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Boards Must Carefully Exercise Fiduciary Duties in M&A Deals

Merger and acquisition activity in the community banking sector is on the upswing as regulatory burdens increase, margins are squeezed, and banks seek improvements in efficiency and scale, two leading bank M&A lawyers told participants at the ABA Bank Director Boot Camp, held this past October in Nashville.

A steady 4 percent of financial institutions consolidated in each of the last three years, with relatively more activity on the small end of the market—that is, among banks with assets of less than $1 billion, according to John J. Gorman and Lawrence M.F. Spaccasi, partners in the Washington, D.C., law firm of Luse Gorman. They provided board members with an overview of how M&A works and what types of negotiations and obstacles may arise.

See pages 5-7 for more coverage from sesions at the ABA Director Boot Camp, held before the ABA Annual Convention.

The board's fiduciary duties of loyalty and care are unchanged in an M&A situation, but a third duty may come into play, known as the "Revlon duty," if an institution enters into a sale transaction. A doctrine of Delaware corporation law, the Revlon duty means that a board must exercise its fiduciary duties to obtain the best price "reasonably available," Spaccasi said.

"Your role in an M&A context is no different from any other role you have as a board member, but it is potentially subject to more scrutiny," Spaccasi added. Records of deliberations may be examined closely by regulators, examiners, and shareholders during a transaction or after it is concluded, which makes it very important to document any talks and decisions. "The record of decision-making is as important as the decision you make," he said.

Not every bank wants to sell, but even unsolicited offers need to be taken seriously, Spaccasi added. "You don't have a duty to engage in discussions. However, if someone drops a letter, you need to be on the record saying you received an offer and rejected it for carefully considered reasons." In other words, it must be clear from the record that the board made an informed decision.

"Just saying no is a valid response," Gorman added. "Under the law, it is a board's prerogative to decide how to deliver value and over what time period."

Even if the bank has no interest in buying or selling, it is prudent

Mergers *(Continued on page 4)*

FOCUS ON COMMITTEES

Audit Team Must Tune In to Current Risks

Bank audit committees play a timeless role that has earned them the status of the most important committee on a financial institution's board of directors. Consisting of independent members of the board, with no members from the bank's staff, audit committees monitor the financial reporting process and oversee the bank's internal and external audit functions. They also ensure that banks have—and properly apply—policies and procedures to mitigate risks.

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COMMITTEE FOCUS: AUDIT

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But timeless doesn't mean static, according to Sal Inserra, with Crowe Horwath LLP. (ABA endorses Crowe Horwath's Corporate Governance/Internal Audit Services.) He identified cybersecurity and strategic initiatives as two hot topics that will demand the attention of bank audit committees in 2017.

Cybersecurity is not a new concern, but it is an evolving risk that requires heightened attention, Inserra said. The Federal Financial Institutions Examination Council in 2015 unveiled a two-part cybersecurity assessment tool, and boards should be familiar with it.

The cybersecurity tool is a classic example of the type of regulation that "runs downhill," Inserra said. When the FFIEC introduced the tool, it urged banks over $10 billion to complete the exercise. "Yet I've had banks in the $500 million-asset range that were examined and the first question asked was, 'Did you use the toolkit?'" Inserra said.

The cybersecurity tool is a classic example of the type of regulation that 'runs downhill.'

Inserra urged audit committees to be skeptical of claims that the bank is not susceptible to cybersecurity incidents. He recounted an audit committee meeting where the IT director insisted the bank wasn't at risk of being hacked. "You have to ask, 'Why are we so different from everyone else?' There are two types of banks: those that know they're being attacked and those that don't."

For many banks, branches are no longer a major risk point as cybersecurity risks have grown. And yet, Inserra says, "we still see internal audit programs that are highly focused on some of the old issues, as opposed to new realities. Audit committees need to redirect internal audit toward new realities."

Turning to strategic initiatives, Inserra pointed out that the audit committee has a special role to play as banks step up their search for new revenue streams and business opportunities. It's up to the audit committee to label initiatives as new, determine the implications for risk, and never accept that an activity is riskless. "Maybe your organization hasn't been very active in mortgage banking, but it is increasing its role," Inserra said. "Anytime someone jumps on a bicycle for the first time, they'll fall off the bicycle. It should be expected any time you enter into a new business that you will face completely different risk elements."

Of course, even as audit committees wrestle with hot topics, they have basic responsibilities to tend to. "A tsunami of new accounting literature is coming out over the next three to four years, and it needs to be applied," said Inserra. Changes afoot include the introduction of the current expected credit loss model (CECL), and changes to leasing, revenue recognition and stock options. "Audit committees will be reviewing financial statements that are significantly impacted by these changes in accounting," Inserra said. Committees should request expert advice, understand how peers are implementing the changes, and insist on training.

Directors of Failed Bank To Pay $5M in Damages

Eight directors of the failed Buckhead Community Bank of Atlanta were found personally liable Oct. 25 for losses resulting from four bad loans and were ordered to pay a combined $5 million in compensatory damages. The verdict by a federal jury of the U.S. District Court for the Northern District of Georgia also dismissed civil claims related to six other loans. The decision appears to be one of the few instances in the aftermath of the financial crisis of 2008-2009 in which a bank's directors have been found personally liable for losses. Buckhead Community Bank failed in 2009 and was sued by the FDIC in 2012. In its original complaint, the FDIC cited repeated violations and breaches of the bank's loan policy and other problems.

DIRECTORS BRIEFING

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Owners of Non-Public Banks Need Special Care

Mutual institutions and privately held banks face unique considerations in dealing effectively with their owners in a time of growing shareholder activism, attorneys told participants in a recent free ABA member webinar.

Mutuals are owned by their depositors, while privately held banks usually have a relatively small group of investors or family members who own the institution. Most banks, including the hundreds that are publicly traded, face a shared set of challenges, including growth, competition, merger pressure, and regulation. And all banks, regardless of ownership structure, owe a fiduciary duty of loyalty and care to all their investors, not just the controlling or founding family or the largest depositors in the case of mutuals. But the dynamics of addressing investor challenges are very different for mutuals and privately held banks.

The dynamics of addressing investor challenges are very different for mutuals and privately held banks.

Read on for expert insights into the right approach to investor relations for each of these ownership structures. A replay of the webinar is available at aba.com/shareholders.Ⓜ

Mutuals Urged: Control Your Own Destiny

Mutuals have numerous paths to remain independent in the face of pressures on growth and efficiency, said Laura Biddle, counsel with the Hogan Lovells law firm. They can form a mutual holding company, affiliate with other mutuals, or engage in mutual mergers, among other options. But, she added, "The key for a mutual is to control its own destiny."

Additional challenges facing mutuals are professional depositors and, at the federal level, dwindling regulatory expertise. "Mutuals are being examined by those without a strong understanding of the mutual structure," she said, and this can make it harder for an institution to shape its future. In addition to adhering to their fiduciary obligations of loyalty and care, mutuals should strive to have a strong strategic plan and a sound corporate governance structure, she said.

The board should review the strategic plan annually and update it every year, and the plan "should breathe mutuality," Biddle said. She recommended including a strong statement of commitment to mutuality and conveying community involvement and participation.

As for corporate governance, Biddle noted that "there is no one-size-fits-all structure." One starting point is to make sure that the nomination process is predictable and transparent. For instance, if depositors can nominate directors, what percentage of depositors is needed to make a nomination? What is the time frame for nominations? And who is qualified to serve? "Bylaws should set forth a process that makes clear only those nominations meeting the requirements can be entertained," Biddle said.

Within the bylaws, it may be prudent to establish a residency or market area requirement for board members and to set age limitations for board service, she added, though she pointed out that there are arguments for and against age limits. Having one establishes a non-discriminatory standard for retirement, but it can also limit the candidate pool.

Separating the CEO and chairman positions can help to inoculate boards against investor criticism, but again, there are pluses and minuses. Separation potentially increases the accountability of the CEO to the board. On the other hand, an outside chairman might lack a deep understanding of the banking industry. Appointing an independent or lead director can be "a practical middle ground," Biddle said.

Many mutuals are concerned about professional depositors, who have been known to push for mutual-to-stock conversions. Mutuals that want to minimize their impact may want to adopt deposit acceptance policies tied to the institution's mission statement. "State any purposes for avoiding out-of-market deposits, such as volatility," Biddle said. "And make sure policies do not indirectly or directly result in discrimination, such as redlining."

Other measures, such as having a conflict of interest policy, establishing a succession plan, and avoiding overly generous employment and change in control agreements, can insulate mutuals against conversion pressures, Biddle said. She also urged institutions to consider adopting supermajority requirements for significant transactions.

Succession, 'Valuation Moments' Can Shake Up Closely Held Banks

Shareholder activism is uncommon at privately held banks, and with good reason, said Brian Christiansen, a

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partner with the Skadden law firm in Washington, D.C. Most closely held banks are smaller than their public counterparts, and few professional investors invest time, energy and money to drive decisions about these banks. Less information is available about privately held banks, which translates into fewer chances for an activist to accumulate a stake.

Still, there are scenarios that can give rise to shareholder-related concerns at privately held banks, Christiansen said. Generational succession, valuation "moments," differing liquidity needs among shareholders, and tension among different shareholder factions can roil quiet waters, he said.

Family-owned banks are particularly vulnerable to pressure to sell or merge when there is uncertainty and doubt about management succession. Uncertainty can increase when shares have been passed to children and grandchildren who have less interest in the bank than their forebears had.

Pressure also mounts on occasions when a private institution has to obtain a valuation. "In private companies, valuation is seen and observed less frequently than in public companies," Christiansen said. "Valuation moments can bring out disagreement." Raising capital, entering into mergers and acquisitions, or granting equity to management can all trigger a valuation.

Christiansen said aggrieved shareholders have a number of levers available if they want to find allies. Most states give shareholders the right to inspect the company's books and records and obtain an investor list. Privately owned banks have fewer disclosure requirements than their public counterparts, but they must make financial information public in call reports and holding company reports.

How can closely held bank navigate shareholder concerns? Christiansen offered some ideas:

- Communicate regularly with shareholders. "An information vacuum can foster rumor and misinformation," Christiansen said. Also, get to know the influencers within the shareholder base. "There might be 100 shareholders, but they may align into camps led by a handful of influencers," he said.
- Take expressions of concern seriously. An investor raising concerns should never be dismissed as just one voice, because the concerns may be shared by other, less vocal investors, Christiansen said.
- Periodically assess corporate arrangements. For example, shareholder agreements may have been put in place a long time ago and never refreshed. Should investors be restricted outright from transferring stock, or should company consent be required? Such questions should be worked out with an adviser who has experience with shareholder agreements, Christiansen said.
- Keep regulatory filings up to date in terms of shareholder structure. Over time, personally owned shares may shift into family trusts and other estate-planning vehicles, and this must be accurately reflected in filings.
- Consider borrowing the best of public company governance. Christiansen pointed to have independent directors on the board as a practice that private companies can consider.

MERGERS

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to understand the market and stay informed, Gorman said. Board members should request periodic presentations on the M&A market, pricing analyses, and details on recent transactions among peers.

If the board decides to engage in a transaction, whether as a buyer or a seller, it helps to form a special M&A committee of the board, Spaccasi added. "This is largely for convenience, so you don't have to grab 12 people every time you need to meet." Gorman added that due diligence must be thorough and should be completed before signing any agreement. Gorman also stressed the importance of having any supervisory issues resolved before undertaking a merger or acquisition. "The need to communicate with your regulator regarding deals is critical today," he said. For example, unresolved exam issues—"matters requiring attention"—are likely to be a roadblock. He pointed to M&T Bank Corporation's acquisition of Hudson City Bancorp, which took two and a half years to complete while M&T was being pressed to resolve Bank Secrecy Act issues to the regulators' satisfaction.

Boards must be aware that shareholder lawsuits are a real possibility whenever a bank enters into M&A discussions, Gorman said. However, the outlook has improved. Several years ago, lawsuits were viewed as a kind of transaction tax, with 95 percent of M&A transactions giving rise to a legal challenge, Gorman said. However, "Delaware and other courts have pushed back. Now maybe 40 percent of transactions face shareholder lawsuits."

Using Model Governance and Validation Can Boost Confidence That Boards and Management Understand Risks

How can a board of directors have confidence that the models used to monitor risk and improve decision-making are sound?

The answer is to make a commitment to model governance and validation, said Eric Holmquist, managing director for enterprise risk management at FIS Global, a leading provider of financial technology services.

Model governance is the framework for overseeing the bank's use of modeling, while validation is a process of determining how the models are working, Holmquist explained. The risk inherent in all models is that invalid assumptions can lead to incorrect decisions based on model results, which can lead in turn to financial losses and regulatory consequences.

During a session at the ABA's Bank Director Boot Camp, Holmquist offered practical tips on the board's role in model governance and validation.

Start with an inventory. Good model governance begins with having a list of all the models used in the bank. Boards should insist on knowing every model that is in use, and must also probe to understand which are most critical to the business, Holmquist said. There also needs to be agreement on the board about what actually falls under the definition of a model (see "What is a Model?"), whether it is a simple spreadsheet or a sophisticated application. Although the must-have models may vary from bank to bank, the list is likely to include models for enterprise risk management, allowance for loan and lease losses, asset-liability management, capital, liquidity and reserves, and Bank Secrecy Act/anti money-laundering data.

Validation is a process of determining how the models are working.

Insist on documentation. "A large percentage of models get developed without documentation, and that is bad," Holmquist said. "We don't want the guy with the recipe to leave us not knowing how to make ice cubes any longer." Boards should press management for documentation, which should include what the assumptions are, how to run the model, what key calculations are embedded in it, data sources, and business uses.

Commit to independent validation. The person who checks the model should not be the same person who designs or runs the model. Although it can be beneficial to hire a consultant, "it doesn't have to be someone from outside the company, provided you can demonstrate independence from the actual model owners," Holmquist said. The board should be satisfied that it is getting an objective party's input on how the bank uses modeling and how models are tested.

Understand regulatory expectations. Regulators are not looking to be dazzled by a bank's models. They want to know whether the board and management have confidence that the people running the models know what they are doing. They also want insight into the quality of reporting that the board is receiving and how the board interprets data it is given.

What Is a Model?

Financial models use data, formulas and assumptions to provide quantitative outputs that influence decision-making. In other words, financial models are a way of describing business activity mathematically, and using the information generated to predict future outcomes or other unknowns. Insured financial institutions use models for a variety of purposes, including making credit decisions, measuring risk and estimating asset values. These examples from the FDIC are instructive:

- "Credit scoring models inform decision making, providing predictive information on the potential for default or delinquency used in the loan approval process and risk pricing.
- "Interest rate risk models measure risk, monitoring earnings exposure to a range of potential changes in rates and market conditions.
- "Derivatives pricing models estimate asset value, providing a methodology for determining the value of new or complex products for which market observations are not readily available."

As Compensation Evolves, Some Questions Persist

It's an understatement to say that bank compensation practices are in flux. Regulators are finalizing Dodd-Frank incentive compensation rules that could impose sweeping changes on the way banks reward employees. Banks' sales cultures are under scrutiny as the industry absorbs the fallout from incentive pay issues at Wells Fargo. At the same time, shareholders and advisory firms like to see a strong alignment between pay and performance.

Nevertheless, there are some enduring characteristics of an effective bank compensation program, according to Susan O'Donnell, a partner with Meridian Compensation Partners. "Think of it as a puzzle with many key elements," she told participants in the ABA Bank Director Boot Camp. She described components of compensation that can be tweaked to tailor packages that mesh with an individual bank's goals and strategy.

Pay mix. Should pay be fixed, performance-based, or some combination thereof? Executive pay is usually balanced among fixed salary, short-term and annual bonuses, and deferred long-term compensation. But there are wide variations in how the mix is distributed. Also, what portion of incentive pay should be in cash as opposed to equity?

Approach. Does the compensation program place more value on quantitative or qualitative factors? Formulas and discretion are both valuable tools in creating compensation programs, and "regulators like to see both approaches," O'Donnell said. But regulators differ among themselves: The Securities and Exchange Commission and shareholders tilt toward the quantitative, while banking regulators more readily accept discretionary approaches, she added.

Absolute vs. relative performance. Is it the bank's practice to set its own specific performance goals, or to compare performance to peers or an industry index? How do risk, growth, and earnings factor into this calculation?

Time horizon. How much weight should be given to short-term versus long-term performance? There is no single, perfect measure of performance. Annual incentive measures can be aligned with the annual business plan. Long-term incentive measures should reflect long-term impacts, such as value creation and shareholder returns.

Bank, team or individual. How should individual, team or whole-bank performance factor into the compensation plan?

Split Decision? OCC Open to Exploring Separate Bank CEO, Chairman Roles

The OCC may examine whether national banks should separate the roles of chairman and chief executive officer, Comptroller of the Currency Thomas Curry said at an industry event on Nov. 30. "The OCC's heightened standards require that a percentage of national banks board members be independent. This is one area that may require further work."

He pointed out that "some national banks have split the roles of board chairman and chief executive officer to clearly delineate roles and governance of the institution and eliminate potential conflicts of interest that exist when the same individual serves in both roles," adding that "we should consider whether this structural change by some national banks makes sense for all federally supervised banks, or at least the largest most complex ones."

'We should consider whether this structural change by some national banks makes sense for all federally supervised banks.'

In related news, Wells Fargo & Co. announced Dec. 1 that it had amended its bylaws to separate the roles of chairman and CEO. The $1.9 trillion-asset bank, the third largest in the United States, also said it would require its chairman and vice chairman to be independent directors. Wells Fargo Chairman Stephen Sanger characterized the change as part of an effort to restore customer and employee trust following disclosures of wrongful sales practices that took place in its retail bank.

The question of whether banks should split the roles of chairman and CEO has been debated for decades. Regardless of whether a company unifies or separate the two roles, most governance experts agree that it is vital to have an independent, engaged board that is willing to ask questions as it defends the interests of shareholders.

Detecting and Preventing Fraud Demands Vigilant Approach Across Entire Financial Institution

Readily available software has helped perpetrators of fraud grow adept at creating fake and manipulated financial information, forensic accountant Angela Morelock told directors attending the ABA Bank Directors Boot Camp.

Professional-caliber graphic design software has made it possible for determined scammers to create bogus bank and brokerage statements and use them to falsify credit applications. "It used to be hard to create fake information, but now everybody's got Adobe and we are just swimming in fake documents," said Morelock, managing partner of the forensics and valuation services division at BKD, a national CPA and advisory firm. To guard against fake and manipulated documents, it's incumbent on banks to independently verify their accuracy.

Morelock highlighted a range of fraud trends and schemes that she and her team have helped to investigate. She noted that banking and financial services companies top the list of industries that are fraud victims, making up 16.8 percent of companies experiencing fraudulent activity between January 2014 and October 2015, according to the most recent data by the Association of Certified Fraud Examiners. A total of 368 financial companies were defrauded, with an average median loss of $192,000.

She told of a community bank she investigated that had 69 false loans totaling $312,000. The branch manager had been going to the teller line to cash cashier's checks, allegedly on behalf of a customer, but was diverting the funds for personal use. "The bank made it policy across the board that employees cannot process cash transactions on behalf of customers," Morelock said.

"The two most-abused positions in terms of shoving fraudulent transactions through are the teller line and loan clerks," Morelock continued. When the fraud is occurring inside the organization, it is not unusual for the perpetrator to exploit the trust of tellers and loan clerks by getting them to provide the second sign-off on a transaction.

It is not unusual for the perpetrator to exploit the trust of tellers and loan clerks.

Loan file maintenance is another area where fraud can be covered up. Morelock said she has seen instances where a lender changed payment due dates, maturity dates and interest rates to cover up cash flow problems.

Fraud awareness training is a fundamental part of any company's fraud prevention strategy, Morelock said. While the accounting department, internal auditors and external auditors can provide a line of defense, the entire workforce must be alert to fraud to detect and deter it.

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Fintech Growth Matters to Community Banks, Comptroller Says

Failing to understand threats to a bank's business is the essence of strategic risk. As community bank executives and boards grapple with a host of risks and unknowns, they should pay special attention to the explosive growth of nonbank financial technology companies, or fintechs, Comptroller of the Currency Thomas Curry said Nov. 18.

85 million millennials consider non-traditional service providers.

Fintechs are providing financial products and services through alternative platforms and delivery channels, spurred on by the willingness of 85 million millennials to consider non-traditional financial services providers, Curry told the 11th Annual Community Bankers Symposium sponsored by the Federal Reserve Bank of Chicago. *American Banker* has defined fintechs as companies that use innovative technology to solve real-life business problems.

As of 2015, there were 4,000 fintech companies in the U.S. and United Kingdom. "While fintech companies are still a small portion of the industry, their rapid growth requires banks and regulators to ask big-picture questions about the future of banking," Curry said. These questions include "how consumer needs are being met and whether we have the necessary regulatory tools and structure to ensure that the changes occur in a safe and sound manner, promote financial inclusion, and avoid consumer abuse," he added.

To mitigate strategic risk, bank executives and boards must ask bold questions, Curry said. "Instead of, 'Is this product performing?' or 'Are we meeting our growth goals?' you have to ask, 'Are we offering the right products, and have we identified the right goals? Have we properly identified the needs of our customers and communities? Do we have a plan for adapting to the changing marketplace in the next five or 10 years? Has our board adopted approaches and policies consistent with the bank's long-term business model, and have we articulated our goals effectively?'"