Buying and Selling Branches

by Francis X. Grady

Overview

The past two years have seen an appreciable surge of activity, interest and premiums commanded in branch sale transactions. While branch sale statistics provided by SNL Securities reveal that the number of branch transfer transactions declined nationally by approximately 10% in 1995 compared to 1994, what confirms 1995 as the year of the branch sale is the median deposit premium paid in 1995: 5.63% versus 1994's median premium of 2.86%. In light of the trend in branch sales and acquisitions, this article discusses the current environment for such transactions, highlights the most important issues that typically arise in branch transfer transactions and identifies compliance obligations that can be all too easily overlooked by a purchasing institution intent on increasing its market share opportunity.

Catalysts for Branch Sales

Several unique reasons explain the current level of branch transfer activity. Unlike the typical selling institution of the late 1980's and early 1990's, financial institution branch selling in the mid 1990's has been spurred by superregional banking organizations' divestiture in banking markets with low market share and limited near term prospects for market share gain. Many superregionals and their predecessor banks built retail delivery channels through their respective acquisition programs that were designed by the acquired institutions. When one considers that many of the nation's largest banking organizations have grown ten-fold or more during the past decade, the logic of restructuring a branch delivery configuration that grew by acquisition happenstance, not intentional design, becomes clear. As these larger institutions reduce the number of subsidiary banks and implement national franchise names, a well-orchestrated divestiture strategy presents both strategic and financial benefits to these institutions. The preponderance of thrift acquisition opportunities during the last ten years and the relative scarcity of bank branch acquisition opportunities make well-managed commercial bank franchises the subject of significant bidder interest and high prices. In addition, the mega bank mergers of the 1990's are promoting divestiture acquisition opportunities for selected buyers.
Branch Purchase Motivations

Several factors provide a unique impetus for financial institutions to consider a branch purchase in the present environment. Many banking organizations are overcapitalized and welcome the opportunity to deploy capital in purchase accounting transactions. With the Resolution Trust Corporation now gone from the merger and acquisition scene, a major growth opportunity for community banks and thrifts is to acquire branches from superregionals rationalizing their branch network. In addition to these unique factors motivating branch purchases, more traditional reasons for buying a branch include the following: increasing the deposit base, market share and future earnings; expansion into more attractive markets; enhanced economies of scale through a larger deposit base and more affordable marketing programs; reduction in interest rate sensitivity; and the slowing of deposit growth in the banking industry.

Since 1991, cross-industry branch purchases, such as when a member of the FDIC’s Bank Insurance Fund (“BIF”) purchases deposits insured through the FDIC’s Savings Association Insurance Fund (“SAIF”), have been considerably easier to effect in what is known as an "Oakar II" transaction. Unlike the original "Oakar" transactions authorized in 1989 by FIRREA, an Oakar II purchase transaction permits any insured depository institution, whether or not under the control of a bank holding company, to participate directly in a merger or consolidation, assumption of liabilities or transfer of assets with any other insured depository institution, subject to the prior approval of the acquiring institution’s federal banking agency. As changed by the FDIC Improvement Act of 1991, an Oakar II transaction is no longer subject to the statutory formula that acquired thrift SAIF deposits are considered to increase by 7% annually. Instead, the acquiring bank’s actual deposit growth rate will apply in all cases, excluding deposit growth through future acquisition. Even though the traffic in cross-industry branch purchase transactions continues to be dominated by banks buying thrift SAIF deposits, SAIF-insured institutions have since 1991 been eligible to be the surviving or acquiring entity in cross-industry purchase transactions.

Crucial Negotiating Issues

Once considered fairly simple transactions to close, branch transfer transactions rival bank mergers for complexity of negotiating issues and pitfalls. Defining exactly which assets and which liabilities are to be transferred is the first order of the day and sets the stage for the most difficult item of negotiation -- pricing the assets and liabilities to be transferred. Fixed assets are frequently priced at book value, replacement cost or market value, with a further subtle issue as to when that value is to be established (at the signing of the branch purchase agreement or closing of the branch transfer transaction). It is the subject of the premium to be paid on the deposit liabilities assumed that occasions the most negotiation. A buyer typically prefers not to pay a premium on any jumbo certificates of deposit (CDs with balances greater than or equal to $100,000), public fund deposits or brokered deposits. Such funds are not considered to be part of a core deposit base.
Different geographic markets command significantly different premiums. 1995 branch sale statistics compiled by SNL Securities indicate that the median premium paid was highest in the Southwest at 7.32% and lowest in the West at 3.70%, reflecting in that latter case the recovering economic health of that region. 1995 median premiums for other regions include New England (6.25%), the Mid-Atlantic states (6.79%), the Midwest (4.49%) and the Southeast (7%). Interestingly, the region with the greatest increase in premium pricing was the Southwest, where 1994 median premiums went from 1.50% to 1995’s 7.32%. The Midwest exhibited the most consistent pricing over the period, essentially remaining unchanged from 1994 to 1995 at 4.50%.

Real Estate Issues

Environmental issues have become a significant component in a branch purchase transaction. The institution purchasing branches must insist on environmental inspection rights relative to the seller’s owned real estate proposed for transfer. Environmental inspection rights are particularly important because many institutions selling branches, particularly large superregionals, provide limited seller representations and warranties concerning the absence of environmental contamination on the branch properties proposed for transfer. Such a limited seller representation and warranty arises in the form of a referenced seller representative regarding his specific knowledge of environmental concerns at the subject branches. Typically, a Phase I environmental assessment is commissioned at the buyer's expense, with a right on the seller’s part to receive preliminary findings of the Phase I environmental assessment before the report's issuance. Sale-side institutions are loathe to limit their freedom of maneuver in the event that the branch offices proposed for transfer are discovered to have environmental contamination. Often the buyer and seller address the issue of environmental contamination at the time contamination is discovered, rather than comprehensively negotiate in the branch purchase agreement (a buyer’s typical preference) for a contingency that might not materialize. Satisfactory responses to address known environmental contamination include the buyer leasing rather than purchasing the branch office real estate, buying the property at a significant discount to compensate for the known remediation costs or simply excluding the branch in question from the branch transfer transaction.

Related to environmental inspection rights are property inspection rights granted to the purchaser of branch office real estate. The institution purchasing branches should conduct a physical inspection of all improvements, buildings and mechanical improvements, with the branch purchase agreement to schedule the buyer’s premises inspection, determine the period for the buyer to notify the seller of material defects and the period for the seller to remedy such defects. Generally, the seller has a right to cure the defect or credit the repair cost against the purchase price. As would be standard in any sizable commercial real estate sale transaction, the buyer should have a final walk-through inspection right several days before the closing to confirm the property’s continued satisfactory condition.

Real estate purchase issues also include the seller’s obligation to deliver preliminary and final title reports and schedule a period for the seller to cure any title defects. The buyer must have the right to object to title defects or liens evident from the preliminary title commitment, subject to so-called permitted exceptions. Permitted exceptions include the five standard exceptions appearing as Schedule B items in a standard ALTA owner’s title insurance policy, statutory liens
for current taxes or assessments not yet due, other liens, imperfections in title, and restrictions
which do not materially detract from the value of the property as a retail bank branch and such
other exceptions as are approved by a buyer. The branch purchase agreement must also provide
that the owner’s title policy delivered at closing be the same as the title commitment. Yet another
real estate purchase issue which can present itself for hotly contested negotiations is whether the
seller will deliver a general warranty or a limited warranty deed. Surprisingly, the size of the
institutions most often is the variable responsible for resolution of this matter. Large banking
organizations generally insist on providing only a limited warranty deed, while community banks
involved in the selling side of branch transactions often will provide a general warranty deed to
the buyer.

A real estate issue which can surprise both parties is obtaining landlord consent to the
assignment of leased real estate. A landlord’s assurances or promises to consent to the assignment
of leased real estate should never be assumed to be the same as an actual written consent. Though
exceedingly unlikely, it is not beyond a landlord to threaten nonconsent on the eve of the
scheduled transaction closing in an attempt to use such leverage as the time to renegotiate a short
remaining leasehold to a market rate and a longer term.

Branch Staff

Personnel issues and related employee benefits are other topics that must be subject to
careful negotiation. Because disgruntled workers can do more to chase customers away than any
other factor, it should be a mutual goal of both the buyer and seller to address employee anxiety
about job certainty. While the buyer is typically interested in retaining the existing personnel
because they know the office, its customers, its procedures and its records, there may be instances
where the buyer will not wish to retain specific employees who are not competent or who are
superfluous to the buyer’s operations. The branch purchase agreement should clearly identify
which branch personnel are to be offered employment by the buyer and the terms of the offer.
To facilitate the buyer’s hiring decision, the branch purchase agreement must provide the buyer
with a right to review seller employee benefit information, employee hire dates, wage practices,
performance reviews, pre-employment investigation and background checks. Some financial
institutions selling branches consider job security and employee benefit entitlements for transferred
branch employees to be a strategic issue in their branch sale negotiations, while others adopt a
laissez faire approach.

As it is generally a goal of buyer’s management to treat the new branch employees as it
treats its current employees, the branch purchase agreement often requires the buyer to treat an
employee’s service with the seller as service with the purchasing institution for the purpose of
determining benefit accrual under a defined benefit plan or defined contribution plan maintained
by the buyer. Buyers may also credit an employee’s service with the seller for the purpose of
determining vacation benefits. Given the sometimes catastrophic loss associated with certain
employee pre-existing health conditions, some branch buyers exclude an employee's pre-existing
condition from health care insurance coverage.
Institutions purchasing branches should be vigilant in their negotiations to make certain that the seller has no expectation of passing along training costs for the value of seller employee time spent in transition training on the buyer's systems. While far from a widespread practice, many branch buyers have been surprised at the closing table to discover that the seller seeks to pass along the cost of, for example, three days' training time on the buyer's systems during the transition period between the signing of the branch purchase agreement and the transaction closing.

**Protective Buyer Measures**

Some branch sale agreements provide a premium refund or rebate mechanism if an excessive deposit outflow is experienced for a specified period of time following the deposit acquisition. For example, in a $50 million deposit acquisition with a 5% premium, a deposit outflow of $5 million (in excess of an assumed threshold of $2.5 million) within the period of time covered by the rebate would entitle the buyer to a refund of $125,000 on the original premium payment of $2.5 million. While some institutions selling branch deposit liabilities are willing to agree to a premium refund provision, most sellers adopt the position that the risk of managing the deposits from the date of purchase rests with the buyer. As such, if the institution selling the branches is unwilling to agree to a premium refund provision, the buyer and its counsel must be particularly adept at demanding protective covenants in the branch purchase agreement. These protective provisions would limit the seller's marketing or solicitation with respect to the purchased deposits for a specified period of time both before and after the acquisition.

The scope of the covenant not to compete contains a number of discrete issues of paramount importance to a branch buyer. The covenant not to compete must address the period of prohibited competition (1-2 years is standard), the geographic area covered by the prohibition, whether de novo ATM establishment is included in the covenant not to compete, whether establishment of branches through future acquisition by the selling institution is prohibited and the scope of prohibited advertising.

Notwithstanding the truism that good public relations are the most vital ingredient in successful purchases of branch offices, buyers and sellers do have opposing public relations interests. The buyer is interested in sending out its "hello" customer notification letter as soon as possible to the customers of the purchased branches while the institution selling the branches seeks to delay the timing of the letter until such time as it is all but certain that the transaction will in fact close. Most branch purchase agreements resolve these competing concerns by providing for the issuance of the "hello" and "goodbye" customer notification letters following regulatory approval of the purchasing institution's application.

While a complete discussion of data processing branch transfer conversion issues is beyond the scope of this article, the branch purchase agreement should provide that the seller will provide product functions, file formats and test tapes shortly after the branch purchase agreement is signed. The buyer should also insist on a seller representation and warranty that the information contained in the file formats and on the test tapes is accurate.
So that the institution acquiring branches can satisfactorily discharge its tax information reporting obligations with the Internal Revenue Service (the "IRS"), the buyer should insist the branch purchase agreement require the seller to provide a computer listing at the closing of "B" notices (taxpayer identification numbers do not match) and "C" notices (under reporting/IRS-imposed withholdings). Most branch purchase agreements also provide that each of the seller and buyer will provide interest reporting for the respective period of ownership during the year, rather than imposing this obligation on the buyer alone with a seller covenant to provide the information on a timely basis to the buyer for consolidated reporting at year end.

Compliance Pitfalls

Consumer compliance issues present a number of pitfalls. Avoiding Community Reinvestment Act ("CRA") surprises should loom large in the consciousness of any branch buyer. The institution purchasing branches should review and document its CRA process and activities before submitting a branch purchase application. If a substantive CRA issue or protest is raised in the application process, an applicant that has established an effective community reinvestment process -- one it can document -- can expect a favorable resolution.

Few issues in a branch transfer transaction receive less attention than the truth-in-lending compliance of the selling institution's passbook loans (passbook loans represent a backwater of truth-in-lending compliance in any event). In any secondary market loan sale transaction, the purchasing institution receives a seller representation and warranty that loans sold are in compliance with truth-in-lending disclosure obligations. The purchasing institution should insist that the truth-in-lending compliance standards for passbook loans be no less in a branch purchase transaction.

Although a branch buyer has up to one year after the branch acquisition to continue to follow the funds availability practices of the seller, the expedited funds regulation requires a bank to send notices to its customers when the bank changes its availability policy for consumer accounts. Inadvertent violations of the change-in-policy notice requirement may occur in connection with branch purchase transactions, thus possibly subjecting the institution to administrative enforcement from its federal financial institution regulatory agency and civil liability from depositors. Depending upon the funds availability practices of the buying and selling institutions, the acquiring financial institution may have to do the following before making any changes to funds availability practices: (1) post a revised schedule of its funds availability policy in lobbies of the purchased branch facilities, (2) revise its specific availability policy disclosure, (3) mail a notice to customers of the purchased branches of the change in funds availability policy and (4) hold employee training programs to familiarize employees with the change in funds availability practices.

Truth in savings is another not so well understood compliance obligation affecting institutions in branch purchase transactions. The truth-in-savings regulation requires a depository institution to send a 30-day advance notice to the consumer of any change in the items required to be disclosed in the truth-in-savings account disclosures if the change might reduce the annual percentage yield ("A.P.Y.") or adversely impact the consumer. The 30-day advance notice
requirement has interesting implications in the context of financial institution mergers, consolidations and branch purchase transactions. Successor financial institutions should consider carefully change-in-terms issues. Oftentimes, due to computer system incompatibility or different pricing practices, the resulting or successor financial institution will wish to change certain account terms. Once the underlying right to make a change in terms of an account is established, the next step is to determine if the proposed change represents a term that was required to be disclosed in the initial truth-in-savings account disclosure. The resulting or successor institution should then determine if the proposed change in account terms is adverse to the consumer, i.e., the change could reduce the A.P.Y. or otherwise adversely affect the consumer. If the compliance officer is called "into the loop" only shortly before the scheduled closing date, it is important to realize that the 30-day advance notice (if applicable) does not have to delay the scheduled closing of a branch purchase or financial institution merger transaction. For example, if a 30-day advance notice is sent out only two weeks before the scheduled branch purchase closing, the successor financial institution could delay charging for the changed account term until 30 days have passed from the providing of notice.

If either the seller or buyer is an institution or the subsidiary of a holding company whose stock is registered under the Securities Exchange Act of 1934, a branch transfer transaction can trigger a number of securities compliance obligations. Depending on the magnitude of the contemplated transaction, a seller or buyer should consider issuing press releases and filing reports on Form 8-K at various times including the signing of a letter of intent, the signing of the definitive branch purchase agreement and the closing of the branch purchase transaction. In addition, press releases could be necessary to comply with exchange listing requirements. Buyers and sellers should also consider the appropriateness of instituting a moratorium on insider trading. This consideration is particularly appropriate when the branch sale transaction may represent an extraordinary gain with a significant impact on net income.

Conclusion

With branch acquisition premiums likely to remain at high levels, particularly in metropolitan areas, it is more important than ever that bank executives engaged on the buy side or sale side of branch transactions properly evaluate all opportunities and risks in such transactions.

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