GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Wisconsin, Minnesota, Iowa and Montana!

UNSOLICITED OVERTURES

We have had multiple new and current clients contact us in the last couple of weeks about unsolicited overtures. You note I use the word "overture," not offers. These are unsolicited inquiries generally by the CEO of the buyer to the CEO, chairman of the board, or another principle director of the seller. Each one of them follows the same pattern. The contact was made. The potential buyer requested a "lunch" visit in the nature of a "meet and greet."

Keep in mind that at those types of visits what normally happens is the potential buyer discusses how great the buyer's organization is and what a good fit the seller's organization would be for the buyer and the seller. Generally, no price or terms or anything of consequence is discussed.

One CEO recently asked, "Should I even have lunch?" My response was only if the board approves it and is aware of what is going on. The lunch could always result in a credible, unsolicited offer, which the board, in the exercise of its fiduciary duty, has to consider, even if its long-term strategy is to remain independent. The real test is whether the bank holding company shareholders are better off taking what is being offered or holding the bank holding company stock. That is not to say even if the board concludes the shareholders may be better off doing something other than holding the bank holding company stock for the long-term that this particular buyer is the winner. Normally what happens is that informal overture ends up putting the target bank in play. That means they may not sell to the original unsolicited inquirer, but they will likely sell to somebody.

This whole mating dance is often described as a "slippery slope" toward acquisition. If you are really not interested, then do not do anything to encourage an unsolicited offer.

ATTRACTING AND RETAINING KEY PERSONNEL

In every planning session we conduct, the issue of "Do you have the tools to attract and retain key personnel?" is part of the agenda. In the current acquisition environment and the highly competitive industry environment, particularly in metro areas, the "lift out" or simple outright "theft" of key personnel is a strategy that many banks are looking to employ. This means that your institution needs to focus heavily on retaining its key players and make sure the tools are available to attract other key personnel. The real question is what "arrows" are there in the quiver that you can use? There are numerous alternatives, such as equity or equity-like incentives (e.g., stock appreciation rights, phantom stock, restricted stock, an ESOP or a KSOP, or something similar), a cash bonus incentive based on individual performance and/or group performance, and some longer-term incentives, such as deferred compensation. Most of the mid- and long-term incentives are funded ultimately by bank-owned life insurance.

WHAT ARE THE ALTERNATIVES?

One client recently came to us with an unsolicited offer. This client is in a C corporation for tax purposes. Part of our analysis of the unsolicited offer was what other alternatives are there to enhance the value for the target's shareholders. The unsolicited offer certainly was not over the top or "preemptive" in any way. The analysis of converting the bank to an S corporation and consolidating ownership as part of the process made a lot more financial sense. This in no way takes the bank off the market should they get that great unsolicited offer sometime in the future. In the interim, however, the Subchapter S conversion will turn this particular organization into a significant cash cow with a strong capital and earnings position. This is a much greater benefit to the shareholders than simply maintaining C corporation status.

DE NOVO "REGULATORY RELIEF"

I am sure each of you has seen the FDIC publicly touting its desire for an increase in de novo bank activity. This is evidenced by the recent FDIC day-long conference, in part, discussing how to increase the number of de novo charters. One of the things that has come out of the FDIC recently as it relates to de novos is a shortening of the de novo period.

The de novo period, which is a period where the FDIC provides extra scrutiny and supervision over the bank, was formerly three years. As a result of the financial crisis, the de novo period was increased to seven years. The FDIC is now waving a flag of regulatory relief and seeking to increase the number of de novo applications by reducing the de novo period back to the three years. Something is better than nothing.

The FDIC's reduction of the de novo period to three years is a noble endeavor. Is it going to make any meaningful impact on the number of de novo applications? The FDIC's own reasoning for reducing the de novo period is, essentially, that the rules and restrictions that were applicable to de novos are now encompassed in other regulatory guidance. Was the "seven year" de novo period what was really standing in the way of de novo applications? The real culprit here is the fact that it is generally easier to buy a bank than it is to start a new one, and the capital requirements for obtaining a new charter are enormous. I am optimistic we will have more de novos, but I do not believe the FDIC's action is going to help much.

POST-ACQUISITION PROBLEMS

I recently received a telephone call from a client that recently completed an acquisition of another community bank. This client was calling me to talk about what he described as "inaccuracies" in the target bank's representations and warranties in the contract. Based on what he told me, I more accurately described them as breaches.

In summary, the target bank made a number of representations and warranties in the contract that were simply not correct at the time they were made or at the time of closing. Our client's real question was whether he had any recourse against the seller. The answer to this question is in large part dependent upon the language in the Agreement and Plan of Merger. Sometimes the terms of the agreement provide that the target's representations and warranties terminate at the time of closing. Other times the agreement provides that the representations and warranties continue for some agreed upon amount of time (usually between 12 and 24 months).

Our agreement included provisions for the latter. This is beneficial to our client because it makes the path to recovery much easier from a legal perspective.

If you are thinking about buying or selling a bank, make sure that you (and your counsel) really understand the ramifications of the terms and conditions of the contract. It is very important that the board understands the terms and conditions and what they mean both before and after closing.

FAMILY-OWNED BANK ESOPs

I was recently with a board of directors of what I would describe as the proto-typical family-run bank. The management team in the bank today is essentially all members of the ownership family. These are the sons and daughters of a gentleman that purchased the bank some 60 years ago. It is a very successful bank. The stock is doing very well. During the planning session, the family clearly recognized that the health and well-being of the bank was largely attributable to its employees, many of whom have been there for many years. The family indicated they wanted to have some avenue to compensate the employees for the value they have created for the family, while being sure to maintain control of the institution. The solution, in my opinion, was pretty easy: implement an ESOP.

For this organization, an ESOP made perfect sense. The family group wanted to provide ownership of the organization to the employees while maintaining control. An ESOP does that. The ESOP also allows the employees to participate in the growth of the value of the common stock. Most importantly, this bank is a Subchapter S. As I have said before, an ESOP in a Subchapter S is so good it should be illegal.

For this particular family-owned bank, an ESOP is going to do very well for them. It is going to allow the employees to participate in the growth of the value of the common stock while also ensuring the family does not lose control of the institution.

WILL “AGGRESSIVE NEGOTIATING” KILL A DEAL?

We are currently working with a community bank board that recently received an unsolicited offer for the purchase of their holding company and bank. The initial offer was enough to get the ball on the transaction rolling. However, I would not put it in the category of a preemptive offer that was worthy of immediate acceptance.

To assist the board in working through this potential transaction, the first thing we did is "run the numbers" on the transaction to determine the purchaser's ability to pay. We identified a couple different purchase prices based on our analysis. One of the purchase prices is one that we believe makes sense for all parties involved. The second was a higher purchase price that we showed could be supported by the numbers, but was not a likely purchase scenario given the fact that the comparable transactions do not really support that pricing.

Armed with this information, our client went back to the potential acquirer and said they would be willing to sell the bank if they would pay a purchase price that was a good bit higher than the purchase price we identified made sense. It was also above the purchase price we thought was too high based on similar transactions. Our client's thinking was that they could always come down. My caution is that I have previously seen this type of response blow up and kill a deal totally. What will happen in this transaction? Time will tell. We will keep you posted as to whether the transaction happens.

CONCLUSION

Happy Tax Day. Those of you that know me know that comment is totally facetious. I will refrain from making political comments in *Musings*, but let's just say it would be nice if the tax money we paid to the government was used a little more appropriately.

In any event, enjoy the next two weeks.

Jeff Gerrish *and* *Greyson Tuck*

