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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Expiration of Capital Gains Tax Rates and Banking Consolidation

The banking industry continues to consolidate throughout the United States from a number of factors, with banks experiencing loan portfolio problems resulting in inadequate capital on one hand and the pricing of banks in acquisition transactions on the other hand. The 2006 Summary of Deposits released by the Federal Deposit Insurance Corporation ("FDIC") reflects that the number of insured institutions has dropped from 14,176 in 1999 to 8,778 in 2006, or a 48 percent decrease. Published reports reflect that the average price of the 275 transactions announced in 2006 had a book price/book multiple of 2.36 and a price/earnings ratio of 27.87. During 2005, there were 253 banks and thrift acquisitions announced at an average price/book multiple of 2.28 and average price/earnings ratio of 26.16. During the first quarter of 2007, 81 transactions were announced reflecting a continuation of the pricing of banks. It appears that the trend in banking consolidation will continue to increase in part due to the expiration of the capital gains tax rates which are scheduled to expire on December 31, 2010. In 2003, President Bush signed into law The Jobs and Growth Tax Relief Reconciliation Act which reduced the tax rate generally on appreciated capital assets that are sold after being held for more than one year to 15%. There was originally a sunset provision for these capital gains tax rates to expire on December 31, 2008. However, in 2006 Congress passed the Tax Increase Prevention and Reconciliation Act providing a two-year extension through December 31, 2010, to keep these favorable rates in place. Once the extension ends, capital gains will effectively be taxed at a 33.33 percent higher rate, i.e., 20 percent instead of 15 percent. The current administration wants to extend the favorable tax rates beyond December 31, 2010, but many lawmakers believe the country cannot afford them with the federal budget deficit being at an all time high. The capital gains tax rate applies on the difference between a taxpayer's basis in the stock and the sale price. The basis is generally that amount a taxpayer pays for stock, but if stock is inherited, the basis is the price of the stock on the day the owner died. In the event that the basis exceeds the sale price, a taxpayer has a capital loss which can be utilized to offset capital gains. Although the banking industry continues to consolidate with over 300 transactions projected for 2007, this figure may substantially increase in the next three years as the deadline for the expiration of the favorable capital gains tax rate approaches.

Employment and Change in Control Agreements

As consolidation continues in the financial sector, banks and bank holding companies should consider the use of employment agreements and change in control agreements for key senior management. In the event a bank or bank holding company has either of these agreements in place, they need to be reviewed from time to time to determine if revisions are needed because of economic or legislative changes, including changes in tax laws.

An employment agreement is generally defined as an agreement between a company and its employee which specifies the rights and obligations of each. The term of an employment agreement will normally run for a fixed period of time or it may run for a fixed term plus rolling renewal periods. One of the advantages of a rolling renewal period in an employment agreement is that the parties do not have to renegotiate the agreement at the end of the fixed term. Besides the term, an employment agreement will normally specify such things as duties, salary, bonus, benefits, disability, death and retirement.

A change in control agreement is designed to become effective upon a change in control of the company. A few examples of events constituting a change in control are as follows:

- A third party acquires 50% or more of the outstanding voting stock of the company.

- The company is a party to a merger or consolidation which results in 50% or more of the voting stock of the company being converted into securities of another entity.

- The sale or disposition of all or substantially all of the company's assets.

- A change in the composition of the board of directors within a specific period of time, resulting in fewer than a majority of the directors continuing to serve as directors.

A change in control agreement serves at least two purposes. It assures that key management personnel will be available both prior to and following the transition in the change in control of a company. Secondly, it assures key management personnel that they will be employed and continue to have their existing authority, duties and compensation.

Employment agreements and change in control agreements generally contain provisions regarding the protection of confidential information belonging to the company, and a noncompete period prohibiting the executive from competing with the company for a specific period of time and in a specific geographic area following the termination of employment. In addition, both agreements may address termination for cause by the company for acts of the employee, such as fraud, conviction of a felony, excessive absences without approval, use of drugs or alcohol and similar conduct. At the same time, both agreements should provide protection for the executive by allowing termination for good cause, such as reduction in salary, demotion or relocation without the executive's consent. Unlike a termination for cause by the company, a termination for good cause by the employee will generally allow the executive to receive the compensation and benefits under the remaining term of the agreement had the agreement remained in force. Because provisions in employment and change in control agreements may result in adverse tax consequences to the parties, as well as having provisions which may be unenforceable, it is best to utilize the services of a professional to make sure that the agreements comply with applicable law.