the costs of examinations. Section 27 of the Federal Deposit Insurance Act establishes the maximum rates that insured state-chartered depository institutions may charge their customers for most types of loans. The statute has been construed to provide state banks with "most favored lender" status and to permit state banks to "export" interest charges allowed by the state where the lender is located to out-of-state borrowers.

## C. Federal Savings Associations

Another available charter is that of a federal savings association or federal savings bank. The OCC has supervisory and rulemaking authority over federally chartered savings associations, the FDIC has supervisory authority over state-chartered thrifts, and the Federal Reserve has supervisory and rulemaking authority over savings and loan holding companies.

The federal savings association charter was created by the Home Owners' Loan Act of 1933 ("HOLA") in response to the financial difficulties resulting from the Great Depression with the focus of such entities being mortgage lending. Over time the need for such specialization has waned as commercial banks compete with savings associations in the mortgage lending industry. As a result of their initial mandate, both federal and state savings associations are subject to the Qualified Thrift Lender Test ("QTL Test"), which is discussed below. Similar to national banks, federally chartered savings associations enjoy a level of federal preemption of state laws. However, as with national banks, the Dodd-Frank Act limits the preemption of state law in respect of federal savings associations, amending HOLA to provide that it "does not occupy the field in any area of state law" (effectively overriding the traditional position that little state law would apply to federally chartered thrifts), and that any preemption determination by a court or a director of the CFPB regarding the preemption of state law would be made in accordance with the laws and legal standards applicable to national banks.

Section 206 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (codified as section 5A of HOLA) permits a federal savings association with total consolidated assets of $20 billion or less as of December 31, 2017, to elect to operate as a "covered savings association." A covered savings association would have the same rights and privileges as a national bank and would be subject to the same duties and limitations that apply to a national bank. Under the terms of the statute, a covered savings association would still be treated as a federal savings association for certain purposes, including governance, dividends and mergers.

### D. State-Chartered Savings Associations

A state-chartered savings association (also referred to as savings and loan associations, building and loan associations or savings banks under certain state laws) is analogous to a state-chartered bank. It is chartered under state law and supervised and regulated by both the relevant state banking authority and the FDIC. Notably, the OCC has rulemaking authority for both federally and state-chartered savings associations. As is the case with national banks and state banks, a federal savings association charter has offered the benefit of federal preemption of state law while a state savings association charter has not (an advantage which, as noted above, the Dodd-Frank Act and the CFPB may significantly erode).

### E. Non-Bank Banks

Although Congress has made efforts to close off avenues for commercial or non-financial companies to control depository institutions, certain charters can still be controlled by a commercial company. For example, prior to the enactment of the Gramm-Leach-Bliley Act in 1999, any type of company could own a savings association, regardless of the nature of the company's activities. Today, in order for a company to own a savings association, all of the company's activities must be financial in nature, with the exception of those savings and loan holding companies owning a savings association grandfathered in the Gramm-Leach-Bliley Act.

However, some non-financial companies engage in banking activities through the use of "non-bank bank" entities other than savings associations. For example, various non-financial companies conduct banking activities through industrial loan companies. Industrial loan companies, or "ILCs," are state-chartered, FDIC-insured banks with all of the powers of a commercial bank, except that they must meet one of the following requirements: (1) not accept demand deposits or (2) limit total assets to less than $100 million. This type of industrial loan company may only be established in a handful of states — notably Utah. In addition, it is currently possible for non-financial companies to establish credit card banks or trust companies without becoming bank or savings and loan holding companies subject to organization-wide activity limitations (although this can be challenging and raises a number of issues and hurdles as discussed above).

Under the Dodd-Frank Act, owners of ILCs, certain credit card banks and other "non-bank banks" may be subjected to comprehensive supervision by the Federal Reserve upon a determination by the Financial Stability Oversight Council that the non-bank bank organization poses a significant threat to U.S. financial stability. The Dodd-Frank Act also imposed a three-year moratorium on the provision of deposit insurance to ILCs and required the GAO to conduct a study on whether Congress should eliminate the exemptions from regulation under the Bank

Holding Company Act (the "BHC Act") for the holding companies of these non-bank banks. The study, released in 2012, found that eliminating the exemptions would have a "limited impact on the overall credit market," potentially portending future elimination of the exemptions. A 2016 report of the federal banking regulators to Congress and the FSOC included a Federal Reserve recommendation that Congress repeal the exemption for ILCs and require that all corporate owners of FDIC-insured depositary institutions be subject to Federal Reserve holding company regulation.

Following the FDIC moratorium on ILC charters, several financial technology companies filed applications for ILC charters as an alternative to the OCC's fintech charter. In March 2020, the FDIC conditionally approved the deposit insurance applications for Square, Inc. and NelNet (a student loan servicer), permitting them to operate *de novo* ILC bank charters. However, no approvals have been granted since 2020 and the road to an ILC charter continues to be difficult in the current administration. The December 2020 application by General Motors Financial Company for a new ILC charter (as noted below, General Motors previously controlled an ILC that was converted to a full bank charter during the financial crisis) has been opposed to industry groups. Rakuten, the Japanese online retailer which has been seeking to launch a Utah industrial bank, refiled, for the third time, a deposit insurance application with the FDIC. Unsurprisingly, the application has drawn opposition from banking industry lobbyists arguing that it inappropriately mixes banking and commerce.

Although an ILC is subject to a number of regulatory limitations that make it impractical as a vehicle through which to build an expansive banking franchise, the conversion of subsidiary ILCs to national and state commercial banks was the means through which many notable financial institutions, including American Express, CIT Group, GMAC, Morgan Stanley and Goldman Sachs quickly converted to bank holding companies during the financial crisis. The expanded interstate branching authorization of the Dodd-Frank Act is available to ILCs, as well as to other state chartered banks and national banks.

ILCs have a number of shortcomings as compared to banks and savings associations. While an ILC may offer NOW accounts, it generally may not offer checking accounts. ILCs, being creatures of state law, also have not offered the federal preemption from state laws that national banks and federal savings associations have enjoyed.

Seven states have ILC charters; however, the majority of ILCs are located in Utah (with 15 currently active, according to the Utah Department of Financial Institutions), and some applications are pending. Applicants for ILCs are subject to FDIC approval of deposit insurance. Examples of commercial companies that control ILCs include BMW, Pitney Bowes and UBS. Ford Motor Company, Sears and Westinghouse, among others, have operated thrifts at one time or another. Many commercial companies also have operated sizable credit card banks or finance companies, such as General Motors.

Other companies have developed innovative products that mimic the features of checking accounts without becoming bank holding companies. For example, Fidelity has long offered brokerage accounts with check-writing privileges and ATM access that also are linked to a credit card. These accounts are offered through a variety of mechanisms, including through alliances with unaffiliated banks where a checking account offered by the bank is jointly marketed, and

connected by a sweep arrangement, with a brokerage account offered by the broker-dealer. Because non-banking companies may establish broker-dealers, there are no regulatory prohibitions barring non-financial companies from also offering these types of accounts. Non-financial companies also offer a variety of lesser financial products to their customers, such as check-cashing services and pre-loaded credit cards, which have been financially profitable.

Accordingly, non-banking companies are currently free to offer a wide range of banking services through non-bank bank entities and creative structuring. In fact, a number of the largest industrial companies in the United States have done so for many years. However, as noted above, the Dodd-Frank Act has resulted in many of these non-banking companies becoming subject to regulation as a result of Congress' effort to eliminate regulatory "blind spots."

## II. ACQUIRING CONTROL OF AN INSURED DEPOSITORY INSTITUTION

The ownership of banks, other insured depository institutions, bank holding companies and other insured depository institution holding companies, and their respective subsidiaries is highly regulated. Companies that "control" banks are subject to an extensive system of state and federal laws and regulations as well as comprehensive supervision by the federal banking agencies. It is important to understand the thresholds for being deemed to control a banking organization and the impacts of such a determination. The authority to acquire control of banking organizations emanates primarily from the BHC Act, 12 U.S.C. § 1841 *et seq.*, which regulates acquisitions of control of a bank or bank holding company by a "company" and HOLA, 12 U.S.C. § 1467a *et seq.*, which regulates acquisitions of control of savings associations and savings and loan holding companies. Although this particular discussion is limited to acquisitions of control of a bank or bank holding company, these same principles are applicable to bank holding company investments in nonbanking companies.

Under the BHC Act, prior approval by the Federal Reserve is required for the direct or indirect acquisition by a "company" of "control" of a bank or of substantially all of the assets of a bank. Prior Federal Reserve approval also is required under the BHC Act for an existing bank holding company to (a) acquire "direct or indirect ownership or control" of voting shares of a bank or bank holding company if it will own or control more than 5% of the voting shares after such acquisition or (b) merge with another bank holding company. 12 U.S.C. § 1842(a). Such approval is not required for the acquisition of additional shares in a bank or bank holding company by a company that already owns or controls a majority of the voting shares prior to such acquisition. 12 U.S.C. § 1842(a)(B); 12 CFR 225.12(c).

For the most part, the statutes and regulations related to the acquisition of control of a savings association or savings and loan holding company under HOLA are the same as those articulated above under the BHC Act. Section 10 of HOLA continues to govern acquisitions of control of both federally and state-chartered savings associations and savings and loan holding companies. 12 U.S.C. § 1467a *et seq*. Regulation LL interprets the definition of "control" under HOLA generally in the same manner as the term is interpreted under the BHC Act to the extent consistent with the statute and adopts review procedures that are identical for savings and loan holding companies and bank holding companies. 12 C.F.R. part 238.

## A. Definition of "Company"

A "company" is defined in the BHC Act as "any corporation, partnership, business trust, association, or similar organization." 12 U.S.C. § 1841(b). The definition excludes individuals, and the Federal Reserve has indicated that an investing group consisting of individuals and organizations acting in concert generally will not be considered a "company" unless it has the structural characteristics required to be considered an "association" or "similar organization" or has acted pursuant to a "formalized or structured relationship through an agreement of some kind." Board Ruling of Aug. 19, 1966, Fed. Res. Reg. Serv. ¶ 4-415; Board Ruling of Sept. 13, 1977, Fed. Res. Reg. Serv. ¶ 4-420. This "association" or other "relationship" must be more than mere concerted action. *See* Letter from William W. Wiles, Secretary of the Federal Reserve, to H. Rodgin Cohen dated May 21, 1991.

The Federal Reserve has determined that an employee stock ownership plan is a "company," *First National Bank of Blue Island Employee Stock Ownership Plan*, 71 Fed. Res. Bull. 804 (1985), and this determination has been upheld by the courts. *First National Bank of Blue Island Employee Stock Ownership Plan* v. *Board of Governors of Federal Reserve System*, 802 F.2d 291 (7th Cir. 1986).

## B. Nature of "Control"

A company is deemed to "control" a bank or bank holding company under the BHC Act if:

- It has the power to vote 25% or more of any class of "voting securities" of the bank or holding company;
- It has the power to control "in any manner" the election of a majority of the board of the bank or holding company; or
- The Federal Reserve determines after notice and an opportunity for hearing that the company has the power to directly or indirectly exercise a controlling influence over the management or policies of the bank or holding company.

12 U.S.C. § 1841(a)(2); *see also* 12 C.F.R. 225.2(e). The BHC Act contains a statutory presumption that a company that owns, controls or has the power to vote less than 5% of any class of voting securities of a bank or bank holding company does not have "control" for purposes of the BHC Act. 12 U.S.C. § 1841(a)(3).

The first two prongs of the definition of control are straightforward. However, the Federal Reserve has developed a mostly *ad hoc* process over many years around what constitutes a controlling influence under the last prong. On January 30, 2020, the Federal Reserve approved the issuance of a final rule (which became effective on October 1, 2020) that clarifies and codifies the Federal Reserve's standards for determining whether one company has control over another. The final rule is intended to take the guess work out of the last prong of the definition of control and codify some longstanding Federal Reserve practices around determining whether a company has a controlling influence.

In addition to the statutory presumption of noncontrol below 5%, the final rule establishes four categories of tiered presumptions of noncontrol that are based on the percentage of voting shares held by the investor (<5, 5-9.9%, 10-14.9% and 15-24.9%) and the presence of other indicia of control. As the percentage of ownership increases, fewer indicia of control are permitted without falling outside of the presumption of noncontrol. These indicia of control include nonvoting equity ownership, director representation, management interlocks, business relationship and restrictive contractual covenants.

Unless investors fall within a presumption of control, they generally would have no further need to seek confirmation from the Federal Reserve or separately enter into passivity commitments — which are frequently required by the Federal Reserve today in noncontrolling investments. However, the Federal Reserve has the right to find that an investor controls another company based on other facts and circumstances.

The rulemaking does not discuss the process if a company does not fit within the presumption but still would like to rebut control. Presumably, those companies would have the option to seek out an individual determination from Federal Reserve staff consistent with current practice. However, it is likely that the Federal Reserve will reserve individual determinations for exceptional factual situations, and most investors should be prepared to conform to the new control rule's system of tiered presumptions of control and presumptions of noncontrol to avoid time delays and outcome uncertainty.

*Total Equity*. Under the final rule, investors can hold up to 24.9% of any class of voting securities and up to 33% of the total equity of a company without necessarily having a controlling influence. Previously, a company was required to limit its voting ownership to less than 15% of the voting securities of a company in order to take advantage of holding between 24.9% and 33% of the total equity of that company. Under the final rule, total equity is a defined term and is based on total shareholders' equity under U.S. generally accepted accounting principles.

*Directors*. Perhaps the rule's most significant change is that it materially increases the number of directors that an investor may have on a company's board without being deemed to have a controlling influence. Under the final rule, an investor would be within the presumption of noncontrol if an investor has:

- Less than 5% of the voting shares of a company and less than half of the directors serving on the board; or

- Between 5% and 24.9% of the voting shares of the company and less than a quarter of the directors serving on the board.

In addition, the final rule permits director representatives to serve in various committee capacities, based on the investor's ownership level. Specifically, if an investor controls 14.9% or less of the voting shares of the company, its director representatives may serve as chairman of the board or of key committees. There are be no limits on committee membership if the investor controls less than 10% of the voting shares of the company.

Significantly, the final rule also permits an investor to conduct a proxy solicitation in opposition to a company's board of directors without triggering a presumption of control, so long as the number of directors proposed in the proxy, aggregated with the investor's existing directors, would not exceed the percentage permitted in the presumption. *Management Interlocks*. An investor company that holds 5% or more of any class of voting securities in the second company is presumed to control such second company if (i) the two companies have two or more management officials in common or (ii) an employee of the first company serves as the chief executive officer (or similar position) of the second company.

*Business Relationships*. The level and type of business relationships that the Federal Reserve has permitted in the context of a noncontrolling investment has varied greatly over the years. Under the final rule, if an investor seeking noncontrol holds:

- less than 5% of the voting shares of a company, there are no limitations on business relationships between the two;
- between 5% and 9.9% of the voting shares of the company, business relationships must be limited to 10% of the revenues or expenses of the company;
- between 10% and 14.9% of the voting shares of the company, business relationships must be limited to 5% of the revenues or expenses of the company and be on market terms; and
- between 15% and 24.9% of the voting shares of the company, business relationships must be limited to 2% of the revenues or expenses of the company and be on market terms.

*Restrictive Contractual Covenants*. Under the final rule, a company is presumed to control another company if it controls 5% or more of any class of voting securities of the second company and the first company has a limiting contractual right with respect to the second company. The final rule includes a nonexclusive list of contractual provisions that the Federal Reserve views as problematic as well as a nonexclusive list of provisions that raise no concerns. Investors should carefully review current and pending investment agreements (including side letters, voting agreements and other related contracts) in order to identify potentially problematic provisions. Investors that own or control 5% or more of any class of voting shares of a company also should review any debt instruments or extensions of credit with that company. Provisions that are often common place in those debt instruments may result in a 5% or more investment triggering a presumption of control under the final rule.

Federal Reserve regulations identify other situations in which there is a rebuttable presumption that a company controls a bank or bank holding company for purposes of the BHC Act. The final rule also modifies and adds to these presumptions. Moving forward, a presumption of control will apply if:

- A company enters into a management contract or similar agreement with a bank or bank holding company pursuant to which the first company "directs or exercises significant influence" over the management of the bank;

- A company consolidates a second company on its financial statements prepared under U.S. generally accepted accounting principles;

- A company serves as an investment adviser to a second company, the second company is an investment fund, and the first company, directly or indirectly, or acting through one or more other persons, controls:

    1. 5% or more of the outstanding securities of any class of voting securities of the second company; or

    2. 25% or more of the total equity of the second company.

    This presumption of control does not apply if the first company organized and sponsored the second company within the preceding 12 months.

The final rule also establishes a presumption relating to companies seeking to divest control. Specifically, a company would no longer be deemed to control another company if:

- The first company holds less than 15% of the voting shares and would not trigger any presumption of control;

- The first company holds more than 15% of the voting shares (but less than 25%) and would not have triggered a presumption of control at any time during the previous two years; or

- More than 50% of the shares of each class of voting securities are controlled by an unrelated party.

The final rule also clarifies that a company does not control securities of the second company that are held in a fiduciary capacity without sole discretionary authority to exercise the voting rights of the securities.

When considering whether one company has control over another, it is critically important to understand the Federal Reserve's regulations and views regarding what constitutes a "voting security" and how to calculate ownership levels. The Federal Reserve's regulations provide that the term "voting securities" includes any securities giving the holder power to vote for directors (or other persons exercising similar functions) or to direct the conduct of operations or other significant policies of the issuer. 12 C.F.R. § 225.2(q)(1). Preferred securities, limited partnership interests, LLC membership units and similar interests are deemed not to be a class of voting securities if such interests do not carry the right to vote for directors, the general partner or managing member, its voting rights are limited solely to the type customarily provided by statute with regard to matters that significantly and adversely affect the rights or preferences of the preferred stock or other interest and it represents an essentially passive investment or financing device. 12 C.F.R. § 225.2(q)(2). Non-voting securities that have the right to elect directors upon failure to pay preferred dividends will be considered a voting security only at the time the right to vote arises. Limited partnership interests or membership interests in limited

liability companies will not be voting securities due to voting rights that are limited solely to voting for the removal of a general partner or managing member for cause, to replace a general partner or managing member due to incapacitation or following the removal of such person, or to continue or dissolve the company after removal of the general partner or managing member.

For purposes of calculating ownership in any class of securities or in the total equity, a person that controls a security, option, warrant, or other financial instrument that is convertible into, exercisable for, exchangeable for, or otherwise may become a security, at any time in the future, is deemed to control each such security that could be acquired as a result of such conversion, exercise, exchange or similar occurrence.

In addition, securities that are initially "non-voting" after their issuance to a specified party, but become voting securities, or convertible into voting securities, simultaneously upon their acquisition by another party are deemed to be voting securities for purposes of calculating control, unless they contain certain transfer restrictions. Non-voting securities that are convertible into voting securities will not be considered voting securities if they may not be converted in the hands of the investor and may only be transferred: (1) to an affiliate of the investor or to the banking organization; (2) in a widespread distribution; (3) in transfers in which no transferee (or group of associated transferees) would receive 2% or more of any class of voting securities of the banking organization; or (4) to a transferee that would control more than 50% of the voting securities of the banking organization without any transfer from the investors.

The final rule retains the principle that a person that enters into an agreement or understanding with a second person pursuant to which the rights of the second person are restricted in any manner controls the second person's securities, subject to certain exemptions. These exceptions include, among others, rights of first refusal, rights of last refusal, tag-along rights, drag-along rights or similar rights that do not impose significant restrictions on the transfer of the securities.

## III. SIGNIFICANT CONSEQUENCES OF "CONTROL"

### A. Source of Strength Doctrine

In contemplating any acquisition of a bank or savings association, an acquiring entity must be aware of its potential liabilities under the "source of strength" doctrine. The Federal Reserve has relied on this controversial doctrine to compel bank holding companies to provide additional funds to their troubled subsidiary banks. The source of strength doctrine, announced by the Federal Reserve in 1987, states that "a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity." *Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks*, 52 Fed. Reg. 15,707 (Apr. 30, 1987); 12 C.F.R. § 225.4(a). The source of strength doctrine subjects an acquirer to the possibility of almost unlimited liability for an acquired bank's losses. The Dodd-Frank Act amended the Federal Deposit Insurance Act to codify the source of strength doctrine, mandating that federal banking regulators require any bank holding company, savings and loan holding company or other controlling entity to serve as a source of financial strength for any subsidiary that is a depository institution. 12 U.S.C. § 1831o-1.

### B. FIRREA Cross-Guarantee Provisions

In addition to the source of strength doctrine, acquirers must consider the "cross-guarantee" provisions of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") (Pub. L. No. 101-73, 103 Stat. 183 (1989)). These provisions make insured depository institutions liable for losses incurred by the FDIC, and for losses which the FDIC reasonably anticipates incurring, in connection with the default of a "commonly controlled" insured depository institution in danger of default. 12 U.S.C. § 1815(e)(1). Institutions are "commonly controlled" if they are controlled by the same company, or if one depository institution is controlled by another depository institution. 12 U.S.C. § 1815(e)(8). The constitutionality of the cross-guarantee provisions has been questioned, but to date it has been upheld. *Branch* v. *U.S.*, 69 F.3d 1571 (Fed. Cir. 1995), *reh'g en banc denied*, 1996 U.S. App. LEXIS 3921 (Fed. Cir. Feb. 7, 1996), *cert. denied*, 136 L. Ed. 2d 18 (U.S. 1996).

### C. FDICIA Capital Restoration Plans

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), all undercapitalized institutions must submit an acceptable capital restoration plan to the appropriate federal agencies generally within 45 days after the institution becomes undercapitalized. 12 U.S.C. § 1831o(e)(2). Among other things, a capital restoration plan must specify the steps that the institution will take to become adequately capitalized, the levels of capital to be obtained during each year that the plan is in effect, how the institution will comply with the restrictions *applicable* to the institution and the types and levels of activities in which the institution will engage. Before a plan can be accepted by a federal agency, each company having control of the institution must guarantee that the institution will comply with the plan until the institution has been adequately capitalized on average during four consecutive quarters. Controlling companies also must provide appropriate assurances of performance, subject to a cap on aggregate liability equal to the lesser of 5% of the depository institution's total assets at the time it becomes undercapitalized and the amount necessary to bring the institution into compliance with all applicable capital standards as of the time that the institution fails to comply with the plan.

## IV. PROMPT CORRECTIVE ACTION

Under the regulatory scheme initially established by FDICIA, capital is of primary importance. Well capitalized institutions are free to exercise a broader range of powers. Among other things, being well capitalized (and well managed) is critical to maintaining an institution's status and privileges as a financial holding company, making capital distributions that deviate from the institution's capital plan, engaging in interstate acquisitions, as discussed above, and, most likely, receiving approval from a federal bank regulator to engage in a merger or acquisition. The well capitalized percentages discussed below should be considered a starting point. The federal banking agencies have advised that institutions and their holding companies should maintain capital ratios well above the minimums for well capitalized status. In addition, an institution's or holding company's primary regulator may require additional capital based on the institution's size, complexity and risk profile. Weaker institutions are required to address their capital and operating deficiencies promptly or face regulatorily mandated corrective actions, including a possible forced recapitalization or merger.

FDICIA amended the Federal Deposit Insurance Act to provide that each federal agency must take "prompt corrective action to resolve the problems of insured depository institutions." FDICIA and the regulations promulgated thereunder, which became effective in 1992, establish strict guidelines governing what constitutes prompt corrective action. The Basel III implementing rules adopted by federal regulators in 2013 modify some of these guidelines, as described below.

**A. Capitalization Categories**

FDICIA established a comprehensive regulatory scheme based upon capital adequacy, with better capitalized institutions being subject to lower deposit insurance premiums and greater operating flexibility. FDICIA and the regulations promulgated thereunder (as modified by the Basel III implementing rules) establish five categories based on a depository institution's capital position:

- *Well Capitalized* institutions have a total risk-based capital ratio of ≥ 10%, a Tier 1 risk-based capital ratio of ≥ 6% (increasing to ≥ 8% under the Basel III implementing rules), a leverage ratio of ≥ 5%, a common equity Tier 1 ratio of ≥ 6.5%, and may not be subject to an order, written agreement or directive relating to capital;

- *Adequately Capitalized* institutions have a total risk-based capital ratio of ≥ 8%, a Tier 1 risk-based capital ratio of ≥ 4% (≥ 6% effective as of January 1, 2015) and a leverage ratio of ≥ 4% and a common equity Tier 1 ratio of ≥ 4.5%;

- *Undercapitalized* institutions are those which fail to meet the requirements of an adequately capitalized institution;

- *Significantly Undercapitalized* institutions are those with a total risk-based capital ratio of < 6%, a Tier 1 risk-based capital ratio of < 4% or a leverage ratio of < 3% or a common equity Tier 1 ratio of < 3%; and

- *Critically Undercapitalized* institutions are those with less than 2% tangible equity to total asset ratio.

If an agency determines that an institution is in an unsafe or unsound condition or engaging in an unsafe or unsound activity, it may impose more stringent treatment than would otherwise apply, based upon the category of capitalization into which the institution falls. An institution may be deemed to be engaging in an unsafe or unsound practice if it has received a less than satisfactory rating for asset quality, management, earnings or liquidity in its most recent report on examination.

**B. Restrictions on Dividends, Distributions and Management Fees**

All insured depository institutions are generally prohibited from making any capital distribution, or paying management fees to control persons, if doing so would leave the institution undercapitalized. This restriction would also generally apply to buybacks and other

recapitalizations and may impair the feasibility of certain restructurings and other corporate distributions.

## C. Undercapitalized Institutions

Once an institution becomes undercapitalized (whether by failure to meet capital ratios or by regulatory determination), a host of significant restrictions and regulations come into play. *See generally* 12 U.S.C. § 1831o. The federal agencies are required to closely monitor all undercapitalized institutions and their compliance with FDICIA capital restoration plans.

As noted above, all undercapitalized institutions are required to submit an acceptable capital restoration plan to the appropriate federal agencies pursuant to a deadline to be established by the agencies. The capital restoration plan must: (A) specify (1) the steps that the institution will take to become adequately capitalized, (2) the levels of capital to be obtained during each year that the plan is in effect, (3) how the institution will comply with the restrictions applicable to the institution, and (4) the types and levels of activities in which the institution will engage; and (B) contain such other information as the agency may require. The agencies cannot accept the capital restoration plan unless the plan (1) is based on realistic assumptions and is likely to succeed in restoring the institution's capital and (2) would not appreciably increase the risk (including credit risk, interest rate risk and other types of risk) to which the institution is exposed.

In addition, before a plan can be accepted, each company having control of the institution must (1) guarantee that the institution will comply with the plan until said institution has been adequately capitalized on average during four consecutive quarters and (2) provide appropriate assurances of performance. "Control" for this purpose is defined as it is under the BHC Act. *See* 12 U.S.C. §§ 1813, 1841. The aggregate liability of controlling companies under such guarantees is limited to the lesser of (1) 5% of the depository institution's total assets at the time it becomes undercapitalized and (2) the amount necessary to bring the institution into compliance with all applicable capital standards as of the time that the institution fails to comply with the plan. The provision requiring a holding company to guarantee the performance of its subsidiary depository institutions can raise significant creditors' rights issues that should be carefully examined before any such guarantee is granted.

In addition, the asset growth of undercapitalized institutions is restricted. An undercapitalized institution may not increase its quarterly average total assets unless (1) its capital restoration plan has been accepted by the appropriate agency, (2) any increase is consistent with the plan and (3) the institution's ratio of tangible equity to assets increases during the calendar quarter at a rate sufficient to enable the institution to become adequately capitalized within a reasonable period of time. Likewise, an undercapitalized institution may not acquire any interest in any company, establish any additional branch office or engage in any new line of business unless (1) its capital restoration plan has been accepted *and* (2) the Board of the FDIC determines that the proposed action will further the purposes of FDICIA. These requirements make significant expansion by undercapitalized institutions generally unfeasible.

Finally, the appropriate agency may take the actions described under Section VI.D below if the agency determines such actions are necessary to carry out the purposes of the prompt

corrective action statutory provisions. In accordance with this power, the FDIC implemented an interest rate cap on banks that are less than "well capitalized." Pursuant to this rule, banks that are less than "well capitalized" are prohibited from paying in excess of 75 basis points above the U.S. average.

## D. Significantly Undercapitalized Institutions and Undercapitalized Institutions that Fail to Submit and Implement Capital Restoration Plans

Once an institution becomes significantly undercapitalized — or if it fails to take steps to become adequately capitalized — it becomes potentially subject to a series of draconian measures, within the discretion of the regulatory agencies. In addition, as described below, companies controlling such institutions also become potentially subject to several significant restrictions.

### 1. Restrictive Actions

The following may be imposed by statute or by appropriate agency action:

- *Requiring Recapitalization/Sale/Merger*. Requiring the institution to recapitalize by selling enough shares (including voting stock) or obligations to adequately capitalize the institution and, if grounds for the appointment of a receiver or conservator exist, requiring the institution to be sold or merged;

- *Divestiture of the Institution*. Requiring any company having control of the institution to divest the institution if the appropriate agency determines that divestiture would improve the institution's financial condition and future prospects;

- *Restricting Transactions with Affiliates*. Requiring the institution to comply with section 23A of the Federal Reserve Act as if the provision exempting transactions with certain affiliated institutions did not apply, or otherwise restricting transactions with affiliates;

- *Restricting Interest Rates*. Restricting interest rates paid on new deposits, including renewals and rollovers, substantially to the prevailing rates of interest on deposits of comparable amounts and maturities in the region where the institution is located;

- *Restricting/Reducing Asset Size*. Restricting asset growth even more stringently than for undercapitalized institutions, or requiring asset shrinkage;

- *Restricting Activities*. Requiring the institution to alter, reduce or terminate any activity the agency determines poses excessive risk;

- *Changing Management*. Ordering a new election of the board; dismissing any director or senior executive officer who held office for more than 180 days immediately before the institution became undercapitalized; or requiring the institution to employ qualified senior executive officers who, if the agency so specifies, shall be subject to agency approval. Although directors and senior

executive officers that have been dismissed have the right to petition the agency for reinstatement, they bear the burden of proving that their continued employment would materially strengthen the institution (The provision on dismissals does not apply to persons who were serving as directors or senior officers prior to the enactment of FDICIA unless their terms are extended or renegotiated.);

- *Prohibiting Brokered Deposits from Correspondent Banks*. Prohibiting the acceptance of deposits, including renewals and rollovers, from deposit brokers;

- *Requiring Prior Approval for Capital Distributions by Bank Holding Companies*. Prohibiting any bank holding company having control of the institution from making any capital distribution without prior approval of the Federal Reserve;

- *Divestitures*. Requiring the institution to divest or liquidate any subsidiary the agency determines to be in danger of becoming insolvent and a significant risk to the institution or likely to cause a significant dissipation of the institution's assets or earnings;

- *Divestiture by Parent Company of a Non-depository Affiliate*. Requiring any company having control of the institution to divest or liquidate any affiliate other than an insured depository institution that the appropriate agency for such company determines to be in danger of becoming insolvent and a significant risk to the institution or likely to cause a significant dissipation of the institution's assets or earnings; or

- *Requiring Other Action*. Requiring the institution to take any other action the agency determines will better carry out the purposes of FDICIA than the actions described above.

**2. Presumptively Mandatory Actions**

The Federal Deposit Insurance Act, as amended by FDICIA, sets forth a presumption that the following actions will be taken unless the agency determines such actions would not further the purposes of the prompt corrective action provisions:

- Requiring the sale of shares or obligations or requiring the institution to be sold or merged;

- Restricting affiliate transactions; and

- Restricting interest rates.

**3. Executive Compensation**

All significantly undercapitalized institutions and all undercapitalized institutions that fail to timely submit an acceptable capital restoration plan or that fail in any material respect to implement a plan accepted by the agency are required to obtain prior agency approval before (1) paying *any bonus* to any senior executive officer or (2) providing compensation to any senior

executive officer at a rate that exceeds the officer's rate of compensation (excluding bonuses, stock options and profit sharing) during the 12 months prior to the month in which the institution became undercapitalized. Agency approval may not be granted if the institution has failed to submit an acceptable capital restoration plan. These provisions do not apply to persons who were serving as senior officers prior to the enactment of FDICIA and whose contract of employment has not been renewed or renegotiated.

### E. Critically Undercapitalized Institutions

The FDIC is required to act by regulation or order to carry out the purposes of FDICIA by restricting the activities of critically undercapitalized institutions. At a minimum, the FDIC is required to prohibit critically undercapitalized institutions from doing any of the following without the FDIC's prior written approval: (1) entering into any material transaction other than in the ordinary course of business; (2) extending credit for any highly leveraged transaction; (3) amending the institution's charter or by-laws; (4) making any material change in accounting methods; (5) engaging in any covered transaction (as defined in section 23A(b) of the Federal Reserve Act); (6) paying excessive compensation or bonuses; and (7) paying interest on new or renewed liabilities at a rate that would increase the institution's weighted average cost of funds to a rate significantly exceeding the prevailing market rate on insured deposits.

Except in certain limited situations in which the FDIC has determined to delay the appointment of a conservator or receiver as described below, a critically undercapitalized institution may not make any payment of principal or interest on the institution's subordinated debt beginning 60 days after becoming critically undercapitalized.

The Federal Deposit Insurance Act, as amended by FDICIA, calls for the appropriate federal agency within 90 days after an institution becomes critically undercapitalized to either (1) appoint a receiver, or with the concurrence of the FDIC, a conservator, for the institution or (2) take such other action as the agency determines with the concurrence of the FDIC would better achieve the purposes of FDICIA (after documenting why such action would be better).

Any determination to postpone the appointment of a receiver or conservator must be renewed on a revolving 90-day basis. The agency is required to appoint a receiver or conservator if the institution continues to be critically undercapitalized on average during the calendar quarter beginning 270 days after the date the institution first became critically undercapitalized. This latter appointment can be delayed by the agency only if (1) the agency determines with the concurrence of the FDIC that the institution has a positive net worth, has been in substantial compliance with an approved capital restoration plan, is profitable or has an upward trend in earnings that is sustainable, and is reducing the ratio of non-performing assets to total loans; and (2) the head of the appropriate agency and the Chairman of the FDIC both certify that the institution is viable and not expected to fail.

## V. ENFORCEMENT ACTIONS BY FEDERAL BANK REGULATORS

After the financial crisis there was a significant increase in supervisory and regulatory enforcement activity against banking organizations. Although there was a decrease in overall actions initiated during the Trump Administration, the banking agencies and the CFPB have been

more aggressive in the threats of enforcement actions and the ramifications continue to be meaningful. In the case of many banking organizations regulatory actions have been designed to address fundamental concerns of the regulators regarding capital and liquidity, however, there continues to be a strong trend in formal regulatory actions addressing concerns in the areas of consumer and anti-money-laundering compliance, risk management and governance. This factor, in particular, is causing increased market confusion concerning the significance of the differing types of regulatory measures the marketplace is witnessing. To the further consternation of institutions accused of violations, banking agencies (and the CFPB and SEC) are more frequently seeking to require admissions of wrongdoing, and there has been an increase in the use of criminal complaints.

The failure to effectively communicate the meaning of a particular regulatory action can result in significant reputational risk, an undue significant decline in a company's share value and increased investor and customer unrest. Often shareholders do not recognize that institutions are significantly restrained in the manner in which they can communicate regulatory actions to the marketplace — making an understanding of the fine distinctions between the various types of regulatory actions and the underlying predicate to those actions all the more important for marketplace participants.

Federal bank regulators have a formidable array of enforcement mechanisms. Set forth below is a brief overview of the types of enforcement actions generally used by the federal bank regulators in order of increasing severity, including whether the actions are made public by the regulators. In general, enforcement actions can be divided into two categories: informal and formal. Usually less severe in scope, informal actions are generally not made public by the regulators and often remain undisclosed by the target, while formal actions are in all but a few rare instances made public. In light of the increase in regulatory enforcement actions and the premium placed on clear, balanced disclosure, banking organizations should take a close look at the Management Discussion and Analysis ("MD&A") section of their SEC filings. An effective MD&A discussion of the general nature of an institution's supervisory posture and the significant informal supervisory powers of the federal regulators can help mitigate the need for direct disclosure of informal enforcement actions.

### A. Informal Actions

*Informal Supervisory Directives*. All banking organizations should maintain a close supervisory relationship with their primary regulators. When that relationship is functioning at its best, all material transactions and plans are shared and discussed with the bank's regulators and a good deal of informal supervisory direction is provided by the regulators to the banking organization. All banking organizations receive informal advice and direction from their regulators and often make significant adjustments to their operations and capital, liquidity and controls as a result of that informal input.

*Supervisory Criticisms Within Examination Reports*. Bank regulators deliver formal examination reports to their regulated institutions on a regular periodic basis. These examination reports often contain express criticisms or concerns regarding a bank's operations or controls and directives from the regulators concerning the steps that need to be taken to correct such deficiencies or address such concerns. Examination materials are expressly confidential and may

not be publicly disclosed by the institution, without prior written approval of the relevant banking agency (which is seldom granted).

*Supervisory Letter*. A supervisory letter is an informal communication from a regulator to a bank either requesting information with respect to a targeted area or specific transaction or requesting that the bank take, or refrain from taking, certain actions. Supervisory letters are generally not publicly disclosed by the regulators and are used to call attention to specific areas of concern.

*Commitment Letter/Operating Agreement*. A commitment letter is an informal written agreement between a bank and its regulator in which the bank commits to take certain corrective actions. Commitment letters often are entered into in connection with an approval request for a specific transaction or an expansion of powers. With increasing frequency in recent years, the OCC has entered into operating agreements with banks to ensure that certain subsequent actions are taken by the bank, as a condition of regulatory approval for a transaction. Such agreements are generally considered to be enforcement actions. Such commitment letters and operating agreements are generally not publicly disclosed by the regulators. The regulators also sometimes seek board level commitments through the adoption by the board of formal resolutions on a given matter.

*Memorandum of Understanding*. A memorandum of understanding is also considered an informal enforcement action, and is typically executed by the full board of a banking organization and the regulator. Memoranda of understanding are generally not publicly disclosed by the regulators.

### B. Formal Actions

During (and since) the financial crisis, each of the bank regulatory agencies has issued numerous formal enforcement actions. Many of these actions have been directed at banks' capital deficiencies (tellingly, nearly all bank failures in recent years have been preceded by formal action of one type or another) or BSA/AML/OFAC or consumer compliance deficiencies. The regulators generally are required by law to publicly disclose formal enforcement actions. An exception to this public disclosure is represented by the agreements the Federal Reserve enters into with a financial holding company that falls out of compliance with the well capitalized and well managed criteria for financial holding company status. Although such agreements are considered to be formal enforcement actions, they are not publicly disclosed because such agreements would reveal information about the confidential supervisory ratings of the financial holding companies or their subsidiary insured depository institutions.

*Formal Written Agreement*. A formal written agreement is an agreement typically signed by the board of directors of a bank and the regulator. Formal written agreements are generally publicly disclosed by the regulators absent a compelling reason to maintain confidentiality. A prominent earlier example of a formal written agreement was an agreement entered into in 2002 by PNC with the Federal Reserve in which PNC was required to retain corporate consultants to review risk management, capital planning, corporate governance and internal controls. PNC's management mounted an aggressive program to address the regulators' concerns and build a best-in-class governance and risk management model, and was able to rapidly restore its well-

managed status. In a typical recent example, in 2019, the Federal Reserve entered into a written agreement with Sumitomo Mitsui Banking Corporation, Tokyo, Japan, and its U.S. branch office in New York, requiring, among other things, that the board submit a written plan acceptable to the Federal Reserve to strengthen board oversight of the management and operations of the branch office's compliance with anti-money laundering laws, including the Bank Secrecy Act.

While not public, written agreements generally accompany a downgrade in a bank's composite rating to one of the higher risk categories or to a downgrade of the bank's compliance rating to less than satisfactory. Such downgrades and formal actions can restrict the ability of banks to engage in new activities and strategic acquisitions.

*Consent Order*. A consent order is an order containing a series of corrective actions. The regulators are required by law to publicly disclose consent orders. In the wake of the financial crisis, numerous depository institutions that had avoided regulatory issues in the past found themselves subject to consent orders, often relating to inadequate capital and poor asset performance. While consent orders have historically been used less often than formal written agreements and cease and desist orders, they have become increasingly prevalent. Federal Reserve, OCC, FDIC and CFPB consent orders issued in the recent years (sometimes involving civil money penalties) involved matters such as alleged deceptive marketing and debt collection practices, processes for identifying and reporting non-accrual loans, BSA/AML or consumer compliance risk management and internal audit deficiencies. For example, in 2018, the OCC issued a consent order and $500 million civil money penalty for failure to implement and maintain a satisfactory enterprise-wide compliance risk management program and resulting violations of the unfair acts or practices provision of Section 5 of the Federal Trade Commission Act. More recently, in October 2020, the OCC issued a consent order and a $400 million civil money penalty related to deficiencies in enterprise-wide risk management, compliance risk management, data governance, and internal controls.

*Cease and Desist Orders*. A cease and desist order is imposed after the issuance of a notice of charges, a hearing before an administrative law judge and a final decision by the regulator. More often, banks consent to a cease and desist order by dispensing with the need for the notice and administrative hearing, in order to expedite resolution. Temporary cease and desist orders can be issued on an interim basis pending completion of the steps necessary to issue a final cease and desist order. In addition, federal bank regulators may impose civil money penalties in connection with cease and desist orders (or other enforcement actions) in a number of circumstances, including: violations of law; non-compliance with commitments, final orders or conditions imposed in writing; unsafe or unsound banking practices; or breaches of fiduciary duty.

## C. Troubled Condition

The federal bank regulators also have the ability to declare a depository institution or holding company to be in "troubled condition," which then subjects the depository institution or holding company to heightened scrutiny, including a requirement that any addition or change of directors or senior executive officers be subject to prior regulatory approval. A troubled depository institution or holding company also becomes subject to the FDIC's "golden parachute" regulations, which require prior regulatory approval in order to make a broad range of

payments to any officers, directors, employees or controlling shareholders that are contingent on the termination of that person's employment. As a practical matter, the imposition of these regulations can jeopardize severance and other compensation arrangements entered into between a bank and its executives. Under the federal banking agencies' regulations, a bank or bank holding company is in "troubled condition" if it:

- Has a composite safety and soundness rating of 4 or 5;
- Is subject to a cease and desist order or formal written agreement that requires action to improve the financial condition of the institution unless informed otherwise by the agency;
- Is informed in writing by the agency that it is in troubled condition; or
- Is subject to an FDIC proceeding for termination or suspension of deposit insurance (FDIC regulations covering state non-member banks).

During the financial crisis, a large number of depository institutions and holding companies were deemed to be in troubled condition.

### D. Capital Directives and Safety and Soundness Plans

Federal bank regulators also have the authority to issue capital directives that are used to enforce specific capital levels at a bank. Such directives can be issued pursuant to the Prompt Corrective Action regulations promulgated under the Federal Deposit Insurance Act or otherwise and they often, but not always, are accompanied by a formal enforcement action. Capital directives often require that a bank submit a capital plan within a specified number of days that indicates in detail how the bank proposes to increase its capital levels. Capital plans are typically accompanied by a capital maintenance and liquidity maintenance agreement executed between the parent holding company and the bank pursuant to which the parent holding company agrees to make available to the bank adequate capital to assist the bank in successfully implementing its capital plan. Similarly, regulators can require a bank to file a safety and soundness compliance plan in the event that regulators determine that the bank has failed to satisfy a safety and soundness standard relating to such matters as internal controls and the payment of reasonable compensation. Under these plans, banks must outline the steps that they plan to take to restore compliance with the standard(s). If the bank fails to submit an acceptable plan within the required time period, the federal bank regulator must issue an enforcement order requiring the bank to correct the deficiencies and imposing other requirements.

During the financial crisis, a bank's declining capital level often was a lagging indicator of the severely troubled nature of an institution. In a number of cases, a liquidity crisis rather than the critically undercapitalized status of an institution led to its closure and the appointment of the FDIC as receiver. As the crisis progressed, the federal bank regulators tried to issue capital directives and enforcement actions, and require safety and soundness compliance plans, at earlier stages of an institution's declining financial condition.

The federal bank regulators are increasingly expecting capital plans to be submitted in connection with expansionary proposals of banking organizations of various sizes, whether or not they are specifically required by regulation. A material expansionary transaction may require the resubmission of a capital plan.

## E. Special Implications for Financial Holding Companies

The serious consequences of financial holding companies falling out of compliance with the "well managed" and "well capitalized" standards lend enforcement mechanisms added severity. If a financial holding company or its bank or thrift subsidiaries cease to be "well capitalized" or "well managed," the financial holding company must enter into an agreement with the Federal Reserve to correct the capital or management deficiencies. During the corrective action period, the financial holding company's ability to enter into new activities or acquire shares of an entity require prior approval of the Federal Reserve, which is hesitant to grant such approval. As previously noted, if the deficiencies are not corrected within six months of the agreement date (or extended period), the Federal Reserve has the authority to require the holding company to divest any of its depository institution subsidiaries. Alternatively, the holding company may elect to conform its activities to the narrower range of activities permissible for bank or savings and loan holding companies that are not financial holding companies. A bank or savings association is deemed to be well capitalized if it meets the standards discussed above.

A bank or savings association is generally deemed to be "well managed" if it has received from the applicable federal banking agency at least a satisfactory composite rating and at least a satisfactory rating for management and compliance. For this purpose, a satisfactory rating is a rating of 1 or 2 under the Federal Financial Institutions Examination Council's ("FFIEC") rating system. As noted above, a composite rating of 4 or 5 will automatically result in a banking organization being deemed to be in troubled condition. However, a rating of 3 or more will result in a loss of one's "well-managed" status. And we have recently seen that, if a federal bank regulator downgrades a banking institution to a 3, it will also often determine that the banking institution is in troubled condition. As discussed above, holding companies also must be well capitalized and well managed to qualify for and retain financial holding company status. The federal bank regulators can lower the rating of a bank, savings association or holding company at any time with little warning.

## F. Conversions or Mergers of Troubled Banks or Savings Associations

Responding to concerns about so-called "regulatory arbitrage," regulators and Congress have taken steps to limit the ability of a troubled bank or savings association to convert into another type of entity, or change its primary federal regulator, and thereby potentially evade a pending supervisory matter. In 2009, the FFIEC issued a policy statement affirming that charter conversions or changes in an institution's primary federal regulator should be conducted only for "legitimate business and strategic reasons." The policy statement specifies that conversion requests submitted during the pendency of material enforcement actions should not be entertained, and that, with respect to any outstanding corrective program, while a conversion request will be evaluated on its specific facts and circumstances, at a minimum, the corrective program's requirements should be maintained and compliance overseen by the new supervisor.

The policy statement further prescribes that, in connection with any conversion request, prospective supervisors consult with current supervisors with respect to any pending or outstanding supervisory actions.

The Dodd-Frank Act formalizes the core of the FFIEC policy statement, prohibiting a national bank, a state-chartered bank or a savings association from converting to another type of entity if the institution is subject to a cease and desist order (or other formal enforcement order) issued by, or a memorandum of understanding entered into with, the applicable federal or state supervisor with respect to a significant supervisory matter. (By its terms, this prohibition does not apply when a federally chartered savings association converts to a national bank, presumably, because the OCC is the primary federal regulator for both charters.) This prohibition is subject to an exception if the proposed new federal supervisor gives the supervisor that issued the cease & desist, enforcement order or memorandum of understanding written notice of the proposed conversion, including a plan to address the significant supervisory matter in a manner that is consistent with safety and soundness, the issuing supervisor does not object to the conversion within 30 days of receiving the written notice, and the new supervisor implements the plan to address the supervisory matter. The Dodd-Frank Act also requires that an applicant for conversion share a copy of the application with both its current federal supervisor and its prospective new federal supervisor, and formalizes the FFIEC statement's provision for interagency consultation by requiring information sharing with respect to ongoing supervisory and investigative proceedings.

Consistent with regulators' reluctance to approve conversions involving troubled financial institutions, regulators generally will not permit a bank, savings association or holding company with a composite rating, or a financial, capital or management component rating, of 3, 4 or 5 to acquire another depository institution or non-banking company. Typically, approval of such an acquisition request is subject to the regulators concluding that: the prospective acquirer has largely addressed its deficiencies; it is raising a significant amount of additional capital contemporaneously with its proposal; it has sufficient managerial resources to handle the acquisition and integration without any material distraction on or delay to the acquirer's completion of its own remedial efforts; the deficiencies of the target are in different areas than those of the acquirer; and the transaction will materially strengthen the acquirer's financial condition.