We have been busy over the past several months working with a number of our bank clients in the mergers and acquisitions area. It seems that a lot of community banks are evaluating entering the M&A arena for the first time. I thought I would share a few thoughts on key points that buyers and sellers should consider in the early stages of the merger process.

**Due Diligence**

For buyers, it is important to get a full picture of the target bank during the due diligence process. Some critical areas are obvious, such as scrubbing the target bank’s loan portfolio and Other Real Estate (ORE) to determine the quality of the assets being acquired. There are other areas that may not be quite as obvious which can lead to higher than anticipated transaction costs. Getting a handle on these costs early in the process will allow the buyer to better price the transaction and also help avoid unpleasant surprises after the merger agreement has been signed. I have highlighted a few of these areas below.

Most banks enter into long-term contracts with their data processing vendors that can last five to seven years. These contracts will contain a provision requiring the payment of a termination fee if the contract is terminated early. These penalties can be very punitive, and the data processing vendor is generally unwilling to negotiate...
a lower amount. Even for a small community bank, the early termination fee can be as high as $1.5 million to $2 million. The termination fee provisions can be difficult to understand. It is important to work with the target bank’s vendor early in the due diligence process to pin them down on their calculation and to factor the early termination fee into the total transaction costs. Data processing contracts tend to have the highest termination fees, but it is important to get a complete list of all vendor contracts of the target bank and review them to determine if they contain early termination fee provisions.

Another important area for a buyer to review closely is any arrangements the target bank has in place with directors, officers, and employees that may trigger additional payments due to a change in control and/or termination. For example, many banks have change in control agreements with key employees that provide for a significant severance payment in the event of a change in control. Sometimes these payments can be triggered just by the occurrence of a change in control, and sometimes they require a change in control coupled with a termination of employment without cause. A buyer should also review any supplemental retirement, salary continuation, deferred compensation, and similar plans to determine any future funding requirements or early vesting triggers due to a change in control. Understanding the full scope of these expenses is important to ensuring the buyer is not overpaying for the target bank.

**Employee Retention**

The announcement of a merger transaction can be an unsettling time for employees of the target bank. Understandably, many employees are concerned about what their role will be after the merger closes, or whether they will have a job at all. Competitors in the market may try to capitalize on this vulnerability and poach key employees. Once a transaction is announced, it can take several months to get regulatory approval and shareholder approval and to be in a position to close the transaction. It is in the best interests of both parties for the target bank to carry on its business with minimal interruption during this period. The target bank will not want to lose key employees prior to closing the merger in the event the transaction does not close. It is also important to the buyer that it not lose key producers, as this could result in loss of business. One way to mitigate the risk of losing key employees during the period between announcement and closing is to offer a retention bonus for employees who stay through the closing of the merger. The buyer may want to extend the retention bonus period through the time of the operational conversion, as a loss of key employees can make the conversion process more challenging.

The buyer may also consider offering employment agreements to key producers to lock them down early in the process. These agreements can pay a signing bonus and include a noncompete provision to ward off competitors attempting to poach. An employment agreement also provides comfort to employees, so they know their future compensation and role with the resulting bank.

These are just a few of the key issues that banks should be mindful of during the early stages of the merger process.
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