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Super de novo Banks – How to Put One together

This is Part II to the article "Creating Capital and Providing Liquidity for *De Novo* Banks – the *Super De Novo* Solution," first published here in January 2001. In Part I, we described the *de novo* community bank landscape and the challenges to the management and owners of such banks in dealing with the need for additional capital to support growth, as well as the need for aftermarket liquidity for their stockholders who have seen only a very limited trading market develop for their shares.

As Part I of this article described, the late 1980s and early 1990s witnessed a significant increase in the organization of *de novo* banks nationally. Their success was due in part to a strong U.S. economy and the consolidation of multi-billion dollar financial institutions, which alienated millions of bank customers. However, despite earlier successes, *de novo* banks currently face the important new challenge of raising additional capital and providing stockholder liquidity.

These newly formed banks now require more capital to support greater customer demands. Loan demand and asset growth is now outstripping the banks' ability to maintain required capital ratios.

To satisfy capital demands, new banks are typically forced to turn to their original investors for more capital; however, for many *de novos*, willing investors have all but disappeared.

Investors, by and large, are unwilling to currently invest in *de novos* due to a lack of shareholder liquidity, depressed bank stock valuations, and a limited return on their investments. Highlighting these problems are the facts that new banks, typically smaller and community-focused, do not have a large number of investors, or any institutional investors, which tends to preclude Wall Street research and analysis coverage and active aftermarket trading. Collectively, these problems have led to stockholder illiquidity. Also, *de novos* have been largely unsuccessful at meeting investor expectations for their sale or initial public offering within five to seven years after formation. In fact, *de novos* as a group have completed very few IPOs, paid virtually no dividends, and have remained independent, thus falling short of providing any investor "payday" to their owners.

In the past, community banks that have "tapped out" with their original investors have turned to third-party institutional investors for capital. However, in today's market professional investors are unwilling to come forward to acquire or invest in *de novos*. Furthermore, regulatory resistance to the deployment of certain types of capital limits the choices *de novos* have in meeting their increased need for capital. According to the *Bank and Thrift Merger Review,* the year 2001 may have the lowest number of bank merger transactions in a generation. Although the trust preferred security is stepping to the front, either in stand-alone issuances or community bank-pooled form, and providing a key capital augmentation service for community banks, it is not a panacea. There are many limitations on the use by *de novo* banks of trust preferred capital, either by the terms of the security itself or those imposed by investors willing to purchase the securities. Most importantly, it does nothing for stockholder liquidity.

In order for *de novos* to meet the ongoing challenges of augmenting necessary capital and providing their owners with investment liquidity, successful *de novos* should consider joining together into a *"Super De Novo."* This combination of newer community banks is the next logical step for institutions seeking to meet their business plans and their owners' needs. A *Super De Novo* can provide capital for current and future growth and for attracting new shareholders and provide liquidity and potential dividends to existing shareholders. It is a true partnership of new banks, as will be seen below. This partnership theme will be stressed throughout this article.

The ideal partnership candidate for a *Super De Novo* will be a community bank that will have approximately $150–300 million in assets, 150–250 shareholders and generate $2.3 million net income or a 1+ percent return on assets.

Super De Novo as a Partnership of Banks – The MOE Structure

The partnership structure of the *Super De Novo* will be accomplished through a traditional merger of equals ("MOE"). In a MOE, neither party receives a control premium for its shares. Instead, the control is shared among the merger partners, which in this case are two to four well-positioned, successful *de novo* banks. A MOE is by its very nature a partnership, which adopts the best aspects of all the constituent banks in order to accomplish a mutually enhancing combination.

The *Super De Novo* would have numerous advantages. Following its successful IPO, as a NASDAQ-listed stock, it will provide liquidity to aftermarket-starved investors and could be used to raise additional growth capital. Also, it would be able to realize operating efficiencies not achievable by its bank constituents alone, provide diversification of credit risks during economic downturns and be in a better position, because of its greater size, to draw in new capital on more affordable terms, such as the trust preferred securities mentioned above.

The IPO will require Wall Street sponsorship and is an involved, lengthy process. It will add the capital that the growing MOE partnership needs and provide the foundation for future capital growth.

In the long run, the *Super De Novo* will allow for further acquisitions of other small community banks and provide more attractive stock options and equity incentives through a "public stock currency," thus creating incentives for key employees to join and remain within the *Super De Novo* association. *De novo* bank managers currently face the dilemma of owning stock options that are exercisable for shares that cannot be sold as a practicable matter.

Once the MOE has been consummated, the goals of the *Super De Novo* will be to focus on earnings growth and franchise development with the intent to eventually sell the franchise within five to seven years. In order to sell the bank optionally within this time frame, the *Super De Novo* bank should plan on purchasing other *de novos* or community banks, each consisting of roughly $100 million in assets, in hopes of reaching $1 billion in total assets. This level of profitable growth should create an institution worthy of additional Wall Street research coverage, in turn improving the visibility of the bank and enhancing the likelihood of a successful ultimate sale.

Demonstrating the potential of a *Super De Novo,* a number of community banks have recently merged under the MOE structure. For example, in Alabama the South Alabama Bancorp and The Peoples BancTrust merger saw the successful combination of the ownership of 41 separate banks. In New York State, the NY Community Bancorp and Richmond County Financial organizations merged for an expected annual pretax savings of $17 million.

Engineering the *Super De Novo* Bank

To get the partnership up and running, the *Super De Novo* must be a balance of the interests, oftentimes competing, of the original bank investors, the CEOs of the *de novo*, and their boards of directors. The original investors desire a return on their investment – that's why they're in the deal! The Bank CEOs desire competitive compensation and reasonable job security – most of them have already lost a CEO position in a prior bank merger. The Bank board members want to ensure a continuing level of strategic control so that they can protect their respective investor groups. These concerns rise against a backdrop of conventional MOE issues, such as the all-important exchange ratio applied in the merger (how do we share the ownership pie?), the structure and social attributes of the new entity and compensation packages for the key officers. Resolving these issues in a salutary and timely manner is crucial to the launch success of the new bank holding company and future value of the MOE partnership.

Important Features and Steps

We will stipulate that the model *Super De Novo* is a new bank holding company formed by merging three successful *de novo* bank organizations, arranged under a stock-for-stock exchange and becoming a publicly traded entity on NASDAQ in the process. This may sound easy. However, the actual three-way merger could prove difficult to put together. Finding like-thinking partners could prove daunting. It will take a good deal of due diligence and partner-building to get a MOE launched.

In a MOE, unlike a typical acquisition, the transaction must be structured in such a way that no one shareholder or group has given up or obtained control of the entity, without an actual buyer or seller involved. Therefore, in the very preliminary stages, it is important to identify key leaders who have a common vision for the partnership. They will need to make – collaboratively – important decisions such as the exchange ratio on which to base the stock allocations in the *Super De Novo*. As noted, the resulting ownership can be viewed as the pie; which bank gets the biggest slice of the pie, and why, is the major challenge for the partners-to-be.

Retaining a Financial Advisor

In addition to their legal and accounting professionals, the decision makers need to get a financial advisor involved from the beginning. With its help, the sharing or exchange ratio can be set. The exchange ratio should be set to reflect more than just the relative book value of the *de novo* banks; it should also reflect comparisons of the overall asset levels and strengths, historical performance data and trends, earnings and capital contributions, market capitalization and local economic and demographic conditions and prospects. A key first step is the retention of a single, mutually agreed-upon independent advisor, one who is free of any conflict of interest. The advisor will decide on (and be prepared to defend) the exchange ratio. By using a totally independent advisor, the *de novo* owners will feel more comfortable in knowing that the banks were valued using a constant series of standards applied by an objective party, thereby achieving an unbiased assessment.

Choosing the Management Team

As with the exchange ratio, no single *de novo* bank should gain the upper hand in the management of the new entity. Instead, the partners-to-be will need to achieve a fair balance in all key management areas. Among the key positions of the *Super De Novo* are the holding company CEO ("CEO"), the *de novo* bank CEOs ("Bank CEOs"), the board of directors of the holding company ("Board"), the board of directors of the *de novo* banks themselves ("*de novo* board"), and the executive committee of the Board of the *Super De Novo* (the "EC"). As noted, the banks will remain separate entities with their boards essentially intact.

The CEO of the new holding company should be an experienced, big-picture strategist with skills and know-how in handling issues that would typically arise in a billion-dollar publicly held bank holding company, such as SEC issues, regulatory and accounting issues, managing shareholder expectations and working proactively with the individual Bank CEOs. However, it is not necessary that the CEO be a commercial banker; rather, the CEO must have experience in operating relatively large organizations and in strategic agenda setting because, in running the *Super De*

Novo, the CEO will be less concerned with everyday commercial banking tasks and more concerned with the overall business plan implementation.

As a practical matter, choosing one of the *de novo* banks' leaders as the new partnership's CEO may very well prove to be the undoing of the new partnership. *De novo* bank CEOs have been known to have large egos. By hiring an *independent* and experienced CEO, no one *de novo* or its CEO gains an advantage in overall management, and the *de novos,* as a whole, will have a much better opportunity to act together in accordance with the new corporate goals, thus creating and maintaining a successful partnership. This will also allow the Bank CEOs to concentrate on what they do best – running a successful, customer-focused organization and ridding themselves of those burdensome administrative duties that can be best handled on a consolidated basis at the holding company level.

In recruiting the CEO, the *Super De Novo* should offer the candidate a two-year employment contract, with a one-year severance provision. The CEO's compensation package should be tilted heavily towards the stock option component, with options that become less valuable after seven years (option price increases thereafter), unless there is a sale of the company. We suggest 3 percent or so of the outstanding share option for this key executive. This compensation package will induce the new leader to join the new holding company with the assurance of significant cash compensation, yet will also give the partnership the ability to bring in a new CEO promptly if unsatisfied with the organization's progress. Furthermore, by focusing on a sale by the end of the seventh year and by tying the CEO's total compensation to stock, and stock that is more valuable if a "big shareholder payday" occurs, the *Super De Novo* is more likely to accomplish its overall ownership goals and provide a substantial investor return.

On the other hand, the Bank CEOs have a slightly different perspective of the *Super De Novo* compared to the CEO. To be sure, in the new structure the Bank CEOs will continue to be concerned about their positions, job security and the level of their compensation and opportunity. The Bank CEOs will be losing a position of absolute (at least relatively speaking) control in exchange for a second-tier position. Bank CEOs will closely scrutinize the benefits of the *Super De Novo* in comparison to their current positions/prospects. Therefore, the merger must effectively address such issues and, in the end, induce the Bank CEOs to lead the way into the new partnership of banks.

In order to induce the Bank CEOs to support the organization of the *Super De Novo*, the Bank CEOs should be offered an initial three-year employment contract with termination only for cause, and a two-year golden parachute severance if the company is sold. With respect to salary, the Bank CEOs' salary should consist of their current base, plus the opportunity for a performance bonus, the bonus being tied initially to 60 percent based on their own *de novo* bank's goals, and 40 percent based on the *Super De Novo's* overall performance goals. This compensation package will offer the Bank CEOs reasonable security in the event the *Super De Novo* is sold, which is, of course, a major goal of the organization.

The Board of Directors

In order to ensure a smooth transition, the appearance and reality of balance between the merging entities is crucial to the success of the new organization. This is true not only for the CEO and Bank CEOs, but also the board of directors, executive committee and other "cultural" aspects of the merger.

In order to provide balance at the Board of Directors level and to give the governing body a broader perspective, the Board should be made up of 12 members comprising the three Bank CEOs, two directors from each *de novo* ("insiders"), the CEO and two other totally independent directors (*i.e.*, with no business ties to any constituent bank). The insider directors, who should be chosen from among the largest shareholders of the constituents and be mutually agreeable to all *de novos,* should rotate as Chairman of the Board every year. By allocating board positions evenly and rotating the chairmanship, all parties will have an equal opportunity to participate in the governance of the *Super De Novo.*

The Bank CEOs and the CEO of the holding company should sit on the Executive Committee. The chairman of the Executive Committee should be one of the Bank CEOs, with the position rotating every year. Some might argue that the CEO should hold this position; we think not. It will help the Bank CEOs get on board. This allocation and rotation will also give each *de novo* equal representation at the most focused level of the board, thus preserving the notions of fairness and balance. It will also require consensus building, as do most successful partnerships.

On the other hand, the *de novo* boards should remain unchanged in their size and composition, helping to ensure a level of continuity, experience and local presence at the *de novo* banks themselves. To encourage the overall goals of growth and profitability of the *Super De Novo* and its community banks, the Board's fees would be tied directly to deposit and loan growth of the banks.

For the *Super De Novo* to effectuate a smooth transition, the *de novo* banks must adopt a common corporate culture. Although differing cultural views may affect many different aspects of any MOE, the *Super De Novo* will initially need to address two key issues: The *Super De Novo* organizer must choose the new corporate name and the headquarters location of the new entity. Often, the early resolution of these issues goes a long way toward setting a cooperative attitude throughout the MOE. It is suggested that the parent company not office in the premises of any of the constituent banks – again, the jealousy/favoritism factor should be recognized from the onset.

The organizers will have many possibilities when choosing the new name of the partnership. They may create an entirely new name, combine the names, or retain one of the old names. The actual name chosen may prove to be of little business or strategic consequence; however, it is the process of cooperation in choosing the name that will facilitate a strong *Super De Novo*.

Stockholder Rights

To protect the various stockholder groups from becoming minority holders in the parent organization without having received a change-of-control premium in the MOE, the corporate charter and by-laws of the *Super De Novo* need to be tailored to prevent overreaching by the insiders. A "fair price" provision, calling for any transaction undertaken where a corporate insider is a party to the transaction to be subject to a "super-majority" vote (80 percent), is recommended. This will help prevent any shareholder group from allying itself with only part of the total sharemember base and imposing its will on the combined shareholder group.

Protecting the Partnership

"Lock-ups" are contractual provisions that prevent potential acquirors from easily stepping into and interfering with existing merger agreements. MOE participants are particularly vulnerable to receiving higher offers than the no-premium terms provided in the MOE. One example of a typical lock-up provision grants reciprocal treasury stock options to each of the merging parties. These options discourage the intervention by outside bidders and help to safeguard the MOE. The *Super De Novo* structure should provide for treasury stock options requiring each *de novo* to issue

19.9 percent of its stock to the other *de novos*. This lock-up provision will make it more difficult, but not impossible, for another acquiror to poach on a *de novo* contractually committed to the MOE by offering a higher price if the *de novo* bank will forsake the partnership.

Fairness Opinion

The "business judgment rule" presumes that when making a business decision the board of directors acted on an informed basis, in good faith, and with an honest belief that its actions were in the best interests of the corporation. With a MOE, the *de novo* boards, acting as fiduciaries, must take the necessary steps to inform themselves and assess the relevant information relating to the partnership/merger. Often this decision entails receiving and reviewing a fairness opinion on the terms of the merger – the pie-sharing decision referred to above. The process of dividing the pie should culminate in the receipt of a fairness opinion, addressed and delivered to the boards of each *de novo*, attesting to the fairness of the terms.

At least one court has implied that the failure of the board to obtain a fairness opinion in connection with a merger led the court to find that the board had breached its fiduciary duties; however, fairness opinions are not required as a matter of law.[1]

Conclusion

With limited numbers of buyers for community banks at expected historic price multiples, the *de novo's* shareholder owners have been left without their anticipated return on their investments. The *Super De Novo* idea is one that should lead to eventual realized value, providing much needed liquidity in the interim.

However, despite the potential upside, MOEs are hard to conceive and execute. Due to complex valuation and governance issues involved with merging equal parties, the appearance and reality of balance are essential and must begin at the first meeting of the organizers. Similarly, positive investor reaction, employee morale, and future customer relationships are all crucial to the success of the *Super De Novo* bank.

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Buyer Beware!

The recent ruling of the Delaware Chancery Court in *Iowa Beef Processors v. Tyson Foods*[2] should prove to be a landmark decision in merger law. Because the case involves a Delaware court applying New York law to specifically enforce a merger agreement between two huge corporations, it has much broader application than other notable decisions in the field (*e.g.*, the Texaco/Penzoil dispute which was a Texas state court decision regarding letters of intent). The ruling involves important considerations that implicate key buyer and seller rights in many forms of business sales. The opinion itself is a virtual tour of the M&A legal and tactical landscape. Despite its length (57 pages in textbook form), it is required reading for anyone who is a serious M&A professional. Its effect on material adverse effect (MAE) procedures and the interplay of the MAE clause with post-contract deal pricing is already being felt.[3]

Executive Summary:

Tyson Foods, Inc. ("Tyson") successfully outbid Smithfield Foods in an auction for Iowa Beef Processors, Inc. ("IBP" or the "Company"), setting in motion the merger of the two food products giants. Prior to closing, Tyson sought to cancel the deal, claiming IBP had fraudulently induced Tyson to enter the merger agreement, and that IBP had breached its terms. IBP then sued Tyson, asking for specific performance of the merger agreement, an unusual step by a seller and one with a very unusual result if a forced closing were granted. The Delaware judge granted IBP's request, pointing out that Tyson was sufficiently apprised of IBP's internal problems prior to signing the agreement, and that Tyson was simply suffering from "buyer's remorse." The judge then ordered the parties to close the deal, which the parties agreed to do. The decision is important for its far-reaching effects on relative buyer and seller rights in a pending business sale where buyers attempt to back out of a deal, or renegotiate the price, using claims of MAE, fraud, and breach of warranty.

Because of the long record before the court and the many and interrelated claims and contentions of the parties, Vice-Chancellor Strine of the Delaware Chancery Court issued an exceedingly lengthy and fact-focused opinion. The facts involved are hardly unique, however, and a number of the key facts and patterns of business behavior set forth therein are commonplace in mergers and sales of businesses.

The Background

IBP is the number one beef processor in the United States and is number two in pork production. IBP's fresh meats business acts as a middleman between ranchers and grocers, and it has formed the foundation of the company since its creation. Depending significantly on ranchers' production, as well as the weather, it is a cyclical business. Fresh meats currently account for about 80% of IBP's total business. The company's Foodbrands division was established in 1998 to build up IBP's presence in the food processing arena where margins, as a "value added" business, are significantly higher. Recently, IBP acquired a number of companies whose products include canned or packaged foods intended for sale to restaurants and grocery stores. The purpose of this initiative was higher profits and the addition of counter-cyclical businesses. One of these companies was an "airplane food" business called DFG.

In July 2000, an investor syndicate (the "Rawhide Group" or "Rawhide") broached the idea of a leveraged buy-out with IBP's Board. In making preparations for a possible deal, Rawhide asked IBP to provide five-year performance projections to it for evaluation (the "Rawhide Projections"). Specifically, IBP predicted the Foodbrands division would produce $125 million in earnings before interest and taxes in 2000, with this number growing to $300 million by 2005.

IBP Gets First Offer

On October 1, 2000, the Rawhide Group made an offer to purchase all of IBP's stock at $22.50 per share. Shortly thereafter, in mid-November, Smithfield Foods, the leading pork producer in the United States and one of IBP's major competitors, made an unsolicited bid for IBP. IBP management, however, was not interested in a merger with Smithfield.

In mid-October 2000, IBP top management first learned of problems with DFG's books, at that time believing that DFG had overvalued its inventory by about $9 million. As a result, IBP announced that it would revise its FY2000 third-quarter reports to show a $9 million reduction in pre-tax earnings. At that time, IBP management thought that the correction was the extent of DFG's irregularities, although a full audit of the entity's books was ongoing.

Tyson Enters the Game

Tyson is the country's leading poultry producer, and IBP management had a much friendlier relationship with Tyson and the Tyson family, its principal owners, than it did with Smithfield. After the Smithfield bid, Tyson CEO John Tyson arranged a meeting with IBP's management, which quickly led to serious merger discussions.

Despite repeated warnings about IBP's cyclical business, that the cattle cycle was on a downward trend and that the severity of the cycle would affect IBP's ability to meet its five-year forecasts, Tyson was extremely anxious to put together the deal as soon as feasible. To facilitate the due diligence review, Tyson executed a standard confidentiality agreement, which essentially allowed it access to all of IBP's non-public information materials, irrespective of who prepared them. Additionally, Tyson agreed that it would not rely on any oral statements by any IBP official. Rather, any representations or warranties would have to be reduced to writing if IBP were to be liable for them.

Though it wanted to close the deal quickly, Tyson took the due diligence process seriously. During the process, Tyson identified several areas of concern including "possible asset impairments at DFG and certain other Foodbrands companies." Additionally, Tyson was informed that certain Foodbrands information was missing because IBP was hesitant to divulge competitively sensitive information to Smithfield, believing that if it shared the information with Tyson, it would also have to share it with Smithfield.

During the due diligence process, IBP executives revealed that the DFG problem was becoming more serious and that the overstated earnings could approach $30 million. The representatives then discussed anew the Rawhide Projections, Tyson's team again concluding that they were reasonable.

In mid-December, the IBP special board committee formed to oversee the possible sale or merger of IBP requested that company management update the Rawhide Projections in preparation for the sale. These projections showed that IBP's earnings were lower than expected by $70 million. After learning of this reduction, the still-eager Tyson increased its bid per share by $1.

On December 29, 2000, Tyson was informed that the DFG problem had grown to at least $30 million and the unit would at best break even that year; that the entire $70 million reduction was attributable to Foodbrands' underperformance; and that the Rawhide Projections for future years were still attainable. As a result, Tyson asked Merrill Lynch, its investment bankers, to reexamine their original recommendation to determine if the acquisition still made sense. Additionally, Ernst & Young, IBP's accountants, opined that IBP might have to restate its financials because of the DFG problem, and that IBP might have to accept an impairment charge.

Tyson Wins the Auction

On December 30 and 31, 2000, Smithfield increased its bid twice. Both times, Tyson met and beat the offers. IBP accepted Tyson's bid.

The Merger Agreement (the "Agreement") drafted by the parties was conventional in most ways. It called for various disclosure schedules qualifying the parties' representations and warranties. Of these, Schedule 5.11 ("Undisclosed Liabilities") was one of the most significant. IBP's Schedule 5.11 modified Section 5.11 of the Agreement, which declared that IBP had no liabilities that had not been disclosed. Schedule 5.11 itself declared that IBP had no liabilities "[e]xcept as to those potential liabilities disclosed [elsewhere], and any further liabilities (in addition to IBP's restatement of earnings in its 3rd Quarter 2000) associated with certain improper accounting practices at DFG Foods, a subsidiary of IBP."

The following sections of the Agreement were also implicated in this case: Section 5.07, "SEC Filings," Section 5.08, "Financial Statements" and Section 5.09, "Disclosure Documents," all dealt with the accuracy of IBP's 1999 and 2000 SEC Form 10Ks and 10Qs (the "Warranted Financials" or "Financials"). Section 5.10, "Absence of Certain Changes," allowed Tyson an out if IBP were affected by a MAE (as defined below).

A minor issue in the case involved a misdirected "comment letter" from the SEC Staff ("SEC Comment Letter"), which addressed accounting issues in IBP's financial statements as filed with the Commission. The letter was not produced in a timely fashion to Tyson, which later attempted to characterize this fact as an intentional withholding of information.

In early January 2001, both Tyson's board of directors and its shareholders assented to the merger. After the respective ratification meetings, John Tyson enthusiastically and publicly proclaimed his excitement about the merger and about its prospects for the future. At no time did he ever mention DFG as a concern.

About Vedder Price

Later in the month, Tyson was informed that the DFG problem was approaching $50 million; that an impairment study was in progress at DFG; and that some of the DFG problems went back to 1999 and might cause IBP to have to restate its 1999 financials. In response, Tyson took no action to indicate that its concern was substantial or that it might back out of the deal.

IBP met with the SEC in late January 2001, hoping to get some direction as to how to remedy the DFG problem. By the middle of February, the SEC demanded that IBP restate the financials. On February 22, IBP announced the restatement figures and that it would take an impairment charge, whereupon Tyson announced that it was delaying proceeding with the merger and that it would review the deal once IBP had settled the DFG matter with the SEC. Throughout this entire period, counsel for both companies had been in communication, and neither mentioned the idea that the restatements of prior financial statements might constitute a breach of the Agreement because Tyson had not decided yet whether it considered the Agreement breached.

Tyson Terminates the Deal

Meanwhile, both companies were experiencing dramatically depressed earnings compared to FY2000. As a result, IBP managers began to expect Tyson either to back out of the deal or ask for a renegotiation. John Tyson was, in fact, concerned with the slow starts for both companies. Nonetheless, he had determined that the deal was still a good one, though he was inclined to try renegotiating the deal to get a better price. Other Tyson managers, particularly Don Tyson (the former CEO, John's father, and a controlling Tyson shareholder), were not positively inclined. Buyer's remorse was settling in. Rumors and back-channeling about a price renegotiation began in earnest, but still there were no overt threats of a "crater."

In late March, Merrill Lynch informed Tyson that the deal was still a great opportunity for its client. During that same time frame, Tyson and IBP met to discuss renegotiated prices. However, on March 28, Don Tyson decided to cancel the deal and Tyson issued a press release to that effect, highlighting its reasons for the termination. Among the reasons given were:

1. the financial restatements;
2. delays in the process; and
3. misleading IBP information inducing reliance by Tyson.

The release did not mention any material adverse effect.

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The Lawsuit/The Legal Issues

In response to the press release, IBP filed suit to specifically enforce the Agreement. This is an extraordinary remedy – an equitable one that is rarely sought or obtained in merger practice. Sellers in particular almost never attempt to judicially enforce a breached merger agreement and force a closing "in the judge's chambers."

IBP contended that Tyson's termination was improper because IBP had not breached any of the warranties and representations in the Agreement. Tyson, on the other hand, claimed that IBP had breached the Agreement in several major respects and sought rescission of the Agreement. First, Tyson claimed that IBP breached its representations as to the Warranted Financials when it was compelled to restate them. Second, Tyson claimed IBP fraudulently induced it to enter into the Agreement. Third, Tyson claimed that IBP's sub-par performance in the first quarter of FY2001, coupled with the DFG impairment charge, constituted a MAE, warranting Tyson's termination of the Agreement.

In order for IBP to obtain specific performance that would force Tyson to close the deal, IBP had to show that:

1. there was no practicable way to adequately determine a damages award;
2. the Agreement was a valid contract;
3. IBP had substantially performed its obligations per the Agreement, and that IBP was able and ready to finish performance; and
4. Tyson was capable of performing its commitments under the Agreement.

These standards are important to this remedy and are not all implicated by a suit for monetary damages following a breach. Alternatively, for Tyson to obtain rescission, it had to prove by clear and convincing evidence that IBP's breach of warranty excused Tyson's non-performance of the Agreement.

Warranted Financials

In resolving the merits, the court first looked at whether, under the Agreement, Tyson accepted the risks related to DFG and any past, present, or future charges to earnings arising from DFG's accounting irregularities. It ruled that Tyson had accepted those risks. The court found that Schedule 5.11 qualified all of the IBP representations in the Agreement. It stated that it would be absurd for Tyson to allow IBP to take a $45 million charge to earnings in the fourth quarter of 2000, but yet not to allow IBP to restate the Warranted Financials to reflect the charge.

The court did not take the same view of the Impairment Charge with respect to DFG. It noted that the Impairment Charge was not due to the accounting problems within DFG, but rather was due to the severe drop in DFG's sales that occurred in the fourth quarter. Therefore, no section of the Agreement specifically covered the Impairment Charge.

Fraud and Misrepresentation

Tyson also argued that IBP fraudulently induced it to sign the Agreement. In addition, Tyson claimed that IBP made material misrepresentations that Tyson relied upon when contemplating the merger. Finally, Tyson claimed that IBP omitted material facts that would have been pertinent to Tyson's consideration of the merger. All of these misrepresentations, according to Tyson, dealt with three areas:

1. the Rawhide Projections;
2. the misdelivered SEC Comment Letter; and
3. DFG audit reports.

Because of these missteps by IBP, Tyson claimed it should have been allowed to rescind the Agreement.

In disposing of these arguments, the court first pointed out that Tyson signed a Confidentiality Agreement that was designed to prevent Tyson from filing suit based on due diligence deficiencies, unless the purported deficiency was later covered by a specific provision of the written Agreement, and unless the deficiency also amounted to a breach of that specific provision of the Agreement. With respect to the Rawhide Projections, the court found that IBP's management did nothing more than express confidence in its ability to perform in accordance with the Projections. The forecasts contained standard disclaimers, expressing IBP's intent that the projections not be construed as warranties of future results, etc. Expressions of confidence in one's ability to meet one's goals, said the court, are insufficient to support a claim for material representation. Information that was competitively sensitive had been appropriately withheld because Tyson, not IBP, did not want Smithfield to see it. Finally, the court dismissed as meritless Tyson's suggestion that IBP's failure to disclose the SEC Comment Letter misled Tyson, viewing the accounting issues raised in the letter to be of little consequence.

Material Adverse Effect

Merger contracts typically contain language in the termination section that allows the buyer to escape its obligation to consummate the merger if the seller has suffered a change of circumstances amounting to a MAE prior to closing. However, MAE clauses also typically contain qualifying exclusions that limit the types of changes or new circumstances or their consequences that constitute a MAE: *i.e.*, exclusions for declines in the applicable market sector, bad weather, adverse regulatory rulings, etc. In this case, Section 5.10 of the Agreement warranted that IBP had not suffered a material adverse effect since December 25, 1999, unless that effect was stated in the Warranted Financials or in Schedule 5.10. The Agreement defined Material Adverse Effect as "any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect…on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as whole…" Section 5.10, however, included no exclusions of the sort described above and, though simply worded, the section presented complex issues with potentially far-reaching ramifications to the court.

Tyson's position was that the DFG Impairment Charge and IBP's sub-par performance through the last quarter of 2000 and the first quarter of 2001 were sufficiently material to allow Tyson to terminate the merger. IBP countered that the Warranted Financials disclaimed the risks of a trough in the cattle cycle to the extent that such a downturn could not constitute a MAE. The court found Section 5.10 ambiguous and determined that the section must be read as part of the Agreement as a whole. The court reasoned that this approach allowed for a "baseline" that bore satisfactory resemblance to the actual condition of IBP as Tyson knew it when the parties signed the Agreement.

Looking at IBP's 1999 SEC Form 10-K, the Warranted Financials for 2000 and the Rawhide Projections, the court made the following determinations:

1. IBP was "consistently profitable, but subject to strong swings in annual EBITA and net earnings;"

2. third quarter earnings for 2000 were trailing third quarter

earnings for 1999 by about $40 million;

3. Foodbrands was, at that time, a highly inconsistent and somewhat insignificant source of earnings for IBP; and

4. the Rawhide Projections clearly showed a trough in the cattle cycle that would not put IBP back on a high-level earnings pace until 2004.

Given that Tyson had access to all of this information at the time it signed the Agreement, the fact that Tyson didn't mention MAE in its termination letter, and the fact that Tyson top executives virtually ignored DFG throughout much of the negotiation process, the court concluded that *Tyson had approached this merger as a long-term strategic move, rather than as a short-term investment opportunity*. Given a long-term outlook, the court then determined that a *"short-term hiccup" in a company's earnings would not qualify as material to a long-term strategic buyer*. It found that in a complex, highly negotiated merger agreement, a MAE clause is best viewed as a "backstop" that protects a buyer from an unknown or unsuspected happening that can threaten or permanently damage a company's overall earnings for a significant period of time.

While considering the parties, arguments about cyclicality, reliance, long-term versus short-term time perspectives, current trends and effects and other like notions, what finally pushed the court to find that no MAE had occurred was Tyson's own reliance on third party analyst estimations of IBP's worth. Though IBP's early 2001 performance was arguably dismal, several Wall Street analytical reports found IBP's 2001/2002 estimates of earnings to be consistent with IBP's actual earnings during other "trough" years. Thus, the court found that as of the date Tyson terminated the Agreement, IBP was still a "consistently but erratically profitable company struggling to implement a strategy that will reduce the cyclicality of its earnings." Additionally, the court found that Tyson's focus on the Foodbrands aspect of IBP was misplaced, given that Tyson was buying the company as a whole, and that the company as a whole was performing in keeping with its history.

Specific Performance – the Shotgun Closing

Having concluded that Tyson breached the Agreement by improperly terminating the deal in March 2001, the court addressed the question of whether specific performance was the appropriate remedy.

The court started from the premise that *buyers* (IBP was the Seller) are frequently allowed to argue that they cannot be made whole by a damages remedy because of the uniqueness of the company they are seeking to buy. It then stated that it could not deduce any convincing reason why a seller could not successfully make the same argument. In this case, the particular uniqueness came in the form of IBP shareholders having the choice to accept cash, or Tyson stock, or a combination of the two in exchange for their IBP stock. The Tyson-acknowledged synergies of the merger made the potential value of the combination unique – and hard to quantify.

The court then went on to note that, though a damages award could be fashioned, it would be terribly imprecise, "staggeringly large" and absolutely valueless to Tyson and its shareholders. [Tyson's counsel undoubtedly inferred from this statement that their client would face bankruptcy if damages were awarded.] Conversely, specific performance would be sensible for Tyson, especially given that its own investment banker still maintained that the deal was a great value for Tyson. In short, the court declared, without requiring much proof on IBP's part, that specific performance was the only logical remedy, and because of that, specific performance was granted.[4]

The fallout of the decision is difficult to assess: clearly, buyers will be more careful in due diligence; they will be less likely to assert preclosing MAEs in attempts to lower the price and MAE clauses will take longer to negotiate. Many of these clauses are already overly complex and sometimes difficult to interpret when the deal begins to "go sideways." One suggestion is to put important seller business standards/goals in separate closing conditions, as opposed to the MAE clause itself. The lesson of this very important decision ultimately seems to be that in putting together merger agreements, even more careful attention needs to be paid to already carefully attended to legal issues.

[1]*See Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

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[2]2001 WL 675330 (Del. Ch.).

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[3]"Buyers Could Lose Wiggle Room on Merger Price Tags," *Corporate Financing Week*, July 2, 2001.

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[4]Vice-Chancellor Strine ordered Tyson and IBP to comply with his order by June 27. The result of that directive is that Tyson agreed to honor the original terms of the Agreement. The purchase price for IBP is considerably lower than the original figure, $2.7 billion as opposed to $3.2 billion, but this is due to Tyson's stock having dramatically decreased during the interim. "Tyson Sticks to Original Terms for IBP Deal," *Financial Times* (London), June 28, 2001; "IBP, Tyson Start to Merge Companies in Their Vision of Protein Powerhouse," *Feedstuffs*, July 2, 2001.

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SELECTED 2000 - 2001 SECURITIES OFFERINGS AND MERGERS/ACQUISITIONS

Included below is a listing of recent transactions reflecting significant activity in the financial institutions market.

Client	***Transaction***
MAF Bancorp, Illinois	Pending Acquisition of Mid Town Bancorp, Inc. ($70 million)
Bridgeview Bancorp, Inc.	Offering of Pooled Trust Preferred Securities ($15 million)
Michigan National Bank	Sale of Home Equity Loans to Provident Bank
ABN AMRO North America, Inc.	Placement of Money Market Preferred Stock Custodial Receipts ($1.05 billion)

Success Bancshares, Inc.	Pending Sale to BankFinancial Corporation ($48 million)
MFN Financial Corporation	Institutional Placement of Automobile Receivables Backed Notes ($301 million)
Michigan National Bank/LaSalle Business Credit	Acquisition of Asset Based Lending Business of Mellon Bank
First DuPage Bancorp, Inc.	Secondary Common Stock Offering ($4 million)
ABN AMRO Bank, N.V.	Sale of European American Bank to Citibank, N.A. ($2.05 billion)
Hasten Bancshares, Inc.	Pending Acquisition of Harrington Financial Group, Inc. ($40 million)
ABN AMRO North America, Inc.	Purchase of Michigan National Corporation ($2.75 billion)
Irwin Financial Corporation	Offering of Trust Preferred Securities ($90 million)
Private Bancorp, Inc.	Offering of Trust Preferred Securities ($20 million)
LaSalle Bank NA/Michigan National Bank	Creation of Merchant Bank Card Processing Joint Venture with National Processing Inc.
Private Bancorp, Inc.	Organization of a federal savings bank, Private Bank, St. Louis, Missouri ($8 million)
ABN AMRO North America, Inc.	Offering of Trust Preferred Securities (Floating) ($350 million)
ABN AMRO North America, Inc.	Offering of Trust Preferred Securities (Fixed/Floating) ($510 million)
Lena Bancorp, Inc.	Acquisition by Foresight Financial Group, Inc. ($5.4 million)
Bridgeview Bancorp, Inc.	Acquisition of B&I Lending, LLC
Midwest Banc Holdings Inc.	Offering of Trust Preferred

	Securities ($20 million)
Benchmark Bancorp, Inc.	Acquisition of Financial Institutions, Inc. and Private Placement of Common Stock ($8 million)
St. Anthony Bancorp, Inc.	Acquisition by Canadian Imperial Bank of Canada ($5 million)
The Peoples State Bank of Newton	Acquisition of The First National Bank of Newton ($5 million)
Mutual Federal Savings and Loan of Chicago	Association Reorganization to a Mutual Holding Company
MAF Bancorp, Inc.	Acquisition of Selected M&I Bank Branches
Wintrust Financial Corporation	Offering of Common Stock ($26 million)
Security Savings Bank	Reorganization to a Mutual Holding Company
Private Bancorp, Inc.	Acquisition of Johnson Bank Illinois ($20 million)
Security Financial Corp.	Acquisition of Lovedahl & Shimmin, Inc.
Irwin Financial Corporation	Acquisition of Onset Capital Corp. (Canada) ($3 million)

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