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Top 10 Negotiated Points in a Bank Transaction

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BANK TRANSACTIONS have increased substantially in recent years. At the current pace, bankers could easily find themselves in negotiations as a buyer or a seller. Many of these deals have complex nuances where a buyer and seller can disagree on the best approach to protect their respective interests. As legal advisors charged with helping negotiate such deals, we see specific issues arise over and over again. Here is a list of negotiated deal points in which we routinely see buyers and sellers spending a significant amount of time when negotiating a bank transaction.

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1 Purchase price:

While the overall price paid in the deal is certainly key (and an obvious focal point), the components of purchase price such as how the book value is defined and the method for determining book value at closing are heavily negotiated points.

The starting point for pricing negotiations is often book value plus a certain pricing multiple. The definition of book value — what is and isn't included in the computation — is very important to both buyer and seller. This definition will take into account special additions or deductions from book value, which may include:

- the allocation of unrealized profits or losses in a bank's investment portfolio (especially key in today's rising interest rate environment);
- special accruals for benefit plans;
- special accruals for one-time expenses related to the transaction, and
- the calculation of the selling bank's ALLL.

Further, the timing of when the purchase price is actually determined can be contested. Oftentimes it is difficult, if not impossible, to determine the purchase price on the same day as closing. Parties typically pick a date to lock-in the purchase price (called the "determination date") which is often the month-end prior to closing.

Because of the gap from determination of price until actual close, a savvy seller will push for the inclusion of an interest rate or *per diem* concept to bridge the gap from the determination date to the closing date to approximate net income during that time period. This too becomes a pricing component that must be negotiated.

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No. 1: Purchase price, *continued from previous page*

Finally, the mechanics of preparing and reviewing the final balance sheet to determine the purchase price must be negotiated. A buyer and seller need to take into account special accruals, the amount of time each party gets to prepare and review the calculations and what happens if the parties do not agree upon the final price. A seller does not want to be railroaded with big price changes the date before closing, but a buyer needs enough time to understand all of the components of seller's balance sheet that flow into book value. ❖

2 Payment terms:

The main components of a payment terms negotiation are the currency to be used (cash, buyer's stock, or a mix of each) and whether an escrow or other holdback will be applied at closing.

While cash is king, a buyer using its own stock as consideration for a purchase will trigger additional negotiations surrounding how that stock is valued on closing. When a closely-held buyer is offering its shares as currency, negotiations are often focused on when and how the value of buyer's stock is computed. In the case of a public buyer, a seller and buyer will often spar over the date the stock price will be locked in and whether to insert a trailing average or to incorporate daily fluctuations.

Once price and currency are set, the negotiations will turn to the nuts and bolts of the payment delivery. A buyer may seek to protect itself against post-closing damages it suffers as a result of the purchase (see point No. 4) while a seller desires to see its purchase price paid free and clear at close. This can result in seller and buyer discussing an escrow of a purchase price, the size of the escrow, how the escrow will be paid out and whether an independent third party administrator should be involved. ❖

3 Financial condition of the bank:

Buyers desire to obtain value for the premium they pay and sellers want the ability to maximize their sale price. This dynamic focuses negotiations on minimum capital level requirements, the allowance for loan and lease loss balance at closing, and special dividends or capital reductions that occur prior to closing.

Because of the need for regulatory approval, bank transactions (with few exceptions) are structured as "sign and later close" deals, meaning the parties will first sign a definitive agreement, then seek regulatory approval (and often shareholder approval), and close the transaction later. This gap is anywhere from two to four months or longer depending on regulatory issues or, in the case of bank merger transactions, available core-conversion dates. As a result, the buyer will seek to put certain protections in place to ensure the condition of the bank at the closing remains the same or better than it was when the buyer conducted diligence. Sticking points include:

- Parties negotiating minimum and maximum capital levels, with the purchase price being diminished or increased in the event the bank's core capital levels are above or below the negotiated threshold at closing.
- A selling sub S bank that declares quarterly tax dividends may want to ensure their shareholders can continue to rely on such payments, but a buyer may try to place strict limits on tax or other dividends, which will diminish the value of the institution below a certain level.
- A special dividend is often contemplated and negotiated to permit the seller to remove excess capital from the bank at closing, which shields the buyer from having to pay for the excess capital. ❖

4 Post-closing liability:

In privately held, all-cash deals, oftentimes a buyer and a seller will negotiate what type of post-closing liability the seller has for losses incurred as a result of conditions at the bank that were created under the seller's watch.

First, the parties need to come to accord on the length of time after closing when a claim can be brought. This can range anywhere from six months to three years (or longer for special losses such as failure to pay taxes).

Parties will negotiate a "deductible" to weed out claims for immaterial losses, and a "cap," which sets the maximum amount of recovery that can be sought. These limitations are often not applicable in cases of fraud or willful misconduct on the part of the seller. Parties will frequently negotiate carve-outs for breaches of certain fundamental representations, such as title to the stock of the bank or authority to sign the agreement. ❖

5 Earnest money & break-up fees:

Negotiations often include whether or not seller will require buyer to make an earnest money payment when the deal is signed; how and when the earnest money is applied to the purchase price, paid to a seller or returned to a buyer; and break-up fees for either a buyer or a seller if the agreement is terminated prior to consummation.

The amount of earnest money fluctuates with the size of the transaction, the confidence the parties have that regulatory approval will be obtained, and whether the earnest money constitutes "liquidated damages." If a buyer insists that earnest money constitutes liquidated damages (recompense for the buyer's failure to complete the transaction) the seller may insist on more earnest money.

In transactions where directors want to fully ensure they can exercise their fiduciary duties as part of the deal, seller may be required to pay break-up fees in the event the transaction does not close for one of a number of negotiated reasons. Further, a seller may insist that buyer pay a reverse break-up fee to compensate seller for any harm to seller's business if there is little to no earnest money and buyer refuses or fails to close.

Break-up fees are designed to "lock in" the parties to complete the transaction, even when a better deal comes along. These fees are generally higher than an earnest money payment — between 1 percent to 5 percent of total purchase price. ❖

6 Non-competition provisions:

A non-competition provision will help a buyer protect its investment, particularly when a seller is only selling a portion of its operations and will continue operating following the closing.

The scope of who signs a non-compete is often hotly contested. Some buyers may want key board members and management to sign non-compete agreements as a condition of the deal or closing. This demand can result in heated negotiations, especially where those individuals are not currently subject to such restrictions.

On the flip side, in the case where a holding company is selling a bank that is the only, or the largest asset, of the holding company, a non-compete may not be controversial. Parties will most often discuss the duration, geographic scope and conduct regulated by the non-compete. ❖

7 Representations and warranties:

There can be a push-pull between a buyer's desire for the seller to stand behind the operations of the bank being sold, and the seller requiring a buyer to perform due diligence and take ownership of the acquired bank. Important representations can include the enforceability of the loan portfolio and loan files (but not the collectability), the current condition of any bank buildings and real estate, proper preparation and disclosure of financial statements, any undisclosed liabilities, validity of any intellectual property, and the seller's and bank's legal and regulatory compliance.

While a buyer will conduct some diligence on a bank, the buyer typically prefers a comprehensive set of representations from seller to disclose any present or potential liabilities as part of the sales process. The seller will frequently attempt to limit its representations and warranties to the "knowledge" of its key management, or to exclude all but "material" issues present at the bank. The parties will frequently attempt to agree on what is practical for a seller to know, and attempt to balance that against the buyer's need for assurance that it is not walking into potential or existing liability upon close. ❖

8 Operational covenants:

Special covenants are always at the heart of the deal, but certain operating covenants set an expectation between buyer and seller on the operation of the organization from the date of the agreement through closing. Operational covenants can include commitments to operate in the ordinary course, to conservatively manage the investment portfolio and to restrict capital expenditures until the closing date. Generally, the covenants will seek to prevent the seller from staking out risky positions or not undertaking expensive or long-term activities that the buyer would inherit at closing.

Bank regulators do not want to see buyers exercise undue control over an organization prior to consummation of the deal. Neither party wants to force the seller to commit to take, or not take, an action that will cause the bank to perform poorly or inconsistently from its current operations. As a result, negotiations often spur important conversations between parties related to management expectations for the period between signing and closing. While often heavily negotiated, these covenants more often than not settle into a practical middle ground that both parties agree upon. ❖

9 Third-party agreements:

Vendor termination or change in control fees can be significant; who bears the burden of these fees can become a contested point in transactions. This can be further complicated by the anticipated post-closing conversion of the seller's operations and the vendor's willingness to work with both parties in the assignment or termination of any given agreement. Ultimately the resolution of this issue is often subject to the current status of a seller's vendor agreements, as well as the parties' relative negotiating positions. ❖

10 Employment matters:

In any transaction the treatment of people who work at the selling organization is as important as any other facet of the deal. Buyer and seller will often want to negotiate who are key employees as a condition of the deal, what type of restrictions are in place for employees, how to transition employment relationships, how to integrate benefit plans and how to integrate culture as a whole. Parties may wrangle over stay bonuses (to compensate key people to stay through deal close) and employee releases, to provide the buyer with a blank slate for employment-related claims that may have accrued during the seller's tenure and might be brought forward after the sale.

Sellers often seek to block such releases from becoming "closing conditions" as it gives employees outsized bargaining power in the transaction. The parties may also discuss who pays severance for any terminated employees either prior to or following closing; this can be important to a seller to compensate long-term employees while ensuring a buyer works hard to retain employees. ❖