How Stock M&A Deals Can Work For Privately Held Companies

Privately held community banks shouldn’t let misconceptions about their ability to issue stock stand in the way of exploring mergers and acquisitions, two attorneys from the Atlanta law firm of Bryan Cave Leighton Paisner said.

There are two widely held and diametrically opposed views about the ability of private banks to issue stock for M&A, said Kevin Strachan, an associate in the firm’s financial institutions practice. The first is that private companies must use cash to acquire another company; the second is that when a private bank decides they do want to issue stock, they can do so freely.

In fact, there are ways for private banks to issue stock—but they must pay careful heed to the restrictions.

Privately held, state-chartered banks that don’t have a holding company may rely on the securities exemption for issuances by banks and issue stock in a merger, said Robert Klingler, a partner in the firm. A bank may even acquire another institution in this way.

Although state banks without holding companies have significant flexibility, this is not true of national banks, Klingler pointed out. That’s because the Office of the Comptroller of the Currency has effectively adopted the Securities and Exchange Commission’s regulations for securities issuances, so the shares issuance would have to be registered with the OCC and ongoing reporting would be required.

The second option is not being a private company anymore. If a bank really wants to issue stock, it should consider going public and staying public. If it plans on being acquisitive, a public offering will provide it with a currency that it can use for acquisitions, Klingler said.

Becoming a public company via an initial public offering or a merger is, of course, an option, Klingler said. But, he added, “being a public company is not worthwhile until the institution is at least $1 billion in assets. It’s a minimum threshold at which you’re going to have enough of a shareholder base to take real advantage of public markets.”

Another option for privately held banks is to do an issuance under SEC Regulation A-plus, which governs limited public offerings under the Securities Act of 1933, Strachan said. A rule providing a streamlined approach to issuances of up to $5 million has been around for some time, but the Tax Cuts and Jobs Act of 2017 increased the ceiling to $50 million.

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As CECL looms, FASB itself faces criticism.

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months,” said Julie Hembrock Daum, leader of Spencer Stuart’s North American board practice, and a co-author of the report “The Road to Strategic Board Succession.” “Boards that plan well in advance will be in the best position to find the right director candidates that address the board’s future needs.”

Succession planning has always been important, but board composition and refreshment is a topic that is receiving more attention from shareholders and other stakeholders. The big questions surround diversity in the boardroom, whether the board has the right skill mix, and attitudes toward director tenure, the report said.

Daum and co-author George Anderson, leader of Spencer Stuart’s board effectiveness practice, identified five actions that separate reactive boards from truly strategic ones:

Make board succession a priority on the agenda. It is a best practice for the nominating/governance committee to lead a regular planning process that is discussed with and agreed upon by the full board.

Take a multi-year view toward departures and upcoming leadership changes. The nominating/governance committee looks ahead to anticipated director departures and leadership changes and focuses on the aggregate tenure of the board.

Set directors’ expectations around tenure. The board sets clear expectations about director tenure, regularly reviews individual director tenure, and determines the optimal mix of new directors, medium-tenure directors and long-tenure directors.

Assess skills and attributes, and incorporate results from performance assessments. A board skills matrix is used to identify current and expected skill gaps. Board and director assessments are seen as a continuous improvement exercise and results are incorporated into the succession planning process.

Agree on a plan that prioritizes needs and builds a talent pipeline. The nominating/governance committee maintains a multi-year succession plan and director candidate profiles with a prioritized list of skills and attributes, and a talent pipeline is developed for future needs.

The report also noted some benchmarks for board tenure. Among S&P 500 companies, 71% report having a mandatory retirement age for directors. Among those boards, 43.5% set the retirement age at 75 or older. Only 5% set explicit term limits, with the majority of those set at 15 years or more.

M&A DEALS

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million, making it a “mini public offering,” he added.

Reg A-plus offerings fall into two tiers. Issuances of up to $20 million require no ongoing reporting requirements. Issuances between $20 million and $50 million require ongoing Exchange Act reporting, but only semiannually rather than quarterly. And companies can cease reporting after a year if they have fewer than 1,200 shareholders.

“It’s a nice way to test out whether you want to be a public company,” Klingler said, adding that it is expressly available for merger activity.

Another process for stock issuance that is available to private companies in some states—including California, Georgia and North Carolina—is to pursue a state fairness hearing exemption, Strachan said. This process involves a public hearing, to which shareholders are invited, to present the case that an agreed-upon merger is fair to the targeted shareholders. A state body would then issue a fairness determination.

“Presenting the hearing case is very similar to presenting the case to the board or to the shareholders explaining the fairness of a transaction,” Klingler said.

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SPECIAL REPORT

Making All Voices Heard in the Board Room

In an ideal world, the board of directors is a group of equals, led by the chairman, and each member is as willing as the next to speak up and make his or her voice heard. But sometimes even the best boards get out of balance, and one of the symptoms of imbalance is when relatively few people dominate discussion. The job of bringing equilibrium to board discussions falls to the chairman.

What happens when a few voices begin to dominate board meetings? The emergence of an “alpha director” isn’t always a bad thing if they are adding value and are highly respected for their opinions, noted Jeff Plagge, president and CEO of Northwest Financial Corp. “But if they start to stifle important board debate and opposing points of views, it is a problem and will make for a low performing and under- or unengaged board,” he said.

ABA Chairman Jeff Szyperski, chairman and CEO of Chesapeake Bank, Kilmarnock, Va., said his bank has kept this sort of conflict out of the board room in a number of ways. His board has relatively long tenure, and all major committees are headed up by a director other than himself, ensuring a high degree of independence. An open-door policy is also important. “Each of our directors, especially those that chair one of the committees, are great communicators and will not hesitate to contact me if they have a question,” Szyperski said.

Still, the struggle to be heard is real. Directors Briefing asked board chairmen and governance experts to offer their insights into ensuring that all directors have a chance to be heard. Excerpts follow.

Look in the Mirror
Jeff Plagge, President & CEO, Northwest Financial Corp., Arnolds Park, Iowa

Some boards may have alpha or dominant directors—and if you can’t identify the violator, it may be you.

If one or two board members are drowning out others and dominating the conversations, the chairman or the CEO needs to be willing to step in and do something about it. This most likely would involve scheduling a private meeting to make directors aware if they are having a negative impact. Encourage them to listen more and to talk less for the good of the board as a whole.

The chairman also needs to solicit comments from quiet or disengaged board members and reinforce the value of that engagement. If that encouragement doesn’t yield results during the board meeting, the chairman can meet privately to make directors aware if they are having a negative impact. Encourage them to listen more and to talk less for the good of the board as a whole.

The chairman also needs to solicit comments from quiet or disengaged board members and reinforce the value of that engagement. If that encouragement doesn’t yield results during the board meeting, the chairman can meet privately to make directors aware if they aren’t engaged or to talk about how and where they can add more value. Maybe they just aren’t experienced board members and the bank needs to be willing to send them to a board education opportunity or two to give them more confidence and make them a more productive and valuable board member.

If the dominant board member is the chairman, it gets more complicated. That will probably call for a meeting with the chairman by the vice chairman and/or the CEO to talk about the problem. These are never comfortable meetings but without the discussion, it will only get worse and ultimately cause more board members to become disengaged or maybe even leave the board.

Set the Tone
Cathy Owen, Chair, Eagle Bank & Trust, Little Rock, Ark.

The board chair sets the tone and should make sure meetings are conducted in a professional and respectful manner. An alpha director can be very destructive, negatively impacting the rest of the board.

The chair must have the knowledge, experience and confidence to control any directors that are out of line and not let them take control of discussions. This can be done in a professional manner, by expressing appreciation while making clear that the opinions of several other directors are wanted. If this doesn’t work, a private discussion with the director can be helpful.

The chair needs the humility to know they do not know everything and to impress upon their board members that the board is only as good as the input of the entire group. The chair must make sure all board members recognize and appreciate the value each member brings to the board. Our board ranges in age from 37 to 92. All of them have an equal voice. They ask questions and voice their opinions. As chair, I continually remind our board of the importance of their input. I can’t know everything, and a “yes person” does us no good.

(Continued on next page.)
Directors know I am counting on them to bring their voice of knowledge and experience to each board meeting. In return, they are all comfortable in voicing their opinions and more often than not, my role ends up being more focused on keeping us on topic rather than encouraging discussions.

Get It Out in the Open
James McAlpin Jr., Partner, Bryan Cave Leighton Paisner LLP, Atlanta

First, and most important, the chair needs to establish control of the order and flow of conversation during board meetings. When the CEO is the chair and the aggressively loquacious director is a major shareholder, the lead independent director needs to become involved.

Once a year, have a full and open conversation among board members about what is going well in board meetings and what could be improved. Start with the agenda: Does it contain the right mix of topics, is sufficient time provided for discussion of key items, would changes to the agenda be helpful for the board members? Then move into a discussion of participation at board meetings: Are all directors being heard from, are there impediments to participation? This line of inquiry usually results in discussion of issues, including whether someone is dominating board conversations.

There is usually a question in annual director evaluation forms that reads “Does the director actively participate in meetings?” In a self-evaluation, a director who tends to dominate board conversations will give himself or herself a top mark in response. In a 360-degree evaluation, it’s helpful to encourage comments beyond yes or no for such a question. I’d also suggest adding a separate question: “Does the director appropriately participate in board conversations, displaying interest for the thoughts and views of others and not dominating discussions?”

Conduct Assessments
Susan Keating, CEO, WomenCorporate Directors, West Palm Beach, Fla.

Strong personalities can make great board members, as can those who deliberate more quietly. And thus we see one of the reasons why the chair has such a complicated and important role—she or he must deftly balance the diversity of all the personalities in the room so that the board can have all the information and insights to make the best decision possible.

With companies taking steps to increase the diversity of gender, ethnicity, geography, expertise and age sitting around the boardroom table, the benefit of this broader range of perspectives is too important to be derailed by letting a single director drown out other voices.

It is critical that the chair keep the board deliberation process on track, soliciting input from board members broadly—and certain directors specifically, if necessary—to ensure that decisions are made based on full board consideration.

If there is a dominant board member who is disrupting this process, it is up to the chair either during the meeting or outside the meeting to make it clear that the board needs broader input and broader director representation into the decision being made.

Board assessments are another way in which this kind of feedback can be delivered. Another good tactic is to coach and mentor new directors. This can be especially useful for new board members who may be the lone director or one of a few representing a different background from the rest of the board, whether in gender, ethnicity, age or some other respect.

OCC Cites Strategic Factors in Assessing Risk

Strategic risk is elevated for many banks, and boards have a key role to play in mitigating it, the Office of the Comptroller of the Currency said.

The OCC identified strategic risk as an emerging risk in a special section of its Semiannual Risk Perspectives for spring 2019. The agency defines strategic risk as threats to a bank’s financial condition and resilience that may arise because of faulty decision making and implementation or the failure to respond to change.

“Strategic risk increases not only when innovation is pursued without appropriate planning and governance but also when banks fail to keep pace with change,” the OCC said.

“The board, in consultation with bank management, should establish the bank’s strategy and risk appetite and take actions designed to properly prepare the bank to adapt, leverage, and profit from evolution in its customer base and larger industry.”

Banks should evaluate whether governance and risk management are effective when considering new products, services, and processes, the OCC said. The board should assess whether business practices align with bank’s risk appetite. The onus is on management to understand what is required to undertake new activities, the OCC added.
As Proxy Season Dies Down, Lessons Begin to Emerge

The 2019 proxy season has drawn to a close, and lessons are just beginning to emerge.

Among the takeaways: Proxy battles aimed at giving activist investors a bigger voice on the board of directors are alive and well. And in response, stock-issuing companies are buttoning down meeting-attendance procedures in the face of growing shareholder activism.

Smaller, more technical issues also regularly crop up, according to two Northern Trust Co. proxy team executives. Undeliverable proxy ballots due to account set-up issues have been a challenge for securities custodians. And investors sometimes don’t understand that all their securities need to be fully settled and in the custody of the bank or broker in order to vote on the ballot, according to Patrick Krull and Ryan Chislett—vice president and second vice president, respectively, on Northern Trust’s U.S. proxy team. They shared their perspectives on an ABA webinar, “Proxy: What You Need to Know in 2019.”

Chislett noted that 90% of all proxy voting occurs between February and May in the U.S. The purpose of proxy voting is to enable a shareholder to vote on and influence all proposals at a company’s annual meeting.

Although the proxy season is short, it culminates extensive work by companies to identify and engage with their stock owners, Krull said. “Companies need to reach out to their shareholders throughout the year, because they don’t want surprises when it comes to the annual meeting,” he said. “The proxy process wraps up a year’s worth of activities in communications that issuers are having with their stockholders.”

Proxy battles among community banks are uncommon, but certainly not unheard of. At press time, Seattle-based HomeStreet Inc., the parent company of $7.1 billion-asset HomeStreet Bank, was facing a battle at its June 20 annual meeting. Blue Lion Capital Management, a Dallas-based hedge fund, was seeking to unseat two board members and replace them with its own candidates. Blue Lion has been pushing for changes at HomeStreet since 2017, and failed in a similar bid last year.

It will be months before final numbers can be tallied for the 2019 proxy season, but 2018 trends point toward a more activist environment. According to the law firm Sullivan & Cromwell, 2018 saw a 5% increase in total number of publicly announced campaigns against U.S. issuers. And smaller entities were not exempt: Issuers with market capitalizations between $1 billion and $10 billion were targeted in 40% of announced 2018 campaigns even though they made up only 21% of Russell 3000 companies.

Sullivan & Cromwell also reported that 37% of activist campaigns in 2018 focused on mergers and acquisitions objectives, up from 26% a year earlier. Proxy contests focusing on board-related governance matters decreased significantly from 51% to 14%. And activists obtained on average 0.8 board seats per campaign, up 56% from a year earlier.

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Critics See Flaws in FASB as Credit-Loss Changes Loom

As U.S. banks prepare to implement an overhaul of loan accounting standards starting in 2020, the standard-setters themselves are coming under criticism.

Writing in The Hill newspaper on May 28, William Isaac and Thomas Vartanian argued that stronger checks are needed on the Financial Accounting Standards Board. They cited FASB’s plan to require banks to forecast and book current expected credit losses (CECL) over the life of loans as a prime example of misguided accounting standards. “Forecasting and booking losses over the life of a 30-year mortgage is highly speculative at best and requiring it to be done will likely sound the death knell for long-term mortgages and perhaps the banks holding them,” Isaac and Vartanian wrote.

They argued that CECL would hit banks hardest during economic downturns “when they can least afford it.” In addition, they said, there are inadequate checks on FASB, which is a creation of the accounting profession and “largely operates according to its own rules.”

Isaac, an industry consultant, is a former chairman of the FDIC and of Fifth Third Bancorp. Vartanian, former general counsel of the Federal Home Loan Bank Board, directs the financial regulation and technology program at George Mason University’s Scalia Law School.

The authors urged regulators to resist FASB’s push to impose CECL and stressed the importance of stopping to study the impact CECL would have on the economy, a direction favored by ABA. Bills have been introduced in the House (H. 3182) and the Senate (S. 1564) to delay implementation while an impact study is conducted.