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HEADNOTE: A QUESTION OF CAPITAL Steven A. Meyerowitz	385
RESPONDING TO CAPITAL DIRECTIVES AND RELATED ENFORCEMENT ACTIONS Joseph T. Lynyak III	387
THE FRAMEWORK FOR BUYING A COMMUNITY BANK Pinchus D. Raice and Robert C. Lamonica	405
A SIFI IN THREE EASY STEPS? FSOC APPROVES FINAL RULE FOR NONBANK SIFI DESIGNATIONS Heath P. Tarbert, Sylvia A. Mayer, and Derrick D. Cephas	419
FROM COLLATERAL DAMAGE TO CAUTIOUS OPTIMISM: THE U.S. CLO MARKET FORGES AHEAD Deborah Festa, Andrew R. Walker, and James Warbey	432
THE FUTURE OF THE INTERCREDITOR AGREEMENT Robert Sullivan, Geoffrey Maibohm, and Elizabeth Murphy	440
THE <i>BANKATLANTIC BANCORP</i> DECISION — ROADBLOCK OR DETOUR TO OPEN BANK SALE OF DISTRESSED BANKS? J. Mark Fisher	446
BORROWER'S BREACH OF COVENANT TO REMAIN SOLVENT SPRINGS FULL RECOURSE LIABILITY UNDER NON-RECOURSE CMBS MORTGAGE LOAN Robert E. Helpem and Eric S. Schoenfeld	454
COMPTROLLER IDENTIFIES CITIBANK'S BSA/AML DEFICIENCIES, ORDERS CORRECTIVE ACTION Steven A. Meyerowitz	459
BANKING BRIEFS Terence G. Banich	472

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THE FRAMEWORK FOR BUYING A COMMUNITY BANK

PINCHUS D. RAICE AND ROBERT C. LAMONICA

The authors discuss the mechanics of community bank acquisitions.

The Great Recession that began in 2008 altered an array of fundamental market assumptions, bank valuations included. Prior to the recession's onslaught, acquisition premiums were the norm. Between 2002 and 2007, the average price-to-book ratio for acquisitions of domestic commercial banks ranged between 2.26-to-2.56 times book value.¹ During roughly the same period, there were more than 1,300 bank acquisitions.² For investors in the community banking industry, the game plan was straightforward: invest in a *de novo* or other small bank, grow it while achieving a modest return on equity, and then collect the buyout premium from a strategic or financial purchaser.

That historic premium began to evaporate in 2008 and, for the first time in almost 20 years, the average price for acquisitions nationwide fell below book value during 2009. Prices recovered slightly in 2010 to approximately book value, and there is a general expectation that deal prices in the near term will hover moderately above one times book value.³ The industry is buzzing about a potential new wave of acquisitions and mergers simply because prices have not been this attractive in years.

There are many reasons to buy a community bank, but on the whole

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these reasons fall into four general categories. First, and particularly in the current market, a target bank is likely undervalued and therefore represents an opportunity to realize a financial return simply by timing the market for the widely anticipated large scale industry consolidation, or what some might call the coming acquisition frenzy. Second, an acquirer is engaged in, or desires to engage in, a business that would benefit from the synergies generated by a captive bank. Third, the bank may serve as an initial platform for internally-generated expansion or a roll-up of comparable institutions. Finally, some acquirers are attracted to the potential for steady and predictable return on equity and assets that a small, conservatively-run institution can generate.

Despite the greatly divergent purposes for acquiring a community bank, the two focal points for an acquirer during almost any transaction will be balance sheet risk and the regulatory approval process.

BALANCE SHEET RISK

A small, conservatively-operated bank that generates a modest profit year-after-year will likely have the least risk in its loan portfolio. In this scenario, building an institution guided by a conservative philosophy with a risk-averse balance sheet was almost certainly ownership's intention from the outset and management is likely to have a thorough understanding of its loan and asset portfolio. Despite having a smaller, less diversified balance sheet than other potential targets, this bank will likely demand the highest premium in the market. In an environment where banks are selling without a premium to book value, a historically profitable "little engine that could" will, like any other going concern, price on its discounted cash flows. This purchase price will equate to a multiple of the stock's book value. So while a less rigorous due diligence review of the loan portfolio may be required than is necessary with other targets, and exposure to balance sheet risk will be minimized, this peace of mind will extract a price at closing.

For all other acquisitions, whether motivated by short-term sale profit or the desire to obtain a platform for acquisitions or business integration, the results of due diligence are likely to make-or-break the transaction. The highest risk areas are loan portfolio quality, allowance for loan and lease losses and deposit funding sources.

Quantifying aggregate exposure to the weakest parts of the loan portfolio is essential. Until you put all of the target's troubled assets together and assess the likelihood of unrecoverable losses, you cannot determine what the book value is, let alone determine the appropriate purchase price. The greatest risk during this process is that you will be unable to identify a finite set of bad loans. If underwriting criteria were deficient throughout the lending department, it will be nearly impossible to reduce the exposure to a fixed amount.

The analysis of the loan portfolio is tied directly to a review of the allowance for loan and lease losses. The ALLL reflects the target's estimate of reasonable reserves necessary to offset expected losses in its portfolio. A thorough diligence process is necessary to expose any inaccuracies in the loan risk-rating system. Even if you are successful in finding the asset quality "bottom" of the loan portfolio, you may find that the amounts reserved for these troubled assets are woefully insufficient as a result of inaccurate risk-rating. Deficiencies in the ALLL will effectively increase the hole in the balance sheet, compounding any problems that may exist in underwriting.

Although perhaps not as critical a concern as asset quality and reserves, the character and nature of the target's deposit liabilities should not be overlooked. Both federal and state bank regulators are increasingly focused on core deposits and demanding that they constitute a meaningful percentage of total deposit liabilities. The oversimplified, and therefore slightly inaccurate, definition of a "core deposit" is a deposit in an amount below the FDIC insurance limit, on which the interest rate is below the FDIC national rates and that was deposited by a local customer. Bank regulators consistently take the position that core deposits are less volatile funding sources than any other. To the extent an acquisition target is heavily dependent on non-core deposits, such as brokered jumbo CDs, its regulators are likely to require an immediate roll-off of those deposits. Accordingly, you could be facing a severe regulatory liquidity criticism the day after you acquire the bank, a potential headache that should not be ignored in assessing a potential target.

REGULATORY APPROVAL

In the first instance, the tripartite principal concern that bank regulators exhibit is an institution's risk, regulatory and compliance management sys-

tem. The institution's business plan, and whether its economics are realistic and achievable, while important, arguably are secondary. That said, in many if not most bank targets, incumbent management has already established adequate risk management and compliance procedures that have been accepted by its regulators. As a result, the single most significant sticking point when seeking approval for a change-in-control of a community bank is the proposed business plan and its underlying financial projections.

PATH OF LEAST RESISTANCE

Unless a bank is troubled as a result of a failed business plan, the easiest way to achieve approval for a change-in-control is to de-couple the application from a change in the plan. This option is available to investors who are looking to capitalize on the potential for increased industry consolidation in the future. To the extent the target is profitable and its operations are aligned with its current plan, there are few incentives to shift the bank's strategic focus if the primary investment strategy is to garner the return generated by a subsequent transaction. By eliminating the need for the target's regulators to consider the feasibility and safety and soundness of a new plan, the approval process is limited almost entirely to a review of the biographical backgrounds of the investors.

The appropriate federal banking agency may disapprove any proposed acquisition if "the competence, experience, or integrity of any acquiring person or of any of the proposed management personnel indicates that it would not be in the interest of the depositors, or in the interest of the public to permit such person to control the bank...."⁴ Although there are no clearly defined limits on the discretion of federal regulators in making a determination as to the suitability of a controlling investor, an acquiring party who is turned down is entitled to an adjudicatory hearing on the record.⁵ If, following the hearing, the proposed acquisition is again disapproved, the acquirer may seek review of the decision at the federal appellate court level.⁶ In other words, the regulators have a strong disincentive to reject change-in-control applications for less-than-obvious reasons because of the availability of administrative and judicial review of their decisions.

SELLING SYNERGIES TO REGULATORS

For an existing business, entry into banking may offer several advantages, not the least of which is access to low-cost funding sources, the most sought-after being consumer deposits insured by the FDIC. Access to capital resources is further enhanced by access to the Federal Reserve's discount window and its lending facilities. In addition, for investment houses and arbitrageurs that hold large amounts of cash for relatively short periods, ownership of a bank allows them to capture the significant fees that would otherwise be lost to third-party banks when transferring deposits or performing escrow services. Generally speaking, banks are attractive integration targets in many industries because the transaction fees generated through affiliate transactions appear as revenues on the consolidated company's income statement, offsetting what would otherwise be unrecouped expenses.

In most instances, an acquisition motivated by the perceived benefits of integration will necessitate submission of a revised business plan. It is unlikely that the target bank is already heavily engaged in lending to, or otherwise transacting with, your existing business. Even if it does operate in that space, it will certainly not be conducting the volume of business with your industry that you intend for it to transact post-acquisition.⁷ It can therefore be particularly tricky to receive approval for a business plan that differs materially from the somewhat nebulous but nevertheless limited concept of community banking.

There are two closely-related considerations that should be addressed by acquirers when extolling the virtues of post-transaction synergies to community bank regulators. First, community banking is characterized by a model based on gathering deposits from local customers primarily through the deployment of brick-and-mortar offices and investing those funds in loans to the same community from which the deposits came. A clear example of a strategy that strays from the community bank model is one where a single branch office in South Dakota collects deposits but makes loans primarily to real estate developers in Tennessee. To the extent that your existing business targets a specific geographic market, you are best served by acquiring a community bank in that region to avoid a deposit-lending area mismatch. Likewise, your change-in-control application will meet with resistance if your business plan is likely to create an excessive concentration of loans in a particular industry. This conflict is difficult to avoid because the primary driv-

ing force behind a synergy-based acquisition is the projected increase in deal volume between divisions and lower transaction costs.

Second, Sections 23A and 23B of the Federal Reserve Act are prophylactic statutes that restrict certain types of transactions between a bank and its non-bank “affiliates.” A bank’s covered transactions with (i) any single affiliate are limited to no more than 10 percent of the bank’s capital stock and surplus and (ii) all affiliates are limited to no more than 20 percent of the bank’s capital stock and surplus.⁸ Covered transactions include purchases of assets from an affiliate, loans or extensions of credit to an affiliate, investments in securities issued by an affiliate, guarantees on behalf of an affiliate and certain other transactions that expose the bank to an affiliate’s credit or investment risk.⁹ In undertaking any bank acquisition to capitalize on synergies, it is imperative to have an excellent grasp on Section 23A and 23B transaction restrictions and to be prepared to address how these limitations will be monitored in your business plan.¹⁰

One solution that reduces the potential for excessive asset concentrations resulting from affiliate transactions is to select an acquisition target with a sufficiently large balance sheet to absorb the volume of affiliate transactions you intend to undertake. For example, if you are a manufacturer looking to factor a rolling balance of \$5 million worth of receivables through your newly-acquired bank, the likelihood of your business plan being approved will be greater if your target bank has assets of at least \$500 million (assuming \$50 million of capital and a 10 percent leverage ratio) that are not commercial and industrial loans. In this scenario, your \$5 million of receivables would represent only one percent of the bank’s total assets (10 percent of capital to be compliant with Section 23A)¹¹ and concentration risk would be offset by a balance sheet that has almost all of its loans in other lines of business. Unfortunately, the calculus for determining the size of the balance sheet necessary to accommodate your intended transactions is not exact and will depend largely on the bank’s current lines of business and the familiarity of its current or proposed management with lending to your industry.

BUILDING A REGIONAL OR SUPER-REGIONAL BANK

Rather than buying a bank and waiting for the consolidation tide to wash over them, some investors prefer to create the wave that sweeps banks

together. To implement a roll-up, almost any community bank will do as a jumping off point and the initial goal should be to acquire a target with the smallest balance sheet, regardless of its profitability.

In most instances, a plan to grow a bank through acquisitions will require a significant amount of outside funding and will not rely on the first acquired bank's retained earnings to generate the dollars used to make subsequent purchases. With such a large amount of money being invested at the outset in a small bank, the holes in its balance sheet will be relatively insignificant and easily absorbed by the funds set aside for acquisitions. Accordingly, the smallest target will, paradoxically, represent the best platform for launching a roll-up strategy to create a regional bank.

The lynchpin to receiving regulatory approval for a consolidation is presentation to the regulators of a comprehensive and scalable risk and compliance management system. An acquirer can avoid the changing-the-business-plan obstacle that tends to impede approval because a roll-up does not require a change in the business plans of the subsequent targets. To the extent that future targets are soundly run banks, their utility to the overall growth strategy is their geographic reach and deposit base. The focus of the change-in-control approval process therefore shifts away from the safety and soundness of the business plan and focuses more on effectively managing risk during the expansion.

The regulators' heightened concern for risk management is straightforward: the larger the institution, the larger the overall risk to the banking system and, for the FDIC in particular, the Deposit Insurance Fund. A large part of the time and energy devoted to merger integration is spent on achieving operational objectives and for good reason. Poorly integrated compliance systems could mean losing control of enterprise portfolio risk, lack of a focused BSA/AML program and spiraling costs, to name only a few of the potential pitfalls. Timely integration of systems and processes is necessary for the merged banks to derive economies of scale and eliminate incompatible workflow functions to achieve effective and efficient risk management and reporting systems. To the extent an acquirer is able to present for approval a management team with a depth of experience in managing the mergers of financial institutions and a high-resolution, comprehensive plan for doing so, the regulatory approval process is likely to be less complicated than if it were matched with a new business plan.

CONCLUSION

The mechanics of community bank acquisitions are substantially similar to those for acquiring any business. However, an acquirer that has a thorough understanding of a bank's portfolio risk exposures and is attuned to the concerns and focus areas of the target's regulators has a far greater likelihood of completing a successful acquisition.

NOTES

¹ Lenney, W., *Pace of Bank Mergers and Acquisitions Increases as Valuations Gradually Improve* (Third Quarter, 2010).

² Jagtiani, J., *Understanding the Effects of the Merger Boom on Community Banks* (Second Quarter, 2008).

³ Brophy, T., *Are Banks on the Brink of a Merger Boom?* (July 18, 2011).

⁴ 12 U.S.C. § 1817(j)(7).

⁵ 12 U.S.C. § 1817(j)(4).

⁶ 12 U.S.C. § 1817(j)(5).

⁷ Permissible activities of bank holding companies across varying industries is beyond the scope of this article.

⁸ 12 U.S.C. § 371c(a)(1).

⁹ 12 U.S.C. § 371c(b)(7).

¹⁰ A full analysis of the restrictions of Sections 23A and 23B is beyond the scope of this article.

¹¹ A bank's "extensions of credit" to affiliates must be secured by a statutorily defined value of collateral, ranging from 100 percent to 130 percent of the initial amount of the extension of credit depending on the nature of the collateral.

SELLING A COMMUNITY BANK: PRACTICAL TIPS

You are the chief executive officer of a community bank. Last night, the board of directors agreed in principle with a potential acquirer to sell a majority interest in the bank. The message blinking away on the mobile device at your bedside helpfully says "Selling 75% of the stock at 10% premium to book. Get the deal done. Thx."

After downing a couple of antacids, you head to the office to call the bank's outside counsel and start the ball rolling. Unfortunately, counsel has more questions for you than answers. When is "book value" being measured? How will it be calculated? How is the acquisition being funded? Who is submitting the change in control? How many control parties are applying? As the questions rattle off your attorney's tongue like so many ball bearings down a metal playground slide, you grip the phone tighter and wonder when in your life you left behind the basics of borrowing low and lending high in favor of navigating a bank through an acquisition.

Here are a few pointers for bank executives responsible for negotiating a sale of a majority position in a bank. The topics are the ones that crop up most frequently in community bank acquisitions and that many community bankers find to be the most important.

WHAT IS BOOK VALUE?

Determining book value should be a softball question easily throttled out of the park: Book value is the quotient of stockholders' equity divided by the number of shares of stock outstanding. This is technically correct, but acquirers are always suspicious of a bank's book value. They will invariably conclude during their due diligence that the bank's loans are not as strong as the bank believes and that the loan loss reserves are insufficient. In other words, the acquirer believes the bank's stock is worth less than described in the financial statements because weak assets will take a bite out of the bank down the road.

If a bank acquisition signed and closed during the same month, negotiating the book value would be straightforward. You and the acquirer would sit down together, review each loan and haggle over the appropriate reserve. When the horse-trading is over and the dust settles, the book value is set. In this scenario, the bank and the acquirer have locked in exactly how much of the risk of a decline in book value each will bear.

A theme throughout bank acquisitions, however, is the importance of time. More specifically, how long will it take the bank's regulators to

approve the change in control applications? The longer the time between signing and closing, the greater the likelihood that write-downs will occur and that book value will suffer. Acquirers are reluctant to accept the risk of a declining book value while they wait for regulatory approval. They want to buy the stock at closing book value adjusted for actual events and are generally unwilling to agree to a price today that may not reflect economic reality six months later.

The acquirer's position sounds reasonable at first blush, but the unique nature of the regulatory process makes the acquirer's view patently inequitable. To a large degree, the acquirer controls the timing between signing and closing because it controls one side of the regulatory approval process. If an acquirer drags its feet on submitting necessary change-in-control information, the regulators will simply wait for the submission and the bank will continue to bear the risk of additional declines in book value. In a troubled bank acquisition scenario where the bank is unprofitable, the acquirer can use these delays to ride out the bank's portfolio to expose weaknesses and experience the added benefit of a lower purchase price as a result of operational losses.

A common solution to deter the acquirer from delaying the application process is to require "best efforts" in prosecuting the change in control. This only goes so far because no matter how much information the acquirer provides to the regulators, the regulators may want more: more projections, more business plan details, more background information and more financial information. Besides, outside of an expensive litigation, who is going to determine whether best efforts were really used? A better solution is to incent the acquirer to expedite its side of the regulatory approval process, and to hound the regulators for approval, by sharing the risk of book value erosion.

A sliding scale approach is often an effective technique and is tailored to address directly the perverse incentive acquirers have to delay closing. For example, during the first two months after the deal is signed, the bank would bear 100 percent of any losses from its portfolio or operations (this provides the acquirer sufficient time to submit a complete change-in-control application without any risk). Thereafter, the bank would bear

only 50 percent of any losses to reflect the fact that both parties are equally subject to the regulatory approval processing timeline. This fifty-fifty split also serves as compensation to the bank for having granted exclusivity to the acquirer between signing and closing. If the process continues beyond a certain point, the acquirer could be made to absorb all losses. In the end, there are any number of permutations for sharing the risk of book value erosion, including distinguishing operational losses from loan, litigation or other extraordinary losses, and shifting percentages based on the passage of time or the occurrence of certain events. What is most important is allocating the time-risk in a way that provides an incentive for all parties to move the deal along quickly.

SHOW ME THE MONEY

As the market appetite for financial sector securities bottomed in late 2008, the doors opened to bargain hunters looking to make a foray into the community bank space. With credit tight, acquirers were less likely to have a ready pool of cash waiting to make their acquisitions. Instead, with banks in such weak negotiating positions, acquirers sought to ink deals before raising the funds necessary to deliver the purchase price. Their reasoning: it's easier to raise capital with a locked-in acquisition target waiting at the other end. Unfortunately for many community banks, this model of unfunded acquisitions has continued during the economy's soft recovery.

In an ideal world, acquirers would show up at the negotiation with a bank statement showing sufficient funds to close the deal tomorrow. Although that may at times be the case, in the community bank space it is far more likely that the buyer is light on funds. Even more likely, the person at the bargaining table is not necessarily the money player. In the least desirable - but unfortunately not entirely infrequent - case, he or she is a deal broker, someone who has met with one or perhaps several wealthy individuals who displayed some degree of interest in moving into the bank space. As the president of a target bank, your goal is to bring the money into the transaction as early as possible. Your reasons are three-

fold: (i) to alleviate any concerns about an agency problem between the person with whom you are negotiating and the parties whose names will be on the checks; (ii) to determine the structure of the deal; and (iii) to convince the regulators that the deal has a good probability of closing.

Often, the “deal broker” will not have a good sense of the regulatory process involved in a bank acquisition. Even if the broker does, it is likely that the broker has not explained that process to the principal investors. More specifically, the principal investors frequently do not know that they are likely to become the targets of the change-in-control application process, and when they are informed, may not want to take part in that process. By having them place a significant purchase price deposit at risk at signing, you can be sure that the principal investors have considered whether they are willing to pursue a change-in-control and the thorough disclosure this requires. Few people are willing to cut a check into escrow without being advised on all of the major points of a transaction.

Insisting on the escrow of all or a significant portion of the purchase price upon execution of the stock purchase agreement goes a long way to convince the regulators that the deal is real and also identifies the field of potential control parties that will require regulatory approval. In a \$25 million acquisition for half of a bank with Tier 1 capital of \$25 million, any investor who invests \$5 million or more will be presumed to control the bank.¹ In this hypothetical, to the extent that any single escrow deposit exceeds \$5 million, the target bank will know that such investor will be required to submit a change-in-control application.² This allows the target bank to begin its own due diligence into the personal backgrounds of the principal investors.

It is incumbent on target banks to research their potential principal investors. This best practice protects a target from wasting time and money in pursuing a transaction with a counterparty that may have a personal or financial history that would never pass regulatory scrutiny. Equally important, by winnowing out potentially “unapprovable” proposed control parties before submitting their names to regulators for review, a target enhances its credibility and supervisory relationship when it finally approaches its regulators with a proposed deal.

Finally, showing your regulators a significant escrow deposit will go a long way toward expediting the change-in-control process. All things being equal, a bank with a higher Tier 1 capital ratio is more favorably viewed by regulators than a bank with lower capital ratios if for no other reason than protection of the Deposit Insurance Fund. By bringing funds to the table immediately, acquirers remove any uncertainty for the regulators that their time spent in reviewing and assessing a change-in-control application will be wasted because the deal never closes for lack of funds. With the purchase price on deposit, only their approval will delay the injection of capital and increase in capital ratios.

IMPORTANCE OF EXHIBITS

Behind the signature page of every stock purchase agreement trails a host of schedules and exhibits to the agreement. While these are critical elements and frequently the foundational representations of a deal, they may not always be perceived to contain material business points and are therefore often left to counsel to make final determinations. Particularly in the bank acquisition context, however, targets should take advantage of exhibits to expedite the application process for a change-in-control by requiring that the entire application be an exhibit.

As discussed above, in the bank application process acquirers control the flow of information to bank regulators. Target banks can avoid any initial application delay by requiring the acquirer to prepare a complete application before signing the purchase agreement. By insisting that the proposed business plan, financial projections, management structure chart, board of directors and principal investor list be drafted in advance, you can be assured that the application will be submitted the day after signing. In addition to the above documents, target banks should require that federal Interagency Biographical and Financial Reports be completed by all proposed directors and principal investors and attached as exhibits to the purchase agreement. Finally, the acquirer should have its pre-filing meeting before signing the stock purchase agreement to ensure that any obvious kinks in the application are worked out even before it is submit-

ted. Accordingly, acquirers should represent and warrant in the purchase agreement that they have concluded a pre-filing meeting and that they have, to the best of their ability, amended their application to incorporate and address all of the areas and questions posed to them during the pre-filing meeting. By agreeing to each of these exhibits in advance of signing, you remove as many regulatory approval obstacles as possible before committing to exclusivity.

A good general practice for community bankers charged with selling their banks is to reduce the number of variables to the extent possible before signing an agreement. Negotiate for the largest possible escrow deposit, demand a complete list of principal investors and proposed directors as control parties and require preparation and delivery of all of the pieces of a change-in-control application in advance. To the extent your counterparty is unwilling to do any of these things before signing the stock purchase or similar agreement, you immediately have good reason to suspect their credibility and should be wary of signing any agreement that limits the flexibility of the bank to pursue other transactions.

NOTES

¹ 12 C.F.R. § 303.82(b)(2).

² Rebutting presumptions of control under applicable federal regulations is beyond the scope of this sidebar.