GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Florida, Georgia, Texas, New Mexico, and Wisconsin!

ACQUISITION STRUCTURE

Two things are really important in acquisitions. The first is making sure you have an appropriate structure from a tax and regulatory standpoint. The second is that you get professional help that knows what they are doing.

I received a call from a now new client who had tried to structure an acquisition transaction for his community bank, but he tried to do a lot of it himself (to save money, I suppose) and used a local lawyer to help with the documentation. Unfortunately, the structure was not right. The regulators objected and now we are going to have to go back, start over, and do it correctly this time (it probably would have saved him a lot of time, energy, and effort if he would have done that the first go-around).

Acquisitions, particularly these days, can be creative. There is no problem with that, but they still need to be something that can get regulatory approval, and, as a corollary, not get you in trouble with the regulators because you structured it improperly.

THE REGULATORY "NO-NO"

I was recently visiting with what is now another new client about some regulatory issues he is having. He started the conversation by telling me that the regulators had threatened to throw him out of banking, assess civil money penalties, and other like things (I assume criminal

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charges as well) because of something he had done at the bank. Apparently, the holding company had redeemed some this individual's personal shares. The holding company gave him a note for the amount of the redeemed shares (no problem) and a contingent payout based on the recovery on a couple of charged-off assets (i.e., pro rata portion). Conceptually, that does not really seem to be a problem. The problem came in when the recovery came in on a couple of these charged-off assets and the bank (yes, the bank) directly cut him a check for his "portion" of those charge-offs.

When I first heard this, I knew he had a problem because the friendly federal regulators were going to accuse him of diverting bank assets for his own benefit. The way to handle that transaction would have been on the contingent purchase price to have the recovery at the bank. Have the bank pay a dividend to the holding company. The holding company would then pay him his additional purchase price. That was not what was done in this case apparently. Here, the bank simply cut him a check for the amount of those assets. The regulators understandably are accusing him of misappropriating bank funds and a host of other bad things.

Hopefully we can get this mistake straightened out. I will keep you posted.

ENTERPRISE RISK MANAGEMENT

As part of planning sessions I facilitate, I generally include an agenda item on enterprise risk management, no matter the size of the bank. As I am sure all *Musings* readers know, enterprise risk management is simply an assessment by the bank and its consolidated holding company of the risks associated with doing business. It is basically identifying risks, determining risk tolerance, monitoring risks, controlling what you can, and reporting on it.

These days, no matter the size of the community bank, the regulators are expecting to see some type of enterprise risk management system. The larger the bank, the more "robust" the system must be. If you have not started doing anything with enterprise risk management in a serious way, you probably need to give some thought to it. Enterprise risk management has a lot of subsets. These include cyber security, asset quality, reputation risks, vendor risks, and a host of others. Your community bank needs to show some effort in this area to keep the regulators at bay and for the good of the bank.

VENDOR MANAGEMENT HOT BUTTON

I have received correspondence from numerous clients in the last month or so on issues of vendor management. Some of those have been direct regulatory questions where the

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regulators have asked the bank to improve or further assess its vendor management. Some of those deal more directly with our consulting and law firms as vendors. A number of banks are being proactive and asking all of their vendors to certify confidentiality of customer information and the like, among other things. Fortunately, through the law firm, we have attorney/client privilege, which will be a much stronger privilege than any vendor management confidentiality agreement that could be signed. It has occurred to me, however, that the regulatory pressure on vendor management is accelerating and it probably makes sense to be proactive with respect to contacting your vendors to make sure that they have their own systems in place for confidentiality as it relates to sensitive or privileged bank information.

LOOKING FOR INVESTORS

I was with a community bank the other day that was looking to do a capital raise. They are basically looking for investors. We had a good, healthy discussion with respect to not only some of their alternatives, but also some of their preferences. As a community bank under $1 billion, they, of course, could debt leverage capital into the subsidiary bank without being consolidated for capital purposes. My general recommendation was "let's look for debt first." Because this community bank holding company is under $1 billion on a consolidated basis, there is no need for subordinated debt, which can count as capital at the holding company level, since they are not consolidated for capital purposes and likely will not be for years.

After you exhaust the debt possibilities, or determine you do not want to leverage the company, then the next stop for capital is generally the board of directors. This is particularly true where the holding company does not have preemptive rights (our usual recommendation). Once the directors have been tapped out, the next logical step is the existing shareholder base.

Existing shareholders are the ones that already have skin in the game and may want to have more in the game, or at least might want to protect their percentage of ownership and not have their ownership percentage diluted by not participating in a subsequent placement of holding company securities.

If the capital is not or cannot be raised from the shareholder base, then new investors, generally in the form of individuals you would like to have as owners of your organization (i.e., local business people who want to do business with the bank), followed by private equity funds, are the next names on the list.

Simply put, when you are looking to raise capital, there are a lot of alternatives.

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A MISTAKE

What happens if your bank just flat out makes a regulatory mistake? This is a situation where the regulators told your bank directly not to do something and through some inadvertent error, it occurred anyway.

The answer is, "throw yourself on the mercy of the court." Regulators do not like surprises. They also do not like banks that do not follow directions or intentionally, even though inadvertently, violate the law. We have had a couple of these situations come up lately. The best thing to do is just tell the regulators exactly what happened, why it occurred, and that it will not happen again. That is no guarantee, but it is the best shot you have.

THE DEAL THAT DID NOT COME TOGETHER

Over the past several months, we have been assisting one of our clients in pursuing the acquisition of another community bank. The "dance" between the potential buyer and seller lasted for some time. The transaction was going to be a stock-for-stock swap, and quite a bit of work was put into deciding the relative value of each organization and how much of the combined organization each of the shareholder groups should own. Unfortunately, the transaction did not ultimately come together. The target shareholder group, which was very concentrated, simply could not give up control of their institution. They were not willing to give up an illiquid community bank stock they controlled for an illiquid community bank stock they did not control.

Unfortunately for our client, this is not all too uncommon. I have seen a number of times in the past where transactions make perfect sense on paper, yet fail to materialize because the realities of the transaction, particularly for the seller, are simply not palatable. When this happens, it is particularly frustrating for the buyer, having spent time, effort and money in pursuit of the deal. Unfortunately, it is just a risk in the process that cannot be avoided.

EMPLOYEES IN TRANSITION

Over the last month or so, we have consummated a couple different community bank acquisitions. In one of the transactions, we represented the seller. In the other we represented the buyer. Both of these deals required a significant amount of work as it relates to the target bank employees.

As I am sure you can understand, in most community bank acquisitions, the target bank employees are nervous. These transactions represent a significant amount of change for them.

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Most acquirers look to recognize "cost savings" through the transaction, which is a polite way of saying most acquirers look to fire a number of the target's employees. Putting all of this together results in nervous target bank employees that will consider any option to secure their employment.

In both of these acquisitions, the target bank employees were pretty much safe. There were a small number of employees that lost their jobs, and they knew about that well in advance of closing. For the remaining employees, closing was a non-event, as they were going to continue with the combined organization. However, notwithstanding these facts, there was still quite a bit of angst.

If you are looking at an acquisition from the buy-side, keep in mind the mindset of the target bank employees. Simply keeping them around is not enough. To be a great acquirer, you have to be proactive in dealing with the target bank employees. You have to work to alleviate, to the extent you can, their concerns, and to make them comfortable regarding the transaction. If you can do that, your chances of a successful acquisition and integration are significantly increased.

THE SCOPE OF DUE DILIGENCE

We are currently assisting a number of community banks through the sale of their institution. In two particular transactions, we are in the heart of due diligence. In both of these transactions, we are representing the seller. Prior to the beginning of due diligence, each of these sellers inquired as to the scope of due diligence. What they really wanted to know was which portions of their bank that were "off limits" to the acquirer.

My response to each of these sellers was the same – nothing is off limits during due diligence. During the due diligence review, the acquirers (rightfully) expect to have full access to the target's information. This includes all the different pieces of information in the bank, such as loan files, reports, policies and procedures, and the like. There are no secrets during due diligence. The potential acquirers that have been allowed to get to that step in the process have to know all of the information concerning the target bank in order to make an informed decision.

CONCLUSION

It is now mid-August – right at the tail-end of Graduate School of Banking season. As many of you know, I taught at four Graduate Schools of Banking for many, many years, including SMU, Pacific Coast in Seattle, Wisconsin, and Colorado. I managed to pass my duties

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at the Graduate Schools of Banking on to my partners, Greyson Tuck and Philip Smith. Set forth below is one of Greyson's stories about the Graduate School experience that I thought you might enjoy:

> During the past couple of weeks, I spent some time teaching at a Graduate School of Banking. While I was at the school, I spent one of my nights "hydrating" at a local restaurant. The bartender asked what brought me to town, and we got into a discussion concerning community banking. The bartender commented to me that they did not use a bank, but always found credit unions to have better rates. I asked the bartender whether their favorable view of credit unions would change if they knew credit unions paid no taxes. The response was "absolutely." I then used that opportunity to educate the millennial bartender on credit union taxation (or lack thereof). I threatened to tip an amount equal to the taxes paid by credit unions over the past ten years. I think that really drove the point home. Maybe I created a new convert out of the discussion.

Have a great two weeks.

Jeff Gerrish *and* *Greyson Tuck*

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