MERGERS & ACQUISITIONS GUIDE FOR BANKERS

ACQUIRE OR BE ACQUIRED CONFERENCE • JANUARY 30 - FEBRUARY 2, 2016

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A Modern Firm with Established Roots

Baird Holm LLP's integrated team of 80 attorneys, licensed in 20 states, is committed to connecting each of its valued clients to the positive outcomes they seek. With extensive and diverse expertise, Baird Holm leverages each attorney's skills to respond efficiently to its clients' local, regional, national and international legal needs. Baird Holm is proud to represent public and private companies, individuals, private funds and other investors, financial institutions, governmental entities and nonprofit organizations. Rooted by the promise to constantly evolve in anticipation of its clients' rapidly changing needs, Baird Holm has enjoyed steady and measured growth since its founding in 1873.

Baird Holm attorneys have broad experience in civil law practice, including: agriculture and agribusiness finance; banking; bankruptcy and financial dispute resolution; benefits, ERISA and fiduciary responsibilities, business, tax and estate planning; corporate and business matters; education; environmental; finance; government affairs, lobbying and legislative services; health care; intellectual property, copyright, patent and trademark; international services; labor relations and employment; litigation; prepaid card services; privacy and security; public finance; real estate and construction; renewable energy; securities; and technology & e-commerce.

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Jonathan J. Wegner helps banks and other businesses close deals. He regularly assists U.S.-based companies with complex mergers, acquisitions and capital raises. He also helps business owners, directors, executives and compliance professionals navigate difficult regulatory issues, corporate governance matters and other complex problems. In addition to his day-to-day work with financial institutions, Jonathan regularly counsels businesses in a wide range of industries, including manufacturing, logistics and distribution, investment advisory services, electronic payments and mobile technology. He and his team pride themselves on working collaboratively with clients to complete projects quickly and efficiently.

Jonathan is the editor of the firm's Banking Update e-newsletter and has been recognized by *Super Lawyers* as a "Rising Star" for his work in banking. He received his law degree, *summa cum laude*, from Creighton University School of Law. Prior to joining the firm, he worked as a business reporter for the Omaha World-Herald, Business Week Online and Consumer Reports. He studied at Oxford University and holds a Master of Science in Journalism from Northwestern University.

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John S. Zeilinger primarily represents banks and bank holding companies in purchase, sale and merger transactions, state and federal regulatory approvals and compliance, charter approvals and conversions, negotiating enforcement orders, capital raising and securities law compliance.

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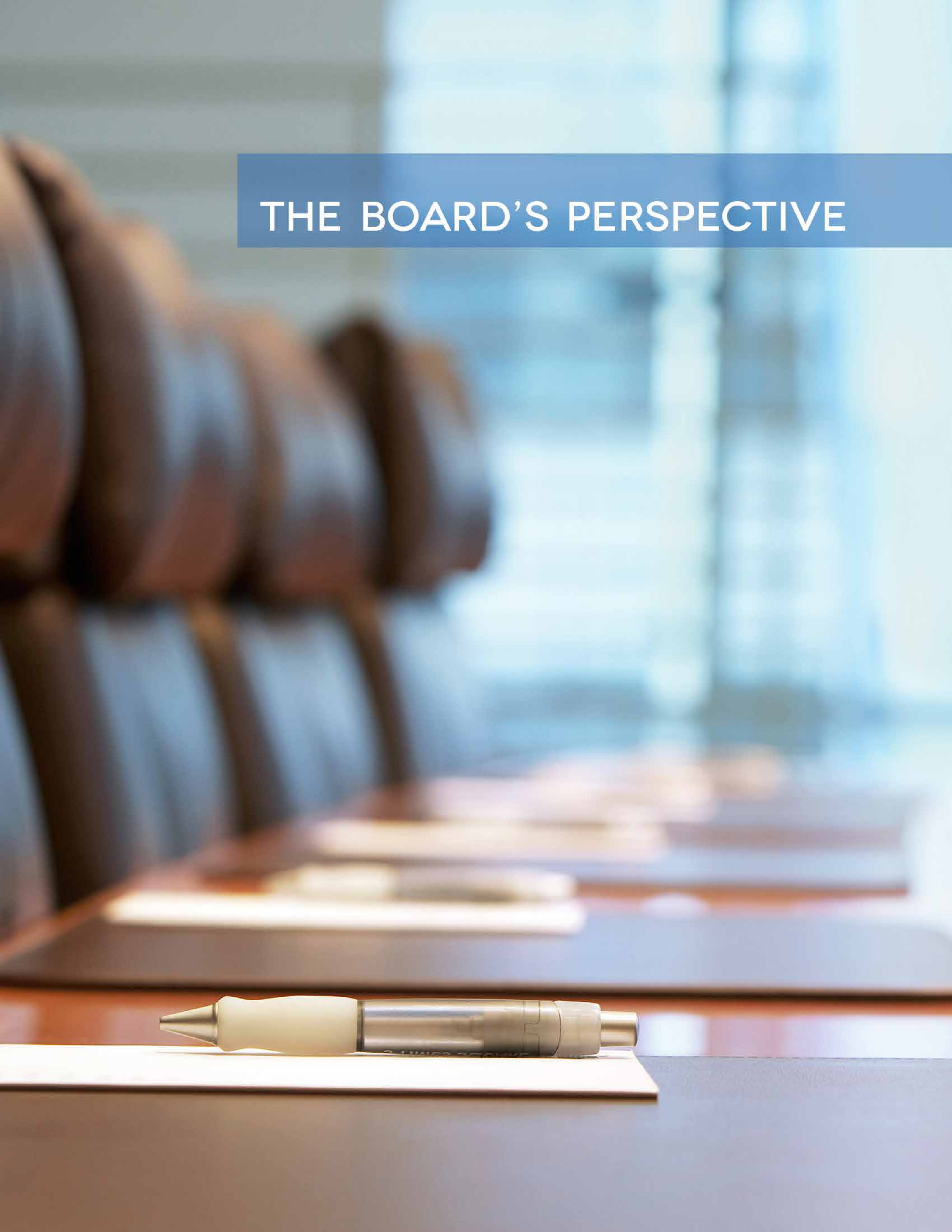
John has presented at or chaired programs held by BankDirector, Baird Holm LLP, the University of Nebraska College of Law, the Nebraska Department of Banking and Finance, NCLE, Inc., and the Community Banking Institute.



THE BOARD'S PERSPECTIVE

All corporate powers of a bank or its bank holding company are exercised by the board of directors (or by agents pursuant to authority granted by the board). In exercising this power, the directors act as fiduciaries to their shareholders. Risks associated with the discharge of fiduciary duties are heightened in contexts in which control of an institution is widely dispersed or where a substantial percentage of minority shareholders lack board representation.

Business Judgment Rule

Cases challenging a target board's decisions in the M&A context generally are won or lost depending on whether the board's actions qualify for the judicial presumption known as the "business judgment rule." This principle generally holds that that courts will not second guess a decision made by directors who are disinterested and independent, act in good faith, and employ a reasonable decision making process.

In the context of a merger or acquisition transaction, the following fiduciary duties underlie the business judgment rule.

DUTY OF LOYALTY

The duty of loyalty requires that a director's decisions not be motivated for personal ends (e.g., to retain the director's employment at the target) or clouded by conflicting interests, such as when the director has an ownership interest in the bidding suitor so that the director is on both sides of the transaction (i.e., "self-dealing").

DUTY OF CARE

The board's decision-making process must evidence that the board was informed and acted with due care. In a leading Delaware Supreme Court case, this duty was described as requiring the board "to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders." In general, courts look to whether the board made use of all reasonably available relevant information about the question presented.

DUTY OF GOOD FAITH

The duty of good faith is the duty to act reasonably and in the best interests of the bank.

In discharging its duty of care when contemplating a merger or acquisition transaction, case law suggests that boards should adhere to the following principles:

1. **CREATE A RECORD.** Courts review the process used by the board in reaching its ultimate decision, not the decision itself. Documentation of the board's process is crucial to demonstrate that due care was exercised.

2. **REVIEW AND CAREFULLY CONSIDER ALL RELEVANT INFORMATION.** Material information should be circulated as far in advance of the meeting as possible, and all material should be reviewed carefully reviewed prior to authorization.

3. **SEEK INFORMATION FROM THE INSTITUTION'S OFFICERS AND EMPLOYEES.** Reliance on officers who would be expected to have relevant information is justified, and the board should seek out officers that may have relevant information.

4. **RELIANCE ON OUTSIDE ADVISORS ALSO MAY BE PRUDENT.** Use of outside legal counsel and/or investment bankers is common and helps the board build a record to evidence an informed understanding of the market and the M&A process.

5. **AVOID HASTE (AS WELL AS THE APPEARANCE OF HASTE).** A decision to sell should be made only after the board has had adequate time to review and understand all relevant information.

6. **ASK QUESTIONS.** The board should not only attempt to obtain all relevant information but also should test the quality and reliability of such information.

7. **REVIEW ALL ALTERNATIVES.** Consider all reasonable available alternatives, including other possible deals or continuation as an independent institution.

8. **CONSIDER ALL RELEVANT FACTORS.** Consider available background information on the purchaser that is relevant to the likelihood of obtaining regulatory approvals or financing for the transaction. If the buyer's stock is being used as consideration for the transaction, evaluate the risks and benefits of such shares.

9. **UNDERSTAND THE DEAL DOCUMENTS.** Review draft agreements and understand their key provisions. Reliance on experts, such as attorneys and investment bankers, is common.

Confronting Conflicts of Interest

DUTY OF LOYALTY

Let the Independent Directors Lead. If a majority of the board consists of independent outside directors, courts generally deem their disinterest sufficient to purge the taint of any potentially conflicted director(s). It may be advisable to allow the independent directors to deliberate separately, especially during discussion of any issues that may create conflicts.

Establish an Independent Committee. Where there is not a majority of independent directors, a special committee of independent directors may be formed to achieve the same result. To be effective, the committee should be empowered to negotiate early in the transaction process, engage its own advisors and take meaningful action.

WHETHER THE BANK IS "IN PLAY"

A board is not required to negotiate with suitors or to sell the institution just because a premium offer has been made, provided that the board makes an informed decision in good faith that it would be in the corporation's best interests to reject the offer.

The "just say no" defense, as this is sometimes called, means just that: a board will not be found liable for a decision to reject an unsolicited bid if it makes a good faith, informed decision that the offer is not in the best interest of the bank and its stakeholders.

SALE OF CONTROL

Once the board has determined to sell the bank, a higher standard of care applies to directors' decisions. Instead of merely exercising due care in making a decision, the board's duty evolves into a duty to obtain the best value in consideration of the proposed sale. To determine whether the best price has been obtained, sellers may:

- **Conduct a competitive auction**. In the event multiple bidders seek to acquire the bank, the institution may choose the bid that presents the best total value to its shareholders.
- **Allow a "market test."** The board may reach out to the most likely prospects for competing bids to test their interest in a transaction. The long period pending regulatory approval often serves as a *de facto* market test following the public announcement of the deal.
- **Include a "fiduciary out."** A definitive agreement include provisions allowing directors to terminate the agreement and/or recommend that shareholders reject the merger proposal in the event a superior proposal is submitted after the contract has been signed.
- **Develop a "body of reliable evidence."** The board may obtain relevant information establishing the value of the company relative to its competitors. A fairness opinion may help support the fairness of the price received.

Deal Protection Measures & Break-Up Fees

"NO SHOP" CLAUSES

A "no-shop" clause prohibits the board of the target bank and/or bank holding company from soliciting or encouraging bids from other potential suitors. Such clauses typically require the board of the target bank or bank holding company to use its best efforts to obtain the requisite shareholder vote to authorize a sale.

However, the "no shop" can present a Catch-22 for a target's board: they prefer to do a deal without one, but they may not be able to do a deal without one. A "no shop" may subject the board's action to criticism since it could prevent the target bank from seeking a superior bid. Yet many buyers will not sign an agreement that omits a "no shop" provision, fearing that the target would use the bidder as a stalking horse to try to find another buyer that will pay a higher price. As such, the target's board may lose a healthy premium if it refuses to agree to include a "no shop" provision.

VOTING AGREEMENTS

Bidders may seek commitments to vote in favor of the transaction proposal from shareholders who own significant stakes in the target bank, despite any change in the board's recommendation. Such agreements also can contain provisions that require such stockholders to vote against any alternative acquisition proposals and may even require that an irrevocable proxy be granted to the bidder to vote the shareholders shares (although such proxies can raise concerns that the bidder may obtain premature control of the target bank).

FIDUCIARY OUTS & BREAK-UP FEES

Once the bank is in play, the board's fiduciary duty becomes an obligation to the shareholders to obtain the best price from the sale transaction. The appropriately named "fiduciary out" is an exception to the "no-shop" provision or other deal protection measures that allows the target bank's board of directors to fulfill their fiduciary duty to their shareholders and pursue a superior transaction proposal even after the purchase agreement has been signed up. Break-up fees typically are coupled with such provisions in order to reimburse the buyer for its expenses related to the cost of preparing and making the offer if another bidder steals the deal. Break-up fees cannot be so large that they have a chilling effect on other bidders attempting to purchase the target bank. It is common for such fees to average between 2% and 3% of the proposed purchase price, and courts have generally upheld break-up fees at that level.

PREPARING THE DEAL

THREE DEAL PRECURSORS

Engagement Letter

Sellers and buyers frequently engage investment bankers (I-Bankers) to assist in development of potential deals and the negotiation of a transaction. An engagement letter sets forth the terms of the investment bank's engagement. Engagement letters have many standardized terms, but key provisions typically are subject to negotiation, including:

- **Fees.** The primary source of compensation, a success fee, usually is tied to the transaction purchase price and may be a fixed percentage or tiered with different percentages based on price thresholds.
- **Tail on Termination.** Most engagement letters include a tail that requires payment of a fee if a transaction is consummated within a certain time frame, usually one year or less.
- **Other Key Provisions.** Key definitions include the consideration (usually broadly defined to include cash, stock, notes, assumed debt and other compensation) and the types of transactions covered (also usually broadly defined).

Nondisclosure Agreement (NDA)

One key point of tension in obtaining an NDA from a potential bidder is whether the name of the target will be disclosed before or after the NDA is signed. Generalized descriptions are typically used to describe the seller, but bidders should be cautious about signing an NDA when the target potentially could be in the same market.

It is common for bidders to sign NDAs without giving serious consideration to its terms. Bidders should be cautious when entering into NDAs because the NDA typically becomes the property of the bidder who ultimately acquires the target, which means it may be enforceable against your institution by your competition.

SELLER'S VIEW

Sellers typically solicit offers from numerous potential bidders, and NDA is the price of entry for a would-be bidder to have a chance to submit a proposal. Provisions protecting confidential information assure the target bank's board that the information necessary to prepare a proposal will not be used to compete.

BUYER'S VIEW

Common NDA provisions, such as covenants to not solicit customers or employees, can be challenging for in-market bidders, which often have the ability to submit the strongest proposals. Similarly, for large institutions, such covenants may present challenging implementation issues, particularly where the number of employees aware of the potential deal is small.

Confidential Information Memorandum (CIM)

The CIM will be accompanied by bid instructions that may set forth the seller's desired transaction structure and instruct bidders as to the required timing for submissions.

LETTER OF INTENT

The purposes of letters of intent are three-fold: to express suitors' interest in the target; to outline the non-binding deal terms of a suitor's bid; and to establish binding terms to enable the exchange of additional information. An LOI fleshes out the parties' expectations and helps bring to the surface early on any major points of contention.

Non-Binding Terms

The LOI will provide that most terms of the transaction are non-binding and subject to execution of a definitive agreement. Non-binding terms outlined in an LOI often include:

Transaction Structure

Depending on the financial condition and ownership structure of the target, a transaction may be structured as a stock sale, merger or purchase and assumption.

Purchase Price or Exchange Ratio

The purchase price or exchange ratio of a financial institution is typically tied to its equity capital, subject to negotiated adjustments (e.g., exclusion of intangibles and unrealized gain or loss on securities). The buyer will establish a minimum equity capital to be delivered at closing, as well as a minimum allowance for loan and lease losses.

Other Non-Binding Terms

The LOI also may address in broad terms:

- Employment, consulting and non-compete agreements
- Representation, warranties, closing conditions and indemnities
- Essential contracts (data processing) and allocation of termination costs

SELLER'S VIEW

Sellers may seek to bypass the LOI process entirely and proceed directly to the negotiation of a definitive agreement. By avoiding an LOI's typical exclusivity provisions, the sellers maintain greater leverage in the negotiation by leaving the door open for another bidder to present an offer.

BUYER'S VIEW

An LOI provides the buyer with confidence that the material terms of the transaction have been agreed to and that the time and expense of conducting due diligence and preparing a definitive agreement will not be wasted due to the seller's simultaneous negotiation with a competitor.

Binding Terms

The LOI also will include certain binding terms that will enable the transaction process to move forward. These may include:

Exclusivity

A buyer typically will seek a period during which it will have the exclusive right to evaluate a transaction and propose the terms of a definitive agreement. This is referred to as a "no shop" provision. Sellers usually resist a no shop provision to maximize the speed of the deal and to keep the door open for better offers.

Due Diligence

The terms pursuant to which due diligence may be completed typically are laid out in the LOI. Deadlines for accomplishment of certain milestones may be included.

Other Binding LOI Provisions May Include:

- Public Announcements
- Expenses
- Confidentiality

DUE DILIGENCE

The due diligence process is the means by which the buyer comes to better understand the potential risks and rewards associated with the target's business and prospects. The most important assessment will involve the target loan portfolio, of which the buyer and its advisors must develop an independent assessment.

The due diligence process typically involves the following steps:

- Buyer will submit a due diligence request list and send an initial request for information
- Materials will be provided for review or uploaded to a secure data room
- Diligence team members review and prepare reports based on subject-matter expertise
- Findings are communicated to key decision makers

The depth and duration of the due diligence review will vary depending on:

- Whether the target is subject to regulatory enforcement action or litigation
- The quality of loan files and documentation
- The structure of the proposed transaction (Assets v. Stock/Merger)

Benefits of undertaking a thorough due diligence process include:

- The ability to uncover potential deal-killers early in the process before significant expense is incurred
- The ability to assess the quality of a loan portfolio and other assets
- The ability to determine necessary consents in order to consummate the deal (e.g., landlords, shareholders)
- An assessment of the target's corporate culture and internal controls

The Due Diligence team should include:

- Accountants and tax advisors
- Legal advisors
- Consultants as needed (e.g., environmental, surveys)
- Internal due diligence team member

The results of due diligence provide the basis for developing and assessing many elements of the Definitive Agreement, including:

- Representations and warranties
- Survival periods
- Knowledge and materiality qualifiers
- Carve outs
- Disclosure schedules
- Indemnification
- Escrow holdback amount
- Covenants
- Closing conditions

SAMPLE DUE DILIGENCE CHECKLIST

The following is a preliminary list of documents and information to be reviewed by Buyer in connection with its due diligence investigation of Target Bank Holding Company (the "Company") and Target Bank (the "Bank"). [Note: If the transaction is limited to the purchase of assets and assumption of liabilities of the Bank, certain of the Company documents may not need to be reviewed, although it is usually advisable to do so.]

1. Corporate Matters – Company and Bank

- ☐ 1.1 Currently effective Articles of Incorporation, as amended to date.
- ☐ 1.2 Currently effective Bylaws, as amended to date, certified by the Secretary.
- ☐ 1.3 For the past three years, the minutes of all meetings of the board of directors and any committees thereof.
- ☐ 1.4 For the past three years, the minutes of all meetings of shareholders.
- ☐ 1.5 Any proxy statements for annual meeting of shareholders and all annual and quarterly reports to shareholders distributed for the past three years.
- ☐ 1.6 List of all equity investments held by the Company or the Bank, including percentage and nature of interest.
- ☐ 1.7 List of all states where the Company or the Bank own or lease property or maintain an office, indicating in which states they are qualified to do business.
- ☐ 1.8 The Company's and the Bank's annual reports to shareholders, including financial statements (audited if available), for each of the three most recent fiscal years.

2. Securities Matters

- ☐ 2.1 Copies of all prospectuses, private placement memoranda, offering circulars or other offering documents used by the Company or the Bank in connection with any sale of stock or indebtedness during the past five years.
- ☐ 2.2 Evidence of qualification or exemption of all such sales by the Company and the Bank under the Securities Act of 1933 and applicable state blue sky laws during the past five years.
- ☐ 2.3 Copies of any officer/director questionnaires used in preparation of proxy statements for the past three years.
- ☐ 2.4 List of all shareholders of the Company and the Bank, including mailing addresses and class and number of shares owned.
- ☐ 2.5 Any buy-sell or stock restriction agreements among the shareholders of the Company or the Bank.
- ☐ 2.6 Any voting trust relating to stock of the Company or the Bank.
- ☐ 2.7 Any agreements pursuant to which the Company or the Bank has granted registration rights, redemption rights, preemptive rights or rights of first refusal with respect to their securities.
- ☐ 2.8 List of outstanding options, warrants or convertible securities entitling the holder thereof to acquire (whether or not subject to conditions) shares of capital stock of the Company or the Bank.

3. Banking and Bank Regulatory Matters

- [ ] 3.1 Copies of all (state and federal) examination reports of the Bank during the past five years, and the Bank's responses thereto.
- [ ] 3.2 Copies of all Reports of Inspection of the Company by the Federal Reserve System during the past five years, and the Company's responses thereto.
- [ ] 3.3 The most current CRA compliance reports of the Bank.
- [ ] 3.4 The Bank's most recent Call Report and general ledger.
- [ ] 3.5 Copies of any cease and desist or other regulatory order, memorandum of understanding, written agreement, capital forbearance plan or other similar agreement with a bank regulatory agency or any resolution by the board of directors of the Company or the Bank in lieu of the foregoing which was in effect during the past five years.

4. Litigation and Audits - Company and Bank

- [ ] 4.1 All letters which have been sent to auditors in connection with the audit of the Company and the Bank for the current and past two fiscal years, including "litigation letters."
- [ ] 4.2 All auditor's letters to management regarding internal accounting controls and management's response thereto for the last three years.
- [ ] 4.3 Description of any material litigation to which the Company or the Bank is a party or in which they may become involved, whether as plaintiff or defendant. Include all pleadings, counterclaims and claims against surety, bonding or insurance companies.
- [ ] 4.4 All active litigation files of the Company and the Bank, including letters asserting claims, complaints, answers, etc. Include all audit inquiry response letters from attorneys during the past three years.
- [ ] 4.5 All litigation settlement documents to which the Company or the Bank is subject.
- [ ] 4.6 All decrees, orders or judgment of courts or governmental agencies to which the Company or the Bank is subject.
- [ ] 4.7 Advise as to date through which all federal income tax returns of the Company and the Bank have been audited by IRS, State or other taxing authority and settled.
- [ ] 4.8 Status of any pending IRS or state tax examination, outstanding deficiency or refund pending or existing material dispute as to taxes with respect to the Company or the Bank.
- [ ] 4.9 Any change in the method of accounting or accounting practices of the Company or the Bank during the past five years, and any deviation from generally accepted accounting principles.
- [ ] 4.10 Any claim for indemnity or basis for such claim during the past five years, by any person or party against the Company or the Bank and any present contract, agreement or obligation of the Company or the Bank to provide such indemnity.

5. Employee Benefit Plans and Employees - Company and Bank

- ☐ 5.1 Pension Benefit Guaranty Corporation approval of termination of any defined benefit plan.
- ☐ 5.2 Pension Benefit Guaranty Corporation approval of any termination distribution from a defined benefit plan.
- ☐ 5.3 IRS approval of termination of any defined benefit plan.
- ☐ 5.4 IRS qualification letter for each qualified employee benefit plan, including but not limited to any employee stock ownership plan (ESOP) and/or 401k plan; and copies of the complete plan document (not the summary plan description).
- ☐ 5.5 All consulting, employment, union, collective bargaining and noncompete agreements with any current or former independent contractor, officer, director or employee.
- ☐ 5.6 Description of any labor or employment problems or union activity.
- ☐ 5.7 A list of all officers and directors, together with information for each such person regarding all offices and positions held, principal occupation or employment during the past five years and other material business experience.
- ☐ 5.8 Schedule of compensation for the past and current fiscal years for the all officers, employees and consultants, including all forms of cash compensation, salaries, commissions, bonuses, deferred compensation and other fringe benefits.
- ☐ 5.9 Schedule of compensation of directors and list of any other directorships held by each director.
- ☐ 5.10 Advise whether there are any promises or commitments to increase salary or other compensation of employees.
- ☐ 5.11 Copies of all contracts, agreements or documents relating to any transactions or proposed transactions with the directors, officers or shareholders of the Company or the Bank, or the immediate family of any of the foregoing, or disputes with any such persons.
- ☐ 5.12 Schedule showing family relationships among officers and directors.
- ☐ 5.13 Copies of, and documents relating to, all employee bonus, incentive, deferred compensation, stock purchase, stock appreciation right, phantom stock, stock option, severance pay, pension, profit sharing, stock bonus, thrift, savings and other employee benefit plans, agreements or arrangements.
- ☐ 5.14 Copies of all personnel policies (including hiring, vacation, sick leave, training, time off, etc.) and accrued or accumulated hours in each category by employee.
- ☐ 5.15 Employee manual or handbook.
- ☐ 5.16 List all employees during the past five years who have been disciplined, promoted, demoted or transferred; list all employees currently on leave of absence.
- ☐ 5.17 Copies of all change in control, "parachute," deferred compensation and "stay put" bonus agreements or any other agreement or understanding that obligates the Company or the Bank to pay any employee or consultant in the event of the sale, change in control or merger of the Company or the Bank.
- ☐ 5.18 Evidence of Company's S corporation election and Bank's election to be treated as a qualified subchapter S subsidiary, together with all related correspondence with IRS.

6. Material Leases and Contracts - Company and Bank

Copies of all material written contracts and agreements (and a list of all material oral contracts and agreements) to which the Company or the Bank is a party or is subject or by which their respective assets or property may be bound, including, but not limited to:

- ☐ 6.1 All borrowing and line of credit agreements, notes, bonds, loan agreements, security agreements, indentures, letter of credit or indemnity agreements, mortgages, guaranties, trust preferred securities and similar instruments relating to borrowings by the Company or the Bank or to which either of them is a party or is bound or to which any of their properties are subject.

- ☐ 6.2 Executory contracts for the purchase, sale or lease of goods, materials, equipment, supplies, capital assets or properties involving more than $10,000 or binding for more than six months which may not be cancelled without penalty or liability on or before the expiration of 30 days, or made otherwise than in the ordinary course of business.

- ☐ 6.3 All data processing and software agreements.

- ☐ 6.4 Property, liability, officer and director, key man and all other insurance agreements, including self-insurance and bank owned life insurance (BOLI), and advise whether there are any pending claims thereunder; advise whether all such policies are in full force and effect with all premiums billed thereon paid, and whether the Company or the Bank has failed to give any notice or present any claim under any insurance policy in a due and timely manner.

- ☐ 6.5 License agreements, royalty agreements, development agreements, research agreements, joint venture and general or limited partnership agreements.

- ☐ 6.6 Schedule of amounts, rates and maturities of any brokered or out-of-market area deposits, and forms of documentation related thereto.

- ☐ 6.7 Description of operations in derivatives, futures markets and hedging activities, including interest rate and currency swaps, caps, collars, etc., listing particulars of all such transactions, including counterparties and estimated exposure.

- ☐ 6.8 Schedule of funds invested in repurchase agreements and reverse repurchase agreements during the past year and copies of repo and reverse repo agreements pertinent thereto.

- ☐ 6.9 All letters of intent and agreements, including confidentiality agreements, to which the Company or the Bank is a party concerning any material acquisition, disposition, reorganization, purchase of assets, etc. during the past five years, or with respect to any such proposed transactions.

- ☐ 6.10 All documents relating to the pooling or securitization of mortgage loans and sale in the secondary market.

- ☐ 6.11 All material mortgage loan servicing agreement and documents pertaining to the purchase and/or sale of servicing rights.

- ☐ 6.12 All documents relating to the Bank's correspondent relationships with other financial institutions.

- ☐ 6.13 Any contracts receivable on real estate.

- ☐ 6.14 Any shareholders rights agreement, "poison pill" agreement or other anti-takeover agreement or board resolution.

- ☐ 6.15 Every other contract not made in the ordinary course of business to which the Company or the Bank is a party or by which it is bound which is material to it and is to be performed in whole or in part in the future or which was entered into during the past three years.

- ☐ 6.16 Every contract, agreement or lease (whether of real or personal property) to which the Company or the Bank is a party which requires the consent of a third party in the event of a sale, change in control or merger of the Company or the Bank or their assets.

- ☐ 6.17 Identify any property on the Bank premises not owned by the Bank and the owner of such property.

- ☐ 6.18 All agreements relating to purchased loan participations and sold loan participations.

7. Environmental Matters - Company and Bank

- ☐ 7.1 Describe the storage and disposal of all hazardous waste or substances, if any, and the names of any party with which the Company or the Bank contract for these purposes.

- ☐ 7.2 List any properties currently or previously owned, leased or otherwise used by the Company or the Bank, including OREO, with environmental problems, toxic substances, asbestos, underground storage tanks, etc.

- ☐ 7.3 Supply copies of any Phase I environmental property assessments or other environmental assessments, relating to the foregoing properties.

- ☐ 7.4 All correspondence to or from any environmental regulatory agency or any insurance carrier relating to environmental matters.

8. Real Estate

- ☐ 8.1 Abstract of Title brought current or recent title insurance policy on any real estate owned by the Bank, including OREO.

- ☐ 8.2 Survey on any real estate owned by the Bank, including OREO.

- ☐ 8.3 Copies of all leases or subleases of real estate to which the Bank is either lessee or lessor, or otherwise occupies or uses, including those relating to OREO.

Note: Whenever OREO is referred to in this Due Diligence Document List, it includes properties under foreclosure.

THE DEFINITIVE AGREEMENT

REPRESENTATIONS AND WARRANTIES

Representations and warranties are given by one of the parties to a transaction to induce the other party to enter into an agreement. They are statements of fact made as of a particular moment in time, and they help give the buyer confidence it has a clear understanding of what it is purchasing.

The package of representations and warranties in any transaction are heavily negotiated. The buyer may ask the seller to stand behind the representations made in the definitive agreement by allowing the representations to survive closing for a period of time and by providing either personal indemnification or an escrow holdback.

A party's representations and warranties may be qualified by:

Knowledge Qualifers. A knowledge qualifier limits the universe of persons who could be aware of breaches. A knowledge qualifier can be based on the actual knowledge of a person or the knowledge a person would have after reasonable inquiry. A knowledge qualifier typically specifies whose knowledge serves as the baseline (e.g. directors, officers or key shareholders).

Materiality Qualifers. Qualifications that indicate a representation is true "in all material respects" or similar language serves to exclude potential breaches due to unimportant inaccuracies. Materiality qualifications give the seller comfort that the buyer will not be able to terminate the agreement and walk away from the deal for an immaterial breach.

A "Material Adverse Effect" Standard. Representations can be further limited by restricting the representation to those facts and circumstances that would give rise to a "Material Adverse Effect." This term is often broadly defined to encompass changes that would be "material and adverse to the business, assets or deposit liabilities, properties, operations, results of operations, condition (financial or otherwise) or prospects of the seller, taken as a whole." Sellers typically seek to carve out economic and geopolitical factors that are beyond their control.

Disclosure Schedules. Many of the representations and warranties that the sellers are asked to give would not be true or correct as formulated. To correct such statements, the buyer requests the seller to provide disclosures that list the exceptions to each representation or warranty. Schedules typically are used to disclose and document information that is too lengthy to address in the contract itself. Once an item is disclosed on a disclosure schedule, the risk related to the disclosure shifts to the buyer unless the buyer demands a provision to address that risk.

Common representations and warranties include:

- **Loans** – Represents that all of the loan documents contain genuine signatures, all security interests are properly perfected and all agreements are enforceable. However, no representation as to the collectability of any loan is given absent extraordinary circumstances.
- **Financial Statements** – Represents that all audited financial statements and interim financial statements are true, complete and correct and prepared in accordance with generally accepted accounting principles.
- **Compliance with Laws** – Represents that the seller has operated and continues to operate the bank in compliance with all laws. Separate legal compliance representations for labor laws, laws applicable to benefit plans and environmental laws are common given the heightened exposure noncompliance may pose.
- **Title to Assets/Shares** – Represents that the sellers have good and marketable title to all assets or shares (depending on how the transaction is structured

INDEMNIFICATION & ESCROW

Buyers often seek post-closing protection from the sellers in the form an agreement to indemnify and hold the buyer harmless from losses that result from breaches of warranties, covenants or other provisions contained in the agreement. If the transaction is structured as a purchase & assumption, indemnities against excluded liabilities also are common.

An indemnity is like an insurance policy. It is invoked by the indemnified party to be made whole for any damages incurred due to facts or circumstances that existed before closing and that are covered by a representation, warranty or covenant.

SELLER'S VIEW

The seller operates on the principle of caveat emptor and seeks to place as much of the post-closing risk on the buyer. When the seller ceases to own the bank, it no longer has the benefits of ownership and should no longer bear the risks of ownership.

BUYER'S VIEW

Indemnification is predicated on facts that arose prior to closing, so the seller already has the risk of loss and would suffer the loss if they did not sell their bank. Indemnification gives the buyer comfort that the seller is willing to stand behind its representations and warranties.

The key components of the indemnification provisions are:

Indemnity Scope: Indemnification typically covers representations, warranties and covenants. To the extent that a disclosure contained in a disclosure statement includes an unacceptable carve out, a buyer may require a specific indemnity.

Source of Funds:

Personal Liability: In a closely held corporation, individual shareholders may be liable for any indemnification obligations. Liability may be joint and several among the shareholders or pro rata in accordance with their percentage ownership.

Escrow: A portion of the purchase price may be held back as a source of funds for indemnification.

Survival: The survival period for the representations, warranties and covenants after closing that are subject to indemnification may vary from as short as a few months to as long as the applicable statute of limitation. Survival periods for essential warranties (title, authority) and warranties that have potentially high exposure (taxes, benefit plans, environmental) may survive for a longer period than others.

Cap: The maximum amount of the purchase price subject to indemnification.

Basket/Deductible: The minimum aggregate amount of damages that must occur before a claim for indemnification can be made. A basket may "tip" so that once damages of the minimum amount have been incurred, all amounts including the basket amount may be recovered. A true deductible represents the amount the buyer must absorb before a claim can be made.

Process: The procedures to be followed for making an indemnification claim should be clearly defined. Prompt notice should be required, and the parties that have power to make decisions on behalf of the buyer or seller should be defined. The indemnified party usually can participate in the defense of any claim at its own expense.

TRANSACTION STRUCTURE & TAXES

The structure of a transaction and the consideration paid to the sellers has major effects on a deal, including:

- The potential future exposure to unknown or contingent liabilities
- The rate, nature and character of taxes incurred by sellers and the tax attributes of the assets acquired by buyers
- The overall return on the deal to sellers and the overall potential profitability of the transaction for the buyer
- The liquidity of the consideration received by sellers and the types of consideration that can be used by the buyer (stock, cash, notes)

Deal structure and tax consequences should be evaluated early in the transaction process. The transaction structure may impact significantly the economics of a potential sale due to the tax consequences to the seller and buyer.

Unknown or contingent liabilities

Unknown or contingent liabilities are those liabilities that currently exist but about which neither party has knowledge. Examples include: an ongoing fraud by one of the seller's employees; a check kite in process; or an undetected data breach. Such unknown liabilities present significant potential exposure to a buyer.

Unknown and contingent liabilities automatically become the buyer's risk upon the closing of a stock purchase or merger. Damages for such liabilities will be borne by the buyer unless it discovers the unknown liability prior to the expiration of any applicable period in which claims for indemnity must be made.

However, a buyer can exclude unknown and contingent liabilities by structuring a transaction as a purchase and assumption, in which case the buyer agrees to assume only deposit liabilities and other specified liabilities (such as lease agreements). Any unknown or contingent liability contractually remains with the sellers because it is not transferred to or assumed by the buyer.

Tax Effects

The tax consequences of a transaction are determined by the transaction structure and the tax attributes of the selling bank. The key factors are:

- Whether the target bank and bank holding company are classified as a subchapter C or subchapter S corporation taxpayers
- Whether the transaction is a purchase and assumption or a merger/sale of stock

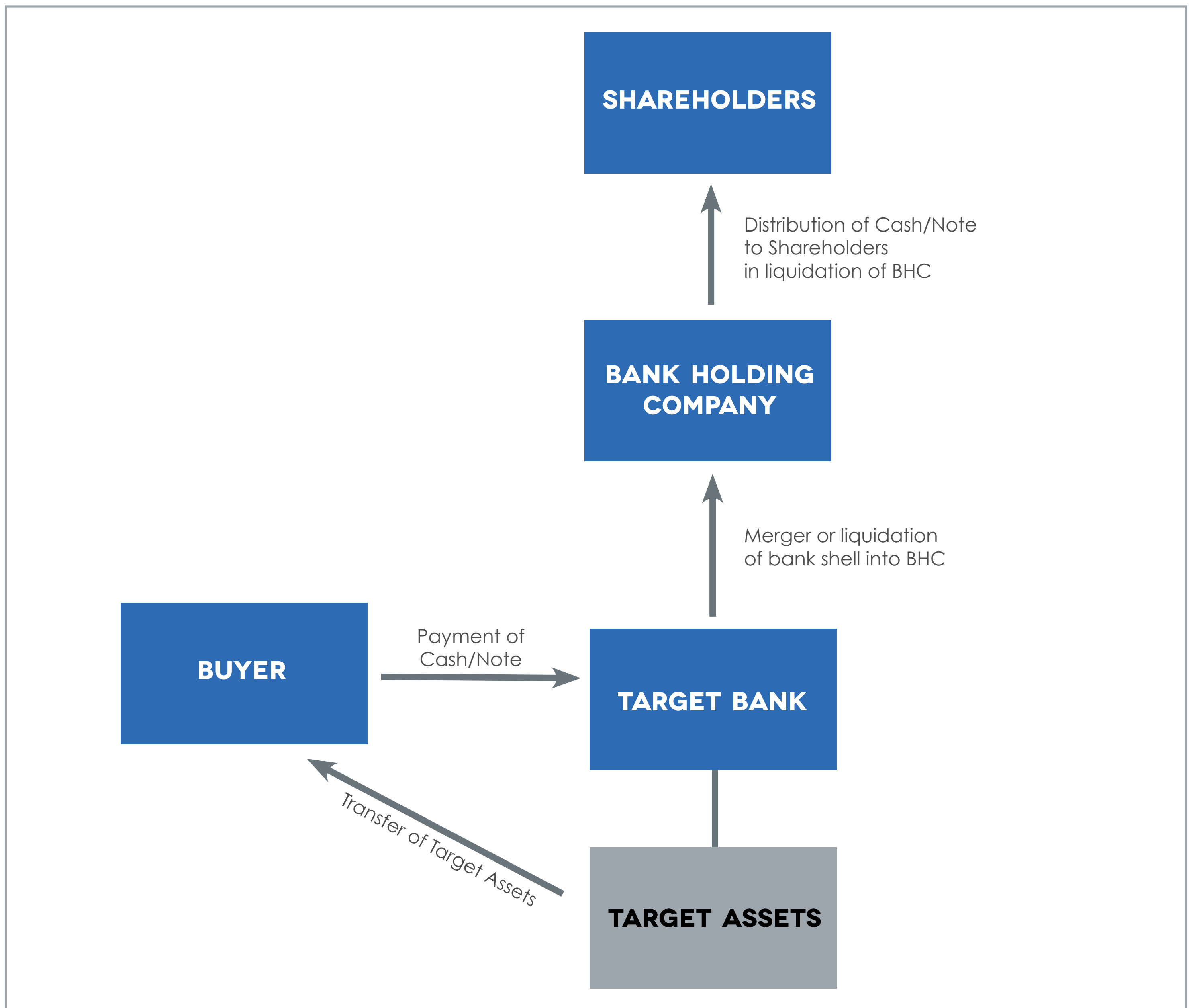
A related consideration in evaluating a transaction structure and its tax effects is the nature of consideration that the buyer wishes to use to pay for the acquisition (cash, stock or a mix of both). The following diagrams outline some common corporate merger and acquisition structures and their tax consequences.

Step 1: Acquisition of assets in exchange for cash/note

- Target recognizes gain subject to tax
- Buyer receives stepped-up basis
- Assumption of liabilities treated like cash

Step 2: Distribution of cash/note to shareholders

- Merger or liquidation of bank shell into BHC
- Taxable gain or dividend income to BHC shareholders
- Capital gain if liquidation or partial liquidation, dividend otherwise
- Potential installment sale treatment on note distribution

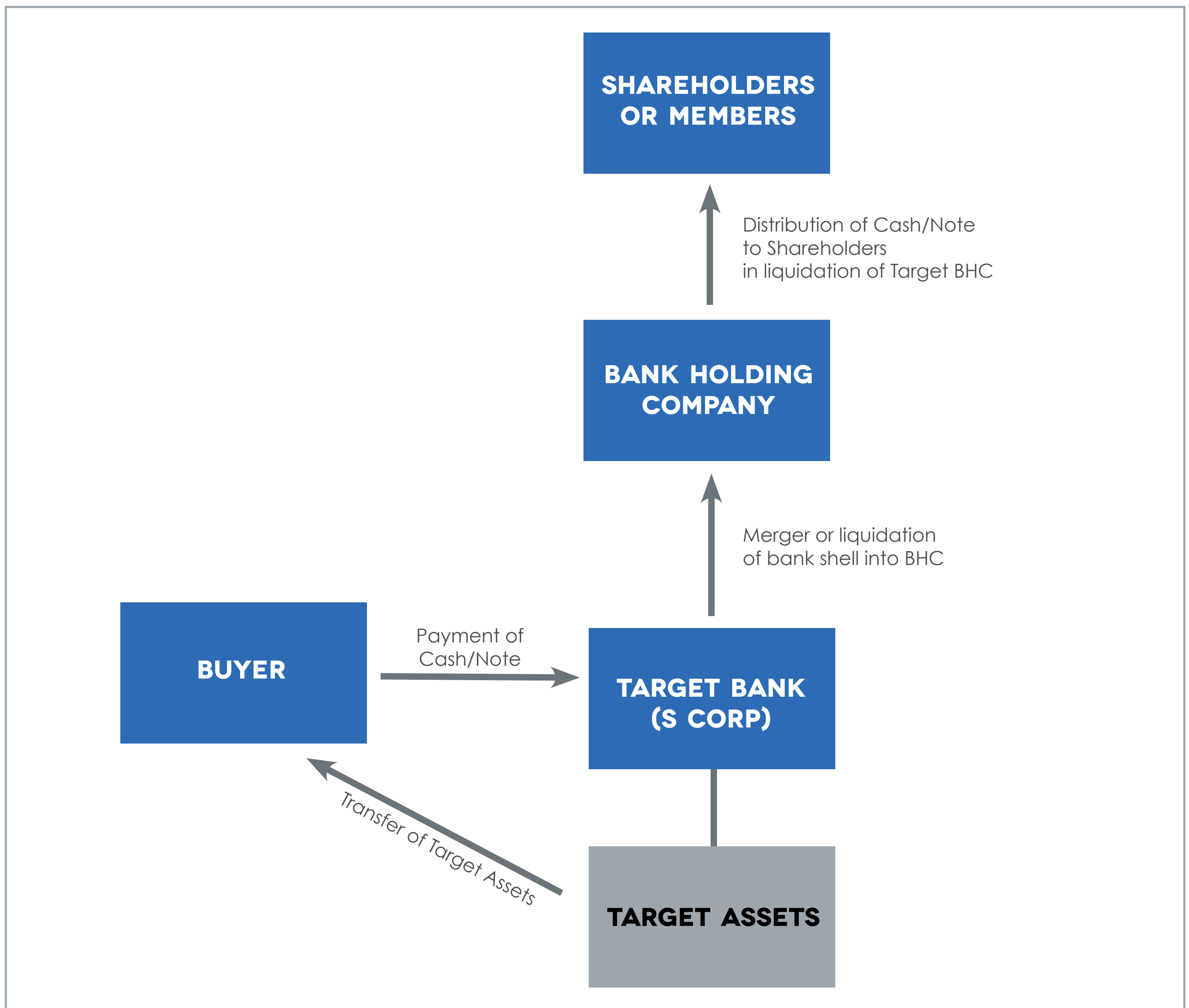


Step 1: Acquisition of assets in exchange for cash/note

- Gain from sale of assets is passed through to Target BHC shareholders/members
- Target owners received stepped-up basis in their BHC shares
- Buyer receives stepped-up basis in Target Assets
- Assumption of liabilities treated like cash
- Target tax attributes do not carry over to Buyer (e.g. NOLs, basis in assets, employment plans)

Step 2: Distribution of cash/note to shareholders

- Merger or liquidation of Bank Shell into BHC
- No gain unless amount distributed exceeds basis
- Potential installment sale treatment for notes

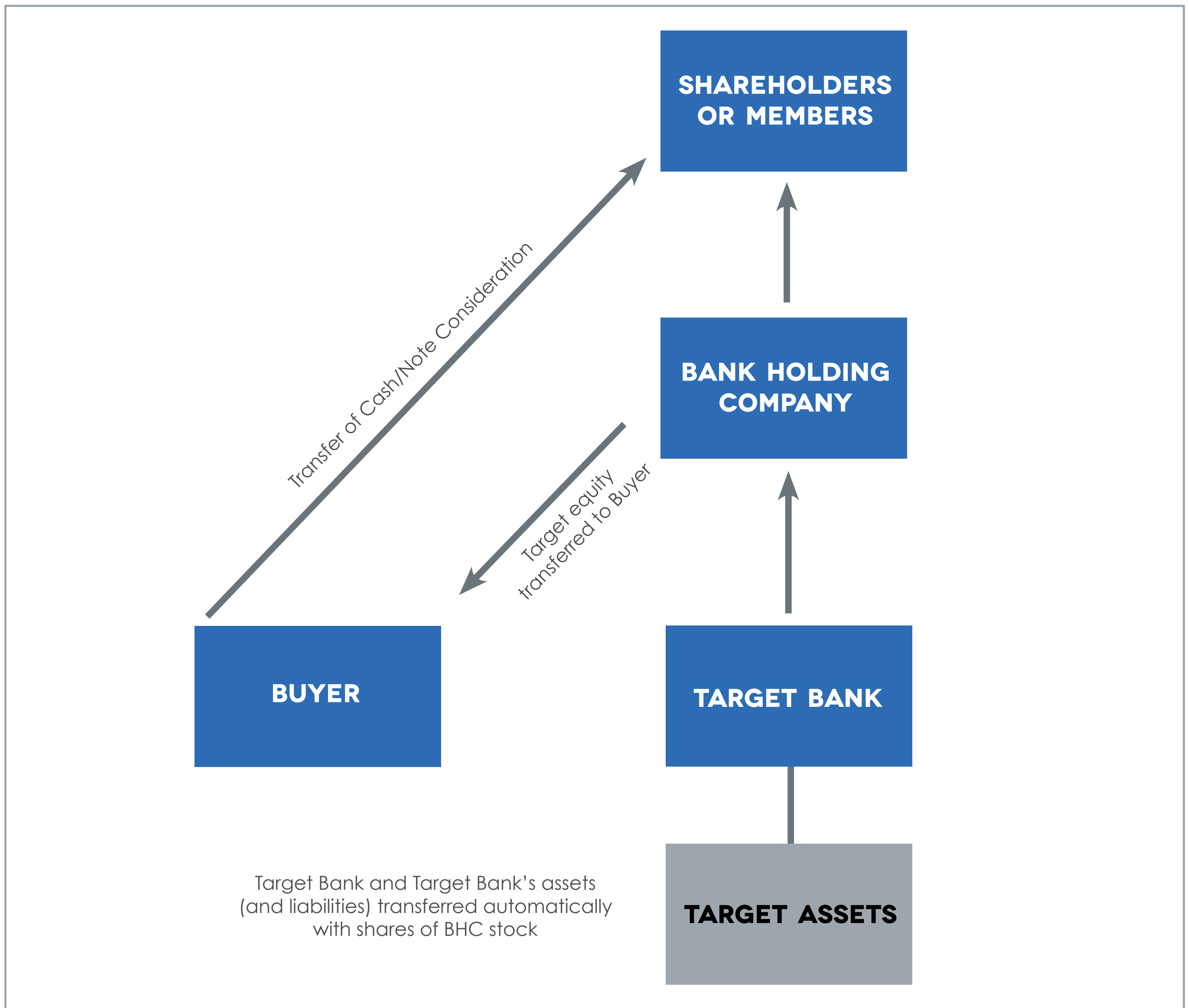


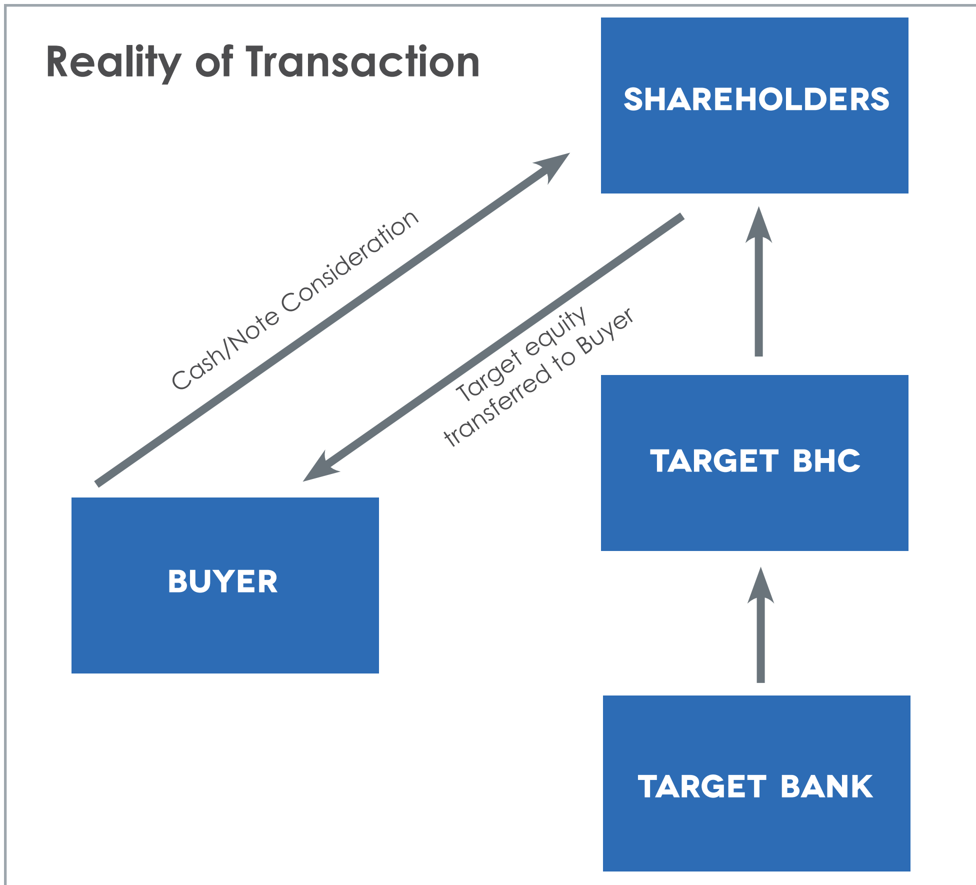
Overview of Tax Consequences

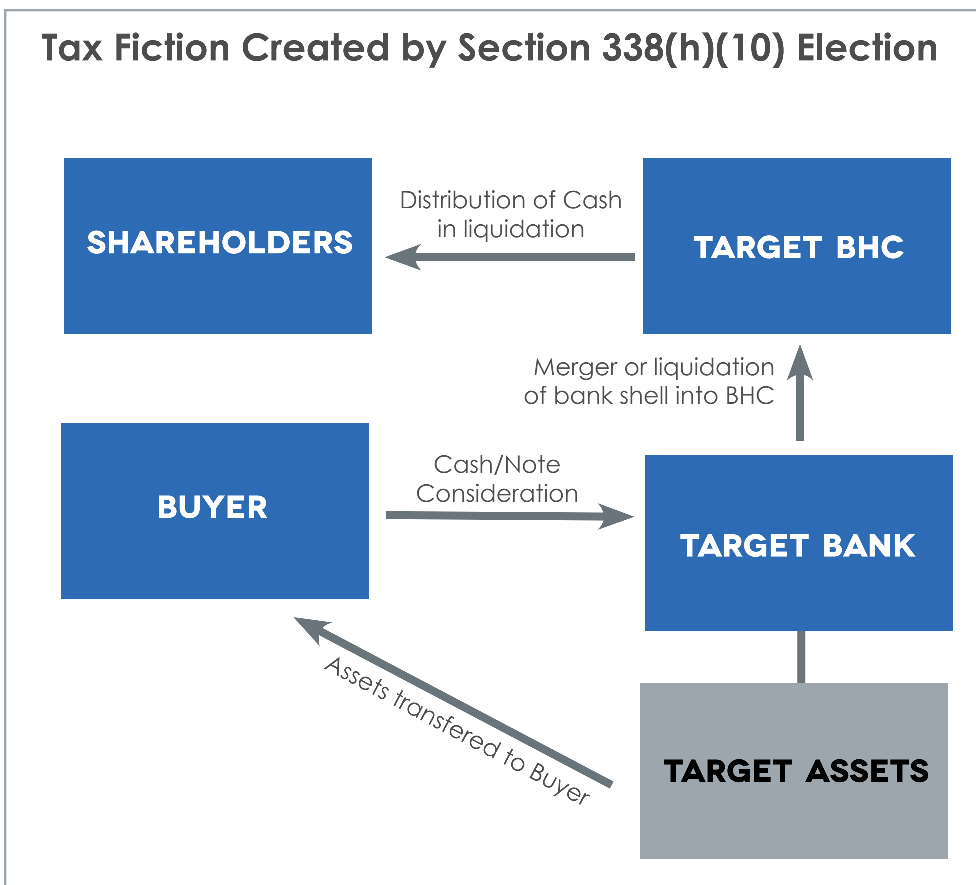
- Target shareholders recognize capital gain subject to tax
- Buyer retains historic basis in Target assets

Other Considerations

- Merger of Target Bank into Buyer's subsidiary Bank immediately following the closing is common
- No step up in basis of Target assets
- Buyer inherits unknown/contingent liabilities of Target Bank & Target BHC







Section 338(h)(10)

A direct stock purchase with a Section 338(h)(10) election is treated as an asset sale for tax purposes

Buyer must (i) be a corporation and (ii) purchase 80% of more of Target BHC stock

Buyer gets stepped-up basis in Target Bank's assets but succeeds to unknown/contingent liabilities.

Purchase of bank stock owned by S Corp. Bank Holding Company results in same tax treatment as 338(h)(10) election

Generally Applicable Requirements for Tax-Free Reorganizations

CONTINUITY OF PROPRIETARY INTEREST

- Requires the shareholders of Target BHC to receive a substantial equity interest in the surviving company

CONTINUITY OF BUSINESS ENTERPRISE

- Buyer must continue significant portion of Target's historic business or
- Buyer must use a significant portion of Target's historic assets

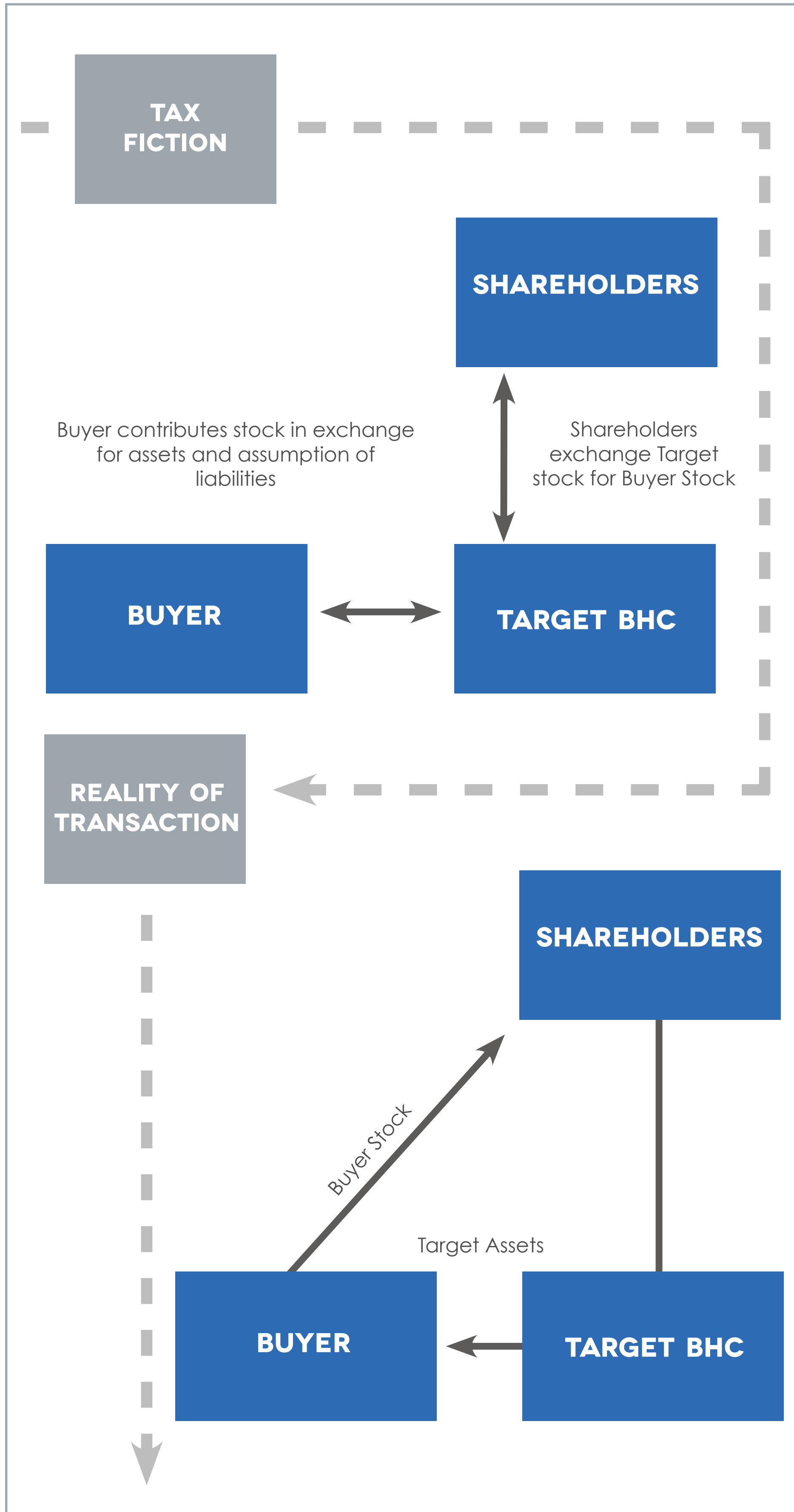
CONTROL

- In many cases, one corporation must be in control of another corporation. Control is defined differently for purposes of the corporate reorganization provisions of the Internal Revenue Code than under banking regulations

BUSINESS PURPOSE

- Tax-free reorganizations must have a bona fide business purpose (other than tax savings)

TAX-FREE REORGANIZATION - TYPE A



Section 368(a)(1)(A) "Statutory Merger"

- In a Type A reorganization, the Target BHC merges into the Buyer with the former Target BHC shareholders receiving the merger consideration in exchange for their Target BHC stock.

Requirements for Type A Reorganization

- Must occur by state law merger
- Consideration must be at least 40% of stock to satisfy IRS safe harbors.
- **Note:** A triangular merger in which a buyer creates an acquisition subsidiary also qualify as Type A Reorganizations.

Section 368(a)(1)(B) "Stock For Stock"

- In a Type B reorganization, the buyer acquires stock of the Target BHC directly from the Target shareholders solely in exchange for Buyer's voting stock.

Requirements for Type B Reorganization

- Exchange of Target stock solely for Buyer voting stock
- Immediately after the acquisition, Buyer must "control" Target (80% ownership)