Time Again for a Governance "Tune-up"

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The financial services industry has seemingly passed out of the dark shadows of the post-2008 "crisis" period. Now, the "Trump Effect," as well as other factors, are influencing industry stock prices positively and generating a renewed interest in M&A and related matters in the financial services industry. It may again be time to review your institution's governance structure, documents, and mechanisms to bring them up to date. A corporate governance "tune-up" can also provide important alternatives and flexibility for responding to M&A and other strategic corporate opportunities and, ultimately, put the institution in a position to better respond to market opportunities and events as they unfold.

In addition to the fact that it remains the responsibility of the board and management to review governance structures and mechanisms on an ongoing basis and to ascertain that they are appropriate for the operations, plans, intended activities and strategic goals of the organization, a proper governance structure will better enable the institution to respond to changing regulatory requirements. This will also allow the institution to control its destiny as a potential acquisition target and to be in a position to quickly respond to acquisition opportunities as a potential buyer. It is also all the more important when it comes to the concepts of corporate "controls" and "enterprise risk management."

What is appropriate varies for each institution and the strategic goals and risks for that institution. There are, however, certain items that make sense on a general basis for all institutions. This article is a summary of the more important things to look for and consider in this "tune-up."

Capital Structure

Governance documents should provide appropriate authorization for issuance of common (and perhaps preferred) stock to address planned capital needs. This will also provide a buffer, if possible, for unanticipated events and opportunities. "Quality" capital has become an important consideration. Hybrid securities are no longer in vogue. A broad authorization for "wild card" preferred stock with terms to be set by the board of the institution can provide flexibility for fairly quick capital issuances. Additional authorized common (or classes of common) may make sense as well for growth including potential acquisitions. Expanded opportunities may also be appropriate for stock-related incentive compensation programs, subject to careful scrutiny by compensation committees and documentation of risk and other considerations in the process.

Of course, the appropriate structure varies by institution, and is impacted by the willingness of existing shareholders to authorize additional shares (where such flexibility is not currently provided). Institutions may, or may not, desire to broaden their shareholder base in light of the changes that can result. Sub-S institutions will need to carefully review the impact of any proposed changes in capital structure on Sub-S status. Perhaps more than any other single item, capital flexibility is important in enabling the institution to take advantage of current and prospective growth opportunities and provides a backup if capital needs arise.

Special Issues for Mutuals

While ready access to capital markets is not as easy for mutuals without substantial expense and change, mutual institutions nonetheless have the same basic need for capital as stock institutions. Retained earnings may have been strained in recent years as the traditional source for mutual capital, and as a result some may be at lower levels than in the past. Regulators worry about mutuals because of the limitations on raising capital when needed, and because mutuals are not typically ready participants in M&A activities because of their unique structure. Nonetheless, conversions and other strategic changes may be appropriate for consideration by mutuals that anticipate growth, a sale, or broadening their structure to include related affiliates and activities. Well-capitalized mutuals may consider cash acquisition opportunities as buyers with banks and thrifts, both stock and mutual, to broaden their markets and reduce expenses. Mutual boards should examine their options on an ongoing basis, including whether their governance structure allows them to maximize opportunities when and if they arise, and to have the ability to respond quickly to strategic alternatives in the market.

Enhanced Focus on "Controls" and ERM

With the enhanced focus on corporate "controls" and "enterprise risk management" (ERM) by agencies and plaintiff's lawyers, it has become imperative that boards focus on their ability to manage ERM. This takes place in part through the governance function. Corporate governance is the mechanism that enables the board to put in place appropriate controls on activities and actions of the institution in order to help identify and mitigate risk. The ability to evidence steps taken to improve all areas of corporate governance in order to implement and address risk management obligations and fulfill the board's obligations for ERM generally is critical from the perspective of a directors' duty of care. It is expected to be an ongoing and non-static activity on behalf of the board. The inability of a board to evidence an ongoing focus on controls and ERM through oversight and attention to its governance mechanisms will result in significant regulatory concern, weakness in addressing issues as they arise and vulnerability to claims by astute plaintiff's counsel.

Indemnification

This too varies by institution. While some institutions address indemnification coverage in their articles of incorporation (or association for national banks), some in the code of regulations or bylaws, some by contract, and some through silence in governance documents with a fallback to relevant state and federal law, it is important that boards and management understand and address this issue. D&O insurance remains available and premiums have settled following the "crisis." And there is of course the limitation on coverage with regard to agency actions and penalties to address. Prospective officers and board members may well inquire as to indemnification coverage in the recruiting process, and insurers will need to determine how those issues are handled by the institution. There is no "one size fits all," and the time to be looking at this issue is preferably long before the lawsuit is served.

Committee Structures and Composition

Standing and special committees have long had an important place in the banking industry. Sarbanes-Oxley has further focused the concepts of "best practices" for non-public companies (including banks) in regard to committee structures and independence. Certain standing committees should be reflected in governance documents, and all committees should adopt and maintain detailed committee charters to provide guidance with respect to committee activities and expectations, as well as membership requirements. Audit, compensation, and governance committees should continue to be focused on "independent" directors, even for non-SEC companies, and the board should take care to ascertain the "independence" of committee members and document that consideration. Again, while not specifically applicable to non-public companies, the committee structure and independence concepts contained in Sarbanes-Oxley, Dodd-Frank, and in the listing rules for NYSE and NASDAQ provide a good "best practices" template for all institutions.

Takeover Protections

Even if the institution is uncertain as to its continued independence plans, adopting appropriate anti-takeover protections can provide a method to enable the institution to better control its destiny should unwanted overtures arise. It is also important to to secure the best transaction (and price) for shareholders. While true "hostile" takeovers are rare in banking, they (as well as shareholder activism) can be costly and difficult to address in the long run. Incorporating appropriate protections in governance structures can provide defensive leverage, a stronger negotiating position, and critical time to consider an appropriate response. Takeover preparedness is important, and defensive protections including a staggered board, "rights plans," "supermajority" provisions, "fair price" protections and other structural and procedural protections will enable the institution to better control its destiny and to maintain appropriate leverage in dealing with unwanted acquisition overtures. Each can be structured so that they are not an obstacle to board-approved transactions., but rather reasonable methods and processes to enable to board to exercise its' fiduciary obligations in a thoughtful and less-pressured manner so as to fulfill those obligations in an appropriate manner.

Likewise, potential acquiring institutions should review their governance structure to examine whether there may be inappropriate obstacles for taking advantage of acquisition opportunities as they arise. Takeover preparedness is important for both potential buyers and potential sellers. Institutions should endeavor to adopt a governance structure which will maximize opportunities for protecting the institution in the event of an unwanted acquisition overture while providing flexibility for responding to opportunities as a potential buyer. Potential acquirers should likewise examine their governance materials for the ability to take advantage of potential assisted transactions for closed-bank and troubled bank opportunities, which tend to arise quickly and sometimes with little or no warning.

Shareholder Activities

The post "crisis" market spawned a number of proposals for increased shareholder activism including "say on pay" activities and expanded shareholder access to the proxy process. Some are now the law through Dodd-Frank and related SEC initiatives and may become further applicable and imbedded in the industry through regulatory "creep" and new agency rules as well as "best practices."

How these proposals will eventually develop remains to be seen, but in the present environment organizations (public and non-public) should anticipate that further state and federal pro-shareholder legislation and regulation is likely. For public companies, the SEC is becoming more supportive of shareholder activism proposals generally, which may quickly make their way into state corporate law and/or banking regulations in the present environment.

Certain aspects of state corporate law has arguably been "federalized" by Congressional and SEC actions, and bank regulators may be pressured into taking a more active role in bank shareholder issues and activities.

While the impact of this expanded shareholder activism remains to be seen, it is very likely to place additional governance burdens on hoards and institutions, increase costs, and create further need for careful review and consideration of governance structures and activities for all organizations.

In addition, "activist" shareholders are becoming more prevalent in smaller institutions than ever in the past. Typically, these shareholders were focused almost solely on larger institutions. However, they are now operating with investment funds specifically targeting community banking organizations as well as larger institutions, both public and non-public. The time to make certain that an institution’s governance documents provide it the strongest position to deal with such activists to protect the best long-term interests of the institution and its constituencies is not after the activist has taken a position.

Holding Company and Bank

Many institutions, particularly community banking organizations, have similar (if not identical) boards at the holding company and the bank. While this can and sometimes does present issues for "piercing the veil" between the holding company and the bank and may be appropriate to avoid, nonetheless in all instances care should be taken to avoid inconsistencies between holding company and bank governance structures and documents. Not that they are not and should not be different, but they should be reviewed carefully to avoid inconsistencies that impact board and committee composition and activities. When the holding company is the sole shareholder of the bank subsidiary, making changes is relatively easy but may entail regulatory involvement at the bank level and taking care to assure compliance with relevant banking law requirements which typically differ from the general state corporate law requirements generally applicable to the holding company.

Making Changes

Depending on the structure, certain changes in governance structure and documents require shareholder approval. Others may be accomplished through amendments to governance documents which may be undertaken by the board without the necessity of seeking and obtaining separate shareholder approvals. In addition, certain changes involve the necessity of seeking and securing prior regulatory and/or debtholder approvals. Changes may also impact existing employment, vendor, creditor, and other contract relationships, and care must be taken to avoid inadvertently triggering certain provisions in related contracts which may have an unintended result.

Proposed changes should be reviewed with appropriate professionals including financial and M&A advisors, investment bankers, accounting and tax professionals, and legal counsel. Again, there is no "one size fits all." What is appropriate varies by institution and the current, and anticipated, issues and activities impacting the institution as well as its strategic vision. Having a documented record of consideration of proposed changes by objective outside professionals can assist in addressing shareholder and regulatory issues that may arise.

Without a doubt, regulatory authorities should be kept in the loop all along in order to avoid any surprises and in order to avoid creating any inappropriate and unnecessary concern or suspicion as to the intentions of the institution in undertaking proposed changes. Their input can also be invaluable with regard to their experience with other institutions.

Conclusions

The time may be right to conduct an overall review and assessment of the governance structure of your institution to better position the institution to address current and prospective industry and market issues; to better position the institution to be able to respond to a changing environment and unforeseen events; and to better enable the institution and board to carry out the institutions' strategic goals.