Evaluating Acquisition Opportunities

Acquire or Be Acquired Conference
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Preparing for an Acquisition

- Considering Acquiring Another
  - Getting the Board on Board
  - Getting the House in Order
  - Getting the Regulators on Board
  - Assembling the Deal Team
  - Developing the Game Plan
  - Conducting Thorough Due Diligence
- Considering Being Acquired
  - Process for Selling a Company
- Current Acquisition Agreement Trends

Considering Acquiring Another?

Getting the Board on Board

- Having a unified board is the key to a successful M&A strategy
- Stress board confidentiality
- Develop acquisition strategy
  - Market
  - Target size range
  - Target characteristics (clean versus challenged)
- The board needs to have a thorough understanding of the steps involved with, and the effects of, undertaking an acquisition strategy:
  - Have bank management present on strategy and goals
  - Have one or more investment banks present on the general and local M&A markets, pricing analyses, recent transactions, accounting issues (e.g., "mark to market"), and the financial effects of various hypothetical transactions

Getting the Board on Board

- Have legal counsel present the steps involved and the timeline for a typical bank acquisition
  - Be aware of the significant time and effort that will be involved
  - Understand that, depending upon deal size, a deal could take the company out of the market for a period of time after closing
- Have accountants present an overview of accounting issues and best practices

- Understand that a successful acquisition may bring with it governance changes, e.g. new board or management team members or compensation changes

Getting the Board on Board

- Understand the responsibilities that come along with undertaking an acquisition strategy, such as a heightened duty of confidentiality and restrictions on trading in the company's or the target's stock

- Take preliminary actions to begin the acquisition process:

  - Engage financial advisor(s)

  - Authorize management to begin exploring potential acquisition opportunities

  - Establish a board committee (e.g., chairman, CEO, and one or two other directors) to explore opportunities on behalf of the full board

  - Consider adopting a Policy on Corporate Opportunities

Getting the Board on Board

- **Have a coordinated communications strategy to prevent potential Regulation FD (selective disclosure) issues**

- Stay informed – have periodic reviews of market and deal issues with investment bankers and legal counsel

Getting the House in Order

- Legal review of corporate documents
  - Confirm that the company has sufficient authorized common stock and blank check preferred stock available
  - Update the articles and bylaws, if necessary (e.g., shareholder proposals/nomination process)
- Review existing board classes
- Review management team and employment agreements
- Review incentive plans and material contracts for change in control triggers
- Confirm that the company's indemnification provisions and D&O insurance are adequate

Getting the House in Order

- Establish process and responsibility for Board and Committee minutes
- Update the company's business plan, if necessary
  - Consider best location (holding company or bank level) for any anticipated new non-bank activities (e.g., registered investment advisor, trust, broker dealer, insurance) and associated regulatory implications
- Review staffing and internal controls, policies, and procedures – do you have the capacity to absorb another company (regulatory consideration)?

Getting the House in Order

- Resolve any regulatory issues and ensure ongoing compliance, particularly BSA/AML, Fair Lending and CRA compliance

- Consider early discussions with any key shareholders to "socialize" the acquisition strategy (need agreement to maintain confidentiality and not to trade)

Getting the Regulators on Board

- Consider the company's and the bank's general compliance history and relationships with their regulators
  - Address any unresolved supervisory issues
  - Communicate with regulators early and often in the process
  - Compliance issues with target can affect the regulatory approvals for the company and the bank
- Most important issues – capital, management, and having sufficient resources to integrate the target
  - Develop capital plan (if needed)
  - Confirm management resources
    - Transaction
    - Integration

Assembling the Deal Team

- Key executive officers
- Key directors (including members of the Corporate Opportunities or M&A committee)
- Outside advisors:
  - Investment bankers
  - Legal counsel
  - Outside loan review firms
  - Accountants/tax support
  - Proxy soliciting firm
  - PR firm

Developing the Game Plan

- Develop pitch materials to market the bank
  - Why is your institution a good long-term partner?
  - What steps could be taken to make your institution more attractive?
  - Public stock currency provides acquirer with flexibility
    - Review public company filing eligibility (S-3)
    - Assess stock exchange requirements

Developing the Game Plan

- Develop parameters for potential target banks
    - Decide on size, location, management, culture and business philosophy, special products, etc.
- Develop internal projections that identify acquisition synergies

Developing the Game Plan

- Be prepared before approaching your first target - know your target
- Be ready to handle rumors regarding the company's plans
  - "No comment" policy is generally the best approach
  - One person, typically CEO, often designated as company spokesperson
- Prepare a form of non-disclosure agreement, due diligence request list, and initial term sheet or letter of intent that can be tailored as needed

Developing the Game Plan

- Be ready to promptly begin due diligence once the NDA is signed
- Build in plenty of time to review the initial draft of the merger agreement before delivering it to the target
- Assess capital needs and develop plan to address as needed
  - Secondary offerings
    - Shelf registration
  - Bridge debt facilities
  - Balance sheet management

Conducting Thorough Due Diligence

- Look for cultural compatibility – "social" issues (including board composition and management responsibilities) are usually the keys to the success of an acquisition
- This step is still critical – due diligence may drive substantive merger agreement provisions
- Understand fair value accounting principles
  - Balance sheet marks and goodwill impact
- Review articles and bylaws for provisions that may affect the acquisition

Conducting Thorough Due Diligence

- Both sides should expect an extensive review of loan and investment portfolios, employment agreements and benefit plans
  - Consider an outside loan review firm to conduct a thorough loan review
  - Review safety and soundness and compliance issues
  - Understand regulatory limitations on disclosure of bank regulatory exams and other correspondence
  - Review executive compensation documents, including employment agreements, incentive plans, SERPs, or other similar agreements, and understand the effects of Part 359, Section 280G, and Section 409A on such arrangements

Conducting Thorough Due Diligence

- Understand tax issues, including the effect of the acquisition on any deferred tax assets
- Confirm that branches and other key assets are owned or that lease agreements can be assigned/do not require change of control consents
- Review material agreements, including data processing agreement(s)
- Review D&O insurance, including tail coverage, as well as ongoing indemnification responsibilities to directors and officers

Conducting Thorough Due Diligence

- Look for pending or threatened litigation against either party
- Be sure to thoroughly analyze costs and potential cost savings
  - Data processing agreements
  - Change-in-control payments
  - Merger-related litigation (strike suits, etc.) and associated costs have become more common – but don’t assume you have to pay to settle these

Considering Being Acquired?

Process for Selling a Company

- **STEP 1:** Analyze your standing in the market place, level of core deposits, customer relationships, quality of loan assets and investment securities portfolio
- **STEP 2:** Consult with experienced legal counsel
  - Conduct due diligence
  - Review employment contracts
  - Remind board of fiduciary duties
    - Duty of care
    - Duty of loyalty
    - Duty of confidentiality
  - Remind board of restrictions on trading
  - Assess any potential board member conflicts

Process for Selling a Company

- Consider implementing a policy regarding potential corporate opportunities
  - Board might establish a standing Corporate Opportunities Committee
    - Explore opportunities on behalf of the bank
    - Discretion to enter into preliminary discussions with third parties regarding any such opportunities
    - Make a preliminary determination that any particular opportunity is not in the best interests of the bank
    - Discretion to inform the third party of its recommendations
  - May require board to sign acknowledgment of fiduciary duties

Process for Selling a Company

- No other director of the bank should initiate any such discussions or respond to any inquires without the prior express direction of the board

    - Proper response to any inquiry:

"The Bank is following its long-term strategic plan, but we are always interested in hearing about ideas that may lead to the long-term enhancement of shareholder value. We have formed a standing committee to analyze and review all such ideas and make a recommendation regarding the idea to our full Board of Directors. It would be inappropriate for me or any other officer or director of the Bank to investigate such an idea independently. Accordingly, if you would like, I will bring your idea to the attention of our committee. At that point, if we are interested in discussing the idea further, we will let you know."

Process for Selling a Company

- **STEP 3:** Engage an investment banking firm to provide financial advisory and investment banking services to the bank in connection with a transaction
  - Investment bank would meet with the board to provide an overview of the bank merger and acquisition market
  - Discuss the reasonable expectations for a transaction, especially regarding the price at which a transaction could occur in today's market
  - Discuss with the board the projected value of the bank under various scenarios if the bank were to continue as an independent entity

Process for Selling a Company

- Discussions would typically occur over the course of more than one meeting

- The board would need to decide whether remaining an independent entity or proceeding with a transaction would be better for the long-term enhancement of shareholder value

    - The board should review its long term strategic plan in order assess its independent options

Process for Selling a Company

- Investment bank would conduct preliminary due diligence on the bank and would prepare a set of materials, including a confidential information memorandum, for use in soliciting potential merger partners

- Investment bank would prepare and deliver to the board a list of potential merger partners

- Investment bank would typically ask each possible potential merger partner to enter into a confidentiality agreement prior to engaging in discussions regarding a potential transaction with the bank

Process for Selling a Company

- Investment bank would provide certain information about the bank to each potential merger partner which it is authorized to contact and with whom it has an executed confidentiality agreement
- If investment bank identifies one or more potential merger partners and if discussions with those companies progress far enough, those companies would likely:
  - Engage legal counsel and possibly a loan review firm to assist with their due diligence
  - Meet with senior management and the full board
  - Limited amount of due diligence conducted by the potential merger partner (minimize interaction with staff)
  - Should discussions progress towards a likely transaction, the potential merger partner would complete more thorough due diligence

Process for Selling a Company

- If satisfactory progress is made, the potential merger partner would deliver to the bank a proposed letter of intent in which it would offer to acquire the bank

- The letter of intent would include a non-binding proposal to acquire the bank, subject to due diligence and other conditions, and would reflect the general business terms of the transaction

Process for Selling a Company

- If the board does not find the potential merger partner's offer attractive enough, it would not be under any obligation to go forward with the transaction and could choose not to respond to the proposed offer

- The board has the authority to terminate negotiations with a potential merger partner at any stage throughout this process

- But recognize it is often hard to stop the process once it has begun

Process for Selling a Company

- If the board finds the potential merger partner's offer attractive enough, it would then negotiate the terms of the letter of intent
- The full board would need to approve the execution of the final letter of intent before it can be signed
  - Proposed transaction would typically remain confidential at this stage. It would not be disclosed publicly, and knowledge of the transaction would be strictly limited to a need-to-know basis within the bank
  - Certain due diligence complete at this point
    - Credit, regulatory, fixed assets, employment, IT
  - If required, reverse due diligence should be addressed as well

Process for Selling a Company

- The bank and the potential merger partner would negotiate:
  - Merger agreement
  - Lock-up agreement
  - Non-compete agreements for directors
  - Non-compete agreements for senior management
  - New employment agreements
  - Claims Letters
  - Voting/support agreements

Process for Selling a Company

Overarching Reminder for All Steps:

- Duties of directors in the context of any business combination transaction:
  - The directors must be informed
    - Obtain input and reports from senior management and experts
    - Rely upon experienced counsel and financial advisors
    - Familiarize yourself and make independent inquiry with respect to all material aspects of the transaction and key documents

Process for Selling a Company

- The board must make good disclosures
  - Disclose all actual and potential conflicts of interest to each other
  - Make complete and accurate disclosure to stockholders whose approval of a particular transaction is sought
- The board must deliberate
  - Engage in robust and extensive deliberations with the board in order to surface and consider issues and perspectives
  - Create a record of the decision-making process, including correspondence with third parties discussing the transaction

Process for Selling a Company

- The board must act in good faith
  - Always act in the best interests of the stockholders
  - Avoid taking any actions (including adopting deal protection devices) that improperly limit the board's ability to exercise its fiduciary duties
  - Avoid making any decisions that would favor one bidder over another without appropriate justification
  - Avoid taking any action that might have the effect of favoring a related party over a competing bidder or the stockholders

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LANDMINES

- The Most Important, the Least Understood, and the Never Discussed Issues that Blow Up Mergers.

Why the federal reserve blocks mergers: SR 14-2 (February 24, 2014)

Safety and Soundness

- Any bank in less-than-satisfactory condition, especially for the risk management, financial condition, or capital components
- Only in limited cases will they consider a composite 3 or a 3 in any component

Consumer Compliance and CRA

- Failure to comply with consumer protection laws and regulations
- A less than satisfactory CRA rating
- If the merger will help CRA, this may still be considered.

Financial Factors

- Insufficient post-merger capital
- Reduction in holding company's ability to be "source of strength"
- Use significant debt to finance acquisition, particularly in violation of guidance

Managerial Factors

- Competence, experience, and integrity of management and officers
- Insufficient expertise for acquired business
- Negative reports from other agencies or government entities

BSA/AML Compliance

- FRB required to consider BSA/AML compliance prior to approval
- Any formal or informal enforcement actions may block approval

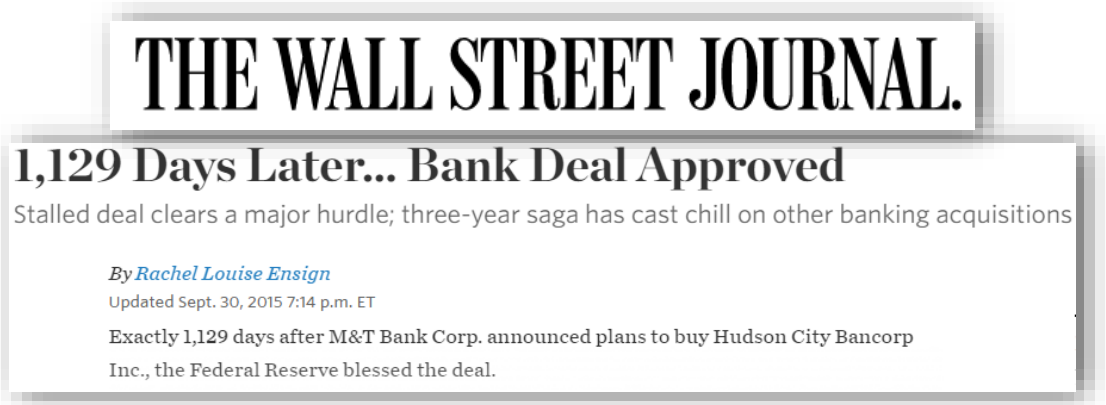
Business Plan

- Overly aggressive business plans
- High concentrations in assets, liabilities, product offerings, customers, revenues, geography, or activity
- Managerial deficiencies in new business

BSA / AML Compliance

With renewed focus by regulators comes increased risks of merger prohibitions.

Case study: M&T Bank and Hudson city Merger



THE WALL STREET JOURNAL.

1,129 Days Later... Bank Deal Approved

Stalled deal clears a major hurdle; three-year saga has cast chill on other banking acquisitions

By *Rachel Louise Ensign*

Updated Sept. 30, 2015 7:14 p.m. ET

Exactly 1,129 days after M&T Bank Corp. announced plans to buy Hudson City Bancorp Inc., the Federal Reserve blessed the deal.

BSA/AML deficiencies were one of the biggest reasons for the delay in a $3.7BN merger of Hudson City into M&T Bank

Though the merger was announced in August 2012, M&T was criticized for inadequate procedures, systems, and processes relating to BSA and AML monitoring.

The Federal Reserve did not approve the merger until September 2015.

$151MM spent enhancing BSA/AML systems

630 employees and 300 contractors devoted to fixing the BSA/AML programs

Lessons continue to be learned

AMERICAN BANKER

BSA issue forces another bank to withdraw a merger application

By
Jackie Stewart

Published
September 27 2017, 9:08pm EDT

More in

Print

Reprint

Issues with Bank Secrecy Act compliance have forced Washington Federal in Seattle to withdraw its regulatory applications to buy Anchor Bancorp in Lacey, Wash.

Washington Federal called off its $64MM acquisition of Anchor Bancorp because of BSA/AML deficiencies and the delays it would cause in the merger. Ultimately, Anchor sold to FS Bancorp for $77MM in July, 2018.

Other Casualties:

- Investors Bancorp terminated $154MM deal with Bank of Princeton
- Capital One terminated deal with Cabela's Credit Card to acquire the entire portfolio
- BB&T's consent order forced it to walk away from merger activity for 2016/2017
- Ameris Bancorp's (one of the most aggressively growing banks) consent order limited its merger activity for 2016/2017

What you can do

- Review the other bank's BSA/AML audits and reports early in the merger discussions.
- Focus on areas of deficiency—this should guide your due diligence.
  - Have the issues been corrected?
  - Are deficiencies noted in subsequent reports?
  - What corrective action plans ("CAPs") were put in place?
  - Are the CAPs sufficient and represent an honest, good-faith attempt to remediate?
  - How knowledgeable is the BSA/AML officer, generally?
- Look for indicators of problems:
  - Correspondence with enforcement agencies or regulators (if available).
  - Are there filing errors for SARs or CTRs?
  - Are there indications of ongoing correspondence with OFAC regarding deficiencies?
  - Does the Bank's risk profile differ from its BSA/AML program?
  - Is there a lack of a "compliance culture?"

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Due diligence checklist

- Are there internal controls to ensure ongoing compliance?
- Is there independent BSA/AML testing?
- Who is responsible for BSA/AML and is s/he qualified and knowledgeable?
- What training is conducted on BSA/AML?
- What happens to employees that violate BSA/AML policies?
- Are BSA/AML issues addressed in policies with procedures *specific to the bank*.
- Is the target's customer base similar to your customer base? Do you have the skills to evaluate the target's BSA/AML program?
- How effective is the customer identification and know your customer program? How I the bank handling enhanced due diligence?
- Is the bank effectively flagging "high risk" customers and managing the relationship? What is velocity and volume of the high risk customer base?
- Review a sampling of SARs (name redacted) to determine if the bank is going beyond simple, electronic screening and truly managing customer risks.

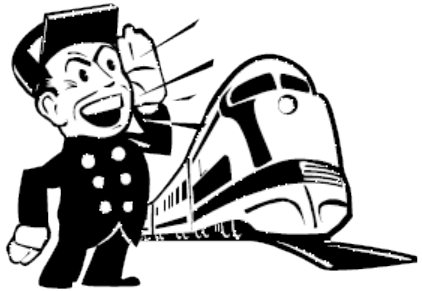
Making sure the Board is on board

Where deals die and CEOs get fired

Case studies

- Board is held legally liable for approving a merger without performing adequate diligence
- Acquiring board splits after a deal has been announced, with 40% of the board members opposing the merger and soliciting proxies against the merger
- Executive committee wants to negotiate the merger without informing the rest of the board
- Target board scuttles a merger at the 11th hour because the target board executive committee kept the rest of the board in the dark
- CEO is fired after presenting a merger proposal to his board
- Another CEO is fired after presenting a merger proposal to his board
- Yet another CEO is fired after presenting a merger proposal to his board

What you can do



- **Do not surprise your board**
- Follow a good process when selling the bank
  - Form a strategic opportunities committee
  - The board should meet multiple times to discuss the merger
  - Consider a meeting to review the merger agreement page-by-page – a day or two before the meeting to approve the merger
- Require unanimous board approval by both the target and the acquirer
- Require support agreements from target board members and other key shareholders
  - And also from the acquirer if its shareholders must vote on the merger
- Have a plan to handle any required board resignations
- Stress board confidentiality and restrictions on trading in the company's or a target's stock
- Make sure the board understands the governance changes that may come with an acquisition, e.g. new board or management team members, compensation changes, or resignations of some existing board members
- **Make sure your merger partner is following this same process!**

Key Contracts with Punitive Termination Fees

When one contract can kill your deal

Early termination fees

Are often the deciding factor regarding the economic justifications for a merger or acquisition.

Merger teams are often surprised by the cost to terminate the acquired bank’s contracts.

Case Study: *Name Withheld*

Invoice No	PO No.	TERMS	Project Number	Customer No.	Invoice Date
Sept4-[redacted]	[redacted]	Due Upon Receipt		[redacted]	[redacted]/2015

DESCRIPTION	Tax	Quantity	UOM	Unit Price	Amount
Br.1-11 Deconversion Term Fee	N	1.00	EA	$ 3,209,621.43	$ 3,209,621.43
Br.1-11 Deconversion Unamortized Flex Cr	N	1.00	EA	$ 495,509.70	$ 495,509.70

Invoice No	PO No.	TERMS	Project Number	Customer No.	Invoice Date
JUN22-[redacted]	[redacted]	Due Upon Receipt		[redacted]	[redacted]2015

DESCRIPTION	Tax	Quantity	UOM	Unit Price	Amount
Br. 34 Deconversion Term Fee	N	1.00	EA	$ 486,201.04	$ 486,201.04
Br. 34 Deconversion Unamortized Flex Cr	N	1.00	EA	$ 75,060.98	$ 75,060.98

Invoice No	PO No.	TERMS	Project Number	Customer No.	Invoice Date
JUL16-[redacted]	[redacted]	Due Upon Receipt		[redacted]	[redacted]2015

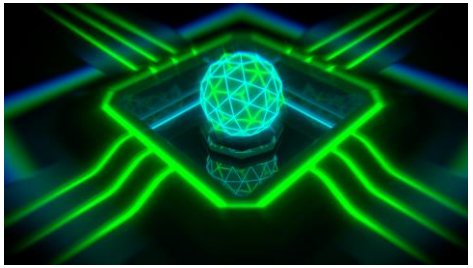
DESCRIPTION	Tax	Quantity	UOM	Unit Price	Amount
Br. 34 Deconversion Term Fee 6/26/15	N	1.00	EA	$ 486,201.04	$ 486,201.04
Br. 34 Deconversion Unamortized Flex Cr 6/26/15	N	1.00	EA	$ 75,060.98	$ 75,060.98
Br. 36 Deconversion Term Fee 7/10/15	N	1.00	EA	$ 31,355.01	$ 31,355.01
Br. 36 Deconversion Unamortized Flex Cr 7/10/15	N	1.00	EA	$ 4,840.67	$ 4,840.67

All-In, this Bank was looking at over $6MM in immediately payable deconversion and termination fees in order to complete a sale.

Case Studies: *Names Withheld*

- Though many of these breakups go unreported, the Bank Performa Network, in a survey of bank M&A activity saw similar trends.
  - In one instance, a $320MM asset institution was selling to a $1.5BN asset buyer. Because the core agreement had auto-renewed, ***the $1.5MM early termination fee scuttled the deal***.
  - In a merger of mid-sized community banks, unanticipated integration problems required both bank's systems to be run side-by-side, adding ***over $400,000 in unanticipated costs***.
  - In an acquisition by a large community bank of a smaller bank, the smaller bank's imaging system could not be integrated. Conversion fees ***added over $500,000 in additional costs to the deal***.
- Not only did the bank in our example face significant termination fees associated with its core processing agreements, but many "unexpected" contracts contained early termination fees:
  - Website hosting,
  - Add on technology contracts: card processing, mobile banking, outsourced card programs, ACH processing,
  - Broker-Dealer and RIA arrangements,
  - Outsourced card programs and card network agreements
- ***Only 46% of Bankers thought their core contracts were optimally structured for M&A activity***.

Core Processing Risks



- Behind facilities and employee expenses, core processing and IT services are the greatest non-interest expenses for banks.
- The average core processing service term has now extended to 66 months—which can lead to extreme early termination fees.
- Proper negotiation of core processing has a significant effect on merger valuations. The CEO of Inland Community Bank ***estimates that it added 7% to the purchase price of the bank through renegotiating core banking agreements and saving $1.2MM over the life of the agreements***.
- For sellers, core agreement structuring can also significantly affect your bottom line profitability that is a key factor driving acquisition price.

*Data from BPI Network 2013 Study

What you can do

- PLAN AHEAD—The first question you should always ask yourself when dealing with a new vendor contract is ***how could our bank's 5-year strategic plan be impacted by this contract***.
- Carefully review material contracts with your attorneys or business consultants. Not every banker needs to understand everything about highly complex vendor contracts. ***Do not hesitate to rely on outside resources***.
- ***Negotiate pricing!*** Rarely is a vendor's opening position its final offer. Also, understand the timing of fees and expenses. Often, this can be structured to optimize your financials for mergers or acquisitions.
- ***Never miss non-renewal deadlines***. Often the renewal periods or "holdover" periods are extremely punitive.

Due diligence

- Key vendor contracts deserve the same level of diligence as loan and deposit quality.
- Obtain a list of all vendors from target bank and copies of the vendor contracts (including amendments)
  - Assess termination rights, fees, and deconversion/conversion costs in contracts
  - Begin assembling tracking chart of terms and expected costs
  - Monitor for “notice periods” and methods of providing termination notices
  - Is there any ability to terminate for cause?
  - Can any of these contracts be carried forward?
  - Is the vendor the right fit for the new institution?
- Review all vendor invoicing a payments to confirm consistency with the contracts
- Review your own contracts
  - Do your contracts contain exclusivity commitments
  - Can you add the target banks accounts, infrastructure, etc. to your contracts
  - Will this change pricing
- How will integration and costs impact the costs and timing of the merger?
- Do not be afraid to negotiate these fees and costs.

Executive Compensation

The most heavily negotiated terms in a merger

"... AND FINALLY WE COME TO A PROBLEM THAT CAN BE SOLVED BY THROWING MONEY AT IT..."

Penny wise vs. pound foolish

- Usually compensation is the first or second (after price) most negotiated provision in a deal – just count on it
- When implementing new compensation agreements, consider the impact on future/view from “other side” – how will a future acquirer view the target’s compensation plans, percentage of deal value attributable to compensation for D&Os
- Internal Revenue Code Sections 409A and 280G - winners, losers, and taxers
- Say on Golden Parachute Rules (applicable to public companies)
- Consider headaches relating to long-term deferred compensation payment obligations

What you can do

- Before exploring a potential sale, identify and address Section 280G and Section 409A tax issues early - a year or more in advance of selling is always better
- Consider troubled bank and other regulatory restrictions, if applicable
- Conduct diligence on compensation plans before agreeing on merger price
  - Even small banks may have numerous compensation plans
- Be prepared to equalize the comp of your existing executives and other employees if necessary
- Be mindful of target executive expectations
  - 3x payout in contract is usually cut back by Section 280G
- Identify key target employees and secure them early
  - Recognize they are vulnerable to a competitor’s management lift-out offer
  - Retention bonuses, incentive comp, etc.
- Include non-solicitation of employee provisions in the NDAs to be signed by potential acquirers

Fair Lending and CRA Compliance

Numerous mergers stalled for years due to CRA and ECOA violations.

Case Study: Bancorp South

- In January 2014, Bancorp South announced two acquisitions valued in $325mm.
- Bancorp South had its CRA rating retroactively downgraded from “satisfactory” to “needs to improve.” This stemmed from a CFPB and DOJ investigation into redlining and fair lending violations.
- The FDIC refused to approve of the proposed acquisitions and they effectively stalled.

Case Study: CRA Stalling mergers

In Unusual Step, Regulators Invite Public to Open Meeting on Bank Merger

The deal seemed all but done when the CIT Group, a lender to small and midsize businesses, announced in July that it was acquiring OneWest, a regional bank in California.

But federal banking regulators put the $3.4 billion merger through an unusual test on Thursday. They invited members of the public to share their opinions about the deal in a rare open hearing in Los Angeles.

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With fewer mergers by big banks, the focus of Community Reinvestment Act scrutiny has shifted to midsized banks. On at least three proposed deals, regulators have taken additional time to review lending disparities identified by CRA commenters.

In one of those cases, the regulators imposed a rare condition for approving the merger. In the other two, the deals were delayed. The takeaway for banks, I think, is that as consumer groups turn their attention to smaller institutions and find disparities that had heretofore escaped their scrutiny, they bring them to the attention of regulators. At least for now, the regulators seem to take these issues more seriously than they did during the 1990s and early 2000s heyday of bank megamergers.

Regulators may block future Fifth Third acquisitions

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"Substantive violations of the Equal Credit Opportunity Act, the Consumer Financial Protection Act, and the Fair Housing Act caused Fifth Third's CRA rating to be adjusted downward," The Fed wrote in its assessment.

"There will be limitations on both mergers and bank openings until a higher rating is received," said Fifth Third spokesman Larry Magnesen.

What you can do

- Recognize that merger activity brings increased scrutiny of fair lending and CRA performance.
- Activist investors and “consumer advocacy groups” recognize mergers as opportune times to leverage banks that have borderline fair lending and CRA performance.
- Understand what the post-merger demographics and MSAs of your bank will be—do not complete a merger and walk into a CRA mess.
- Consider how the new institution will change your service delivery, marketing, or outreach models. Understand that your marketing approaches may need to change.

Due Diligence Checklist

- Review all CRA reports for the target institution.
- Review all fair lending external examinations. If the target does not use outside examiners, this should be a warning sign.
- Determine if the target conducted a full redlining assessment—a regulator hot topic
- Evaluate your branch network strategy, service areas, and MSAs
- Evaluate the target's training and oversight programs.
- Evaluate the target's policies and determine if procedures are *specific to the bank*
- Determine who is responsible for fair lending oversight and if s/he is qualified and knowledgeable
- Determine if the target bank's CRA history and MSAs are similar to your bank's. Determine if you have the skills to evaluate the target's programs and effectively manage compliance after the merger
- Determine how the target bank is back-testing loans or account denials, determine if they are doing any "secret shops" for disparate treatment.
- Determine if CRA statistics or ECOA disparities are generally improving or regressing
- Determine if you need to establish a "community benefit plan" to push through a merger (KeyCorp and Huntington Bancshares)
- Determine if you need to designate a CRA officer to assist in the transition

Confidential Supervisory Information

Regulators are beginning to treat CSI disclosures as a crime scene investigation

What is csi?

- The Federal Reserve Board, FDIC, OCC and CFPB all have regulations restricting the disclosure of confidential supervisory information
- Examples of CSI:
  - Supervisory communications, including emails and oral communications
  - Internal bank documents (e.g. board minutes) discussing such communications
  - Examination and inspection reports, supervisory ratings, nonpublic enforcement actions, SARs
- CSI cannot be shared with outside parties, except in limited instances or with prior approval of the regulator
- Open secret that banks have shared regulatory exams and other CSI in connection with M&A and capital raises, but regulators have recently cracked down on this practice

Case studies

- Regulators asking acquirers to certify in the merger application that they have not reviewed the target bank's CSI
- Regulators asking target bank whether it shared CSI as part of M&A activity
- OCC has asked target bank to return or destroy CSI immediately following effectiveness of merger
- OCC has restricted director's counsel's access to CSI
- OCC has threatened civil money penalties against executives who reviewed a target bank's CSI
- Federal Reserve has delayed merger applications over CSI issues

What you can do

- As a potential acquirer, ask questions of management that get to possible content of CSI (cannot disclose supervisory ratings or specific content of CSI). For example:
  - Have you recently changed any written bank policies?
  - Have you recently changed your target capital levels or business or growth plans?
  - **See the work-around due diligence questions attached as an appendix to this presentation**
- If necessary, request permission from regulators to review CSI
  - Presumption that regulators will reject request, but OCC has granted permission in extraordinary circumstances (troubled bank, etc.)
- Due diligence request responses should carve out CSI
- Merger agreement representations should carve out CSI
- Board minutes should not reference any CSI – be sure to scrub minutes before providing them in due diligence

A little about us:

Neil Grayson a partner with Nelson Mullins Riley & Scarborough LLP’s New York and Greenville, SC offices, and the Chair of the Firm's Financial Services Corporate and Regulatory Practice Group, has a corporate practice focused primarily on the financial institutions and FinTech industries. Mr. Grayson advises clients on matters related to corporate governance, enforcement actions and other bank regulatory matters, recapitalizations, private equity, securities offerings and reporting requirements, mergers and acquisitions, executive compensation, and related corporate and regulatory matters. Mr. Grayson has experience in corporate governance matters, securities compliance for public companies, and representation of emerging growth companies and private equity funds.

A little about us:

Ben Barnhill is a partner in Nelson Mullins Riley & Scarborough LLP's Greenville, SC office. Ben focuses his practice on bank regulatory, corporate securities, mergers and acquisitions, and executive compensation matters, with an emphasis on community banks. Mr. Barnhill represents financial institutions and their holding companies during the organizational, capital raising, and business combination processes. He advises these entities on SEC registration, deregistration, and public reporting obligations. Mr. Barnhill also has experience advising financial institutions as well as other companies on matters involving the interlocking spheres of executive compensation and corporate governance

A little about us:

Jon Talcott is a partner of the Corporate and Financial Institutions Groups of Nelson Mullins Riley & Scarborough LLP's Washington, DC office. Jon is also co-chair of the securities practice group. He previously held positions of chair of the corporate and transactional group and managing partner of the Washington, D.C. office. Mr. Talcott offers counsel to financial services companies, including banks, thrifts, mortgage companies, mortgage REITs, business development companies, investment banks and financial technology companies. His practice focuses on mergers and acquisitions and securities offerings. Mr. Talcott has worked on more than 100 offerings raising in excess of $10 billion during the course of his career.

appendix

- **LEGAL DUE DILIGENCE QUESTIONS**
- ***Please provide answers to the following questions. We are not asking for, and ask that you do not disclose to us the details of or provide to us, any "exempt records" or "confidential supervisory information," such as records that are contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of the Federal Reserve, FDIC, OCC, or any other agency responsible for the regulation or supervision of financial institutions. For example, please do not disclose to us the details of or provide us with any regulatory reports of examination, supervisory correspondence (including letters, directives, responses to reports of examination, appeals of supervisory determinations, and other regulatory supervisory correspondence), or suspicious activity reports.***
- Has management discussed any potential violations of law by the Company or the Bank with the board of directors since January 1, 2016? If so, please describe of all such potential violations of law. We note that disclosure of these potential violations does not concede that a violation occurred, only that an issue has been discussed with or reported to the board.
- Has the Company or the Bank made any changes to any of its policies and procedures since January 1, 2016? If so, please describe such changes and the reasons for such changes. Include, in particular, any changes to the Company's or the Bank's:
- Appraisal policies;
- Bank Secrecy Act (BSA) compliance program;

Anti-money laundering (AML) compliance program;

- Loan review policies;
- Loan impairment measurement method;
- General loan policies, especially any changes to:
- Underwriting criteria;
- The lending authority of any person;

Structure requirements;

- Pricing guidelines;
- Collections policies; or
- Charge-off policies;
- Internal loan review programs;
- Credit administration practices;
- Asset and liability management;
- Risk management practices;
- Capital and strategic plans;
- Off-balance sheet activities; or
- Contingency funding plan.
- Has the Company or the Bank retained any consultants relating to the implementation of any changes of policies or procedures? If so, please identify such consultants and describe the purpose for which each was retained.
- Has the Company or the Bank reclassified any of its loans or made changes to any of its loan classifications since January 1, 2016? If so, please identify and subsequently provide a list of all such reclassifications and/or changes.
- Has the board required any new periodic reports from management since January 1, 2016?
- Does the Company or the Bank make reports to their regulators in addition to call reports and other standard reports?
- Is the Company or the Bank subject to any publicly disclosed enforcement actions? If so, please identify and describe such publicly disclosed enforcement actions and subsequently provide a list of all such actions.

- Has the Company received any advice, comments, or recommendations from its auditors, loan review firm, attorneys, or consultants regarding recommendations for changes in policies, procedures, or internal controls since January 1, 2016? If so, please describe such advice, comments, or recommendations and the source of such advice, comments, or recommendations and subsequently provide any written copies of such advice, comments, or recommendations.
- Has the board established a compliance committee or other committee performing similar functions since January 1, 2016? Has the Company or the Bank appointed a new chief compliance officer or chief risk officer since January 1, 2016?
- Has the Company or the Bank made any changes to its dividend policy since January 1, 2016?
- Has the Company or the Bank received any communications from the Justice Department regarding any aspect of its operations, including, but not limited to, fair lending?
- Have any component ratings in the Company's or the Bank's internal risk management plan been moved to a higher risk category or modified in any way in the past 24 months for compliance reasons? If so, what circumstances led to such changes?
- Has the Company or the Bank been the subject of any enterprise risk assessment or risk management reports in the past 24 months? If so, please identify and subsequently provide copies of such reports.
- Have you met with your regulators about expansion plans recently? If so, please describe such meeting.
- Do you have any reason to believe that the transaction would not qualify as a “waiver transaction” under the applicable rules and regulations of the Federal Reserve? If not, do you have any reason to believe that the Company’s regulatory application with respect to this transaction will not be processed by the appropriate Federal Reserve Bank under delegated authority?
- Do you have any reason to believe that the Bank’s regulatory application with respect to this transaction will not be handled under expedited processing procedures?