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Value Judgments: Parties Look to Tried and True M&A Techniques to Bridge Divergent Asset Valuations

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Valuation is usually the fundamental issue in getting to agreement on a bank deal. Persistent high unemployment, the housing slowdown and significant and changing government policy have combined to exacerbate uncertainty over future performance of bank assets. This can create challenges for parties to get to agreement on how to value a bank's balance sheet and accordingly on a deal price.

Some recent bank deals have brought back traditional solutions, seen in prior generations of bank deals, to bridge the valuation gap. To account for portfolio performance in the period between signing and closing, parties to recent deals have included purchase price adjustments tied to a target's loan portfolio and/or shareholders' equity. In other deals, the buyer has negotiated the ability to exit the deal if the target's loan portfolio deteriorates beyond a specified level, or the target bank suffers a decline in core deposits below a threshold level – offering a potentially more objective exit trigger than the traditional "material adverse effect."

To be sure, it is by no means certain that a price adjustment or condition relating to interim loan portfolio changes is the only way to go with a distressed or challenged target. In many cases, buyers are able to diligence a portfolio well enough that risks can be confidently priced into the transaction without the need for such adjustments or conditions. Targets may be reluctant to agree to objective triggers tied to nonperforming loans or deposits for several reasons, including that they focus too much on a particular set of metrics without allowing for offsetting factors. Negotiating the language of such provisions is often more complex than it first appears. And, often, obtaining these provisions can be a relatively low return proposition for a buyer. In the current environment, prudent acquiror banks likely will have already priced in a relatively conservative view of the target's assets, and may be looking to other features of the target, such as its branch network, deposit base or competitive positioning in a particular product or business line, as the driving value proposition in the deal.

In M&T Bank Corporation's recent agreement to acquire Wilmington Trust, the parties settled on a customary MAE closing condition without specific loan performance tests. By contrast, North American Financial Holdings' recent deal for TIB Financial was conditioned on specified metrics for loan quality and core deposits. Each transaction is different, but as has always been the case with acquisitions of attractive banking franchises, an acquiror's ability to get sufficiently comfortable to go forward without targeted portfolio or other business performance provisions may give that acquiror an edge in a competitive setting.

Where such a provision is included, the particulars of an asset test or adjustment (*e.g.,* size of the possible adjustments, termination thresholds) can vary greatly. Basic questions need to be answered: Which financial metrics are to be measured? Is it better to rely on a broad measure like tangible equity or a more focused metric such as delinquent or non-performing loans? What level of adverse performance is required to trigger an adjustment or termination right? How sensitive should price be to a given level of change in delinquent or nonperforming loans? Are adjustments subject to caps, and if so what should they be? How are disputes handled? Is it necessary to make any adjustments to normal GAAP measures to minimize the possibility for managing to a specific result or to minimize the potential disagreement between the parties as of closing?

Purchase price adjustment provisions based on loan quality typically set forth an adjustment formula where the acquisition price depends on the level of delinquent loans as of some date near the closing. Delinquent loans may encompass various loan categories, such as loans 30-89 days past due, loans 90 days past due and still accruing, nonaccrual loans, restructured and impaired loans, OREO and post-signing net charge-offs. The amount of price adjustment per unit of asset deterioration is a matter of negotiation. The adjustment amount has varied significantly across recent transactions, ranging from as low as 20 cents to nearly a dollar of adjustment for each dollar increase in delinquent loans. The adjustment floor has also varied significantly across recent deals, with decreases being capped from 5 percent to 50 percent of the original purchase price (with the buyer typically having the right to terminate the deal in situations in which it does not have price protection). While upward purchase price adjustments have been rare given the typically distressed nature of many recent target companies, they aren't unprecedented (*e.g.,* Tower Bancorp's acquisition of First Chester County).

Price adjustment provisions come with ramifications, and boards need to be fully informed as to how any such mechanisms work, and understand any issues these provisions could present, to ensure they are properly discharging their duties.

There will also be disclosure considerations. In the merger proxy statement, consideration may need to be given to an appropriate risk factor disclosure and the need for other disclosure to fully inform shareholders about the possible impact on the transaction resulting from interim changes in asset quality. Proxy statements for recent deals (*e.g.,* First Niagara Financial's acquisition of Harleysville National and Bryn Mawr Bank's acquisition of First Keystone Financial) have included updated interim disclosure of delinquent loans and the corresponding impact on merger consideration, while noting the possibility for changes prior to closing.

Although less common than purchase price adjustment provisions, some deals have also employed mechanisms that allow for adjustments based on portfolio performance after the transaction closes. These arrangements, in essence, hold an identified pool of assets separate from the economics of the deal in order to avoid valuation disputes. One way of accomplishing this type of separation of a pool of assets is to issue to the target's shareholders a contractual right ("earnout") or security ("contingent value right," or CVR) to receive additional consideration if the identified pool performs better over a specified period than some agreed benchmark.

A recent example of a CVR is North American Financial Holdings' agreement to make a controlling investment in Capital Bank. There, North American agreed to share with Capital Bank shareholders a portion of the benefit that would result if future losses on specified Capital Bank assets turn out less than anticipated at signing. Capital One Financial employed a similar mechanism in its 2009 acquisition of Chevy Chase Bank.

CVRs can be complex to create and manage, with potentially challenging registration and reporting issues, and issues can arise regarding potential post-closing conflicts or disputes with respect to the management of the applicable assets (the acquiror issuing the CVR often retains an interest in the assets to help align incentives). As a result, payment triggers, measurement periods, and determination standards are among the terms that should be carefully negotiated.

The use of CVRs can also affect the tax treatment of the overall transaction. Although often less of an issue when dealing with a distressed or challenged target (because target shareholders expect to realize a loss on the transaction, even at the upper reaches of an acquiror's valuation), the terms of the CVR may dictate whether the transaction can qualify as a tax free reorganization. Accordingly, the terms of the CVR (*e.g.*, when the CVR is settled, whether it is settled in cash or stock, whether the CVR is traded or not, the value of the CVR, etc.) will have to be harmonized with the overall tax objectives of the deal.

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The re-emergence of these mechanisms to deal with uncertainty and volatility in asset value and performance is an example of the old M&A adage that there is nothing new under the sun. These provisions can appear attractive to resolve uncertainties and differences of opinion regarding asset quality, but they present their own issues for sellers and buyers. A more customary bank acquisition agreement with a material adverse effect closing condition and no specific quantitative asset tests nonetheless remains an appropriate solution for most situations.