DUE-DILIGENCE: LAST STOP BEFORE THE MERGER COMMENCES--OR DIES

Part 6, concluding Jeff's mergers and acquisitions series: Handling due diligence--and who it protects

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This is my sixth and final blog (for now) in the series on Community Bank Mergers and Acquisitions. The first five blogs dealt with the board's receipt, analysis, and response to an unsolicited offer. This blog will deal with the issues of due diligence. [Those of you new to this series may want to start with Part 1.]

I'll first go over the two-sided nature of due diligence, some key how-to points, and then some final words on the importance of due diligence--personally--to bankers and board members.

A two-way street

Due diligence in a community bank acquisition generally goes both ways.

By that, I mean the purchaser will do a thorough review of the books and records of the target institution. That's pretty much understood.

However, I believe the target institution should also do a due diligence of the purchaser. Most community banks, when they think of due diligence, think one-sided only, i.e. the purchaser conducts a due diligence of the seller. That is not accurate--due diligence must go both ways.

Even in a cash transaction, where the seller's shareholders are receiving cash, the seller needs enough information about the purchaser to determine whether the purchaser can obtain regulatory approval and has the cash. In a transaction where the seller's shareholders are receiving stock, then due diligence of the purchaser always should occur as well. That's the return your stockholders will be receiving, so you have to be sure about the "currency."

Generally, if the purchaser is a large public bank holding company, then certainly the target's due diligence of the purchaser would not be the same as the due diligence by the purchaser of the target, e.g. review loan files, etc., as discussed below.

But even so, you have to dig in, go beyond what's on paper.

If the purchaser is such a company, then the due diligence by the target receiving stock should at least involve interviewing the top five or six officers, the outside accountants, and the outside counsel; reviewing the minutes of the institution; and yes, reviewing recent regulatory correspondence and examination reports.

Alternatively, let's say the purchaser which is providing stock to the target is a nonpublic company. That would be a nonpublic community bank in a "merger of equals" situation or something similar where, for example, the $700 million bank acquires the smaller bank for stock.

Then the smaller bank must do an even more thorough due diligence of its prospective purchaser.

Changing prices in changing times

Let's focus for a minute on the purchaser's due diligence of the seller. The goal of the purchaser's due diligence in this case is to confirm public information. Keep in mind, most transactions start with a purchaser making some type of expression of interest or offer based on public information. The purpose of the due diligence is to make sure that that public information is accurate and the offer is supported at the level provided.

Historically, it was rare that after a purchaser's due diligence of the target, the purchaser changed its initial offer downward.

Historically, sometimes the offer would be scaled upwards if additional competition came in during the due diligence period.

So much for history.

In today's economic times, purchasers often, as a result of due diligence, either walk away from the deal completely or reduce the price.

I have had two clients in the last week that have walked away from their transaction simply because they could not get their arms around the target's underwriting standards and loan documentation processes. Those processes were far different from those utilized by the purchaser.

Sometimes the problem is that the credit quality is simply not as presented publicly. This is usually not a result of a target intentionally misstating its credit quality, understating its reserves, and overstating its earnings. It's simply the difference between doing a loan review on your own bank and setting the reserve, and having an outside purchaser come in conducting a credit quality review on the bank and taking significant marks in an abundance of caution.

The general discussion when you cut to the chase in due diligence, is how much the loan portfolio is going to be marked down.

Beyond the loan portfolio

Due diligence does not only deal with the loan portfolio, however. There are multiple due diligence areas that purchasers, in particular, need to be aware of.

Some of these include:

• Legal issues

• Corporate documents

• Minutes

• Exams and the like

• Compliance issues

• Credit

• Bank information systems

• Operations

• Properties

• Insurance

• Risk management

• Internal audit

• Human resource issues

• Investment portfolio

• Trust activity

• Marketing

Who handles due diligence tasks?

As a practical matter, community banks typically need some external help for due diligence, but that will come later. Often, the purchasing community bank is comfortable enough doing the credit due diligence itself--particularly if the acquisition target is another community bank nearby.

Thus, credit due diligence generally occurs first. If the purchasing bank cannot get beyond the credit due diligence, then why go to the other dozen or so areas?

Once the purchaser progresses beyond the credit due diligence, however, there are significant risk issues that are still

present. That is generally when the purchaser obtains external expertise for legal, compliance, operations, data processing, and other types of due diligence.

Considering the stakes--institutional and personal

If your bank happens to be a seller, not a buyer, then you still need to think seriously about due diligence. As noted above, you need to conduct due diligence of the purchaser, but you also need to assess the impact on your bank as a target of the purchaser's due diligence.

This means you need to pretty up the bank for sale, settle litigation, drive earnings, and not enter into long-term contracts.

We had one target that right after we began negotiations with them, announced that they just entered into a five-year data processing contract with a termination fee of approximately $1 million. Expensive to get out of.

Think, if you are a seller, about how you would look under the due diligence microscope of another bank.

Now, a word about your own, personal stake in this, whether you are a senior bank officer or a board member.

Remember, as buyer or seller, management and board must be able to prove, in the event of a later court challenge, that a sound decision was made. Markets shift, plans go awry, business decisions can be wrong. That's life.

But someday a disgruntled shareholder may decide to "get legal" if they feel a bad decision was made.

Due diligence is the armor that will let you stand up in court and say, "We looked at all that and we found it a good deal."

Having done this, you enjoy the shelter of the business judgment rule. The key to that is to have exercised informed judgment.

And that's what due diligence is all about.

You can also catch the article, "Don't slouch towards sale: Put your bank's best face forward for buyers" in the ABA BJ Novembr 2012 Digital Magazine.

About Jeff Gerrish

Jeff Gerrish is chairman of the board of Gerrish McCreary Smith Consultants, LLC, and a member of the based law firm of Gerrish McCreary Smith, PC, Attorneys. He is a frequent contributor to ABA Bankin and ABA Bank Directors Briefing, and frequently speaks at ABA events and telephone briefings.

Gerrish's consulting and law firms have assisted over 1,500 community banks in all 50 states across the nation since their formation in 1988. Gerrish formerly served as regional counsel for the Memphis regional office of the FDIC and with the FDIC in Washington, D.C. with nationwide responsibility for litigation against directors of failed banks. Currently, Gerrish's practice involves mergers and acquisitions, strategic planning, capital raising, and general consulting with community financial institutions

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