The Banking Law Journal

VOLUME 127 NUMBER 9 OCTOBER 2010

The Banking Law Journal (ISSN 0005 5506) is published ten times a year by A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207. Application to mail at Periodicals postage rates is pending at Washington, D.C. and at additional mailing offices. For subscription information and customer service, call 1-800-572-2797. Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 10 Crinkle Court, Northport, New York 11768, SMeyerow@optonline.net, 631-261-9476 (phone), 631-261-3847 (fax). Material for publication is welcomed—articles, decisions, or other items of interest to bankers, officers of financial institutions, and their attorneys.
POSTMASTER: Send address changes to The Banking Law Journal, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207.

Strategic Purchasing: Assessing Open Bank Versus Failed Bank Buying Opportunities

LORRAINE M. BUERGER

In this article, the author examines the benefits and drawbacks of open bank branch acquisitions from a targeted bank, compared to acquiring the entire target bank in an FDIC-assisted failed bank acquisition.

For leaders of healthy financial institutions, the continuing turmoil in banking represents unprecedented strategic buying opportunities. There are two categories of buying opportunities in the current market: buying from a distressed target pre-receivership, most often by cherry-picking branches, or acquiring the target's entire franchise in a Federal Deposit Insurance Corporation ("FDIC")-assisted acquisition post-receivership.

Growth oriented, healthy banks see value in comparing and contrasting these two categories of acquisition type as part of a strategic planning exercise with their boards. This article examines the benefits and drawbacks of open bank branch acquisitions from a targeted bank compared to acquiring the entire target bank in an FDIC-assisted failed bank acquisition. While the difference may appear obvious on the surface, a deeper look reveals nuances that translate into important risk/return decisions.

Lorraine M. Buerger is an attorney at Schiff Hardin, LLP, where she is a member of the firm's Financial Institutions Client Services Group. Her practice concentration is on corporate transactions, primarily for banks, with a particular focus on FDIC-assisted transactions. She may be contacted at lbuerger@schiffhardin.com.

Published in the October 2010 issue of *The Banking Law Journal.*

STRATEGIC FOCUS IS THE STARTING POINT

The starting point for any CEO and board of directors is to understand its own strategic rationale for acquisitive growth. What does the institution hope to gain by buying a piece of or an entire banking franchise? Building consensus in the board room around the bank's strategic objectives is a precondition to a successful acquisition plan.

Is the primary goal to strategically expand the purchaser's franchise footprint in a very specific, carefully targeted market? If so, a well structured branch deal, with a highly motivated seller, can offer an outstanding opportunity to extend the purchasing bank's reach, at a price generally lower than building or renting green-field branches. In addition to the cost advantage, acquisition of an existing branch reduces the initial drag on earnings by allowing the purchaser to enter the new market with a running start, based on the existing franchise, depositor base and established presence in the community. If targeted strategic expansion is the goal, buyers need to be alert to potential opportunities and proactive in initiating contact with prospective targets, because the window of opportunity may close quickly (as discussed below).

Alternatively, is the primary goal to capture the financial upside and potential bargain purchase opportunity associated with the purchase of distressed assets? If so, then disciplined participation in the FDIC's process for selling the assets and deposits of failed institutions offers the best opportunity (even though some assets purchased, including non-strategic branch locations, may have to be divested or shut down later). If this is the goal, participation in multiple bidding processes is likely to be required, and doing more than one failed bank acquisition will generate valuable economies of scale.

From a strategic perspective, open bank branch acquisitions and FDIC-assisted failed bank purchases are very different types of transactions with different risks and rewards. Cherry picking one or more branches from a distressed bank gives the buyer an opportunity to be surgical in its selection process, deliberating taking real estate or a lease, core deposits and select credits. In an FDIC-assisted acquisition, however, buyers purchase an entire balance sheet, the contents of which may not be known until well after closing and which likely includes certain assets and liabilities that a buyer would normally prefer to leave behind. Yet the FDIC loss-share protection in FDIC-assisted acquisitions can be irresistible and justify, for a buyer, taking a bundle of unknown and undesirable assets along with the "franchise."

The pros and cons of open bank branch acquisitions versus failed bank FDIC-assisted transactions are many and require deeper study by any board engaged in strategic, acquisitive growth.

EXECUTION RISK

Open bank branch acquisitions offer a buyer flexibility: first, flexibility in timing of the negotiations, and second, flexibility in the scope and timing of the buyer's due diligence review. But when the target bank is distressed and on the receivership slide, moving quickly and getting the deal closed is important before receivership intervenes.

Gauging where the target bank stands on the slide toward receivership is important because a buyer will be racing against a clock — and putting itself at risk — just as the seller will be racing against the clock but for a different reason: saving itself from demise. A buyer in an open bank branch acquisition involving a distressed target bank must be proactive and move very quickly. If it acts quickly enough, the buyer can control the transaction timing (including diligence timing, agreement negotiation and signing, etc.), subject to regulatory approvals. Within the constraints of the deadlines, the buyer can generally take as much or as little time as it wishes to conduct diligence. Indeed, diligence periods are negotiated between buyer and seller in open bank acquisitions.

While diligence is controllable, the closing and execution risk in an open bank branch transaction is, nevertheless, high when the seller is distressed. If the regulators jointly decide to proceed with receivership, the branch deal (even if already signed but not closed) runs the risk of being repudiated by the FDIC. That is, the FDIC can use its statutory right of repudiation to cancel the signed contract. In such a circumstance, the jilted buyer would receive no break-up/termination fee, even if such a payment was stipulated in the branch purchase agreement, and no reimbursement for lost transaction costs.

Similarly, the regulators can quash a branch sale well in advance of receivership by simply not approving it on the theory that the target bank's franchise value will be higher in the eventual receivership transaction with the branch or branches still attached to the branch. In short, the regulators have enormous discretion to control the branch sale outcome when the selling bank is distressed.

With that risk in mind, a buyer may prefer to wait to make a failed bank acquisition in an FDIC-assisted deal, understanding that the FDIC controls the receivership process and every aspect of the transaction timing including the scope and timing of the buyer's due diligence investigation. The FDIC restricts on-site diligence to two days for each potential bidder, although diligence via an online datasite is generally available for a minimum of several weeks prior to the bidding deadline.

The closing/execution risk is small for FDIC transactions, as once the FDIC begins a bidding process, it is highly unlikely that the process will not go forward to completion. During the last 18 months, in only a very small number of circumstances have distressed institutions, for which the FDIC's diligence/bid preparation process had already begun, managed to avoid receivership.

PRICING ASPECTS

In an open bank branch acquisition, the buyer controls the price discussions and there is a back-and-forth between buyer and seller over value. In an FDIC-assisted acquisition by contrast, the interested buyer engages in a highly competitive, blind bidding process against other bidders and the FDIC makes the final decision over which bidder wins the acquisition. There is no back-and-forth negotiation with the FDIC.

Currently the FDIC is enjoying extremely high interest in its bidding processes. Large numbers of institutions are participating in diligence processes (at least via online datasites, even if not all potential bidders choose to conduct on-site diligence). Although the number of actual bidders is always smaller than those that conduct diligence, the FDIC is generally receiving bids from multiple bidders on every target. Likewise, the FDIC invites and encourages multiple bids, so in some instances the number of bids exceeds the number of bidders.

Therefore, buying one or more branches from a distressed open bank gives the buyer the opportunity to cut an exclusive dealing arrangement with the target and limit the amount of competition for the assets and liabilities targeted for acquisition. And, the price negotiations are just that — negotiations. This stands in stark contrast to FDIC-assisted acquisitions where the process is controlled by the FDIC and pricing considerations reflect the competitive nature of the process.

ASSETS ACQUIRED

With respect to the charter of seller, there is no difference between an open bank branch acquisition and an FDIC-assisted transaction. Only assets are transferred in both transactions, and the charter is not assumed by the buyer.

With respect to the assets, in a branch deal the buyer can choose to purchase only those branches it desires. The buyer will conduct diligence on the loan portfolio associated with the branches to be acquired, and will affirmatively choose those loans it wants to purchase. The buyer is not required to purchase any particular loan.

In an FDIC-assisted transaction, the FDIC in its sole discretion determines what assets will be included and which will be excluded. The buyer has no discretion to leave behind certain problematic assets or the most seriously impaired loans.

LIABILITIES/CONTRACTUAL OBLIGATIONS ACQUIRED

In an open bank branch acquisition, the buyer generally takes 100 percent of the deposits associated with each branch acquired (though negotiations can result in hot money or wholesale deposits being left behind). Similarly, in an FDIC-assisted transaction, the buyer generally takes all deposits (although the FDIC, too, will occasionally exclude brokered deposits from transfer).

Buyers in open bank branch acquisitions generally assume all contractual obligations associated with the branch or branches purchased, to the extent those obligations can be assumed. If specific contracts or agreements require the counterparty's consent prior to assignment, such consents must be obtained prior to closing.

For contracts in FDIC-assisted acquisitions, however, circumstances are very different. First, contractual restrictions on transfer do not apply when the FDIC is appointed as receiver, pursuant to 12 USC 1821(e)(13)(A). Thus, no counterparty consent to assignment must be obtained prior to closing.

Second, pursuant to the Purchase & Assumption ("P&A") Agreement signed between the FDIC and the assuming institution, the buyer has a 30-day period within which to choose to assume or not assume the contracts and agreements for services provided to or by the failed bank. A longer 90-day period applies for contracts and agreements related to data processing (information technology) functions.

EMPLOYEES/REAL ESTATE ISSUES

In the areas of employment and real estate, buyers face similar circumstances under either transaction structure, with several key differences.

Regarding employment, a buyer in a branch deal negotiates regarding exactly which individuals it will assume as employees. Likewise, pursuant to the P&A Agreement, a buyer in most but not all FDIC-assisted transactions has the opportunity to hire only those employees of the failed bank they select. In both types of deals, the buyer assumes no responsibility for target bank employees it opts not to hire.

With regard to real estate, a buyer in an open bank branch acquisition negotiates to determine which bank premises it will purchase and at what price. In FDIC-assisted acquisitions, however, the buyer has a 90-day option to determine which failed bank premises it will purchase. If the buyer in the FDIC acquisition opts to purchase failed bank premises, it must do so at a non-negotiable "fair market value," as determined by an independent appraisal value conducted within 60 days of closing.

IT CONVERSION

A key concern for any bank transaction is achieving a clean, efficient conversion of the information technology ("IT") network. In this regard, there are significant differences between open branch deals and FDIC-assisted transactions.

In an open branch acquisition, the IT conversion work takes place between signing of the definitive agreement and closing. The conversion itself generally takes place on the day of closing.

In an FDIC-assisted transaction, the assuming bank has a 90-day option to determine which IT contracts of the failed bank it will assume. For those contracts it chooses not to assume, the assuming bank has another 50 days (a total of 140 days after closing) to complete its conversion of the IT system.

PRE-CLOSING REGULATORY "HASSLE" FACTOR

Regulatory burdens, prior to closing, for FDIC-assisted transactions are minimal. Potential bidders communicate with the FDIC in order to become "qualified" bidders and to participate in the diligence process. For the winning bidder, other federal and state filing requirements are minimal and handled in a streamlined manner in the days between the FDIC's choice of a winning bidder and the bank closing (generally between four to seven days).

For standard branch deals involving state-chartered institutions, the regulatory burden is greater. State regulatory filings will vary, but a filing of some sort will be required in every state. If branches pursued are located outside the home state of the purchasing institution, filings will be required in both states. At the federal level, a formal filing (in most instances, the Interagency Bank Merger Act Application) and publication of notice in local newspapers will be required. Most importantly, as noted above, if the selling institution is in distressed condition, potential branch buyers must communicate with regulators to confirm that a branch sale is possible. The risk of regulatory denial is significant if the distressed seller has proceeded too far towards receivership.

POST-CLOSING CHALLENGES/OPPORTUNITIES

Post-closing is the point at which the differences between branch deals and FDIC deals are the most dramatic.

For standard branch deals, the buyer will face minimal post-closing obligations, beyond the required notices to depositors and safe deposit box holders. The buyer runs the newly acquired branch as it finds appropriate, and absorbs

100 percent of any losses sustained associated with the acquired assets.

For FDIC-assisted acquisitions,[1] the buyer assumes 10 years of very significant contractual obligations to the FDIC regarding administration of the acquired assets. The obligations include intensive reporting, compliance and audit obligations. In return for compliance with those obligations, the buyer enjoys indemnification for a portion (not to exceed 80 percent) of the losses it sustains on the acquired assets.[2]

CONCLUSION

Of course, everyone hopes that the country never again sees the amount and duration of distress experienced since late 2007 in the banking industry and that fortunes change for industry participants sooner rather than later. But so long as the turmoil continues, healthy banks will have opportunities aplenty to grow through acquisitions.

Targeting distressed banks for surgical branch acquisitions can offer a healthy bank significant market expansion opportunities at reasonable prices. Those overtures, even if left unfulfilled, can put the buyer in a better competitive posture to acquire the target's entire franchise should the target eventually fail and the FDIC auction it in an FDIC-assisted acquisition. Working through the strategic pros and cons of one or multiple branch open-bank acquisitions versus FDIC-assisted acquisitions is valuable time spent for healthy banks because through focused discussion and analysis of these different opportunities, an institution can reach a conclusion as to the ideal format for acquisitive growth in the current distressed market environment.

NOTES

[1] Please note that this discussion assumes FDIC-assisted transactions with loss share. Bidders also have the opportunity to bid on failed banks without loss share protection, although such transactions have been infrequent.

[2] For more information regarding these obligations, see, Lorraine M. Buerger, "The Changing Rules for FDIC-Assisted Acquisitions: Strategies for Minimizing Buyer's Risk in Failed Bank Transactions," 5 *The Banking Law Journal* 127 (2010).