Activist Investors and Community Banks

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It was not that long ago that the concern over preparing for, and dealing with, activist investors was rare in the banking industry, and especially rare for community banks. That comfort is quickly fading, however, as more funds and individuals contemplate opportunities for becoming "activist" investors in community banks through a variety of mechanisms, some for the better and some perhaps not so much. No institution is too big or too small to be safe from the potentially disruptive influence of activist investors, and while most community banks tend to know their shareholders it is nearly impossible for most to stop shares from winding up in potentially "unfriendly" hands.

Activist investors are more prevalent and visible in the corporate world today generally, harkening in some ways to the old days of corporate "raiders" in the late 1900's. Of course not all private investors are corporate gadflies or "activist" investors, and not all "activist" investors are simply focused on short-term profits or expensive and distracting proxy fights and board seats. Significant positions taken by investors with the intent of "helping" the organization realize enhanced returns through reduced expenses, spinoffs and other reorganizations, compensation reductions, or a plethora of other strategies including a forced sale of the organization, may or may not be consistent with the best long term interests of the organization and its other stakeholders. However, organizations that are not adequately prepared to position themselves to face and address such issues may well find themselves with a lack of alternatives and vulnerable to being forced into an unfortunate and undesired situation.

Actual "hostile takeovers" of banking institutions tend to be rare. A number of factors, including the regulatory hurdles and the impact of the business and community environment created by hostile acquisitions on employee and customer relations, tend to dampen the ardor of activists to engage in directly hostile activities. That doesn't mean, however, that activist investors will not want a say in the activities and decisions of the organization and likely seats on the board, or that the board won't receive "bear hug" communications. And

it is not to say that they won't engage in activities which can be disruptive and can have the same impact on the organizational team and customers as a directly hostile action.

Activist investors tend to be more directly board-focused than in the past, and include hedge funds as well as individuals and affiliated groups. Regardless of whether the bank is presently dealing with an activist investor, boards need to be prepared to put their institutions in the best possible position to enable the board to deal with issues consistent with the best interests of the institution and its constituencies before it becomes an issue. That includes building in appropriate protections from undesired intrusions into the responsibilities of the board to provide for the long term best interests of the institution. Not to inappropriately entrench management or the board, but rather to enable the board to fulfill their fiduciary obligations to the best of their abilities and to the fullest extent provided by law. Protections such as "poison pills," staggered board terms, supermajority voting requirements, board nomination protections, ESOPs and other protective measures have time and again been proven to be valuable tools to provide protection against actions that may enrich certain activist investors in the short term, but may not be in the long-term best interests of the institution and its other stakeholders. And such protections, when taken and implemented in an appropriate fashion and for appropriate reasons by boards, have been generally supported by the courts.

Many institutions are engaging in capital raise activities or contemplating same, particularly with implementation of the increased capital requirements of Basel III, thereby opening the door for expanding the shareholder base. Taking appropriate protective measures at the appropriate time and for the appropriate purposes (which is not in the middle of an unwanted overture and not for purposes of entrenchment) is critical. Appropriately documenting the process taken by the institution and the reasons for the actions by its board is also critical.

Who are some of the pivotal players and what are their roles in these matters?

The Board

It is the responsibility of the board of directors to implement appropriate governance measures to enable the board to exercise its responsibilities to the institution and its constituencies consistent with applicable law and regulation. Leaving the institution open to attack without adequate protections can be problematic for directors, and can lead to disastrous results. The "it can't happen here" approach is risky at best, and as activist investors become more "active" in the banking world it becomes even more so. No longer is it just the "big guys" who are subject to these issues. Boards should consider carefully how the institution is positioned to address an approach by an unwanted activist investor and how the board can best direct the institution and protect its constituencies consistent with its duties to those parties. An ongoing review of what types of protections are available and appropriate, and documentation of those considerations, reviewed with appropriate experts, is critical. Boards should work with a team of advisers in regard to positioning the institution to address strategic issues before them arise.

The Regulators

Banking regulators, including notably the Federal Reserve, will become quickly interested and involved in activist activities when dealing with potentially heightened "reputation risk" concerns, a perceived potentially adverse impact on the the safe and sound operation of the institution, or where there are

"control" issues under the Change in Bank Control Act and/or the Bank Holding Company Act. The Federal Reserve has a history of inserting itself in such situations when they become concerned, including restricting board seats and using tools such as passivity agreements to address control concerns. State bank control laws and relevant regulations may also come into play. Applicable law and regulation applies some strict numerical standards to "control" determinations based on holdings of voting shares, but also allows the agencies to determine that an individual or group in fact exercise de facto "control" over an institution in a variety of ways. Regulators are unlikely to be supportive of "hostile" takeovers in the industry for a variety of reasons, including the potential "reputation risk" issues that can and often do arise in that context and which can have an adverse business and financial impact on the institution.

Likewise, securities regulators can and do have an interest in such activities when they involve disclosures and filings that are required for certain levels of holdings for securities law purposes. As with banking regulators, they will become involved in the event that concerns arise with regard to holdings, disclosures, and activities of both the investor and the issuer that relate to activist activities.

The extensive complexity and oversight involved in bank supervision and regulation can have a positive impact by slowing the process and exposing what might otherwise be intentions of an activist investor. Control issues and determinations can be lengthy, detailed and costly for those endeavoring to exercise direct or indirect control over a financial institution, and can make activist investors think twice before undertaking a hostile approach.

Investment Bankers

Investment bankers can play a role in advising the board as to strategic financial alternatives available to the board, finding other, perhaps more friendly "white knight" investors, valuations, and a variety of other roles to assist the board in its fiduciary role. Investment bankers are some of the experts who boards can engage to assist them in their consideration of how best to address protecting the organization and its constituencies.

Legal Counsel

Likewise experienced legal counsel should be part of the "team" advising the board as to actions it may take in preparation for, or in response to, issues of activist investors. Working with the board and investment bankers, legal counsel too can provide advice to the board in addressing its obligations to the institution and its constituencies consistent with applicable law and regulation.

Issues and Protective Measures

A variety of protective measures can and should be considered by the board in positioning the board to best enable it to carry out its fiduciary obligations to the institution and its constituencies. Again, such things as "poison pills," "wild card" preferred stock, staggered board terms, elimination of cumulative voting, "supermajority" voting requirements, board and employee stock holdings through stock compensation plans and ESOPs, large board holdings, avoiding board vacancies, business restructurings through divestitures of branches and/or loans, increased dividends, and advance relations with potential "white knights" can and often are appropriate considerations for the board in ascertaining that it has the

tools to deal with an unwanted advance or undesired situation.

Advance planning is the key, as is reviewing and updating relevant corporate governance documents. Having a "team" composed of internal management and board members as well as outside advisors familiar with the institution and its management and board aware in advance and ready to these issues can save untold problems when and if the issues in fact arise.

Conclusions

Depending on their ultimate intentions, the actions of some types of activist investors can have a positive impact on institutions by providing needed capital and sometimes experienced professional board members. Sometimes it can be difficult, at best, to ascertain the intentions of the investor up front.

That being said, it remains the duty and obligation of the board to ascertain that it can and does act in the best long term interests of the institution and its constituencies. In order to do that, the board needs to review its options and be prepared in advance to address issues that may arise so that its flexibility to exercise its fiduciary obligations is not inappropriately undermined and its ability to do so ultimately usurped.