PRYOR CASHMAN LLP

FINANCIAL INSTITUTIONS GROUP

LEGAL UPDATE

January 17, 2012

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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.

This article is intended to provide a few pointers for bank executives responsible for negotiating a sale of a majority position in a bank. The topics are cherry-picked based on the issues we see crop up most frequently in community bank acquisitions and are the ones that many community banker's 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 loathe 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

[1] 12 C.F.R. § 303.82(b)(2).

[2] Rebutting presumptions of control under applicable federal regulations is beyond the scope of this article.

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 submitted. 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.

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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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Robert Lamonica is a member of Pryor Cashman's Financial Institutions Group and Corporate Group, concentrating on financial institution regulatory matters, merger and acquisition and enforcement actions.

Robert has worked closely with state-chartered banks, national banks, thrifts and bank holding companies in managing regulatory compliance, conducting acquisitions and issuing securities. He regularly counsels financial institutions on compliance and enforcement matters involving federal and state regulatory agencies and has participated in the defense of directors and officers involved in regulatory liability actions.

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.

In addition to his financial institution regulatory practice, Robert's general corporate practice includes private equity investment, securities offerings and corporate formation, finance and governance.

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.

Robert is a 2007 graduate of Emory University School of Law, where he was a member of the Moot Court Society, and the Goizueta Business School, where he earned a Master of Business Administration in finance in addition to his law degree.