PRYOR CASHMAN LLP

FINANCIAL INSTITUTIONS GROUP

LEGAL UPDATE

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THE FRAMEWORK FOR BUYING A COMMUNITY BANK

HOW THE STAGE IS SET

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.

[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).

There are many reasons to buy a community bank, but on the whole 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 system. The institution's business plan, and whether its economics are realistic and achievable, while important, are arguably 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.

[4] 12 U.S.C. § 1817(j)(7).

[5] 12 U.S.C. § 1817(j)(4).

[6] 12 U.S.C. § 1817(j)(5).

SELLING SYNERGIES TO THE 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

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

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 driving 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

[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.

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.

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.

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This brief discussion of bank acquisitions is not comprehensive and is for general information purposes only. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Pinchus Raice at 212-326-0104, praice@pryorcashman.com or Robert Lamonica at 212-326-0810, rlamonica@pryorcashman.com.

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Pinchus Raice is the Chairman of the Financial Institutions Group. Pinchus represents financial institutions and individuals in negotiating and completing mergers and acquisitions in the community banking industry, and represents banks and bank officers and directors before all federal and state bank regulatory agencies, including contested administrative proceedings. Pinchus has served as counsel to numerous New York and New Jersey-based commercial and savings banks in a wide range of matters; as in-house counsel to a New York savings bank; and as a federal bank regulator with the FDIC's New York office.

Pinchus has extensive experience representing financial institutions in informal regulatory enforcement actions, such as commitment letters and board resolutions, memoranda of understanding and safety and soundness compliance plans, and in formal enforcement actions, including consent orders, cease and desist orders, formal written agreements, safety and soundness orders and PCA and capital directives. Pinchus also has extensive experience representing boards of directors in a broad range of administrative enforcement matters and court proceedings, including defense of civil money penalty actions and removal and industry bar orders and defense of FDIC-receivership lawsuits claiming breach of fiduciary duty.

In June 2008, Pinchus and co-author David Thomas received the Burton Award for Legal Achievement for their article *Sinners at the Pearly Gates – A Primer on the Standards of Admission to the Banking Fraternity*. The presentation was made at the Library of Congress.

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In the past year, Robert's financial institution representation included the acquisition of a thrift through a multi-tier holding company, the sale of a majority interest in a national bank and the investigation of a complex fraudulent transaction scheme at a state-chartered bank.

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Prior to joining Pryor Cashman, Robert worked as an analyst with the Emory University Endowment where he was responsible for reviewing and tracking investments in private equity partnerships, hedge funds, and real estate investment trusts.

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