

Recent Developments

FINANCIAL INSTITUTIONS DEVELOPMENTS

Recent Deals Show Usefulness of Contingent Consideration in Bridging Valuation Gaps

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The recovering, but still uncertain, economy and real estate markets have led to diverging opinions and concerns over the future value of a target's assets which might otherwise prevent agreement on transaction pricing. As discussed in prior memos, contingent consideration structures have for years been used to bridge differences between buyers and sellers in uncertain times. With the burgeoning trend of increased M&A activity involving smaller banks, it is important to remember that these structures, while requiring careful thought, can be useful in both small and large deals alike to creatively address pricing challenges.

Capital Bank Financial Corp.'s recently announced agreement to acquire Southern Community Financial Corporation is the third transaction in the last 18 months in which that acquiror has utilized a contingent value right, or CVR, as a portion of the consideration. The CVR provides the opportunity for additional value to Southern Community shareholders if the portfolio performance exceeds a designated benchmark, while allowing Capital Bank to limit its exposure if performance should deteriorate. It has a value determined by the performance of Southern Community's legacy loan and foreclosed asset portfolio at the end of a five-year period. Payments under the CVR may range from zero to \$1.30 per share in addition to the primary merger consideration of \$2.875 per share. Any payments would only be made at the end of the five-year measurement period. The CVR was structured so as not to require registration with the SEC, avoiding not only the cost of registration but also the ongoing reporting requirements. Consequently, the CVR is

not transferable, does not grant any voting or dividend rights, bears no stated rate of interest, and will not be certificated.

The recent restructuring of BB&T's agreement to acquire BankAtlantic from BankAtlantic Bancorp is a variation on this theme. Faced with the injunction obtained by the holding company TruPS investors to the original deal, the parties devised a creative structure to make it economically possible for BB&T to assume the TruPS. To compensate BB&T for doing so, the parties agreed that BankAtlantic Bancorp would capitalize, with assets to be retained by it under the original deal, a vehicle in which BB&T would have a 95% preferred interest. BankAtlantic Bancorp (and ultimately its shareholders) will retain a minority preferred interest in the vehicle, as well as the full residual interest. The risk BB&T is assuming is mitigated by careful diligence of the underlying assets as well as the structure of the asset vehicle, which provides BB&T with a preferred return, overcollateralization relative to the TruPS obligation and an additional guaranty from BankAtlantic Bancorp. The BankAtlantic Bancorp shareholders, like those in analogous deals with contingent consideration to target shareholders, retain in this structure significant upside potential from improving economic conditions post-closing, specifically those affecting legacy loan performance.

These transactions are but two recent examples of the art of the possible in bank M&A. Other transactions in recent years including a contingent consideration component include Capital Bank Financial Corp.'s controlling investments in Capital Bank Corporation and Green Bankshares, Inc. and Capital One Financial's acquisition of Chevy Chase Bank. While often shareholders and other constituencies may prefer a fixed or certain consideration where possible, the two parties to a potential deal may have very different ideas of what that certain consideration should be. With industry conditions still recovering and potentially volatile in the coming months, contingent consideration terms may in

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some cases be the best way to bridge this gap and strike a deal.

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