The Future of Community Banking

Presented by:
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JEFFREY C. GERRISH. Mr. Gerrish is Chairman of the Board of Gerrish McCreary Smith Consultants, LLC and Gerrish McCreary Smith, PC, Attorneys. The two firms have assisted over 1,500 community banks in all 50 states across the nation. Mr. Gerrish's consulting and legal practice places special emphasis on strategic planning for boards of directors and officers, community bank mergers and acquisitions, bank holding company formation and use, acquisition and ownership planning for boards of directors, regulatory matters, including problem banks, memoranda of understanding, cease and desist and consent orders, and compliance issues, defending directors in failed bank situations, capital raising and securities law concerns, ESOPs and other matters of importance to community banks. He formerly served as Regional Counsel for the Memphis Regional Office of the FDIC with responsibility for all legal matters, including all enforcement actions. Before coming to Memphis, Mr. Gerrish was with the FDIC Liquidation Division in Washington, D.C. where he had nationwide responsibility for litigation against directors of failed banks. He has been directly involved in fair lending, equal credit and fair housing matters, in raising capital for problem financial institutions and in numerous bank merger transactions. Mr. Gerrish is an accomplished author, lecturer and participates in various banking-related seminars. In addition to numerous articles, Mr. Gerrish is also the author of the books "Commandments for Community Bank Directors" and “Gerrish’s Glossary for Bank Directors”. He writes a regular blog, “Gerrish on Community Banking,” for the Banking Exchange, www.bankingexchange.com. He also is or has been a member of the faculty of the Independent Community Bankers of America Community Bank Ownership and Bank Holding Company Workshop, The Southwestern Graduate School of Banking Foundation, the Wisconsin Graduate School of Banking, the Pacific Coast Banking School, the Colorado Graduate School of Banking and has taught at the FDIC School for Commissioned Examiners and School for Liquidators. He is a member of the Board of Regents of the Paul W. Barret, Jr. School of Banking. He is a Phi Beta Kappa graduate of the University of Maryland and received his law degree from George Washington University's National Law Center. He is a member of the Maryland, Tennessee and American Bar Associations, was selected as one of “The Best Lawyers in America” 2005 through 2014 and as the Banking Lawyer of the Year, Best Lawyers Memphis, 2009. Mr. Gerrish can be contacted at igerrish@gerrish.com.

Gerrish McCreary Smith Consultants, LLC and Gerrish McCreary Smith, PC, Attorneys offer consulting, financial advisory and legal services to community banks nationwide in the following areas: strategic planning; mergers and acquisitions, both financial analysis and legal services; dealing with the regulators, particularly involving troubled banks, memoranda of understanding, cease and desist and consent orders, and compliance; structuring and formation of bank holding companies; capital planning; employee stock ownership plans, leveraged ESOPs, KSOPs, and incentive compensation packages; directors and officers liability; new bank formations; S corporation formations; going-private transactions; and public and private securities offerings including trust preferred securities.
<table>
<thead>
<tr>
<th>Consulting ♦ Financial Advisory ♦ Legal</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mergers &amp; Acquisitions</strong></td>
</tr>
<tr>
<td>Analysis of Business and Financial Issues</td>
</tr>
<tr>
<td>Target Identification and Potential Buyer Evaluation</td>
</tr>
<tr>
<td>Preparation and Negotiation of Definitive Agreements</td>
</tr>
<tr>
<td>Preparation of Regulatory Applications</td>
</tr>
<tr>
<td>Due Diligence Reviews</td>
</tr>
<tr>
<td>Tax Analysis</td>
</tr>
<tr>
<td>Securities Law Compliance</td>
</tr>
<tr>
<td>Leveraged Buyouts</td>
</tr>
<tr>
<td>Anti-Takeover Planning</td>
</tr>
<tr>
<td>Going Private Transactions</td>
</tr>
<tr>
<td>Financial Modeling and Analysis</td>
</tr>
<tr>
<td>Transaction Pricing Analysis</td>
</tr>
<tr>
<td>Fairness Opinions</td>
</tr>
<tr>
<td><strong>Bank and Thrift Holding Company Formations</strong></td>
</tr>
<tr>
<td>Structure and Formation</td>
</tr>
<tr>
<td>Ownership and Control Planning</td>
</tr>
<tr>
<td>New Product and Service Advice</td>
</tr>
<tr>
<td>Preparation of Regulatory Applications</td>
</tr>
<tr>
<td>Financial Modeling and Analysis</td>
</tr>
<tr>
<td><strong>New Bank and Thrift Organizations</strong></td>
</tr>
<tr>
<td>Organizational and Regulatory Advice</td>
</tr>
<tr>
<td>Business Plan Creation</td>
</tr>
<tr>
<td>Preparation of Financial Statement Projections</td>
</tr>
<tr>
<td>Preparation of the Interagency Charter and Federal Deposit Insurance Application</td>
</tr>
<tr>
<td>Private Placements and Public Stock Offerings</td>
</tr>
<tr>
<td>Development of Bank Policies</td>
</tr>
<tr>
<td><strong>Financial Modeling and Analysis</strong></td>
</tr>
<tr>
<td>Financial Statement Projections</td>
</tr>
<tr>
<td>Business and Strategic Plans</td>
</tr>
<tr>
<td>Ability to Pay Analysis</td>
</tr>
<tr>
<td>Net Present Value and Internal Rate of Return Analysis</td>
</tr>
<tr>
<td>Mergers and Acquisitions Analysis</td>
</tr>
<tr>
<td>Subchapter S Election Analysis</td>
</tr>
<tr>
<td><strong>Bank Regulatory Guidance and Examination Preparation</strong></td>
</tr>
<tr>
<td>Preparation of Regulatory Applications</td>
</tr>
<tr>
<td>Examination Planning and Preparation</td>
</tr>
<tr>
<td>Regulatory Compliance Matters</td>
</tr>
<tr>
<td>Charter Conversions</td>
</tr>
<tr>
<td><strong>Taxation</strong></td>
</tr>
<tr>
<td>Tax Planning</td>
</tr>
<tr>
<td>Tax Controversy Negotiation and Advice</td>
</tr>
<tr>
<td><strong>Alternative Dispute Resolution</strong></td>
</tr>
<tr>
<td>Arbitration</td>
</tr>
<tr>
<td>Mediation*</td>
</tr>
<tr>
<td>* J. Franklin McCreary is a Rule 31-listed Mediator</td>
</tr>
<tr>
<td><strong>Strategic Planning Retreats</strong></td>
</tr>
<tr>
<td>Customized Director and Officer Retreats</td>
</tr>
<tr>
<td>Long-Term Business Planning</td>
</tr>
<tr>
<td>Assistance and Advice in Implementing Strategic Plans</td>
</tr>
<tr>
<td>Business and Strategic Plan Preparation and Analysis</td>
</tr>
<tr>
<td>Director Education</td>
</tr>
<tr>
<td><strong>Capital Planning and Raising</strong></td>
</tr>
<tr>
<td>Private Placements and Public Offerings of Securities</td>
</tr>
<tr>
<td>Bank Stock Loans</td>
</tr>
<tr>
<td>Capital Plans</td>
</tr>
<tr>
<td><strong>Subchapter S Conversions and Elections</strong></td>
</tr>
<tr>
<td>Financial and Tax Analysis and Advice</td>
</tr>
<tr>
<td>Reorganization Analysis and Restructuring</td>
</tr>
<tr>
<td>Cash-Out Mergers</td>
</tr>
<tr>
<td>Stockholders Agreements</td>
</tr>
<tr>
<td>Financial Modeling and Analysis</td>
</tr>
<tr>
<td><strong>Problem Banks and Thrifts Issues</strong></td>
</tr>
<tr>
<td>Examiner Dispute Resolution</td>
</tr>
<tr>
<td>Negotiation of Memoranda of Understanding and Consent Orders</td>
</tr>
<tr>
<td>Negotiation and Litigation of Administrative Enforcement Actions</td>
</tr>
<tr>
<td>Defense of Directors in Failed Bank Litigation</td>
</tr>
<tr>
<td>Management Evaluations and Plans</td>
</tr>
<tr>
<td>Failed Institution Acquisitions</td>
</tr>
<tr>
<td>New Capital Raising and Capital Plans</td>
</tr>
<tr>
<td>Appeals of Material Supervisory Determinations</td>
</tr>
<tr>
<td><strong>General Corporate Matters</strong></td>
</tr>
<tr>
<td>Corporate Governance Planning and Advice</td>
</tr>
<tr>
<td>Recapitalization and Reorganization Analysis and Implementation</td>
</tr>
<tr>
<td><strong>Executive Compensation and Employee Benefit Plans</strong></td>
</tr>
<tr>
<td>Employee Stock Ownership Plans</td>
</tr>
<tr>
<td>401(k) Plans</td>
</tr>
<tr>
<td>Leveraged ESOP Transactions</td>
</tr>
<tr>
<td>Incentive Compensation and Stock Option Plans</td>
</tr>
<tr>
<td>Employment Agreements-Golden Parachutes</td>
</tr>
<tr>
<td>Profit Sharing and Pension Plans</td>
</tr>
<tr>
<td><strong>Estate Planning for Community Bank Executives</strong></td>
</tr>
<tr>
<td>Wills, Trusts, and Other Estate Planning Documents</td>
</tr>
<tr>
<td>Estate Tax Savings Techniques</td>
</tr>
<tr>
<td>Probate</td>
</tr>
<tr>
<td><strong>Other</strong></td>
</tr>
<tr>
<td>Public Speaking Engagements for Banking Industry Groups (i.e., Conventions, Schools, Seminars, and Workshops)</td>
</tr>
<tr>
<td>Publisher of Books and Newsletters Regarding Banking and Financial Services Issues</td>
</tr>
</tbody>
</table>

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GERRISH McCREEARY SMITH
Consultants and Attorneys
# The Future of Community Banking

## Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction and Current Environment</td>
<td>Tab A</td>
</tr>
<tr>
<td>I. Introduction and the Current Environment</td>
<td>1</td>
</tr>
<tr>
<td>II. Industry Predictions: Then versus Now</td>
<td>5</td>
</tr>
<tr>
<td>A. Aging and the Educated Population</td>
<td>5</td>
</tr>
<tr>
<td>B. Ethnic and Gender Diversity</td>
<td>6</td>
</tr>
<tr>
<td>C. Technology</td>
<td>7</td>
</tr>
<tr>
<td>D. Products and Services / Lines of Business</td>
<td>8</td>
</tr>
<tr>
<td>E. Competition</td>
<td>9</td>
</tr>
<tr>
<td>F. Industry Consolidation</td>
<td>9</td>
</tr>
<tr>
<td>G. Customers</td>
<td>10</td>
</tr>
<tr>
<td>H. Subchapter S Corporations</td>
<td>11</td>
</tr>
<tr>
<td>I. Regulatory Burden</td>
<td>12</td>
</tr>
<tr>
<td>J. The Future</td>
<td>12</td>
</tr>
<tr>
<td>Strategic Planning: Don’t Make Me Do It!</td>
<td>Tab B</td>
</tr>
<tr>
<td>I. A Positive Approach to Strategic Planning</td>
<td>13</td>
</tr>
<tr>
<td>A. Directors’ and Officers’ Real Job</td>
<td>13</td>
</tr>
<tr>
<td>B. Are You Appropriately Planning for the Future?</td>
<td>14</td>
</tr>
<tr>
<td>C. Independence Decision</td>
<td>15</td>
</tr>
<tr>
<td>D. Mechanics of Strategic Planning</td>
<td>15</td>
</tr>
<tr>
<td>E. Ten Commandments for Effective Bank Strategic Planning</td>
<td>18</td>
</tr>
<tr>
<td>II. How to Ensure Your Strategic Planning is a Success</td>
<td>22</td>
</tr>
<tr>
<td>Success for the Future: Enhancing Shareholder Value without Buying or Selling</td>
<td>Tab C</td>
</tr>
<tr>
<td>I. Formation, Use and Capital Planning with the Bank Holding Company</td>
<td>27</td>
</tr>
<tr>
<td>II. Creating Stock Liquidity</td>
<td>30</td>
</tr>
<tr>
<td>A. Going Public? (Registering with the SEC?)</td>
<td>30</td>
</tr>
<tr>
<td>B. Stock Repurchase Plans</td>
<td>30</td>
</tr>
<tr>
<td>III. Considering Ownership Alternatives</td>
<td>35</td>
</tr>
<tr>
<td>A. Becoming a Public Company</td>
<td>35</td>
</tr>
<tr>
<td>B. Maintain Private Company Status</td>
<td>38</td>
</tr>
</tbody>
</table>
C. The Move Toward a Very Private Company Status (Subchapter S) .................. 38
D. Converting a Public Company to a Private Company ............................. 39

IV. Alternative Lines of Business ................................................................. 41
A. Financial Holding Companies ............................................................... 41
B. Traditional Bank Holding Companies ................................................. 42

V. Attracting and Retaining Human Capital .................................................... 45
A. ESOPs .................................................................................................. 45
B. Incentive Stock Option Plan (ISOP) .................................................... 45
C. The Stock Appreciation Rights Plan (SAR) ......................................... 46
D. Combination Incentive Stock Option Plan (ISOP) and Stock Appreciation Rights Plan (SAR) .......................................................... 47
E. Non-Qualified Stock Options .............................................................. 48
F. Restricted Stock .................................................................................. 48

VI. Enhancing Value through Appropriate Corporate Governance ............... 52

VII. Get the Right Board ............................................................................. 57

Success for the Future: Enhancing Shareholder Value Through Purchase or Sale .... Tab D

I. Buying or Selling Secrets ......................................................................... 58
A. Establish Your Bank’s Strategy Early On ................................................ 58
B. Creation of the Plan ................................................................................ 60
C. Anti-Takeover Planning and Dealing with Unsolicited Offers .................. 65
D. Contact and Negotiation for Community Bank Acquisitions .................. 69
E. Price, Currency, Structure, and Other Important Issues ......................... 74
F. Directors’ and Officers’ Liability Considerations .................................... 84

II. Acquisition Accounting Under FASB 141(R) ............................................ 86

III. Buying or Selling a Branch .................................................................... 89
A. Analysis ................................................................................................ 89
B. Premium (Purchase Price) ..................................................................... 91
C. Regulatory Approvals and Applications ............................................... 92
D. Operational Issues ................................................................................ 95

IV. Conclusion ............................................................................................ 96
Tab A
Introduction and Current Environment
I. INTRODUCTION AND CURRENT ENVIRONMENT

The Great Recession is in the rearview mirror, but community bankers face a banking industry environment that is substantially different than it was ten years ago. Not only are our smaller institutions forced to comply with an ever growing list of regulations and new legislation, but industry analysts and “experts” (not this one) are constantly blowing smoke about how smaller institutions will be unable to survive independently and must seek out a merger or acquisition to achieve economies of scale and compete in the “new normal.” To continue to thrive in a low interest rate economy, many community banks are going back to the basics to increase efficiency, reduce costs, and improve overall profitability. In light of all of these issues, community bank boards of directors that desire for their bank to remain independent must understand the importance of planning to enhance shareholder value as the bank transitions into and acclimates to this new environment.

Despite all of the changes, one constant remains for community banks—the board of directors’ and senior management’s primary obligation to appropriately allocate financial and managerial capital to enhance the value for the bank’s or holding company’s shareholders. Neglecting this foundational mandate will result in the shareholders looking for an alternative investment and the bank merging out of existence or engaging in an outright sale transaction. It is incumbent upon the board and the senior officers to plan to avoid such results. In this regard, it is critical to understand both the short-term and long-term environmental factors. Several factors that are and will continue to impact the environment in 2015 include the following:

- Improved earnings and slow balance sheet growth. In the aftermath of the Great Recession, many community banks bolstered profitability by reducing expenses. Although this trend continues for many community banks, banks have begun to focus on core earnings over the past few years and adopt a “back to basics” approach to lending, which has been primarily evidenced by community banks’ general focus on profitability rather than balance sheet growth. This position is counter to the stance taken by many community banks prior to the Great Recession when most institutions believed that size was the key to profitability. While many institutions have “leveled off” or shrunk assets in order to focus on core profitability, this trend has slightly shifted over the past year. Specifically, in 2014, banks in the industry experienced an annualized asset growth rate higher than any year since the onset of the Great Recession. As a whole, community banks are still adopting a “back to basics” mentality, but many banks will be more aggressive in their balance sheet growth strategy moving forward.

- Increased focus on other lines of business. In addition to focusing on improving core earnings and easing back into asset growth, many community banks are re-assessing other lines of business, such as trust departments or insurance agencies, as a means of increasing non-interest
income and taking some of the pressure off of interest income in a compressed margin environment.

- Increased focus on share liquidity. Additionally, many community banks have heightened their resolve to remain private, locally owned institutions. Because the stock of these privately owned institutions is often illiquid, many community bank holding companies have increased their focus on share liquidity by implementing share repurchase programs as a means of making a market for their own stock.

- Fatigue in general. In addition to borrower fatigue, we are continuing to see significant banker fatigue, which is helping drive some of the consolidation in the industry. Many of the bankers who have been fighting the battle to keep their banks well-capitalized and in halfway decent graces with the regulators have simply had all the “fun” they can stand. For them, there needs to be some relief, and so far the mergers and acquisitions market has provided it.

- Kinder/gentler regulators. On the safety and soundness side, the regulators continue to become more amicable and easy to work with, even in their dealings with problem institutions. Despite this reality, however, enforcement actions are still a reality for many institutions, though the number of terminated enforcement actions began to outpace new actions in 2014. Additionally, although bank failures have continued, the rate of failure has decreased significantly over the past few years. The generally improved bill of health for the banking industry along with the regulator’s “forward looking supervision” has resulted in a much more healthy, friendly regulatory relations environment for safety and soundness.

- Interest rate risk eventually. All community banks have suffered in large part due to the low rates and compressed margins. Interest rates will eventually rise (how is that for a prediction that we can pretty much guarantee?). The only question is when. The Federal Reserve has continued to advance the ball down the field in the interest of keeping inflation low, but we are beginning to see an easing in this regard. Additionally, the regulators have increased their focus on interest rate oversight and risk management. We must be prepared for that interest rate risk as we plan going forward.

- Mergers and acquisitions continue. Community banks continue to focus on their role in the current mergers and acquisitions environment, which has picked up significantly over the past couple of years. Despite merger and acquisition activity coming in the form of a “steady stream” rather than the “wave” anticipated by many industry experts, activity has, in fact, increased significantly among community banks. Based on recent surveys, as many as half of existing financial institutions are open to considering merger and acquisition transactions. Although many
institutions desire to remain independent in the industry, others are seeking economies of scale for compliance purposes, lack appropriate board or management succession to succeed in the future, or have simply had enough “fun” over the past seven years. With transaction pricing continuing to climb, many organizations are “testing the waters” to see whether any good deals are available that would increase profitability and enhance value for the organizations’ shareholders. It is our firm’s belief that community banks have and will continue to be a prominent, successful component of the banking industry regardless of size (and regardless of what arbitrary thresholds industry pundits claim). With these trends in mind, however, each community bank’s board of directors must ultimately make the decision that is in the best interest of the organization’s shareholders.

- Compliance. Regulatory compliance and the overall regulatory burden remain one of the greatest areas of concern for community bankers. Whereas the regulatory focus used to be safety and soundness, which has improved drastically, the regulatory shift to compliance since the Great Recession has been reemphasized through the regulator’s focus on fair lending issues, Bank Secrecy Act violations, Consumer Financial Protection Bureau mortgage rulemakings, and unfair, deceptive, and “abusive” acts or core practices. Even violations of the Flood Disaster Protection Act have been the subject of renewed regulatory scrutiny in light of legislation in 2014. Regulatory scrutiny has also extended to bank overdraft practices, which has been a sore spot for many bankers as the regulators have begun to criticize practices and policies that have been in place for decades.

There is also a recent, troubling regulatory trend of using the “management” rating within the bank’s overall CAMELS rating as a means to send a message when the regulator is simply not happy with something the bank is doing. In other words, if the regulators are critical of something in the bank but cannot formally require the bank take action or cite the bank with a violation, the regulators have begun to reduce the bank’s management rating as a catch-all of sorts. While this practice is not yet widespread, it does highlight the fact that the regulatory environment, though improved, is still settling from a very turbulent economic crisis.

- Enterprise Risk Management. In light of the turbulent banking environment, enterprise risk management, or “ERM,” has never been more important to community banks. ERM means your bank pays attention to everything impacting its business, especially risk. Put another way, ERM is a holistic, risk-centered approach to managing your organization. Our firms are encouraging every bank to implement a well-documented ERM program. This program needs to be tailored to your institution’s size and the complexity of its operations. The regulators do not expect smaller community banks to have the same risk
management framework as a multi-billion dollar regional, but they do expect a comprehensive program specific to the bank.

• Information Technology. Information technology, along with the associated risks, has also received increased regulatory focus, particularly in light of the numerous retailer data breaches that occurred in 2014. In light of the industry’s enhanced focus on security and the risks and costs associated with the ever-changing payment’s landscape, long-term information technology planning as a subset of the board of director’s overall strategic planning process is a non-negotiable.

• Financial Capital. As of January 1, 2015, the Basel III capital framework is in full effect for community banks, although certain measures, such as the capital conservation buffer, will continue to phase in until 2019. As adopted, the Basel III capital rules remain overly burdensome to community banks, but the regulators have made rules more community bank “friendly” by permitting certain trust preferred securities to remain at zero capital, allowing accumulated other comprehensive income to be excluded from regulatory capital, leaving the risk-weighting of residential mortgages unaltered, and providing relief for Subchapter S organizations with respect to restrictions on dividends. Our firm continues to believe that Basel III’s capital rules do not prevent many community banks from safe, sound, and profitable operation. Furthermore, despite the new formal capitalization requirements, the regulators will likely continue to informally expect minimum capital ratios of 9% Tier 1 and 12% Total Risk-Based regardless of Basel III’s formal capitalization requirements.

• Human Capital. Succession issues and attracting and retaining quality employees have become critical considerations across the industry. The days of starting as a teller and rising up through the ranks to CEO are the exception. Competition for quality people is just as intense as competition for loans and other business. Like gaining new business, however, attracting and retaining quality people is more than dollars and cents. Corporate culture and bank stability (which is less predictable in a consolidating industry) are some of the primary considerations for potential hires, which means community banks must be willing to invest more than competitive salary and benefits in its employees.

• Strategic/Action Planning. Strategic planning has such a bad connotation that in our firm, we often refer to it as Action Planning. Action Planning is a “process” where the board gets away from “the process.” It creates an environment where the board and senior management focus on the issues and determine the actions that are appropriate to send the bank forward in accordance with the strategies established.
II. INDUSTRY PREDICTIONS: THEN VERSUS NOW

In the year 2000, I was so bold as to predict what the community banking industry would look like in 2020. Now only five years removed from that date, it is interesting to note how the industry has shifted in some predictable and unpredictable ways.

A. Aging and the Educated Population

Then (2000).

The Yuppies, the Dinks and other “acronym” groups will all have grown up significantly. The baby boom generation will become the elderly. The “me” generation will be middle aged. The generation X’ers, hopefully, will be responsible.

Statistics indicate that currently, the fastest growing sector of the population is of those individuals over 80. By the year 2020, the elderly sector of the population will be dominant, hence the current political jousting with respect to Social Security and Medicare.

According to the most recent census data and projections by the Bureau of the Census:

“In 1995, there were 34 million people ages 65 and over representing 13 percent of the population. The middle-series projection for 2050 indicates that there will be 79 million people ages 65 and over, representing 20 percent of the population. The population ages 85 and over is growing especially fast. It is projected to more than double from nearly 4 million (1.4 percent of the population) in 1995 to over 8 million (2.4 percent) in 2030, then to more than double again in size from 2030 to 2050 to 18 million (4.6 percent).”

In addition to the effect of the “greying” of the population, the consumers of community bank services will also be more well educated. Relying on census data, again, indicates that educational attainment levels continue to rise for the U.S. population as a whole. The Census Bureau indicates that:

“In March 1995, 82 percent of all adults ages 25 and over had completed at least high school and 23 percent had earned a bachelor’s degree or more. Both figures are the highest ever recorded in the United States. The rise in educational attainment for the general adult population is driven principally by the replacement of older, less-educated people by younger people who have completed substantially more education. For example, in 1995, 87 percent of persons 25 to 34 years old had completed high school, compared with 57 percent of persons ages 75 and over.”

As the statistics predicted, the “elderly” sector of the population (however that is defined) is a dominant part of today’s economy. However, it is no longer the dominant demographic. According to more recent statistics, there are approximately 76 million baby boomers, and there are approximately 80 million millennials, which are those individuals born between 1977 and 1995. These younger consumers are increasingly tech-savvy and educated, and they have a decreased overall reliance on traditional banking solutions. The dominance of the younger generations in the market will continue to increase, as will their need for financial services. A recent study conducted by the ICBA indicated that approximately 54 percent of millennials prefer to bank with locally owned and operated community banks. Accordingly, community banks should continue to focus on ways to reach the millennials, and this trend will continue and will require increasing creativity and “out of the box” thinking.

What is the impact on community banks of the changing demographics of the population? The impact is at least fourfold:

- The typical shareholder’s investment intent will change from “growth” to “yield”.
- The need for products and services to be distributed geographically to theoretically a less mobile, higher aged population will continue, but it will continue alongside a need for increasingly mobile products and services to reach the younger generations.
- Due to technology, all age groups will have better access to information on the bank and its competitors.
- The older generations will likely travel more and have more leisure time and inherently become less loyal customers who need to be tied in with high-quality service and technology. The younger, more entrepreneurial generations, however, will seek out locally owned and operated community banks to meet their banking needs.

B. Ethnic and Gender Diversity

Then (2000).

One of the most dramatic changes in the demographic makeup of the United States in the next 20 years will be shifting proportions between ethnic groups. During this time period, the African-American population is estimated to remain fairly stable. The Caucasian population, as a percentage of the total population, will decrease. The Hispanic population of the United States, however, will represent approximately 25% of the total population of the United States. While various sections of the country have had the opportunity to deal with the Hispanic influence for years, many other sections have not but must be prepared to market to this large and influential section of the populous.
The cultural and language differences must be addressed by community banks in order to serve what will become a large segment of their population.


The predictions for 2020 remain largely on track with the Caucasian population decreasing and the Hispanic population continuing to climb. According to 2012 Census data:

“The non-Hispanic white population is projected to peak in 2024, at 199.6 million, up from 197.8 million in 2012. Unlike other race or ethnic groups, however, its population is projected to slowly decrease, falling by nearly 20.6 million from 2024 to 2060. Meanwhile, the Hispanic population would more than double, from 53.3 million in 2012 to 128.8 million in 2060. Consequently, by the end of the period, nearly one in three U.S. residents would be Hispanic, up from about one in six [in 2012]. The black population is expected to increase from 41.2 million to 61.8 million over the same period. Its share of the total population would rise slightly, from 13.1 percent in 2012 to 14.7 percent in 2060. The Asian population is projected to more than double, from 15.9 million in 2012 to 34.4 million in 2060, with its share of nation's total population climbing from 5.1 percent to 8.2 percent in the same period. Among the remaining race groups, American Indians and Alaska Natives would increase by more than half from now to 2060, from 3.9 million to 6.3 million, with their share of the total population edging up from 1.2 percent to 1.5 percent. The Native Hawaiian and Other Pacific Islander population is expected to nearly double, from 706,000 to 1.4 million. The number of people who identify themselves as being of two or more races is projected to more than triple, from 7.5 million to 26.7 million over the same period.

The U.S. is projected to become a majority-minority nation for the first time in 2043. While the non-Hispanic white population will remain the largest single group, no group will make up a majority. All in all, minorities, [37 percent of the U.S. population in 2012], are projected to comprise 57 percent of the population in 2060. (Minorities consist of all but the single-race, non-Hispanic white population.) The total minority population would more than double, from 116.2 million to 241.3 million over the period.”

C. Technology

Then (2000).

1999 was the 30th anniversary of the formation of the Internet. The rapid expansion and acceptance only in the last couple of years of the worldwide web, however, are only beginning. Technology in both the hardware and software arenas is becoming much more sophisticated. In the area of hardware, by 2020, it is likely that computers will be like Timex watches. When they break, you simply throw them away instead of
attempting to fix them. Community banks must be in the technology hunt, no matter how small they are. It is not necessary to be on the bleeding edge of technology but a fast follower approach is certainly warranted. Delivery of products and services through technology is the issue. It will allow community banks to retain their customers and continue profitability. Technology is the great equalizer.


Technology will continue to be a dominant factor and industry trend for the long term. Fortunately, community banks, (a) can be more nimble when it comes to implementing new technology and (b) technology has and will continue to be dramatically less expensive. Community banks, particularly in the small business area, will continue to rely on technology to further relationships with customers by determining the needs of those customers and meeting those needs with technology. In addition, it is likely that the senior segment of the population will become more technologically advanced. Community banks will be “fast followers” at a reasonable cost.

A significant customer trend for the future will be the continued increase in use of mobile technology. Most customers will likely be utilizing “smart phones” that can engage in banking transactions from anywhere in the world. Community banks must have access to appropriate technology and technology security to serve the large segment of the population that is migrating toward mobile banking. This does not mean branches are becoming irrelevant, since history shows us that relationships are still important, particularly when the customer has an issue that needs to be addressed.

D. Products and Services and Lines of Business

Then (2000).

The population in 2020 will demand one stop shopping. If they cannot get it at a community bank, they will find where they can get it. Although the one stop shopping concept has been around through “Kiosks” and the like for nearly 25 years, with the liberalization of the financial services laws and the improvement in technology, the one stop shop will become a reality. Many community banks in 2020 will still be using third party vendors to provide these services, but nevertheless, will be required to provide them to compete.


In the future, it is unlikely that community banks will be “all things to all people.” There is simply not enough managerial and financial capital to do so. It is likely that while most community banks will continue to “stick to their knitting,” in an attempt to diversify their income stream, some banks will joint venture with insurance, securities, real estate, trust, financial planning and other partners. Most of this will be through third party partnerships or joint ventures and not purchase. There will also be a significant effort continuing in the future to target the unbanked, the Hispanic/Latino population and the elderly.
E.  Competition

Then (2000).

2020 will see credit unions subject to federal and state income tax! NOT! It is not likely that anything will continue to happen on the credit union front other than credit unions will continue to grow larger, increase their fields of membership, and become more bank like without taxation. Although credit unions will probably be subject to some type of CRA responsibility, (witness the noise already being made by the National Credit Union Administration in this regard currently) it is not likely that they will ever be subject to the reporting and regulatory burdens of community banks. They simply have too much political clout.

Nothing will change in the competition arena except that it will be more intense and more technology driven by 2020. Some of you may ask how could it be more intense, but nevertheless, it is likely that it will be. Credit unions will grow larger, uninsured financial wholesalers will become more predominant, and the bigger banks will become more predatory (if that is possible) with a wider array of products. For a community bank to survive, it either needs to be in a small community that nobody wants to market directly to, or a niche player. Even a small community bank “generalist”, however, will suffer the effects of technology driven product and service delivery by the larger institutions. Community banking will not get any easier.


The types of competitors will also continue to diversify in the future. As of early 2014, even the United States Postal Service has banking aspirations, and then there is the certainty that Wal-Mart will continue to expand its financial services. Notwithstanding the large scale of the mega banks and Wal-Mart’s financial services (other than retail deposit taking), however, community banks will continue to maintain a distinct advantage within the area of small business lending, agricultural lending and relationship or “high touch” banking. Because of the problems created by the Wall Street bank and the recent economic disaster, and because of the difficulty the large banks will continue to demonstrate in integrating their operations and the constant pressure to centralize operations and decision making for economic reasons, a community bank always will be more nimble, more responsive, more flexible and more creative with its customer base and products and services which will create a continuous competitive advantage long into the years ahead.

Regarding future taxation of credit unions, we recommend not holding your breath.

F.  Industry Consolidation

Then (2000).

For all intents and purposes, consolidation will be over in 2020. There will, in fact, be a barbell effect. It is not likely that the United States’ system, contrary to a lot of predictions, will ever evolve into something similar to the Canadian system with very few
large banks. It is likely that the system will bottom out at approximately 6,500 banks with most either larger than $100 billion or less than $200 million.

In the short term, consolidation in the next six months will continue to be driven by the elimination of the pooling of interests accounting rules. From a short term standpoint, every community bank must, with its board of directors, focus on this significant accounting change. As the implementation of the Gramm-Leach-Bliley Financial Modernization Act progresses, the larger companies will become more like CitiGroup than the traditional large bank. In other words, they will become financial services conglomerates.


Over the last 30 years, the number of bank charters has decreased from approximately 15,000 to approximately than 6,500. The industry has experienced unprecedented consolidation, but, as predicted in the year 2000, this consolidation will likely bottom out around 6,000 institutions. Part of the consolidation over the last 30 plus year period can be attributed to serious periods of bank failures, economic downturns forcing mergers, the introduction of interstate banking and interstate branching, the elimination of unit banking in every state, and a number of other trends that (with the exception of bank failures) do not appear to be significant catalysts for future consolidation.

Contrary to many of those “pundits” who in the past have predicted that the only remaining financial institutions in the United States will be those over $100 billion, and that community banks will consolidate out of existence, it is more likely that the system will continue to evolve and consolidate, such that there will remain over the long term approximately 5,000 bank charters. Most of these banks will be designated as community banks. The middle tier of banks from $5 billion to $100 billion will likely continue to consolidate together and the large tier of $100 billion plus banks will continue to increase their scale through the acquisition of mid-tier banks. When it all shakes out in the long term, it is likely that we will have about 5,000 banks, most of those under $5 billion or over $100 billion with not much in between.

Interestingly, even though the industry has consolidated dramatically over the last 30 years, the number of bank branches has increased from approximately 60,000 to approximately 96,000. Although banks continue to evaluate branches’ utility while cutting costs and adapting to the increased use of Internet banking/the use of technology, it has now been pretty much concluded that customers still like to “deal with people,” especially when they have a problem. As a result, banks will continue to open and utilize new branches. The style and makeup of the branch of the future, however, will likely be significantly different.

G. Customers

Then (2000).

As the population ages, one interesting impact will be the increase in leisure time and the increase in travel and recreational activities (assuming all of us have some money to do it with). For the community bank, this spells far less loyal customer base, less tie to the
community, and more customer attraction to the services that the banks at the other end of the “barbell” can provide on a national or international basis. Communications will be cut to split seconds through one instrument which will serve as a phone, a pager, an Internet connection, and who knows what else. (These are already available, by the way.) Although personal service will remain an important selling point for a community bank, the ability to communicate effectively through technology will be essential.


Although we are unlikely to see any “pagers” (see reference above) in the future, technology will continue to dominate, as noted above. The increased dominance of technology will also play into another trend for the future—less loyal customers.

A number of banks around the country have, in recent years, celebrated their 100th anniversary. When those banks were formed 100 years ago with a few thousand dollars in capital, their local shareholder base was very loyal and exhibited an emotional attachment to that bank and to those shares. As those shares are passed from generation to generation and those generations move away from the location of that bank, the loyalty that once tied that shareholder to that bank begins to dissipate. We will continue to see that trend in the future. This trend of the less loyal shareholder base dictates that the Board and management over the long term focus on enhancing shareholder value since many of these shareholders who no longer have an emotional attachment to the bank’s stock will be looking at it simply as a financial investment.

H. Subchapter S Corporations

Then (2000).

The application of Subchapter S to community banks has been the best thing to happen to community banking since golf courses. It is likely over the next few years, including in the near term, the Sub S qualification rules will be liberalized so even those banks with a large number of shareholders who are reluctant to go through the oftentimes painful “freeze out” process will be able to elect Sub S. From an ownership standpoint, Sub S creates a cash cow and more community banks in the future will take advantage of it. It also levels the playing field with our “friends”, the credit union industry, by eliminating the bank level tax completely. It is likely that most of the community banks surviving in the future, once the rules are liberalized, will be Sub S banks.


Currently, approximately one third of the nation’s banks are organized as Subchapter S companies. Over the long term, it is likely that most remaining banks in the United States will be either public companies reporting to the SEC or Subchapter S companies. It is likely in the future there will not be too many bank holding companies “in between.” Companies that realize their need to be a public company will become “very public” to generate some market liquidity and access to the public capital markets. Those who qualify or can be made to qualify for Subchapter S will become Subchapter S companies. It is likely, as the debate continues regarding the credit unions lack of taxation, that one relief mechanism over the long term will be the continued relaxation
of the Subchapter S rules so that more community banks can comfortably elect and operate under Subchapter S. The most recent substantive changes to these rules in 2004, particularly the generational counting (six generations with a common ancestor equal one shareholder for Sub S purposes) already has triggered this trend. It is likely over the long term that further relaxation of the Sub S rules will occur, which will only increase the number of financial institutions operating as a Sub S.

I. Regulatory Burden

Then (2000).

It is no secret to any director or shareholder of a community bank that regulations still place a significant cost burden on the bank and risk burden on its directors. Although the Gramm-Leach Bliley Act contains certain provisions designed to reduce the regulatory burden on community banks, there are also a number of consumer oriented proposals (such as privacy) which will easily increase the regulatory burden. In any event, there is no legislation which will reduce the number or tenacity of the examiners in the field. Safety and soundness and compliance are lightning rods for many institutions, particularly now that the Y2K issues have been resolved. The cost of the regulatory burden reduces shareholder value without an offsetting gain in anything.


The regulators have been around for a long, long time and will be around long into the future. Although some consolidation of the regulatory system at the federal level has occurred (the OTS merging into the OCC), it is questionable whether any further consolidation will occur.

This regulatory burden, including a permanent trend toward compliance activities, will still fall heavier on community banks due to their inability to spread the cost over a larger asset size and earnings base. It is likely that the regulators will continue to make examples of banks large and small in areas which are hot buttons at the time (look out for fair lending, unfair and deceptive and abusive practices and other compliance issues permanently in the future). These institutions will be held up to their peers in order to assure compliance by others so the same thing “doesn’t happen to them.” For additional information on regulatory issues, see the appropriate section of this handout material.

J. The Future

There is a great future for community banks and community banking. The future will be faster paced, with more competition, more well-educated employees and a greater need for creative and diversified products and services. Community banks will meet the challenge of the future through their continued caring service, relationship banking and their ability to move quickly, particularly in the small business and agricultural areas.

Once you are comfortable with the future, it is time to refocus on the present and determine how best to survive the current challenges.
Tab B
Strategic Planning:
Don’t Make Me Do It!
I. A POSITIVE APPROACH TO STRATEGIC PLANNING

A. The Directors’ and Officers’ Real Job

Directors and senior management of financial institutions have an obligation to enhance shareholder value and to plan for the long term. Hopefully, for most institutions, that means aggressively taking steps to ensure long-term independence and focusing on creating value within the organization. Every institution should at least consider the alternatives of remaining independent for the long term, acquiring another institution or possibly enhancing value through sale. These materials cover long-term planning to enhance value both with and without a sale of the organization.

Today’s short-term operating environment for financial institutions, as noted, is still challenging. Therefore, it is imperative that as directors and officers of our community banks, we fully understand the short-term and long-term environmental issues as well as the drivers for long-term success. If our goal is to continue to serve our shareholders and communities, then long-term independence needs to be assured.

In many parts of the country, the short-term issues in the marketplace will continue to be difficult. As noted, regulatory issues, both safety and soundness and compliance, will continue to be paramount for community banks. The regulatory perception (perception is reality) will continue to drive a significant number of enforcement actions, both the compliance and safety and soundness, by the regulators. While the regulators (to give them the benefit of the doubt) may be well meaning with respect to their establishment of a “corrective program” for the bank, the reality is that the regulatory corrective program may not be consistent with the bank’s business plan for success, may not assist in the attraction and retention of key personnel, may create unintended liquidity events, and will divert significant financial and managerial resources to dealing with actions that will not sustain the profitability or the long-term franchise value for the institution.

Nevertheless, in order to plan to succeed in the long term, it is critical to continue to muddle through the short term.

This material addresses, from a community bank board and executive management perspective, both short-term and long-term issues, including dealing with the regulators and their enforcement action potential.

To thrive over the long term, our banks must ensure that the shareholders are satisfied. Enhancing shareholder value continues to be of paramount concern. Four critical metrics to determine whether the Board is moving toward enhancing the value for the shareholders over the long term and fulfilling its obligation are set forth as follows:

- Earnings per share growth - 8% to 10% a year. Notwithstanding all the discussion of book value among bankers every time a bank sells, earnings drive value. If the bank can grow its earnings per share by either growing
net income or reducing the number of outstanding shares, that will contribute to the enhanced per share value of the organization.

- Return on equity – a range of 10% to 12%. For most community banks, this is merely a “target.”

- Liquidity for the shares. We hear often during board meetings about bank liquidity. As directors and officers, we also need to focus on liquidity for our shareholders, particularly as our shareholder base ages. Liquidity in this context is the ability of a shareholder to sell a share of stock at a fair price at the time they want.

- Appropriate cash flow. This means we must address the dividend policy associated with our shares. As the population ages, it is likely their demand for greater cash return on their investments will increase as well. We need to focus on an appropriate dividend policy.

Please consider these and other factors in connection with long-term planning to enhance shareholder value in the current environment.

B. Are You Appropriately Planning for the Future?

As with many issues, it is almost easier to indicate what strategic planning is not than what strategic planning is. Strategic planning is not:

- Budgeting
- A wish list
- A set of unattainable goals
- A broad base set of platitudes
- A document prepared solely for the regulators
- A useless exercise engaged in too often
- An out-of-town trip for the directors

Unfortunately for some banks and bank holding companies, the above words and phrases are an apt description of their annual strategic planning exercise. The strategic planning process and the plan itself should be designed to answer four broad based and basic questions.

1. Who and where are we as an institution?
2. Where do we want to be over the appropriate time horizon?
3. How are we going to get there?
4. Who is responsible for implementing each of the steps?

The strategic plan should provide a broad based road map for where the institution intends to be over a two to three year time horizon. The Board of Directors of the bank or holding company has the responsibility for setting the direction for the company. This includes not only setting financial goals but establishing the culture, providing the long term strategies, identifying the likely means of implementation and following up on the results of the process. Strategic planning provides the “game plan” for the future.
Can a bank operate without a strategic plan? Certainly, and many do. Many $200 million asset banks also operate the same way they did when they were $20 million in total assets. They don’t operate optimally, but they do operate. The question is not is the strategic planning process essential to a community bank’s survival. The question is can the strategic planning process, if properly engaged in, enhance the value for a community bank’s shareholders through enhancing the value of the company over a longer term time horizon. With strategic planning conducted properly, the answer is yes.

“If you do not know where you are going, any road will take you there.” This off quoted phrase is trite but true. The management team for a community bank or bank holding company needs direction. That direction needs to come from the Board of Directors and needs to be in the form of established and specific goals. We “bother” with strategic planning because, done correctly, it enhances value and preserves independence.

C. The Independence Decision

It is very difficult to establish a strategic plan with any meaningful components if the Board has not made a conceptual determination as to whether it intends to remain independent for at least a two-year time horizon. As noted below, very early on in the strategic planning process, generally after the SWOT analysis, the Board needs to determine whether, subject to its fiduciary duty to consider any unsolicited offer, it intends for the institution to remain independent and for how long.

What considerations should go into the independence decision? The overall question is can the bank or holding company make its stock as attractive as an acquiror’s stock or cash so that its own shareholders desire to hold its own stock.

During the planning process, the Board must focus on how to do that if it wishes to remain independent. As noted above, this involves issues of earnings growth, adequate return on equity, cash flow and stock liquidity.

Other factors that come into the decision about a sale deal with the issues that are identified as “drivers”, including aging of the board and shareholder base, lack of management succession, high sale prices and the like. An additional issue is the potential lack of future acquirors. If the bank has a modestly long term independence goal of, for example, three years, then it needs to specifically analyze what acquirors may be available in three years. Often while meeting with a board in a planning session one year, there may be six acquirors available. The next year it is down to two.

In any event, the independence decision needs to be discussed and determined early on in the process. A number of other decisions will flow from it.

D. The “Mechanics” of Strategic Planning

1. Elements of the Strategic Planning Meeting

Each community bank should structure its strategic planning process around the needs of the bank. With that in mind, our general recommendation is that the strategic planning meeting contain the following elements:
a. An introduction as to the purpose and goals of the planning process.

b. A description of the current environment for community institutions and what it means to enhance shareholder value.

c. Analysis and discussion of the independence issue.

d. An identification of substantive issues.

   This can be done at the meeting, in advance of the meeting through questionnaires, or in a variety of other ways. It serves as an excellent warm up exercise and helps to identify specific issues particular to the institution that need to be addressed.

e. An independent discussion of each of the issues with a recommendation and plan for addressing each issue.

f. The creation of a mission, vision and core value statement, if it is appropriate for your bank.

   A mission statement is generally a brief statement that sets forth the bank’s reason for being, including its operating strategy, philosophy and purpose with respect to customers, shareholders, employees and others. The mission statement may sum up in a paragraph or a few short paragraphs what the bank is about.

   A vision statement is a statement setting forth the long-term vision for the company as determined by its Board of Directors. The vision statement will allow the officers and employees the benefit of the directors’ thought process as to where the company should go.

   The core value statement is simply a statement of the core values by which the institution will operate – integrity, timeliness, etc.

   In our experience, for about 95% of the community banks in the country, these statements serve no purpose other than to satisfy the regulators. Some discussion at the planning session should deal with whether and how these statements should be used in the future. If the bank’s culture is not such that it believes there is any importance to a mission, vision or value statement, then do not waste your time creating one.

g. A recap establishing specific goals, strategies, timetables and assignments of responsibility for each issue.

A well thought out and well executed strategic planning meeting does not make for a relaxing day or more. It is generally hard work. Breaks need to be frequent. The facilitator also needs to move the meeting forward toward
consensus on issues. Our general recommendation is that the strategic planning meeting last a day or two half days. For the first planning session for a Board of Directors, a day and a half may be appropriate. For a bank that has a planning meeting each year, one day would certainly be sufficient.

2. “Mechanics” of the Plan

The results of the meeting should be the creation of a plan. While our firm strongly believes that a plan should be based on the needs of the bank and not on a checklist of items, strategic plans traditionally have some or all of the following components:

I. Executive Summary

II. Situation Analysis (SWOT)
   A. External Analysis
   B. Internal Analysis

III. Mission Statement

IV. Objectives

Objectives are the longer term stated intentions of the specific kinds of performance or results that the bank seeks to produce in pursuing its mission.

V. Goals

Goals are the shorter term, quantifiable performance targets desired to be attained as a measurement of performance in meeting each stated objective.

VI. Strategy

A strategy is the blueprint for indicating precisely how to create the performance necessary to attain the stated goals. Strategies define the parameters for all actions to be taken to attain the goals.

VII. Action Plan

The action plan is the set of projects or specific steps to be taken to implement the strategies. Action plans establish responsibilities by area and individuals and establish dates for accomplishment of the plans to implement the strategies.
VIII.  Review

This section will indicate how often the Board will review the plan and revise it.

The plan does not need to be long. It does not need to be bound in a “spiffy” notebook. In fact, it does not really matter what it looks like. It simply needs to set forth the relevant issues, such as decisions, goals, and strategies identified by the board, and provide an appropriate level of accountability and follow up, such as assignments of responsibility, a timetable for each of the matters addressed in the retreat, etcera. Our general recommendation is that the Board of Directors, at its monthly meeting, be provided with a summary checklist of action items that indicates progress on meeting items associated with the plan and determined at the retreat.

3.  Financial Issues and Budgets

Although a strategic plan is not a budget, it needs to contain financial goals. These financial goals should be created department by department from the ground up (not dictated from the top down) and incorporated into the plan. A top-down financial plan will result in resentment, a feeling of helplessness and inability to meet goals that are not realistic. The bottom-up budgeting also needs to be reviewed for realism, however.

The plan should set forth in broad terms specific goals in the following areas: return on assets, return on equity, loan growth, deposit growth, dividend growth, and perhaps efficiency ratio.

E.  Ten Commandments for Effective Community Bank Strategic Planning

1.  Know that Strategic Planning is a Board Obligation.

Strategic planning is an obligation of the board of directors of your bank and holding company. It cannot be delegated downward to the management nor can it be avoided at the board level. Tactical and operational planning, which is different from strategic planning, is a management obligation once the board sets the long-term strategies as part of its 30,000 foot flyover approach. The board should make conceptual decisions, not micro-manage the institution.

2.  Understand the Foundation for Strategic Planning.

It is critically important for the board of directors to understand the foundation for strategic planning. It is the board’s obligation and part of its fiduciary duty to give direction to management regarding the allocation of capital, both managerial and financial. Managerial capital we can point to, shake hands with and slap on the back. Financial capital we can determine. The board’s obligation as part of strategic planning is to direct the allocation of capital for the next few years.
3. **MEET THE OBLIGATION TO ENHANCE SHAREHOLDER VALUE.**

The board’s obligation to plan involves the allocation of capital to enhance shareholder value. Enhancing shareholder value is a nice “MBA” type term. To put a framework around enhancing value for community banks, it basically means focusing on the four areas noted earlier in these materials:

A. Growing earnings per share – earnings drive the value of the company and per share earnings drive per share value;

B. Targeting a reasonable return on equity – more difficult in the current economic environment and with increased regulatory capital requirements;

C. Creating liquidity for shareholders, i.e., the ability of a shareholder to sell a share of stock at a fair price at any time; and

D. Providing for reasonable cash flow to your shareholders resulting from a reasonable dividend policy.

4. **PREPARE FOR CHANGE.**

In the rapidly changing environment in which our community banks operate, we as directors must, in fact, prepare for change. Change is difficult for many directors, particularly when they have been on the board a long time. They do not handle change well in their personal lives, and they do not handle change well in the bank they have known so long. Nevertheless, we must realize that planning involves change. We must be willing to change, not for change’s sake but to do what it takes to move the bank forward.

5. **GET OFFSITE AND OFFLINE.**

Unless you simply cannot avoid it, do not conduct your strategic planning at the bank and encourage all participants to turn off their cell phones, tablets, and laptops. It just does not work (at least not very well) if everyone is easily accessible to the outside world. Everyone will be interrupted. Get your group offsite and off of their mobile devices and allow them to “bond” (board bonding may be a scary thought for some of the senior management group).

As noted above, the planning process itself should not take much more than six to 10 hours, or one to one and a half days. An afternoon and morning of the following day will usually do it. Feed them and “water” them and you will provide a good climate for discussing the changes involved in planning.

6. **DON’T WASTE YOUR TIME.**

One of the biggest mistakes of the strategic planning process is wasting the directors’ time discussing items that are not board level decisions (micromanaging) or discussing items better left to another time (detailed financial
planning). The strategic planning process is not a budgeting process. While some consideration of financial issues is important, any extended discussion or attempts to project performance ratios and the like is not as productive a use of the board’s time as is the consideration of substantive issues as discussed below.

7. **Have an Agenda.**

Actually, have two agendas. There should be an “open” agenda since the senior management team, or at least the top portion of it, should be at the meeting and there should be an executive session agenda. The executive session is the “board only” including inside directors as well as outside directors. The open agenda will seek input and direction on matters that relate to the company as a whole. The executive session will deal with board issues, attracting and retaining key officers and employees and corporate governance matters. The easiest way to create an agenda (at least what we do as facilitators) is to send confidential questionnaires to participants in advance of the meeting. Confidential questionnaires will elicit the real issues at the institution.

8. **Analyze Substantive Issues.**

The agenda needs to address the substantive issues that deal with your bank and holding company. There are a number of substantive issues of importance to nearly all community banks, including capital allocation issues, ownership, growth versus profitability strategy, geographic expansion, technology planning, creating liquidity for the shares, dividend policy, marketing and the like. There also will be unique issues associated with your institution. These unique issues will be derived from the questionnaires.

9. **Use an Outside Facilitator.**

Address the issue of whether you should use an outside facilitator. There is an obvious cost associated with this route. The offsetting benefit, whether you use a facilitator such as an academic who may be able to assist in facilitating the discussion but has no knowledge of the industry or an “expert” facilitator who has knowledge of the industry, is that if the facilitator is doing his or her job, the facilitator should:

A. Keep the discussion moving;
B. Control the meeting;
C. Move through the agenda;
D. Move the group toward consensus on various areas, if possible;
E. Identify long-term strategies, goals and action plans; and
F. Create an outline of an action plan so that there is accountability as a result of the meeting.

An outside facilitator can also ask the hard questions with no need for political avoidance or often even knowledge that there is a political issue. Our recommendation is to use an outside facilitator when it makes sense for you (we acknowledge the shameless self-promotion involved in this recommendation).
10. **HAVE AN ACTION PLAN.**

The planning process is useless without some accountability. Each planning meeting should result in a specific action plan indicating the action to be taken, parties responsible and the date due. The action plan should be a line item on the board agenda on a monthly or quarterly basis.
II. HOW TO ENSURE YOUR STRATEGIC PLANNING IS A SUCCESS

In addition to the Ten Commandments of strategic planning, our firm has compiled a list of “best practices” over the years to help make community bank strategic planning processes as effective as possible. Some of these best practices overlap with the Ten Commandments earlier in these materials, but that should only underscore their importance.

Make sure the directors and officers “buy-in.”

Why in the world would you engage in a planning session for a day or a day and a half or even a minute if, at the end of that planning session, no one has bought into whatever the result is? In this vein, the oddest question we get when we plan to facilitate a planning session is, “We know the directors should attend, but should we invite the senior officers as well?” Our response is generally, and in not such a nice fashion, “Duh!” First, how are you going to get officer buy-in if the officers do not participate in the plan creation? That is not to say the board cannot meet in executive session to deal with board issues, such as board succession, management succession, board size, board meeting and board governance issues. In fact, every planning session we facilitate, we have an executive session with the board. The main session, however, needs to incorporate the senior officer group and the board of directors to determine at a 30,000 foot level the direction of the company.

Second, the reality is that the board’s job in planning is to allocate financial and managerial capital. How can the board allocate managerial capital effectively when the managerial capital does not participate in the planning session? For example, if the board decides the bank should, as part of its ongoing strategy, diversify its earnings stream by acquiring other lines of business, such as insurance, and that is the strategy but there is no one in the entire organization that knows anything about insurance (human capital), wouldn’t it be nice to know that during the planning session so management can discuss their thoughts on that particular issue?

Include the senior officer team, however that is defined in your bank, in the planning session to make sure, among other things, that the senior officers buy in to the plan and have some enthusiasm toward its implementation.

Make it enjoyable for the participants.

When the Chairman of the Board, or whoever is the lead on the planning process, begins to contact other board members and the board members look for excuses not to attend the planning session, such as “I think I would rather have my annual physical that day than sit through a planning session,” then the Chairman knows that this is because the planning session in the past has not been the least bit enjoyable. This reluctance to participate may be due to prior process, content, facilitator or location of the planning session. Make the process enjoyable and worthwhile. Often, this involves getting offsite. It does not have to be a Ritz-Carlton (although that is always nice). Have some
social activities or at least a dinner where the board and officers can interact outside the bank and provide for a little “bonding time” over golf, a dinner or something else. If the planning process is not enjoyable, then the group will be reluctant to engage in it the next time because it has been a waste of time for them, or a waste of money, or both.

**Do not focus too much on the process itself.**

As noted above, in our firm, we try not to use the term “strategic planning.” We prefer to refer to it as “Action Planning.” If your group is going to insist on establishing a certain number of objectives, followed by goals, followed by strategies, and each must have three bullet points under it, etc., then you are focusing way too much on the process. The important thing in Action Planning is to identify the substantive issues, discuss them and establish a plan to address them. The process is, frankly, unimportant.

**Spend very little time on the SWOT analysis, then move on.**

Virtually every planning session, for a lot of reasons, contains an analysis of the bank’s strengths, weaknesses, opportunities and threats (“SWOT”). This is a good exercise to figure out where the bank is at a certain point in time. What are its strengths, what are its weaknesses, what are its opportunities and what are its threats? Our general method is to send a questionnaire out to each of the individuals who will attend the session to confidentially provide us with their written assessment of the SWOT analysis. At the meeting, generally, there is a live SWOT analysis that takes all of about 20 minutes. What is the purpose of that? It gives each of the participants the opportunity to share with their fellow participants, to the extent they desire, their confidential responses. It also gets all of them talking. The purpose of the SWOT analysis is to figure out where the bank is. At the end of the session, the group should return to the SWOT analysis, paying particular attention to the weaknesses and opportunities, to make sure they have been addressed, at least as appropriate, by the plan. Typically, when officers and directors are involved in the planning process, a lot of the SWOT analysis, particularly from the officers, involves operational and tactical issues within the bank, e.g. departmental communication and the like. These are not appropriate for discussion at the board level action planning session but certainly would be fair game for a management tactical and operational planning process.

**Encourage the participants to be honest with themselves and each other.**

Many of you who are officers and may have grown up on the credit side of the bank realize there are four “C’s” of credit. There are also four “C’s” of planning. These four “C’s” are communication, candor, consensus, and confidentiality. What this all boils down to is that what occurs in the planning session stays in the planning session, but the planning session will be a waste of time if the participants are not honest with themselves and each other. That is difficult. Many boards are populated by directors who have personal agendas and keep their cards fairly “close to the vest.” If the bank wants to have an effective planning session, then everybody needs to get their cards on the table so they can be dealt with, particularly if an outside facilitator is present who can take the emotion and the history out of the discussion. Be honest with yourself and others at the planning session and it will be effective (it may be a little painful, but it will be effective).
Do not let one person dominate the meeting.

Many of you have likely been in a planning session where one person dominated the meeting and as a result, the meeting was a total waste of time. That one person, by the way, could be the principal shareholder, could be the patriarch of the bank, could be the matriarch or it could be the facilitator, particularly if you have a facilitator who likes to talk. Don’t let one person dominate the meeting. Of the hundreds of planning sessions we have facilitated, there have been several where when an issue has come up or a substantive question, everyone in the room was silent as their heads turned to the end of the table waiting for the dominant player to announce what the bank was going to do. That makes for a very ineffective planning session. No one should dominate the meeting, not the principal shareholder and not the facilitator.

Make it more than a budgeting session.

As noted later in this material, there is a significant difference between long-term strategic planning and operational and tactical planning. Strategic planning is at a 30,000 foot level. Operational and tactical planning is on the ground. Creating a budget is part of operational and tactical planning. Establishing the long-term strategies that will impact dramatically the budget is part of strategic planning. Your strategic planning process is not a budgeting process. Often, when we are working with a new client and ask for a copy of the bank’s current strategic plan, what we receive is a budget with a little narrative. The budgeting process and the planning process, while interrelated, are not anywhere near the same. The planning process drives the budget.

Focus on more substantive issues.

The real goal of planning is to focus on the substantive issues, not to have a touchy-feely exercise. If you want to stand in a circle and sing Kumbayah or stand in a circle and fall into each other’s arms as a teambuilding exercise, then do it someplace other than the planning session. The planning session is to deal with substantive issues that face the bank and address the strategy for each. These substantive issues, as noted later in this material, fit into categories such as:

- The current environment
- The bank’s position on independence
- The overall business strategy for the bank
- How capital is going to be allocated, e.g. buy another bank, redemptions, dividends, distributions, etc.
- What the ownership should look like
- Geographic expansion issues through branching or buying another bank
- Marketing issues, if there are any strategic issues at the board level
- Technology issues
- Other miscellaneous issues
Focus less on the mission, vision, and value statements.

Virtually every bank in the country has a mission statement. That is because even though there is no regulatory requirements for strategic planning unless the bank is subject to an enforcement order, the regulators expect to see some kind of a mission statement. Most of the mission statements for community banks across the nation are interchangeable. They all deal with four topics: shareholders, employees, customers and the community. Often, when we ask in a planning session (always toward the end) if anyone is familiar with the bank’s mission statement, 90% of the time we get blank stares or petrified stares that we are going to spend two hours working over a mission statement. 10% of the time, we get the comment, “Of course we are. Every decision we make in this bank is driven by the mission statement.” Neither one of those is a wrong approach. It just depends on the culture of your bank. Same issue with respect to vision and value statements. Most of the value statements are the same, dealing with integrity, etc. Vision statements, of course, will depend on the bank and often, have some vision of expanding geographically and ultimate size goals. There is nothing wrong with any of these statements as long as the bank uses them for something. Our general predisposition is not to spend much, if any, time at all working over these statements. The question is “Based on the plan established, is there any reason to modify the mission statement?” Typically, there is not, but if there is, then generally, the approach would be to assign it to somebody who has attended the meeting to come back with recommendations as to modifications. Don’t spend hours and hours wordsmithing a mission/vision/value statement at the planning session. At least, do not do that if you want anybody to come back next year.

Hold everyone accountable and follow up on the actions taken and strategies established.

As noted earlier in these materials, every plan and the planning process should result in some action plans as a means to implement the strategies established. If the board spends a day or a day and a half together to determine the strategies for the institution going forward, yet there is no accountability for implementation of those strategies, then that time has been wasted. There needs to be an action plan that involves implementation of the strategies. There also needs to be accountability, and that action plan should be reviewed by the board on at least a quarterly basis to make sure there is some accountability that the actions are actually being taken.

Use an outside facilitator.

Whether the bank uses an outside facilitator is the choice of the board and senior management. The comments we normally get are that it is very difficult for management, or even a board member, to facilitate his or her own retreat simply because there is too much history, emotion, politics, and the like involved. An outside facilitator can at least ask the hard questions. If you are going to use an outside facilitator, try and find one that is knowledgeable about the industry. A number of our clients, before they got to us, have used outside facilitators that are academics or facilitate in other industries, etc. If the bank wants to get the most benefit out of the retreat, then it needs to have an industry expert in community banking facilitate the retreat (and, no, this is not simply
shameless self-promotion). A facilitator as an expert in the industry is not coming at the facilitation from an academic perspective, answering questions with no on-the-ground experience. The benefit to the bank of having a facilitator with industry experience is that individual can make suggestions, comment on what other banks have done, and understand the mechanics of how something should take place. If you are going to use an outside facilitator, don’t waste your time and money on someone who does not understand the industry.
Tab C
Success for the Future: Enhancing Shareholder Value Without Buying or Selling
For a community bank or bank holding company, enhancing shareholder value generally means providing some reasonable level of investment liquidity to its shareholders, increasing earnings per share, providing a reasonable return on the investment compared to alternative investments that could be made by the community bank shareholder, and providing some certainty of an adequate cash flow.

The following material will briefly cover several specific strategies for enhancing shareholder value without buying or selling.

I. FORMATION, USE AND CAPITAL PLANNING WITH THE BANK HOLDING COMPANY

Approximately 80% of the community banks in the nation are in a bank holding company structure. All community banks, particularly those under $500 million in total assets, receive significant benefits from the bank holding company structure. It not only provides flexibility in repurchasing shares and in financing those purchases but it also provides flexibility in acquisitions, branch expansion, capital raising, new products and services and other means to enhance the value of the overall shareholders’ interest.

There are five key advantages of a holding company:

* Improved Capital Planning and Financial Flexibility
* Control and Ownership Planning
* New Products and Investment Opportunities
* Additional Geographic Expansion Techniques
* Enhanced Operational Flexibility

A Bank Holding Company (“BHC”) is defined as any company which has control over any bank. In the broadest sense, any corporation or organization that "controls" a bank is a BHC. The Bank Holding Company Act of 1956 ("Act") prohibits any "company" from becoming a BHC without prior approval of the Federal Reserve Board ("FRB").

The Financial Holding Company (“FHC”) is defined in GLBA as a BHC that meets the following requirements:

a. All of the depository institution subsidiaries of the BHC are well capitalized;

b. All of the depository institution subsidiaries of the BHC are well-managed; and

c. The BHC has filed the following with the Federal Reserve Board:
(1) a declaration that the BHC elects to be an FHC in order to engage in activities and acquire shares in companies that were not permissible for a BHC prior to GLBA's enactment; and

(2) a certification that the BHC meets requirements (1) and (2) above.

Bank Holding Companies may borrow money with the debt treated as a liability at the holding company level; however, the funds can be "pushed down" to the bank as new equity capital for the bank. This "double leveraging" technique is most attractive for banks with assets under $1 billion since the bank and the holding company's financial statements are not consolidated for capital purposes by the Federal Reserve. (This $1 billion asset threshold was increased from $500 million as a result of H.R.3329, which was signed into law in late 2014. The original policy statement, which was issued in 1980, applied to bank holding companies with $150 million in total consolidated assets and was increased to $500 million in 2006.) The technique is useful on a more limited basis for those institutions with assets above $1 billion. Dividends from a bank to its holding company are non-taxable, thus the debt is serviced with "before tax" dollars. The BHC and bank file consolidated tax returns, allowing interest on the holding company's debt to be used as a deduction against the bank's earnings.

Through use of the double leveraging technique by the BHC, individual shareholders are not required to provide additional cash to raise capital for the bank. In addition, their ownership percentages are not diluted by a necessary new stock offering to outside shareholders. For small banks, assumption by a BHC of acquisition debt by which the institution was acquired allows the debt to be paid with before tax dollars.

Funds provided by a BHC may be used in many ways, such as:

* Bank Acquisitions
* Non-bank Acquisitions or Activities
* Asset Growth Support
* Replacing Lost Capital
* Restructuring Investment and/or Loan Portfolios
* Providing Liquidity
* Financing Bank Premises or Other Capital Expenditures
* Stock Repurchase Plans
* A General Funding Source

There are also other miscellaneous advantages to a bank holding company in the capital and financial planning area which may be significant for many institutions, such as:

* **Alternative equity forms.** Since a holding company is simply a state chartered corporation, it can utilize virtually any type of equity structure. For example, it can use preferred stock as well as common stock. It can also use preferred stock with an adjustable rate dividend, or preferred stock convertible into common stock.
A BHC may also use different classes of stock. For example, if an institution wishes to raise capital but is concerned about diluting the voting control of existing shareholders, a different class of common stock with no right to vote or a smaller percentage vote could be used.

* **Debt securities.** A holding company may also use various forms of debt. It can use long-term debentures and deduct the interest cost while pushing the money down into the bank as new equity capital. It can issue commercial paper. Short-term or long-term notes or "investment certificates" can be sold by the holding company to existing shareholders, bank customers or smaller banks, thus eliminating the need to pay a traditional lender a higher interest rate or pay an underwriter a fee for placing the securities. Debt securities with convertibility features allowing the debt to be converted into common stock may also be used. Care must be taken in structuring debt issuances to avoid possible consolidation of bank and bank holding company financial statements for capital adequacy purposes with banks less than $1 billion in total assets.

A BHC can also take existing common stock held by individuals wanting a higher yield than they receive from current dividends and purchase those shares with debentures carrying a higher yield. The additional cost of this type of transaction to the bank may be very limited, since the additional money paid as interest is tax deductible as opposed to non-deductible dividends. Consequently, the IRS "pays" a major share of the cost of debentures while, with dividends, 100% of the cost is paid by the bank.

The key is flexibility. A holding company can issue equity and debt instruments quickly and efficiently. There is normally no need for approval from the primary bank regulators since the securities will be issued by the holding company. Normally, there is no need to get shareholder approval since most original holding company charters already authorize various types of securities. The institution is not limited by what type of capital structure a bank can have since the securities are issued at the holding company level.

Debt issued at the holding company level may be unsecured or secured by pledging the bank stock owned by the holding company. Consequently, a BHC will be able to provide a lender with collateral on a loan to the holding company, whereas, at the bank level, any debt would normally be unsecured and subordinated to the claims of all other credits. Finally, a bank holding company, in certain circumstances, will have more flexibility as to the maturity dates of various debt and equity instruments issued through the holding company.

The other benefits of the use of a holding company, including control and ownership planning, new products, investment opportunities, geographic expansion techniques, and enhanced operational flexibility will be addressed elsewhere in this material.
II. CREATING STOCK LIQUIDITY

Uppermost in the minds of management, directors and shareholders of most financial institutions today are two fundamental questions:

- Who will control the institution in coming years?
- Can an institution remain independent and provide a market for those wishing to sell?

A. Going public? (Registering with the SEC?)

Liquidity for your shareholders is important. Liquidity must be planned for. "Liquidity" in this context means the ability of a shareholder of your institution to sell a share of stock at a fair price at the time he desires. Community banks often wrestle in the strategic planning process as to whether they should become "public companies". The greatest tragedies are those community banks that with no thought or preparation inadvertently become public companies by finding themselves with greater than 2,000 shareholders as a result of "death and distribution" or simply sales of minority shares over which they have no control. Many community banks will find the consolidation of ownership is the best way to enhance value. Others will conclude that the expansion of ownership, the creation of liquidity and the generation of a market for their securities will best serve to enhance value over the long term. Whatever the result, however, the community bank, in order to be effective, must plan for it.

B. Stock Repurchase Plans

For the vast majority of financial institutions in the United States, there are very few acquisitions available, if any, which will improve earnings per share and return on equity more than the simple alternative of repurchasing the institution's own stock. Many institutions are currently realizing that the most efficient deployment of excess capital or leveraging ability is in connection with the repurchase of the institution's own stock. This is particularly true for community banks where such repurchases can generally be accomplished at reasonable prices.

The potential advantages of a stock repurchase or ownership restructuring program are numerous. Earnings per share and return on equity may be immediately increased with a stock repurchase or ownership restructuring program. The relative ownership positions of remaining shareholders will also improve. For shareholders wishing to sell, such plans provide a purchaser at a fair price. In addition, a repurchase program may also provide a "floor" for the institution's stock that works to enhance shareholder perceptions of bank stock value.

Some of the advantages and uses of stock repurchase and ownership restructuring plans are as follows:
* **Increased Value.** Earnings per share and return on equity may be immediately increased.

* **Market Communications.** Repurchase plans communicate that management is optimistic about the future and feels the stock is undervalued.

* **Takeover Attempts:** Keep stock in friendly hands.

* **Market Stabilization.** Stock repurchases stabilize the market and provide a minimum price for the stock.

* **Limit or Reduce Number of Shareholders.** Having 2,000 plus shareholders requires bank holding company compliance with federal securities laws including Sarbanes-Oxley. Institutions may use stock repurchases to take the bank holding company private or to keep the number of shareholders below 2,000.

* **Consolidate Ownership.** Some institutions wish to consolidate ownership around a long-term "core" group of shareholders.

* **Forced Sales.** Shareholders may be forced to place their stock on the market due to personal financial difficulties, estate taxes, etc.

* **Use of Excess Capital.** Many banks have excess capital, which can be used to support stock repurchases.

* **Interest Rates.** The cost of incurring debt to retire equity is relatively low because of moderate current interest rates and the tax deductibility of interest payments, which potentially lowers after-tax costs.

A repurchase by a bank holding company of its own shares at any reasonable price level has the following specific positive impacts on enhancing shareholder value.

* Shareholders who desire to sell receive cash and, thus, instant liquidity for their shares.

* The shareholders who do not sell become aware that the holding company has the ability to create a market and achieve "psychological" liquidity for their shares.

* A stock repurchase plan priced appropriately (and appropriately can mean at a fairly high level) will serve to enhance earnings per share for those shareholders who do not sell and therefore the overall value of the shares.

* A stock repurchase plan, by using excess capital, will increase return on equity for the remaining shareholders.
* Shareholders remaining after the repurchase will experience an increase in ownership percentage of the company without having expended any cash.

* If the company continues to pay cash dividends in the same "gross" amount to a smaller shareholder base, the remaining shareholders will receive an increase in cash flow.

A stock repurchase plan by a bank holding company is one of the few "win/win" strategic alternatives a community board that is not interested in selling in the near term can take.
EXAMPLE OF STOCK REPURCHASE PROGRAM

A. Baseline - no repurchase
B. Repurchase of 316,818 shares funded with $3,485,000 of capital
C. Repurchase of 407,727 shares funded with $3,485,000 and $1,000,000 of debt
D. Repurchase of 498,636 shares funded with $3,485,000 and $2,000,000 of debt

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<th>Earnings Per Share (Accretion [+] / Dilution [-])</th>
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<tbody>
<tr>
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<td>A. $1.13</td>
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<tr>
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</tr>
<tr>
<td>A. 19.3%</td>
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<tr>
<td>B. 22.1% (+15%)</td>
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<tr>
<td>C. 23.1% (+20%)</td>
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<td>D. 24.3% (+26%)</td>
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<tr>
<td>A. $5.84</td>
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<td>B. $5.35 (-8%)</td>
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<tr>
<td>C. $5.19 (-11%)</td>
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<tr>
<td>D. $5.02 (-14%)</td>
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## EXAMPLE OF STOCK REPURCHASE PROGRAM
### SUMMARY FINANCIAL DATA

#### EARNINGS PER SHARE

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#### BOOK VALUE PER SHARE

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(%) = % Accretion (+) or Dilution (-) from Baseline
III. CONSIDERING OWNERSHIP ALTERNATIVES

Most boards of directors of banks and bank holding companies, both smaller and growing, do not realize that it is within their prerogative and, in fact, their duty, to determine as a long-term strategic decision, the most beneficial ownership for the company and its shareholders. The board has four basic alternatives in this regard.

1. Public company status,
2. Private company,
3. A very private company (Subchapter S)
4. Becoming a public company

Even if the bank holding company is a public company, the board of directors has the strategic decision to make as to whether to take that public company, which is SEC reporting, and make it into a private non-reporting company. The reality is that the board, through its recommendation and voting of its own stock, can, in fact, often control or direct the ownership of the bank or bank holding company and should make a long term strategic decision in this regard which are in the best interests of enhancing value for all shareholders.

A. Becoming a public company

Under the SEC rules and regulations governing public companies, any bank or bank holding company that has in excess of 2,000 shareholders in any class of stock at year-end is a public company and if it is a bank holding company (a state chartered corporation), it must report to the SEC. If it is a bank (not a bank holding company), it must report as a reporting bank to the bank regulators. The reporting requirements for both the SEC and the bank regulators are substantially similar.

The question is "do you have over 2,000 shareholders". The regulations have numerous attribution rules where shareholders can be combined into one ownership. There are rules that provide that that stock held in street name is considered one shareholder per broker. Also, shareholders who received the stock through an employee compensation plan in an exempt transaction are no longer included in the shareholder count. For additional information, please request Gerrish McCrery Smith Memorandum to Clients and Friends on Counting Shareholders for SEC reporting purposes.

If the bank holding company becomes a public company, it should have been because of an affirmative decision by the board of directors of the bank holding company, not an inadvertent act out of the holding company's control where stock has been transferred. Later in this material, it will be addressed as to how to control ownership to avoid inadvertently becoming a public company. Some of the greatest "tragedies" we have seen in community banking in particular is a bank holding company that "eked" over the prior shareholder limit and became a public company when it really obtained no benefit from doing so and incurred significant expense. Even though the new 2,000 shareholders threshold is not as great a threat as the previous 500 shareholders
threshold, a bank holding company should still take caution that it does not exceed the 2,000 shareholder mark. The reality of becoming a public company is that:

a. Disclosure is significantly increased by both the company and its directors. This includes stock ownership, compensation, meeting attendance and the like.

b. Particularly after Sarbanes-Oxley, as a practical matter, the liability exposure of directors of public companies has increased significantly.

c. The out-of-pocket expense associated with being a public company can run anywhere from $150,000 to $300,000 annually for even a small company.

d. The amount of time and effort put into reporting requirements and the soft costs of personnel is not insignificant.

e. If your public company is listed, it is subject to, in most cases, very little market liquidity and the ability of a single trade to move the market significantly.

Bank holding companies should not become public holding companies without an affirmative long-term strategic decision in that direction by the board of directors. Simply becoming a public company will not increase the marketability or market value of the stock and may, in fact, decrease it. This is simply due to the fact that for public companies, it is much more difficult to engage in repurchase plans and support the market price of their stock in the marketplace.

For most community banks, becoming a publicly reporting company will not serve to enhance the liquidity of their shares. Why, then, would a community bank want to become publicly reporting? The answer for many must lie primarily in the love and affection they have for their lawyers and accountants who they will make even wealthier than they are today.

Seriously, the expansion of ownership by many community banks is without adequate forethought. The community bank, to effectively create liquidity within the issue of "public versus private," must determine to "go all the way" if it is going to become a public company. "All the way" means significantly expanding the number of shareholders, willingly accepting institutional investors, courting the market makers and generally setting up an investor relations program as described below to generate liquidity and value in the shares.

In order to review the issue of enhancing value as a result of expanding ownership, the board needs to understand why community banks are primarily invisible to the markets. This is basically due to four principal factors:1

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1 This information was obtained from Nasdaq Market Services
• The company communicates only with current shareholders.

• Management is unaware they can influence the company’s share valuation.

• Little, if any, information about the company is made available to the outside.

• The company does not have an investor outreach program.

In order to generate meaningful market value and liquidity, the Director of NASDAQ Market Services suggests the following for a community bank.

• The institution needs to understand and help influence the valuation of its shares.

• The institution should market its stock just as it does its own products and services.

• The institution must differentiate its stock and position it among other investment opportunities.

• The institution must take the lead in convincing investors why the stock has investment appeal.

• The institution must focus its message and target its audience.

• The institution must reach out to the analyst community and obtain five or six analysts.

• The institution must be willing to target a mix of institutional and retail investors.

If an institution can accomplish the foregoing, then it has some hope of generating additional value through attention in the market.

In order to do this, however, the institution must have some kind of a formal investor relations plan. This plan, like the overall strategic plan, must have clear and defined objectives, specific marketing strategies, methods to implement the strategies, an idea of how much in the way of resources is going to be allocated to the plan, and a mechanism to measure the results of the plan. Typical goals for a community institution might be to increase share price, increase market valuation, improve trading liquidity, broaden analyst coverage, reconstitute the shareholder base, and decrease trading volatility. As a practical matter, most community institutions that are public simply need more coverage by the analysts. This simply means targeting analysts from regional brokerage firms and participating in conferences in order to tell the story of your institution.
If the board of directors determines to be a public company or already is a public company, then the issue of an investor relations/market liquidity and value planning must be on the strategic planning agenda. The board must recognize that if it is public, it can also influence the market value of its stock through an active investor relations program.

B. Maintain Private Company Status.

Most community banks and bank holding companies are private companies with less than 2,000 shareholders. It is imperative, if the board's long-term strategy is to maintain private company status, that it takes affirmative actions necessary to implement that strategy. This generally means keeping a close eye on the shareholder list and, if necessary, engaging in stock repurchases through the holding company in order to keep that shareholder list from getting over the 2,000 share mark. Many community bank holding companies will establish the long-term strategy of consolidation of ownership. From that comes the desire to reduce the outstanding number of shareholders through either repurchase of "walk ins" or affirmative repurchase plans.

C. The Move Toward a Very Private Company Status (Subchapter S).

Approximately one-third of the banks in existence at year-end 2013 are in Subchapter S status. Since the passage of the American Job Creation Act of 2004, Subchapter S now allows 100 shareholders (counting six generations of one family as one shareholder). All shareholders must still be Subchapter S eligible, execute the shareholders’ agreement, execute the IRS consent, and hold enough shares to be above the “cut line” to be part of the Subchapter S. In most states, any bank holding company that can obtain the vote of 50% of its shares can convert to a Subchapter S, through a “merger like” transaction.

There are at least three significant issues with respect to Subchapter S.

a. Does the conversion from a C corporation to a Sub S corporation make financial sense for the company in view of the number of shares that may need to be cashed out? In other words, can the company continue to execute on its business plan?

b. Politically, is the forced elimination of certain shareholders for cash (even though the price will be fair) a political risk the Board is willing to accept?

c. Will the shareholders remaining in the Subchapter S be better off from an after-tax cash flow standpoint over the long term than they would be in a Subchapter C?

Subchapter S is the greatest way to enhance shareholder value currently available to privately held community banks. In its simplest terms, the Sub S corporation eliminates corporate level tax on the bank and holding company such that all income is passed through without tax at the corporate level and for individual shareholders, it appears on their personal tax returns. This is similar to the tax treatment of a partnership. For most community banks and holding companies, the tax savings alone served to significantly enhance the value for their shareholders. The main caveat is to make sure the bank can provide cash flow through distributions (dividends) to the shareholders to pay the
shareholders' personal tax liability. For additional information, please request Gerrish McCreary Smith materials regarding Subchapter S issues.

D. Converting a Public Company to a Private Company.

With the advent of Sarbanes-Oxley and its increased emphasis on corporate governance disclosure, rapid reporting and certifications, many smaller community bank holding companies with public company status (greater than 2,000 shareholders) are contemplating returning to private company status. In order to take an SEC reporting holding company to a non-reporting holding company status, it must reduce its existing common shareholders to fewer than 1,200. Many community banks and holding companies automatically found themselves below this increased reregistration threshold as a result of the JOBS Act of 2012. For those banks and holding companies with more than 1,200 shareholders in a class, a shareholder reduction can be accomplished either through a cash-out merger which eliminates the smaller shareholders for cash or a “reclassification” transaction which reclassifies the current common shares held by the smaller shareholders into other classes of common stock. There can be fewer than 2,000 shareholders in those classes. (As noted, under the SEC rule, there can be no more than 2,000 shareholders in any class of stock. Once the common class exceeds 2,000, then to go private, it must be reduced to below 1,200 shareholders.) Any time a bank considers a going-private transaction that either forces shareholders to take cash for their shares or forces shareholders into a separate class of stock, the bank must consider two major issues:

a. Can the bank politically afford to eliminate the shareholders or force them into a separate class of stock? In other words, will it so adversely affect the business relationships at the bank as to be an unwise business decision? This is a question only the board and management, after a thorough analysis of the existing shareholder relations, can answer. Our experience has been that generally, even with the elimination of 500 or 600 shareholders, there is rarely more than a handful of shareholders that, in reality, require personal attention by the board.

b. The second major issue is financial: if the transaction is going to involve a “cash-out”, can the company afford to eliminate the shareholders? Fortunately, many bank holding companies have some excess capital, some access to capital, or some borrowing ability that will allow them to finance the elimination of the shareholders through debt. If it is to be a cash-out transaction, it is important to run the numbers after determining that the political issues are manageable to see if the transaction is financially acceptable from a business standpoint. Normally, the freeze out of minority shareholders, which is tantamount to a redemption or a repurchase by the holding company, benefits significantly those shareholders who do not have to sell from an earnings per share accretion, return on equity accretion, and cash flow (dividend) accretion with respect to the stock.
If the transaction is to be structured as a stock reclassification where very few shareholders are to be eliminated, then the financial and political issues are significantly diminished.
IV. ALTERNATIVE LINES OF BUSINESS

In order to assure income growth and de-risk the income stream, it is essential for the bank to focus on alternative lines of business. The most likely lines of business to be offered by community banks across the nation will be insurance, securities, trust, wealth management, and ultimately real estate brokerage, when it becomes available. The key factor, however, is to understand what the bank and/or its holding company can do and what fits with the market niche the bank plans to develop or what the existing customers want.

In 1999, the Gramm-Leach-Bliley Modernization Act (GLBA), which greatly expanded new product and investment opportunities for financial institutions, was enacted. As a result, a financial institution may choose from a variety of structures and entities in order to pursue new product and investment opportunities. These entities include:

- financial holding companies (FHC),
- traditional bank holding companies (BHC),
- bank financial subsidiaries (FS),
- bank operating subsidiaries (OS), and
- bank service corporations (BSC).

This material will focus on the use of the FHC and the BHC for product and service expansion.

Despite this variety of business structures and entities through which to pursue new product and investment opportunities, a financial institution's four basic goals in expanding its products and investment opportunities remain the same:

- An increase in earnings per share, not previously produced by the institution;
- Diversification of risk by decreasing reliance on traditional banking activities;
- Limitation of liability by the institution by using the holding company, its separate subsidiaries, or bank subsidiaries to provide new products and services; and
- Increased geographic range, since FHC and BHC are generally able to offer any permisable product or service in any geographic area.

A. Financial Holding Companies

The most flexible entity for a financial institution to use to engage in new types of financial activity is the financial holding company (FHC), which allows new activities to be conducted through a holding company affiliate regulated by the Federal Reserve...
Board. Congress authorized the FHC under provisions of GLBA that amended the Bank Holding Company Act. Consequently, the FHC is the primary entity through which a financial institution may engage in any type of financial activity, including any type of insurance or securities activity, or become affiliated with any type of financial company. In addition, the FHC is the primary entity through which a non-banking financial institution (e.g. a securities or insurance company) may purchase a bank.

As noted earlier in this material, an FHC is simply a traditional BHC that satisfies, and continues to satisfy, certain regulatory requirements. A BHC that satisfies these new requirements may elect to become an FHC to engage in the broad range of financial activities permitted under GLBA. However, a BHC may elect not to become a FHC if it wants to only engage in the types of activities in which a BHC were permitted to engage in as of the day before GLBA’s enactment.

Financial Activities. An FHC may engage in any type of financial activity that was permissible for a BHC to engage in before the enactment of GLBA. In addition, an FHC may engage in virtually any type of financial activity. An FHC may even be authorized to engage in certain non-financial activities under limited circumstances. GLBA provides a detailed list of new activities that are permissible for an FHC. The most important of these activities include:

- All securities underwriting and dealing activities,
- All insurance underwriting and sales activities,
- Merchant banking and equity investment activities,
- Future (financial in nature) and incidental activities, and
- "Complementary" non-financial activities.

B. Traditional Bank Holding Companies

Permissible "Non-Banking" Activities. GLBA amended Section 4(c)(8) of the Bank Holding Company Act of 1956 (12 USC §1843(c)(8)) to permit BHCs to invest in shares of any company, the activities of which had been determined by the Board by regulation or order as of the day before GLBA's enactment, to be so clearly related to banking as to be a proper incident thereto, subject to such terms and conditions contained in the regulation or order unless modified by the Board. The Federal Reserve Board has compiled a list of permissible activities for BHCs in Regulation Y. Some of the non-bank banking activities listed under Regulation Y are:

- Acting as an insurance agent or broker for certain types of insurance (primarily credit related insurance),
- Underwriting credit insurance directly related to credit extended by the bank holding company or its subsidiaries,
- Making or acquiring loans, issuing letters of credit, and operating mortgage banking, finance, credit cards and factoring operations,
- Leasing personal and real property,
• Appraising real estate for a fee,
• Arranging real estate equity financing transactions for a fee,
• Providing data processing services,
• Selling money orders and travelers checks,
• Providing courier services,
• Underwriting and dealing in government obligations and money market instruments,
• Servicing loans,
• Providing management consulting advice to non-affiliated financial institutions,
• Operating various types of industrial banks,
• Acting as an investment or financial advisor,
• Acting as a futures commission merchant,
• Providing securities brokerage services,
• Investing in community welfare projects,
• Performing trust company services,
• Check guaranty services,
• Tax planning and tax preparation services, and
• Operating a collection agency and collection bureau.

In addition, a BHC may be permitted to engage in other activities not specifically enumerated in Regulation Y if the Federal Reserve Board finds that such proposed activities are "so closely related to banking . . . as to be a proper incident thereto." Recent developments in permissible activities include:

• Commodity trading advisory services,
• Consumer financial counseling,
- Armored car services,
- Future expansion of already permitted activities in the area of property appraisals and futures commission merchant advice, and
- Securities activities and products including limited underwriting.

**Passive Investment Alternatives.** There are investment possibilities at the BHC level which may not be available at the bank level. A BHC may own shares of any company as long as it owns no more than 5% of the outstanding voting shares. It may own a higher percentage of the equity than 5%, but that interest must be non-voting stock. The types of equity securities held by a bank are severely restricted as a result of amendments by the FDIC Improvement Act (FDICIA) to Section 24 of the Federal Deposit Insurance Act.

FDICIA severely limited bank investment activities to those permitted for national banks unless the activity (a) poses no significant risk to the deposit insurance fund and (b) the bank meets applicable capital standards. Only a few applications under this section of the Act have been approved. The safer and easier course, if funding is available, is to make the equity investment or engage in the activity at the holding company level.

There is no limit on the number of corporations in which a holding company may invest up to 5% of their voting stock. A financial institution may diversify the combined investment portfolio of a bank and BHC by using this power.

**Stake Outs.** Some financial institutions structure what is called a "stake out" to invest in banks or prohibited businesses. This is an alternative investment method not only for geographic expansion into prohibited areas, but also for expansion by a BHC into a prohibited industry. Specific guidelines adopted by the Federal Reserve Board limit and monitor this type of transaction. These guidelines were developed with the acquisition of equity interests by out-of-state companies prior to the advent of interstate banking.
A critical key for the directors is to make sure that the company can not only attract but retain quality and key employees. Generally, this means that corporate culture and employee compensation and benefits must be comparable to what an employee could obtain elsewhere.

Providing appropriate incentives for officers, directors and employees can often serve as a means whereby shareholder value is enhanced. It creates an incentive for individuals managing and operating the bank to insure that the bank operates profitably. It also gives those individuals a share in the increased profitability and productivity which they have created. Five major ownership incentives are used in a typical community bank and are fairly easy to implement. These include the employee stock ownership plan (ESOP), the incentive stock option plan (ISOP), stock appreciation rights plan (SAR), non-qualified stock option plans and restricted stock plans. Each of these is briefly addressed below.

A. ESOPs.

An ESOP is a means for a community bank to create liquidity as well as establish an employee benefit for the Bank’s officers and employees. The definitions for Employee Stock Ownership Plans (ESOPs) include:

* qualified retirement plan and trust,
* defined contribution plan,
* stock bonus plan,
* deferred compensation fringe benefit plan, and
* a financing vehicle or strategy.

The basic rules of operation of an ESOP are identical to other qualified retirement plans, including stock bonus plans, profit sharing plans, or defined benefit pension plans. The ESOP must be operated for the exclusive benefit of employees and must not discriminate in favor of the highly compensated and others in the prohibited group including officers, directors and shareholders. The ESOP differs from other plans in that the primary investment of the ESOP must be employer stock.

The use of ESOPs for Subchapter S holding companies or banks, 401(k) ESOPs or leveraged ESOPs have additional operational requirements and offer additional benefits for employers and employees. For additional information, please request Gerrish McCreary Smith material entitled "Utilization of Employee Stock Ownership Plans."

B. Incentive Stock Option Plan (ISOP)

The ISOP is the term used for qualified stock options that do not result in a tax consequence when the option is granted or when it is exercised. (However, the amount that the fair market value of the stock exceeds the option price is a tax preference item used in the computation of the alternative minimum tax in the year the ISO is exercised.)
If the employee holds the stock for two years from the date the option is granted and one year after he receives the stock, the employee’s taxable gain on the sale of the stock will be entitled to capital gains treatment. If the stock is sold before these periods end, the employee has ordinary income. The employer will be entitled to a deduction only if the employee pays ordinary income on his gain. Under current tax laws, capital gains are preferable to ordinary income for many taxpayers; therefore ISOPs have become preferable to Non-qualified Stock Option Plans (which can result in ordinary income to the option holder).

Generally, establishing an ISOP requires that the written plan must be approved by the shareholders, options must be granted within 10 years after the plan is adopted, and options must be exercised by the employee within 10 years after the grant of the option. The option price must not be less than fair market value at the time it is granted (a good faith attempt to establish value must be shown). Additional requirements include:

- The option must be non-transferable except by death, and can be exercised only by the employee.

- The employee, at the time the option is granted, must not own more than 10% of the employer's stock. (This is waived if the option price is 110% of fair market value and requires exercise in 5 years.)

- An option can't be exercised if an earlier ISO granted to the employee is outstanding. (Earlier options can't be cancelled.)

- The value of the stock that can be exercised for the first time by an employee in any one year cannot exceed $100,000, based on the fair market value of the stock at the date of grant of the option.

- A special IRS ruling provides that employees may exercise ISO's with other non-qualified stock options of the corporation and not affect that $100,000 limit above. (Of course, the employee will be taxed on the non-qualified stock options.)

If all requirements are satisfied, incentive stock options are excluded from compliance with IRC Section 409A requirements for defined compensation type plans.

C. The Stock Appreciation Rights Plan (SAR)

Generally, a SAR Plan entitles an employee to the appreciation in value of the employer’s shares held in the employees account over a period of time. At the time of exercise, the employee will receive cash based on the increase in fair market value of the employer's stock from the date the SAR is granted to the date the SAR is exercised.

The key factor is the valuation. Fair market value of one share of stock is usually the value relied on, but the method of establishing the value could be based on book value or otherwise and should be set forth in the SAR plan. In either case, employees' units typically increase in value by (1) appreciation in BHC stock, (2) dividends paid on BHC stock.
Employees receive no vote or ownership rights with units assigned. Employees can receive cash from BHC in exchange for their SAR unit value five years or later from the date the units are awarded or when an employee becomes disabled or dies, whichever comes earlier. The plan may provide that the employee has the option to cash-in his SAR rights after five years or that the employee is required to cash in after five years. If the employee has the option to cash in the SAR after five years and does not exercise the option, the account will continue to grow.

The tax consequences to the employee are:

1) The employee recognizes no taxable income at the time a unit is awarded to his account or as his account grows, and

2) At the time of payment of cash benefits to the employee, he recognizes ordinary income for tax purposes on the amounts received.

The tax consequences to Bank are:

1) Bank gets no deduction at the time the unit is awarded to the employee, and

2) At the time cash is paid to the employee, the Bank can deduct these payments provided the payments under the plan are reasonable enough to be considered ordinary and necessary business expenses.

There is no specific Internal Revenue Code provision authorizing the Stock Appreciation Rights Plan. There are a number of IRS private letter rulings and Revenue Rulings regarding SARs. SARs are excepted from the compliance requirements of IRC Section 409A for deferred compensation type plans if (a) the SAR payment is not greater than the excess of the fair market value of the stock (disregarding any lapse restrictions) on the date of exercise over the fair market value on the date of grant of a fixed number of shares at that time, and (b) the SAR may not include any feature that delays income inclusion beyond the exercise of the SAR.

D. Combination Incentive Stock Option Plan (ISOP) and Stock Appreciation Rights Plan (SAR)

A disadvantage of the ISOP is that in the year the employee exercises the option, he must do so with his own funds or borrowed funds unless the employer pays a bonus to the employee in that year.

For this reason, ISOPs and SARs are often used as a combination. The SAR is granted and timed so that the employee can cash in his SAR units in the same year that he will need cash to fund the purchase of stock pursuant to an ISOP. When this occurs, the employer will have a tax deduction in the amount paid for the SAR and the employee will have taxable ordinary income in this amount. Payment of the funds to the employer for the stock received by the exercise of the ISO will not result in a deduction for the employer or in income to the employee (unless there are alternative minimum tax considerations). From a cash flow standpoint, the employer may have paid out the same amount for the SAR that it
will receive for the stock, so the transactions are a wash to the employer. That transaction would also be a wash to the employee from a cash flow standpoint, but the employee will receive new stock (with a basis of the cost of the stock) and will owe tax on the SAR amount.

The IRS has ruled that tandem ISOPs and SARs are permitted if:

1. The SAR expires no later than the ISO.
2. The SAR does not exceed 100% of the difference between the market price of the stock and exercise price of the ISO.
3. The SAR has the same restrictions on transferability that are on the ISO.
4. The SAR may be exercised only with the ISO.

The SAR can be exercised only when the market price of the stock exceeds the exercise price of the ISO.

E. Non-Qualified Stock Options

Non-qualified stock options are often granted to community bank directors at the same time ISOP's are established for officers and employees. If the non-qualified stock options have a value at the time they are granted, such options are taxable to the employee or director in the year the option is granted to them, unless the option is non-transferable. If it is non-transferable, no tax is due until the exercise of the option. A non-qualified stock option must have the fair market value of the stock at the time of grant as the exercise price and have no other provisions that delay the recognition of income when the operation is exercised, in order to avoid compliance with IRC Section 409A requirements for deferred compensation type plans. When the option is exercised, the employee or director will have taxable ordinary income on the difference between fair market value of the stock at the time of the exercise and the option exercise price. The employer will have a deduction in the same amount.

The non-qualified stock option may contain any of the features required for an incentive stock option plan, but none of those are mandatory. The non-qualified stock option can be used in tandem with the Incentive Stock Option Plan (to exceed the $100,000 annual limit) and with the Stock Appreciation Rights Plan.

F. Restricted Stock

Restricted Stock Plans generally grant stock to executives with certain restrictions. The restrictions may be that certain financial goals must be met before the restrictions lapse or that the executive must continue to be employed for a certain number of years or both. If the conditions associated with the restrictions are not met, the stock is forfeited.

Restricted stock may have favorable tax benefits in that the executive is not required to recognize ordinary income for tax purposes when the restricted stock is issued. Assuming that the restriction constitutes a “substantial risk of forfeiture”, the executive
will not be required to recognize income under IRC §83 until the restriction lapses. The executive will be taxed on the entire value of the stock when the restrictions lapse and the conditions are met, however, which could impose an extreme cash flow hardship if the executive does not want to sell his stock at that time.

If, instead, the executive makes an "83(b) election" as authorized under the Internal Revenue Code, he would have to include in his income for the year of receipt the value of the stock on the date it is granted. The executive would then be able to defer recognition of the increase in the stock's value until the stock is sold, which might be 10 or 15 years later. Additionally, the amount deferred would be taxed at capital gains rates.

A Section 83(b) election is generally unattractive when the amount of taxable income immediately recognized (due to a high stock price) is very high. However, if the current price of the stock was low and substantial appreciation was anticipated, a Section 83(b) election would probably be advisable, since it would be made at a low present tax cost with a possibility of significant tax deferral. Also, the granting of the restricted stock could be spread over a period of years to lessen the tax effect of the 83(b) elections. Granting of the restricted stock can be linked to bonuses that help to pay the tax obligation imposed if the 83(b) election is made.

Another alternative would be for the company to sell the restricted stock to the executive for fair market value, so that a §83(b) election could be made at no current tax cost. The bank could loan to the employee part or all of the funds required to purchase the stock, subject to the limitations under Part 215 of the FDIC Regulations entitled "Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks" (Regulation O). The loan could be made repayable immediately, if the executive left the bank's employment. A part of the executive's bonus each year can be designated to retire the loan.
**Questions and Answers Regarding Restricted Stock Plans**

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
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<tbody>
<tr>
<td>Can employees receive capital gains tax treatment?</td>
<td>Yes, any gain over price at date of grant is taxed as capital gain if an 83(b) election is made.</td>
</tr>
<tr>
<td>Is employee taxed at grant?</td>
<td>No, unless employee makes 83(b) election; otherwise, ordinary income tax paid when restrictions lapse.</td>
</tr>
<tr>
<td>Is employee taxed at vesting?</td>
<td>Yes, unless employee makes 83(b) election.</td>
</tr>
<tr>
<td>Can tax be deferred until sale?</td>
<td>Yes, if 83(b) election made.</td>
</tr>
<tr>
<td>Can Alternative Minimum Tax apply?</td>
<td>No.</td>
</tr>
<tr>
<td>Does the employer get a deduction?</td>
<td>Yes, for amount recognized as regular income to employee.</td>
</tr>
<tr>
<td>Does the employee get dividends?</td>
<td>Can be attached to restricted shares before restrictions lapse.</td>
</tr>
<tr>
<td>Voting rights for employees</td>
<td>Can be attached to restricted shares before restrictions lapse.</td>
</tr>
<tr>
<td>Is there value if the share price goes down below grant?</td>
<td>Yes.</td>
</tr>
<tr>
<td>Do the awards affect dilution and EPS calculations?</td>
<td>Yes.</td>
</tr>
<tr>
<td>Can employees delay exercise after vesting?</td>
<td>No, shares belong to employee when restrictions lapse.</td>
</tr>
<tr>
<td>How is value affected by volatility?</td>
<td>Better in less volatile companies.</td>
</tr>
</tbody>
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### Restricted Stock v. Stock Options

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<thead>
<tr>
<th></th>
<th>Restricted Stock</th>
<th>ISOs</th>
<th>NSOs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Can employees receive capital gains tax treatment?</strong></td>
<td>Yes, any gain over price at date of grant is taxed as capital gain if an 83(b) election is made.</td>
<td>Yes, any gain on shares received on exercise is taxed as capital gain, provided holding period rules are met.</td>
<td>Only for gains on shares held after exercise.</td>
</tr>
<tr>
<td><strong>Is employee taxed at grant?</strong></td>
<td>No, unless employee makes 83(b) election; otherwise, ordinary income tax paid when restrictions lapse.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td><strong>Is employee taxed at vesting?</strong></td>
<td>Yes, unless employee made an 83(b) election at grant.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td><strong>Is employee taxed at exercise?</strong></td>
<td>N/A</td>
<td>No.</td>
<td>Yes.</td>
</tr>
<tr>
<td><strong>Can tax be deferred until sale?</strong></td>
<td>Yes, if 83(b) election made at grant, capital gain can be deferred.</td>
<td>Yes, if requirements met.</td>
<td>No.</td>
</tr>
<tr>
<td><strong>Can Alternative Minimum Tax apply?</strong></td>
<td>No.</td>
<td>Yes, to spread on exercise if shares not sold in year of exercise.</td>
<td>No.</td>
</tr>
<tr>
<td><strong>Does the employer get a deduction?</strong></td>
<td>Yes, for amount recognized as regular income to employee.</td>
<td>Only for disqualifying dispositions for amounts taxed as ordinary income.</td>
<td>Yes, for amount recognized as regular income to employee.</td>
</tr>
<tr>
<td><strong>Does the employee get dividends?</strong></td>
<td>Can be attached to restricted shares before restrictions lapse.</td>
<td>Not until shares are actually purchased.</td>
<td>Not until shares are actually purchased.</td>
</tr>
<tr>
<td><strong>Are there voting rights for employees?</strong></td>
<td>Can be attached to restricted shares before restrictions lapse.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td><strong>Is there value if the share price goes down below grant price?</strong></td>
<td>Yes.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td><strong>Do the awards affect dilution and EPS calculations?</strong></td>
<td>Yes, but normally fewer restricted shares are issued than options because of their downside protection.</td>
<td>Yes, even if the awards are underwater.</td>
<td>Yes, even if the awards are underwater.</td>
</tr>
<tr>
<td><strong>Can employees delay exercise after vesting?</strong></td>
<td>No, shares belong to employee when restrictions lapse.</td>
<td>Yes, usually for several years.</td>
<td>Yes, usually for several years.</td>
</tr>
<tr>
<td><strong>How is value affected by decrease in stock value below date of grant value?</strong></td>
<td>Value of stock decreases, but not worthless.</td>
<td>Worthless.</td>
<td>Worthless.</td>
</tr>
<tr>
<td><strong>Does the employer recognize an expense in its income statement?</strong></td>
<td>Yes, in an amount equal to the fair value of the stock at grant.</td>
<td>Yes, in an amount equal to the fair value of the stock at grant.</td>
<td>Yes, in an amount equal to the fair value of the stock at grant.</td>
</tr>
<tr>
<td><strong>How is the compensation expense recognized?</strong></td>
<td>Accrued on the vesting or performance period.</td>
<td>Accrued on the vesting or performance period.</td>
<td>Accrued on the vesting or performance period.</td>
</tr>
<tr>
<td><strong>Can the employer reverse compensation expenses for forfeited awards?</strong></td>
<td>Yes, for forfeited awards with “service” or “performance vesting”.</td>
<td>Yes, for forfeited awards with “service” or “performance vesting”.</td>
<td>Yes, for forfeited awards with “service” or “performance vesting”.</td>
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</table>
VI. ENHANCING VALUE THROUGH APPROPRIATE CORPORATE GOVERNANCE

Corporate governance is simply a fancy way to refer to the inter-workings of the bank or bank holding company at its highest levels including the board of directors, board committees and senior management. Because of the recent scrutiny applied to corporate governance issues, a review and analysis, or in many cases an overhaul, of the corporate governance processes in our community banks is likely necessary.

The following Ten Commandments will provide food for thought on the key areas where our attention should begin to focus.

I. REALIZE, THE TIMES, THEY ARE A CHANGIN!

Corporate governance for most banks and bank holding companies, other than the largest, was a non-issue prior to the corporate abuses of the early 2000’s. Times are changing even for the smallest bank, which now will require certain corporate governance restructuring. Thanks to the apparent lack of integrity and values in the operation of large corporations, all of us large and small have to pay.

II. ESTABLISH AN EFFECTIVE, CAPABLE AND RELIABLE BOARD OF DIRECTORS.

Every community bank or bank holding company should have an effective, reliable and capable board of directors. This means having individuals with integrity who are qualified and successful in their own fields and who have the capacity, understanding and interest to focus on the financial services industry. That means that a majority of your board of directors should be truly outside, independent directors. Outside independent directors will have some stock ownership (you really don’t want somebody running the company who has no financial interest) but would otherwise be independent; being “independent” typically implies the individual does not work for the company, does not have a material business relationship with the company, and is otherwise able to provide independent advice. The board must be effective and should meet in executive session at least monthly without the CEO, even if the CEO is a member of the board. The board also should set the long-term strategy, policy and values for the organization. However, the board should not micro-manage the institution.

III. ESTABLISH A CORPORATE CODE OF ETHICS FOR THE BANK OR BANK HOLDING COMPANY.

As Yogi Berra said, “if you don’t know where you are going, you will wind up someplace else.” If corporate ethics, values and the like are not established at the top, at the board level, and used to govern the operations of the company, both from a long-term strategy and a daily basis through executive management,
then executive management certainly cannot anticipate the rank and file employees will follow such a code on their own. Establish a workable, reliable and realistic corporate code of ethics for the way the company will conduct business internally and externally and review the code of ethics annually. Have board members and executive officers assist in the development of the code of ethics.

IV. **CONSIDER ESTABLISHING AN OFFICE OF THE CHAIRMAN OF THE BOARD.**

Many organizations have considered establishing an Office of the Chairman of the Board. This may be a paid, full or part time position. It will be compensated only by salary and not subject to any type of supervisory authority by the executive management of the company. A separate Chairman of the Board will report only to the board and will be the board’s eyes and ears on a daily basis in connection with the workings of the company. While this certainly may not be feasible for many smaller community banks, it is still a concept worth exploring with respect to having a truly independent board chairman.

V. **HAVE AN EFFECTIVE AND OPERATING AUDIT COMMITTEE, COMPENSATION COMMITTEE AND NOMINATING/CORPORATE GOVERNANCE COMMITTEE.**

The audit committee, compensation committee and nominating committee should be composed of all independent, outside directors of the company who operate independently. These committees should have access to attorneys and consultants, paid for by the company, other than the corporation’s customary counsel and consultants. Clearly, under Sarbanes-Oxley and subsequent legislation for SEC reporting companies, the audit committee and compensation committee are entitled to such independent counsel and representation. In addition, the audit committee should directly retain the auditors and set the scope of the engagement. The committee also should monitor outside, non-audit work performed for the company by the auditors.

The independent nature of the compensation committee and nominating committee is also critical. The compensation committee should consist of all independent directors and should not be a rubber stamp for management. The nominating committee should consider establishing an evaluation system for board members. Simply because you are a board member elected at the last election, you should not automatically be re-elected at the current annual meeting, unless you bring some value to the institution.

VI. **CONSIDER EFFECTIVE BOARD COMPENSATION.**

Directors, particularly with their new duties, responsibilities and liabilities, should be fairly compensated. However, admittedly, directors never will be truly compensated for the risk inherent in the position. Appropriate questions to consider are as follows. Should directors receive additional compensation for serving on some of the critical committees, such as audit, compensation and nominating? Probably so! Should directors receive stock options or restricted
stock? Many do, as a way of keeping directors focused on the value of the company. If the bank or bank holding company’s goal is to attract and retain the highest quality employees, it also should attract, retain and maintain the highest quality directors.

VII. **REQUIRE CONTINUING EDUCATION FOR DIRECTORS.**

The financial services industry is moving rapidly in a number of different directions. It is critical, even for the smallest institution, that directors be educated about the options and opportunities for the institution. Only then can they make wise choices with respect to its effective long-term strategies. Many state associations and other trade groups are now offering educational programs targeted specifically for directors. Your directors should take advantage of these options.

VIII. **ESTABLISH PROCEDURES FOR BOARD SUCCESSION.**

A critical issue of corporate governance is to make sure qualified board members are available. This involves issues of succession. Does the holding company have a mandatory retirement age that is actually enforced? Does a board self-evaluation process exist to rid the board of non-productive directors? Does the company have a plan to maintain a fully staffed board of directors with capable people, no matter what the ages, as it moves forward for the next several years? All of these must be addressed under the umbrella of corporate governance.

IX. **DISCLOSE, DISCLOSE, DISCLOSE.**

Publicly held banks and bank holding companies (reporting to SEC) will find that disclosure will be quicker and more onerous than in the past. Even for private companies and banks, disclosure needs to be stepped up. This may be through quarterly letters to your shareholders or other types of communication. But some means of communication, though not legally required, will go a long way toward furthering the confidence of your shareholders in your institution.

X. **RECOGNIZE THAT YOUR DUTY IS TO ESTABLISH CORPORATE GOVERNANCE PROCEDURES THAT WILL SERVE TO ENHANCE SHAREHOLDER VALUE.**

The primary job of the board of directors is to enhance the value of the shares held by its shareholders. This is generally done through growing earnings, providing an adequate return on equity, providing liquidity in the shares and some type of cash flow off the shares. All of that is contemplated within an overall strategy established by the board. Corporate governance procedures now should be part of that strategy and should be designed to enhance the long-term value for the shareholders.

The following are real signs that your organization’s corporate governance is not working:
1. **Directors Sign and Approve Documents Without Adequate Review.**

The directors have a duty of care to act as reasonably prudent bank or bank holding company directors. This duty is heightened in the banking context more so than the corporate context. Directors are often presented with material which they have not had adequate time to review yet they are asked to sign off on it. Directors must be provided with adequate time to review material and must actually review that material before they execute it.

2. **Committee Charters Are Boilerplate.**

Larger companies are required to have committee charters for the audit and compensation committees and advised to have charters for other committees. Smaller non-reporting companies often do not have such charters. Those that do, often have adopted a boilerplate charter they have gotten from someplace else.

The creation of a committee charter should be a “real” exercise. The committee charter should indicate what the committee’s obligation is and how they perform it.

3. **The Nominating Committee Is A Social Club.**

Most nominating committees for public or private companies could be best characterized as a “joke”. Very few boards have any type of board evaluation system (although some good ones are available). A nominating committee’s job is often simply to re-nominate those who were nominated and elected last year. The only exception in most community banks is if there is a death or a departure of one of the existing board members, at which point the board searches for someone who will come in without disrupting the board dynamic (whatever that is).

A nominating committee exercise needs to be a real exercise. It is very difficult to make that a real exercise without also implementing some type of board evaluation. The board evaluations that are in place generally involve either the Chairman evaluating the board members or each board member evaluating each other board member, or a self-evaluation.

4. **Board Meetings Are Not Regularly Held.**

Board meetings need to be planned out in advance and held regularly so the board members can attend. For most bank and bank holding companies, this is not an issue as it is with non-regulated private companies, since the bank regulators demand that the board meet regularly and exercise governance over the company.

Meetings also should be based on adequate information provided early and discussed in as much detail as the board wants. Short meetings are not always the best meetings.
5. **Tough Questions Are Regarded As Undesirable.**

Directors need to be independent. They need to ask tough questions. If the climate is such that you have to "go along to get along", you need to get off the board.

6. **Corporate Minutes Are Useless.**

There is a fine line between transcribing verbatim the discussions at a board meeting and providing minutes that have no valuable information. Minutes should not be a detailed description of a meeting, but they should indicate particularly any dissent or the substance of a discussion over particular issues. Generally, if you dissent from a transaction and vote against it at the board level, even if the board approves it, if it turns out to be negligent, you as a director are off the hook. Make sure that dissent is recorded.

7. **The CEO Shields The Board From Other Members of the Management Team.**

If you don't see management members at your board meetings, it is generally that you either have an extremely insecure CEO or there is something to hide. Board members should not try and micromanage the company, but should feel free to call upon the management team both at the board meeting and before and after, to answer questions, provide additional information and assist them in exercising their oversight duties.

8. **The Chairman Demands Unanimity, Not Consensus.**

On many boards, the Chairman views dissent as a sign of weakness. However, the reality is that unanimity is more a sign of weakness because it means that the Board is likely simply a rubber stamp for management. Dissent is healthy and unanimity should not be demanded.
VII. GET THE RIGHT BOARD

Often, the directors neglect to "focus on themselves". If the goal and purpose of the Board of Directors is to direct the institution, then the Board must focus on numerous critical areas of its own existence. These include answering the following questions:

1. What is the ideal board size?

   Most charters for banks and bank holding companies provide a range for the size of the board of directors, e.g. 5 to 25. The Board simply needs to decide what its most effective operating group is. Once that is decided, the Board will recognize whether there are board succession issues or board attrition issues which need to be addressed. In other words, do we need to add directors or get rid of some of the existing directors?

2. What qualifications should there be for board membership?

   As part of an institution's anti-takeover plans, often board members are required to live in the community, etc. Does the Board also want qualifications that deal with minimum stock ownership, age, active trade or business, and the like?

   In addition to general qualifications, what specific skill sets does the Board require when a vacancy exists? In other words, do you need an accountant? A lawyer? An individual with real estate experience? These considerations are very important depending on your current Board's expertise and the needs of the bank at the time of the vacancy.

3. What should the composition of the Board look like?

   This generally means has diversity been adequately addressed on the Board. Does the Board have minority members? Does the Board have women? What should the Board composition be? As with qualifications, this consideration is particularly important when there is a vacancy on the Board.

4. What about Board compensation and incentives? Is the Board adequately being compensated?

   It is pretty clear the Board cannot be compensated for the risk, but can they be incented to bring business to the bank and the like?
Tab D
Success for the Future: Enhancing Shareholder Value Through Purchase or Sale
I. BUYING OR SELLING SECRETS

In 1980, there were 14,870 independently chartered banks in the United States. At year-end 2014, there were approximately 6,500. As the industry continues to consolidate, more and more Boards of Directors of community banks will be faced with tough acquisition choices. Has the Board and ownership had all the fun they can stand? Does older management without succession, an older shareholder base, a dying franchise or being behind the curve on technology dictate selling now? Does a younger and aggressive management, a younger or closely held shareholder base and expanding market dictate an acquisition is in order? Or, should the community bank simply follow the philosophy that “If it ain’t broke, don’t fix it” and remain independent while enhancing shareholder value? Each of these strategic decisions requires a well thought out plan.

The Board’s conscious consideration of the basic strategy of whether to buy, sell or remain independent should be addressed and determined annually. The following material should assist the Board in identifying the issues and common concerns in either buying or selling a community bank or implementing a decision to remain independent and simply keep your shareholders happy by enhancing shareholder value. Any of the three strategies can be viable in the current environment if appropriate planning occurs.

A. Establish Your Bank’s Strategy Early On

It is important that a community bank have an established strategy. Before establishing that strategy, whether it is to buy, sell, or simply remain independent and enhance value, the Board must recognize the issues associated with each alternative. In doing so, it must balance the various stakeholders’ interest, including shareholders, directors, management, employees, depositors, and customers, as well as consider the market environment in which it is operating.

In addition, the Board must consider the management and capital with which it has to work. If embarking on an acquisition, how much can the institution pay and who will manage? If looking to sell, what does the institution have to offer?

1. Stakeholders’ Interest

It is incumbent upon the directors to consider each of the stakeholders’ interests. Clearly, the shareholders’ interests are of paramount importance. The shareholders’ desire for liquidity and increase in market value, combined with a change in the stage of life and general aging of the shareholder population, may drive the Board’s decision in one direction or the another.

In addition to the shareholders, however, the desires of top management, middle management, employees, the customer base and the community must be considered. As a practical matter, it is very difficult to have a successful sale without, at least, the acquiescence of senior management.
Even a sale which the shareholders support can be scuttled by senior management’s discussions with the potential purchaser with respect to the condition of the bank and the valuation of contingent liabilities. As a result, senior management and the other parties’ “needs” must be identified and met.

In addition, if ownership is fragmented, it is in the best interests of the Seller and Buyer to organize and consolidate the “control group” as early as possible. Any possibility of having factions develop among members of the control group should be eliminated, if feasible.

2. Market Environment

In connection with enhancing shareholder value without sale, the typical community bank is faced with a number of environmental forces, including aging of the shareholder base and lack of management succession, technology considerations, increased competition and regulatory concerns, all of which may drive the bank toward the strategy of buying additional institutions or branches to enhance value or selling their own institution to enhance value. In addition to the regulatory burden currently imposed on banks, the inception of the new Consumer Financial Protection Bureau seems intent on increasing that burden significantly, as well as the costs associated with compliance.

3. Capital

The Board’s determination of its alternatives must include how best to allocate its capital. The Board of Directors must first determine how much capital is available. This includes not only the consolidated equity of the bank and the holding company, but also the leveraging ability of the holding company. Once that number is determined, how the capital pie is “sliced” must be considered. The new reality is that community banks will be required to maintain higher capital levels than they have historically. What used to be an overcapitalized community bank, with 9% Tier 1 and 12% total risk based capital, will become the norm and practical regulatory minimums. Does the Board use a significant portion of its capital to repurchase its own stock or does the bank use the capital to offset losses? Does it use some of that capital to buy another bank or branch? Does it use the capital for natural growth? Does it dividend that capital to its shareholders? Or, does it exchange that capital for an equity interest in another institution through sale?

Particularly in light of Basel III, the new reality with regard to minimum capital means that, across the Board, community banks will suffer a lower return on equity and lower pricing multiples. The Board needs to make a conscious decision, particularly in an overcapitalized community bank, as to whether to return some of that capital to its shareholders. The issue is not one of receiving “capital gains” treatment versus “ordinary income” treatment on that “extraordinary dividend” capital. The issue is getting some “value” for that excess capital through a dividend versus limited or no value through a sale which is priced based on the company’s earnings stream. That’s not to say tax considerations are irrelevant.
4. **Management**

Most transactions will result in existing management being retained by the acquiring institution (at least for some period of time). This is simply due to the combination of facts that (a) most acquiring institutions do not have excess management, and (b) most Sellers will not be acquired if management is not assured of a position after the acquisition or otherwise financially compensated. Non-management owners should never forget that there is an inherent conflict of interest in allowing managers to negotiate with a potential purchaser when the management will be staying on after the sale. Obviously, management is then negotiating with its future boss.

5. **Consideration of Potential Acquirors**

If a community bank’s Board of Directors has made the decision to sell the company at some point in the future - no matter how distant - so that the question is not “if” to sell the company but “when,” the Board of Directors must consider which acquirors may be available at the time it finally decides to sell. A community Board should consciously identify its potential acquirors. It should then analyze, as best it can, what may occur with those acquirors. A potential acquiror that is interested in moving into the community where the community bank operates its franchise may do one of several things:

a. It may be acquired itself and thereby be eliminated as a player.

b. If it desires entrance in the market, it may use another entry vehicle, i.e. another institution or a de novo branch and be eliminated as a player.

c. It may simply lose interest and allocate its resources to another strategic direction and eliminate itself as a player.

Unfortunately, if “selling” is in the community bank’s current thought process, i.e. a strategy other than an adamant one for independence, sooner is probably better than later. “Sooner” will provide the maximum number of potential purchasers.

B. **Creation of the Plan**

Whether the Board of Directors’ decision is to buy, sell or remain independent and simply enhance value, it must plan for the ultimate outcome it desires.

1. **Implementing an Acquisition Strategy**

   a. **Needs of the Buyer**

      Before finding a bank, bank holding company or thrift to buy, a Buyer must first define the kind of financial institution it desires and is, from a financial and management standpoint, able to buy. The Buyer must develop an acquisition strategy describing an overall plan and identifying acquisition candidates. Buyers must consider, in advance, the advantages that the Buyer wishes to
obtain as a result of combining with the selling institution. These benefits generally fit within the following categories:

(1) Financial

* Earnings per share appreciation
* Utilization of excess capital and increased return on equity
* Increased market value and liquidity
* Increasing regulatory burden offset by enhanced earning power and asset upgrades.

(2) Managerial or Operational

* Obtain new management expertise
* Additional systems and operational expertise
* Use of excess competent management

(3) Strategic

* Diversification
* New market entrance
* Growth potential
* Economies of scale and/or scope
* Enhanced image and reputation
* Elimination of competition
* Obtain additional technology expertise

b. Formation of the Acquisition Team and Assignment of Responsibility

(1) The Players: The Buyer and the Seller

The typical Buyer in this environment will probably be a small to mid-sized holding company desiring entry into the market to expand its franchise, or a community bank slightly larger than the target, looking to gain critical mass to cover the cost of doing business.

The typical Seller will be a community bank of any size in a good market with acceptable performance, and in all likelihood, with a Board that has “had all the fun it could stand”. From the Seller’s perspective,
the decision to sell an institution will generally fall into one of four scenarios:

(a) The controlling stockholders make a decision to sell after a substantial period of consideration due to the pressures of personal financial factors, estate planning needs, age, technology, competitive factors, regulatory actions, exposure to directors' liability and so forth.

(b) The institution is in trouble and needs additional capital and/or new management.

(c) The institution has no management succession and an older management and shareholder base.

(d) The Board is concerned about missing the upcoming “window.”

(2) The Players: Financial Consultants, Special Counsel and the Accountants

With the status of current regulations and the growing complexity of mergers and acquisitions, few institutions are capable of closing a successful deal without outside assistance. From a technical standpoint, there is a greater need than ever before to secure the services of specialized financial consultants, legal counsel, and experienced auditors. The costs may be high, but it is a misguided chief executive who thinks he or she can economize by doing his or her own legal, accounting or even financial work in an acquisition transaction.

The primary goals of any outside advisor should be to close the deal and to protect his client’s interests. To achieve these objectives, the advisor(s) must have a number of attributes and qualifications, some of which differentiate him or her from many other professionals.

First and foremost, the advisor must have the requisite knowledge and experience in business combinations and reorganizations. This not only includes a solid understanding of the intricacies of acquisition contracts and regulatory issues, but more importantly, also a high degree of familiarity with the business and financial issues that arise in community bank acquisitions.

Second and equally important, it is essential that the advisor understands the tax implications of the acquisition and provides structuring advice early on in the negotiations.

Aside from the technical skills, the advisor(s) must seek to find solutions to problems which may arise rather than simply identifying them. Instead of finding reasons for “killing a deal,” which comes quite
naturally to some, the talented advisor is oriented to “making the deal,” unless it would result in insufficient protection for his client.

The experienced advisor knows what must happen and when it should take place. Along with the principal parties, he must maintain the momentum for the deal. Experienced professionals will prepare and work from a transaction timetable, outlining the various tasks that must be accomplished, the person(s) responsible, and target dates.

An early decision which must be made is who will actually handle the negotiations. A general rule to follow when using outside “experts” for negotiations is as follows. If representing the Buyer, the experts should become involved early, but stay behind the scenes to avoid intimidating an unsophisticated Seller. If the experts are representing the Seller, they should become involved early in the negotiations and be visible to avoid a sophisticated Buyer trying to negotiate an unrealistic or unfair deal with an inexperienced Seller.

(3) Assignment of Responsibilities

Once the bank’s team and advisors are in place, it is critical to specifically assign responsibilities to each member of the team. It is helpful to have one coordinator for these tasks. That coordinator is often the outside counsel or financial consultant who has experience with transactions of this type.

The assignments of responsibilities should be formalized and documented so that significant matters are not overlooked in the excitement of the acquisition process.

(4) Preparation of Candidate List

Typically, Buyers find that the most difficult, frustrating and time-consuming step in buying another institution is finding an institution to buy - one that “fits”. This is especially true for the first-time Buyer who frequently underestimates the time and effort necessary to plan and locate viable acquisition candidates. Unfortunately, many such Buyers start a search for acquisition candidates without being fully prepared. The result is early disappointment with the whole idea. Following a well-constructed plan will assist a Buyer in pinpointing “buyable” Sellers and reduce unproductive time.

The Buyer needs to be aware that there is an inherent inclination toward acquisition. Well thought out and well planned acquisitions create value and minimize risks. Unplanned acquisitions maximize risks and limit future flexibility. Certain studies suggest that bank mergers do not guarantee major cost savings benefits. With planned acquisitions, many of the anticipated benefits will result. With unplanned or poorly
planned acquisitions, they rarely do. In any event, as a Buyer, be careful valuing synergies.

2. Implementation of the Sale Strategy

Some institutions will simply decide it is the time to sell. This may be simply because, with the multi-year recession, the Board and ownership have had all the fun they can stand, or it may be due to an aging shareholder base, lack of management succession, technology issues, a troubled institution or a combination of several of these issues. Once the institution makes the decision to sell, the Board of Directors needs to be certain that it has in place a “process” designed to obtain the highest and best price for the bank shareholders in the best currency. Some institutions attempt to do this by having an appraisal conducted of their bank before they engage in negotiations. Unfortunately, an appraisal will not tell the Board what the bank is worth on the market. It will only indicate what other banks have sold for and what the bank may possibly be worth.

The only way for a Board of Directors to assure itself that it is obtaining the highest and best price in the best currency for its bank is to put the bank on the market on either a limited or extensive basis. Over the past several years, our firm has marketed and sold a number of community banks on a turnkey basis. The process involves:

a. The identification of prospective purchasers.

b. The preparation of confidential evaluation material describing in detail the condition of the bank.

c. The distribution of that material, subject to a confidentiality agreement, to a list of potential acquirors as approved by the Board of Directors.

d. The submission by those potential acquirors of expressions of interest based on the material submitted to them and subject to due diligence indicating the price they would pay for the bank, the currency, i.e. stock, cash or a combination, the structure, i.e. branch or separate bank and any other relevant issues.

e. A review by the Board of Directors of the offers and a determination as to which, if any, of the bidders receive an opportunity to conduct on-site due diligence.

f. The negotiation of the transaction and legal services in connection with closing the transaction.

Once an offer or offers are selected by the Board, only then do the potential acquirors conduct a due diligence of the bank in order to reconfirm or increase their offer and eliminate the due diligence contingency.

Once the decision to sell has been made, the best way for the Board of Directors to assure itself that it has met its fiduciary duty and obtained the highest and best price for
the bank is to market the institution. The second line of defense for the Board of Directors is the fact that the consummation of the acquisition will also be conditioned upon receipt of a fairness opinion shortly prior to the closing of the acquisition.

C. Anti-Takeover Planning and Dealing with Unsolicited Offers

1. Avoiding Unwanted Attempts to Change Control

It is not unheard of for a larger holding company or another community bank to present a community bank target with an unsolicited offer. Although our firm handled the only community bank hostile tender offer to occur in recent memory (representing the target), the offers do not generally take the route of an “unsolicited tender offer” or “hostile offer”, but nevertheless, cause the target bank or bank holding company a certain degree of trepidation.

The implementation of a well thought out and strategically minded anti-takeover plan will give the community bank holding company greater mastery over its own destiny when presented with a potential unsolicited or hostile offer. The anti-takeover plan will not prevent the bank holding company from being sold if its Board of Directors believes it is in the best interest of the shareholders for such a transaction to take place. An appropriate anti-takeover plan, however, will present the Board with the luxury of time to consider an offer or to shop the institution or the ability to reject the offer or make it difficult to obtain approval for an unwanted acquiring company.

For an existing bank holding company, qualified counsel should review the holding company’s charter and bylaws to determine what, if any, anti-takeover provisions already exist. Additional anti-takeover provisions should be added in connection with charter and bylaw amendments at the next regular annual shareholders meeting after full disclosure to shareholders. Banks desiring to form holding companies, because of the exemption in the federal securities laws, which eliminates the need to file a formal SEC registration in connection with the formation of the holding company if the bank charter and the holding company charter are substantially similar, are best advised to form the bank holding company, and as a second step, sometime six months to a year down the road, implement an anti-takeover plan. Once the holding company has been formed, the anti-takeover plan can be implemented with the assistance of counsel at the next regular annual meeting of the shareholders after full disclosure to the shareholders.

The primary benefits of adopting a comprehensive anti-takeover plan are fourfold:

* The existence of the plan may deter unwanted investors from initially seeking a control or ownership position in the institution.

* The plan may be a valuable negotiation tool when the Board is approached by an investor.

* The plan provides specific defenses if a tender offer or other similar maneuver is commenced.
* The existence of the plan will likely drive any potential acquiror into the boardroom instead of out to the individual shareholders directly.

Obviously, strategies for handling a takeover attempt should be considered before the situation is confronted. Numerous courts have rendered significant opinions on anti-takeover and defensive strategies. One of the main reasons for favorable decisions upholding anti-takeover defenses is the timing of the implementation of such defenses.

Corporations amending their charters and bylaws to include such protective provisions as part of advance planning have generally had the defenses upheld in court. In many cases, firms with strategies implemented in response to a specific bid have had such provisions invalidated on the basis they were put in place only to protect existing management and were not in the best interests of shareholders. Last minute, reactionary planning is usually ineffective.

Implementing a comprehensive anti-takeover plan if a financial institution does not have a holding company may be extremely difficult and ultimately ineffective. Amendments to a financial institution’s charter (“articles of incorporation”) as opposed to a holding company’s charter, often must be approved by the institution’s primary regulator. Many standard corporate provisions, such as the elimination of cumulative voting or preemptive rights and staggered election of directors for multiple year terms are expressly prohibited in archaic state and federal banking laws. Regulators are conservative even regarding what charter amendments may be used if legally permissible. In addition, if the regulatory agency ultimately allows the defenses to be placed in the charter, there is little or no legal precedent to determine whether the defenses will be upheld in court.

A bank holding company is not limited by such considerations. For corporate purposes, a holding company is a general state-chartered corporation and is limited only by the law of the state in which it is incorporated. Certain types of “structural” anti-takeover techniques may be used with a BHC as follows:

<table>
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<th>Anti-takeover Defenses</th>
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<tr>
<td>* Stagger election of directors</td>
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<td>* Limit shareholder written consent to approve certain actions</td>
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<tr>
<td>* Limit the size of Board</td>
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<tr>
<td>* Permit special Board meetings on “best efforts” notice basis</td>
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<tr>
<td>* Deny shareholders cumulative voting rights</td>
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<tr>
<td>* Require “supermajority” shareholder vote approval of certain takeover or acquisition transactions</td>
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<tr>
<td>* Allow director removal only “for cause”</td>
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<tr>
<td>* Provide authorized but unissued shares of institution stock</td>
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<tr>
<td>* Limit shareholder ability to replace directors</td>
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<td>-------------------------------------------------</td>
</tr>
<tr>
<td>* Implement director qualification requirements</td>
</tr>
<tr>
<td>* Limit director affiliations with other institutions</td>
</tr>
<tr>
<td>* Require non-management director nominations to meet certain requirements</td>
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<td>* Limit shareholder called special meetings</td>
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In addition to these structural anti-takeover techniques, there are certain general defensive strategies or “black book” procedures that should be followed, including the following:

* Prepare a limited “black book” containing a list of key personnel, including special legal counsel, financial and public relations personnel and their office and home phone numbers.

* Prepare information about how to locate all directors and key personnel on short notice.

* Identify a senior management team of three or four directors and three to four senior managers to deal with an unsolicited offer on a daily basis.

* Review shareholder list in order to ascertain shareholders’ geographic location and identify key shareholders that might assist in solicitation efforts and be able to gauge shareholder loyalty.

* If the bank holding company is a publicly reporting company, the company should implement a consistent “stock watch” program to monitor the daily trading of its stock.

* Implement a shareholder and investment relations program.

* Implement safe keeping practices for your shareholder list.

* Instruct all directors and personnel to decline comment to the press with respect to offers.
* Establish a line of credit with a correspondent bank for a defensive stock repurchase program.

Employment contracts containing “Golden Parachute,” “Golden Handcuff” or “Retention Bonus” provisions may also be entered into with key officers at the holding company level. Although such contracts must comply with IRS Code Section 409A, these contracts provide substantial monetary benefits to such officers if control changes involuntarily. The contracts may serve as a deterrent to “raiders” because of the cost they add to an acquisition. Most importantly, if structured properly, the contracts will help guarantee objective advice by management during a takeover attempt. Without such arrangements, management’s objectivity may be influenced by negotiating with a raider who could be their future boss.

A valid anti-takeover plan and a mission statement certifying that the bank desires to remain independent do not always prevent the institution from receiving an unsolicited acquisition offer. In order to understand how to deal with an unsolicited offer, a banker must understand the difference between an unsolicited offer and an “inquiry.” An inquiry is simply an overture by another institution asking whether the institution is for sale or would sell out for something in the neighborhood of X times book value or X times earnings.

An unsolicited offer is more formal. It generally involves the receipt of a written offer by another institution for a merger or acquisition of the stock of the selling institution. An inquiry is informal and can generally be dealt with informally. An unsolicited offer, however, should be dealt with in a formal manner in order to protect the Board of Directors.

2. Dealing with Unsolicited Offers

Upon the receipt of an unsolicited offer from another institution, the first step that the banker should take is to consult with specialized merger and acquisition professionals and the bank’s Board of Directors. Many unsolicited offers contain very short fuses. It is generally not necessary to strictly comply with the deadline set forth in the offer, but it is advisable to have counsel consult with the offeror and let them know that the Board is currently considering its options.

The Board of Directors has four basic options when faced with an unsolicited offer:

- Reject the offer.
- Accept the offer.
- Negotiate the offer.
- Shop around to see if there is a better offer.

Rejecting the offer out of hand is dangerous for both the individual who has actually received the offer and the Board of Directors. The offer may ultimately be rejected but the rejection should be based upon a detailed financial and legal analysis of the inadequacy of the offer in view of the criteria considered by the Board of Directors.
This would include relying on charter and bylaw provisions dealing with the analysis of offers as discussed above.

A Board of Directors’ acceptance of an “unsolicited first offer” constitutes a breach of fiduciary duty on its face. Many acquirors will generally make unsolicited offers based on public information regarding anticipated earnings-per-share impact on the larger holding company. If the holding company is interested in the franchise and interested in the bank, it will generally increase its offer through negotiation.

The third alternative is to negotiate the offer. Once a community bank begins to negotiate or consider the offer, the bank is clearly in play. It will be sold. Many Boards of Directors of banks desiring to remain independent have found that independence disappears once they decide to try and “negotiate” an unsolicited offer.

The fourth alternative is to see what other offers are available. In any event, when an unsolicited offer is received, the general advice is to test the waters once the bank is put into play and see what other offers are available. It is only through this mechanism that the Board can determine that it has received the highest and best price.

Each of these options must be considered in view of the Board’s extensive fiduciary duties to shareholders in this situation. Numerous issues which are beyond the scope of this brief outline are present. For further specific information, please contact us.

D. Contact and Negotiation for Community Bank Acquisitions

1. The Approach

An acquisition by a regional holding company or another community bank may be one in a series of acquisitions for that institution. It is likely, however, that the sale by the Seller will be a sale by an inexperienced Seller and will be that Seller’s first and often last sale.

a. Preliminary Approach through the CEO or Principal Shareholder

Many different approaches are used by potential acquirors, be they bank holding companies or other community banks, toward target community institutions. In virtually every case, however, the approach will be to the chief executive officer of the Selling Bank or its principal shareholder. Often, the CEO or other high ranking officer of the acquireor will simply call the CEO of the target and ask if he would be willing to discuss the possibility of “affiliating” or associating with it. Inevitably, the potential acquireor’s representative will avoid the use of terms such as “acquisition”, “sale”, or “being acquired” and use the euphemisms of “affiliation,” “association” and “marriage” when talking about the acquisition.
b. Getting Serious

Although potential acquirors have made various approaches in the past with respect to acquisition of community institutions in particular, virtually all potential Buyers have now learned that in order to have any serious discussions with the community bank, the chief executive or chairman of the Board of the Buyer needs to engage directly in discussions with the chief executive of the Selling Bank or its principal shareholder. To be effective, this needs to happen very early in the exploratory stages.

Experience has shown that the Buyers that have tried to acquire banks by sending officers other than the CEO or chairman to conduct any serious discussions have generally not been as successful as those represented directly by one of them. Most community bankers understandably take the position that when they are about to make the most important decision that they will ever make for their bank, they want to directly “eyeball” the CEO of the Buyer. Many understandably resent it if the bank holding company chairman or CEO does not give them at least some reasonable amount of attention.

c. The Sales Pitch

Buyers and Sellers have varying interests and reasons for wanting to engage in a transaction. Usually the acquiring institution, although it is technically a “Buyer,” must “sell” itself to the target. This is particularly true where stock of the Buyer is to be used as the currency for the transaction. The sales pitch varies with the perceived “needs” of the community bank which the Buyer intends to meet as a result of the acquisition. Many times, the needs of the Selling Bank will depend primarily upon the financial condition of the Seller. If the Selling Bank needs additional capital for growth or otherwise, the approach by the Buyer usually emphasizes that an affiliation with the Buyer will provide a source of additional capital so that the bank may continue to grow and serve its community.

If the Selling Bank is already well capitalized and satisfactorily performing, the approach usually involves an appeal to the stockholders of the community bank with respect to the liquidity of the stock of the Buyer and the lack of marketability and illiquidity of the community bank’s stock. The Buyer will also always emphasize the tax free nature of most transactions and the existing market for its stock.

In banks in which the chief executive officer is near retirement age and does not have a capable successor on board, the Buyer generally emphasizes its management depth and its ability to attract successor management who will have a career opportunity with a larger organization.

In summary, the Buyer will generally emphasize that it can bring to the table capital, management, liquidity for the investment, future earnings potential,
appreciation, and career opportunities for employees. The specific needs of the Seller will determine which of these particular benefits will be emphasized.

2. **General Negotiation Considerations**

In all bank acquisitions, there are some advantages that inherently go to those who are selling and others that accrue to the Buyer. No matter which side you are on, two primary goals should be recognized: first, improve your bargaining position, and, second, understand the other side’s position.

a. **Stages of Negotiations:**

(1) Preliminary negotiations leading up to determination of price and other social issues - usually represented by a letter of intent or term sheet.

(2) Negotiations leading up to execution of definitive documentation.

(3) Additional negotiations at or immediately before closing regarding last minute price adjustments and/or potential problems.

Acquisition negotiations can take a long time. It is important that both parties be patient. Although the Buyer may have made several acquisitions, it is likely that the Seller is taking the most important step in its history.

b. **General Negotiation Suggestions for Both Parties:**

(1) No premature negotiations - ignore deadlines. Make concessions late and always get something in return. The opposite is also true - take concessions and attempt to move on without giving up anything.

(2) Plan and attempt to control all aspects of negotiations including place, time and mood. The Buyer usually has an advantage in this regard.

(3) Throughout negotiations, be courteous but firm and attempt to lead the negotiations. Within the general rule that the “Buyer gets to draft”, try to have your professionals retain control over drafting and revisions of definitive documentation.

(4) Use the “foot in the door” negotiating approach to get to higher levels of commitment. As the costs and expenses mount, a party will be more reluctant to terminate the deal since his institution will have to bear the expenses. (These expenses are usually a larger share of the Seller’s operating income.)

(5) Consider using letters of intent or term sheets because they:

- clear up any ambiguity or confusion over the terms of the deal,
- cause a psychological “commitment,”
- take the institution off the market and discourage other bidders, include confidentiality provisions, and
- set forth the timing of the deal.

(6) Keep communications open with shareholders. Make sure all parties in interest understand the delays associated with a bank acquisition.

(7) Always be careful of unreasonable time demands. Is the acquisition so unique that the risk of speeding up the process is justified? Are there other bidders or alternatives for the other party? Where is the pressure coming from to expedite the transaction? How will the faster pace affect the acquisition? Are there “hidden agendas” existing with advisors? Is the potential reward commensurate with the risks?

(8) Be absolutely certain that you receive competent legal advice on exactly what public disclosures should be made regarding negotiations and the timing of such disclosures. Substantial liability can occur for misleading or late disclosures.

(9) Throughout negotiations, be certain everyone understands the importance of the “due diligence” examination since so often these examinations identify major problems. Try to make certain that by the time you get to the closing documents there are no more surprises.

(10) Always attempt to use a win/win strategy. It is almost impossible to make a totally unfair and overpowering deal “stick.” Regardless of the legal consequences, most people will not honor a contract if they realize they have been “taken.”

c. Specific Seller Negotiation Considerations

(1) The Seller should not reveal the reasons his group is interested in selling.

(2) A Seller should always show a limited desire to sell. This will have the effect of forcing the Buyer to sell itself rather than requiring the Seller to “sell” his institution.

(3) Consider using a representative for negotiations so that the representative can use the strategy of saying, “I can only make recommendations to my client. I cannot commit for him.”

(4) Due diligence examinations are integral parts of any acquisition. The Seller should usually try to force “due diligence” examinations before any definitive document is signed or as early as possible. This avoids
premature press releases which can be embarrassing later. Also it removes the major contingency early. Termination of an acquisition, regardless of the reasons given in a press release, will nearly always damage the reputation of the Seller more than the Buyer. It will be automatically assumed that there is something wrong with the institution being sold.

(5) Remember the “foot in the door” negotiating approach used by many purchasers. A Seller should always realize that negotiations are never over until the cash or stock is received.

(6) Bring up integration issues early in the negotiations if the post-acquisition operation of the bank is important to the Seller’s management and directors.

(7) Don’t forget the social issues.

d. Specific Buyer’s Negotiation Considerations

(1) Avoid discussion of price in the initial meetings. It is too sensitive a subject to raise until some personal rapport has been developed. In determining the pricing, always consider what incentive plans must be given to management.

(2) Consider the “social issues” early on.

(3) Make no proposal until you have arrived at a clear understanding of the Seller’s desires and expectations.

(4) With a “cash” transaction, determine in the beginning the “financing” of the deal. Keep in mind that often a Buyer, a lender and the regulators must approve the deal from a cash flow and financial point of view.

(5) If the Seller is unsophisticated enough to allow its existing senior management to negotiate, the Buyer should take advantage of the natural reluctance of management to negotiate “too hard” with its future boss.

(6) It is always important that there is no uncertainty about who is speaking for the Buyer. Also, always make certain the person speaking for the Seller controls the Seller or has authority from the Seller.

(7) Meetings of more than five or six people are less likely to be fruitful.

(8) Be careful of valuing synergies. They rarely exist.
Fair, honest, and straightforward negotiations will produce productive agreements. Any transaction that is “too good” for either side will generate ill will and run the risk of an aborted closing. In order for a transaction to work, it must be viewed as fair to both parties.

E. Price, Currency, Structure, and Other Important Issues

1. Pricing and Currency Issues

If pricing of an acquisition transaction is not the most important issue, then it runs a very close second to whatever is. Granted, although “social issues” play a large role in acquisition transactions and have derailed many through the years, pricing and an understanding of pricing are critical.

a. Stock or Cash as the Currency

When considering an acquisition transaction as either Buyer or Seller, it is imperative to make a decision up front as to whether stock or cash will be the currency. The currency will generally be dictated by the desires of the selling company. If the Seller wants a tax free stock transaction, then a cash transaction will only be acceptable generally if it is “grossed up” for tax purposes, which will often make it prohibitively expensive. Numerous questions arise which should be considered in connection with taking the stock of a holding company or other Buyer. Primary concerns should be as follows:

(i) The number of shares selling stockholders will receive in relation to the perceived value of the community bank’s stock. Is the price acceptable based on the market value of the holding company stock being received?

(ii) The investment quality of the holding company stock at that price. Is the holding company stock a good investment at that price and is it likely to increase in value or is it already overpriced and is more likely to drop?

(iii) The liquidity in the holding company stock to be received. Is the market thin or is there a ready market available for the stock? Although a number of holding company stocks are listed on an exchange and often there are many “market makers” through regional brokerage houses in these stocks, the true market for the stock may be extremely thin.

(iv) Who bears the market risk during the length of time that will transpire between the time an agreement in principle is reached and the time the stock is actually issued to the community bank stockholder so it can be sold?
(v) The taxable nature of the transaction. Will the stock be received in a tax-free transaction so there will be no taxable event unless and until the community bank shareholders sell their new holding company stock?

b. Determining Relative Value of Illiquid Shares

When two community banks are combining for stock and neither bank has a “liquid” currency, then the acquiror and the target must determine the relative value of the two banks and their contribution to the resulting entity. In other words, the banks must determine how large a stake in the new combined company the target represents, which will dictate the value of a share of target stock in terms of stock of the acquiror. This determination is generally based on a “Contribution Analysis”.

To arrive at a relative value of the two institutions and their resulting share in the resulting institution, each bank’s relative contribution of earnings, assets, and equity to the combined resulting holding company should be considered. Because the contribution of a large earnings stream is generally more valuable than the contribution of equity, which is, in turn, more valuable than the contribution of assets, these three criteria should be weighted accordingly. By considering the relative value of each bank’s contribution to the combined entity, and by understanding which category, earnings, equity, assets, contributes more to the long-term value of the combined organization, the two combining banks can determine the relative values of the stock to each other.

c. Pricing

(i) Current Environment of Reduced Price

Once upon a time, in the middle part of this decade, banks were consistently selling for two times book value. As it was not that long ago, it is logical that a potential target bank, whose business has not materially changed, could claim that the value of his bank has not changed either. The fact of the matter, however, is that community banks are operating in a vastly different economic environment, and are selling for significantly lower multiples of book value. Prices are rising, but they are still nowhere near pre-recession levels. Simply put, prices across the board have fallen, and healthy banks are selling for significantly less than what they did five years ago.

(ii) Historical Pricing

“Historical Pricing” is a method of pricing a bank deal by reference to similar deals. A bank will determine its own value by looking at prices paid for banks of similar size and profitability that serve similar markets. The fallacy of this reasoning is that a bank is “worth” only what a willing buyer will pay for it. Valuing a bank by reference to others is rarely, if ever, an effective way at arriving at an accurate value. That is why historical pricing is not considered to be an accurate indicator of a bank’s potential selling price. Historical pricing
can be used to see if an offer is in the correct ballpark, but that is near the extent of its value.

(iii) Price Based on Earnings Stream

As noted, although pricing in bank acquisition transactions is often reported as a multiple of book value, bank acquisition transactions are always priced based on the target’s potential earnings stream and whether it will be accretive or dilutive after the acquisition to the potential acquirer. Whether or not the acquisition will be accretive or dilutive to the acquirer from an earnings per share standpoint is going to depend on the earnings stream that can be generated from the target post-acquisition. This means that cost savings obtained by the acquirer as a result of the acquisition, i.e. general personnel cuts, and revenue enhancements which will be obtained as a result of the target being part of the acquirer’s organization must be considered. Generally, when considering the resulting pro forma reflecting the post-acquisition earnings stream for purposes of pricing the acquisition, the target should be given a significant credit on the purchase price calculation toward cost savings to be obtained by the acquirer. The target generally gets no credit for revenue enhancements, which are items that the acquirer brings to the table, i.e. the ability to push more product that the acquirer already has through the distribution network of the target.

Because most transactions are initially “priced” before obtaining detailed nonpublic information about the target, the potential acquirer generally needs to determine an estimate of cost savings for purposes of running its own model. The general rule of thumb with respect to savings of noninterest expense of the target is as follows:

<table>
<thead>
<tr>
<th>Acquisition Type</th>
<th>% Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Out of Market Acquisition</td>
<td>15 to 20%</td>
</tr>
<tr>
<td>Adjacent Market Acquisition</td>
<td>20 to 30%</td>
</tr>
<tr>
<td>In Market Acquisition</td>
<td>25 to 40%</td>
</tr>
</tbody>
</table>

Once the pro forma earnings stream for the target after the acquisition by the acquirer has been determined, it is fairly easy to determine how many shares or dollars the acquirer could give to the target shareholders without diluting the earnings of its own shareholders. Most acquirors of community banks will not engage in transactions that are earnings per share dilutive, at least that are earnings per share dilutive for very long.

d. Critical Contract Considerations With Respect to Pricing a Stock-for-Stock Transaction

The single most important provision in the acquisition agreement relates to how the price is determined, i.e. at what time will the number of shares to be received by the community bank shareholders actually be determined. This is
important since the value of the stock, particularly if a larger, public holding company is involved, typically fluctuates day to day in the market.

Competing interests between the Selling Bank and the Buyer are clearly present. The community bank’s interest is to structure the price so that the dollar value of the transaction is determined in the contract, but that the number of shares to be received by the community bank increases proportionately as the market value of the holding company stock decreases up to the date of closing.

Conversely, the Buyer’s interest is to structure the transaction so that the value is fixed in the agreement and the number of shares or value of the transaction decreases as the price of the holding company stock increases in the market. These competing desires are usually resolved in one of several ways.

- A fixed exchange ratio that does not change no matter what the stock price is, i.e., a fixed number of shares to the Seller’s shareholders.

- An exchange ratio that fluctuates both up and down but has a collar and a cuff on it so that the amount of fluctuation in the exchange ratio is fixed. If there is a variation in the stock price that goes beyond the collar or cuff, the number of shares does not adjust any further.

Bank stock indices are also often being used as part of the pricing mechanism.

It is also important to obtain a “walk” provision which is utilized in the event the value of the Buyer’s stock drops below a specified dollar amount at a specified time or times. In that event, the Seller’s Board has the right to terminate the agreement without any obligation to proceed further.

As a practical matter, the “walk” provision is generally extremely effective from the Seller’s standpoint. In the unanticipated event that the stock of the Buyer falls below the “walk” price, the community bank always has the opportunity to renegotiate the exchange ratio and thereby retain its flexibility.

The key to the “walk” provision is to determine in advance at what date the holding company stock will be valued. Many acquisition agreements provide for an average value for a twenty-day trading period which ends five days prior to the effective date of the merger. Such a provision, however, may create unnecessary problems in implementation.

It is preferable to have a “walk” provision that has a twenty day period run both from the date of approval by the shareholders of the Selling Bank and from the date of approval of the Buyer’s application by the Federal Reserve Board or other agency. Using these dates gives the community bank two shots at the “walk” provision. This also gives the advantage to the community bank so that if the federal regulatory approval, i.e. the “first walk date,” is obtained prior to the shareholders’ meeting, and the community bank determines to terminate
the transaction, a proxy and prospectus need not be delivered and shareholder vote may never need to be taken.

2. **Social Issues**

Although pricing and pricing considerations are of paramount importance, many transactions stand or fall on social issues. As a result, oftentimes, particularly for a Seller, the negotiation of social issues first makes sense. If the social issues cannot be adequately addressed, then there is generally no need to move on to price discussions. Social issues include the following:

- Who is going to run the bank or company post acquisition?
- What will the company’s or bank’s name be?
- Who will sit on the Board of Directors?
- What will be the compensation of the directors and/or officers remaining?
- What will be the severance provisions for officers and employees who are terminated?
- Will the institution be turned into a branch or remain as an independent charter?
- Will employee benefits change?
- How much autonomy will the Board or advisory board and management have post acquisition?
- How much bureaucracy will be involved post acquisition?

In fact, social and cultural issues are typically the most important considerations outside of pricing.

Even an adequately priced acquisition may never close if the social issues cannot be addressed to the satisfaction of principal players. Address social issues early on.

3. **Merger of Equals**

It is not uncommon for community banks to consider a “merger of equals”. In other words, neither bank considers itself the target. In such situations, banks should be aware that under purchase accounting rules one bank must be designated as the acquiror when accounting for the transaction. Numerous issues are presented in what are purported to be mergers of equals. Often these are referred to as “unequal mergers of equals” not only because one institution must technically be the acquiror for accounting purposes, but generally one institution deems itself to be the acquiror. As
many issues as can possibly be resolved ahead of time should be. Mergers of equals are
difficult to consummate and integrate.

4. Intangible Considerations Associated with the Price and Autonomy

When a Selling Bank considers selling, major concerns on the chief executive’s mind are
generally related to price of the acquisition and autonomy after the acquisition. It is
generally possible to satisfactorily quantify the price provisions and build in certain
protections from market value fluctuations of the holding company stock. It is not as
easy, however, to get a grasp on the issue of autonomy.

The community bank executive must understand, however, that while the acquiring
holding company stresses the substantial autonomy that will be given to its subsidiaries,
in reality, the autonomy dissolves rather quickly as more and more authority is assumed
by the acquiring holding company’s main office.

It is generally true that within two or three years after the acquisition by a larger holding
company, the chief executive officer of the community bank leaves and is replaced with
someone chosen by the holding company. Although there are many reasons for this,
the major one is that a CEO, accustomed to operating his or her own bank subject only
to his Board of Directors, is simply unable or unwilling to adjust to having to respond
to directions from so many people in so many areas in a larger holding company setting.
For this reason, the CEO who is ready, willing and able to retire within a few years of
the acquisition is in the best possible position to negotiate a good deal for his
shareholders. He does not have to be so concerned about his own future at the holding
company and can aggressively negotiate against the people who will be his future bosses
if he stays with the bank after its acquisition.

In general, however, there is an inherent conflict between the desire for autonomy by
the CEO and the best interest of the shareholders. In the usual case, the shareholders’
sole concern is getting the best price in the best currency. If it is not cash, it should be
in a stock that is readily marketable and is expected to at least retain its value. The CEO
must be careful that there is not a trade-off on price to obtain a better deal or more
autonomy for the local Board and management at the expense of the consideration
received by shareholders. Usually the shareholders are not concerned about autonomy
- particularly if it is at their expense.

5. Dividends

The payment of dividends must be considered in any acquisition transaction. Often,
the community bank’s dividend payment history may provide significantly less cash
flow than the dividends that will be received by the community bank shareholders after
application of the exchange ratio in a stock-for-stock transaction. If this is the case,
then acceleration of the closing of the transaction to ensure that the community bank
shareholders are shareholders of record at the time of the dividend declaration by the
acquiring company should be a priority. The worst possible case is that the community
bank does not pay its dividend and misses the acquiring company’s dividend. This is
generally avoided by providing that the community bank can continue to pay its regular
dividend up until the date of closing and that the community bank will be entitled to its pro rata portion of its regular dividend shortly prior to closing if the community bank shareholders will have missed the record date of the acquiring company as a result of the timing of the closing. In other words, the community bank would get its own dividend or the acquiring company’s dividend, but not both. The treatment of dividends must be considered. Since the replacement of the pooling of interest method of accounting, there are no adverse consequences to the payment of an extraordinary dividend. Indeed, many community banks use the extraordinary dividend to reduce their capital account. The payment of an extraordinary dividend in a cash transaction will have no adverse impact.

6. Due Diligence Review

No matter how large the Buyer or whether it is an SEC reporting company, before a Seller’s shareholders accept stock in an acquiring bank or holding company, a due diligence review of that bank or holding company should take place. This is similar to the due diligence review which the Buyer will conduct of the Seller prior to executing the definitive agreement. It is generally best to have disinterested and objective personnel conduct the due diligence review of the acquiror. Several difficulties are generally encountered in connection with this review, not the least of which often times is simply the sheer size of the Buyer whose condition is being evaluated and whose stock is being issued.

An additional and recurrent difficulty involved in the due diligence review is obtaining access to the Buyer’s regulatory examination reports. Although these reports are intended for the use of the Buyer’s company and bank only, it is virtually impossible to justify recommending to the Seller’s Board of Directors and its stockholders that they sell to the Buyer in a stock-for-stock transaction if the due diligence team is denied the right to review the regulatory reports to determine if there are any material considerations that would affect the decision to sell.

It is generally most efficient for the Selling Bank to retain outside experts to either completely conduct the due diligence examination or at least assist and direct the examination with the assistance of key people from the Seller. Individuals who are experienced in doing this type of work will quickly know the areas to focus on, the information necessary to obtain, and can generally facilitate a rapid due diligence review that is of minimum disruption to the Buyer and maximum benefit to the Seller. Most of the experienced and sophisticated Buyers are used to having these reviews performed in their offices and generally they will be cooperative with respect to the process.

Even in a cash deal, prudent Sellers will conduct due diligence on the acquiror to verify that the company has or has access to the cash to execute the deal, and can obtain regulatory approval. In addition, conducting due diligence on a Seller can uncover problems at the front end that would later derail the deal. Spending valuable time and untold thousands of dollars pursuing a deal with no chance of success is an immense waste of time and resources. Due diligence can uncover a host of “under the radar” issues that are imminently important, even to a Seller in a cash deal.
7. **Fairness Opinion**

Another issue that is extremely important to the Selling Bank is that the definitive agreement contain, as a condition to closing, the rendering of a fairness opinion. The fairness opinion is an opinion from a financial advisor that the transaction, as structured, is fair to the shareholders of the Seller from a financial point of view. The fairness opinion will help to protect the directors from later shareholder complaints with respect to the fairness of the transaction or that the directors did not do their job. The fairness opinion should be updated and delivered to the Seller bank as a condition of the Seller bank’s obligation to close the transaction.

Conditioning the closing on the receipt of an updated fairness opinion will also protect the Seller further by permitting it to terminate the transaction in the event of material adverse changes between the time the contract is signed and the closing, which precludes the delivery of the fairness opinion.

8. **Structuring**

A good number of acquisitions, whether large or small, are structured as tax free exchanges of stock. It is imperative that the Seller, its Board of Directors, and shareholders understand the tax ramifications of the transaction as well as the Buyer’s tax considerations in order to fully understand the Buyer’s position in the negotiations.

Any acquisition transaction will be a taxable transaction to the Seller’s shareholders unless it qualifies as a tax free transaction pursuant to the Internal Revenue Code. Although a detailed discussion of the structuring of the transaction and tax considerations is beyond the scope of this outline, it should be noted that often community banks are offered a tax free exchange of stock in the acquiring institution. This will be the result of either a phantom merger transaction or an exchange of shares under state “Plan of Exchange” laws. Under certain circumstance, a transaction can still be tax free for shareholders receiving stock of the Buyer, even though up to 50 percent of the consideration of the transaction is cash.

It is critical that the Seller use a firm that has counsel qualified to review the structure of the transaction. If a transaction is improperly structured, the result may be double taxation to selling shareholders.

It is anticipated that cash transactions will become much more frequent in the near future. From the Seller’s perspective, the obvious advantage to a cash deal involves a “bird in the hand”. Sellers who accept cash are subject to none of the risk associated with taking an equity position in an acquiring bank and have received consideration for their shares that is totally liquid – a big advantage. On the other hand, Sellers for cash are not afforded the upside potential of holding an equity interest. They will not be entitled to dividends or any subsequent appreciation in the value of the acquiror. For better or for worse, Sellers in a cash deal are frequently totally divorced from the bank following the acquisition. In addition, the sale of a bank for cash will be a taxable
transaction. The shareholders will be subject to income tax at capital gains rates to the extent their shares had appreciated in their hands.

9. **Documentation and Conditions to Closing**

Every Buyer or Seller needs to be aware of the basic documentation in acquisition transactions as well as conditions to closing. The basic documentation often used includes:

- Term Sheet
- Definitive Agreement
- Proxy Statement and Prospectus
- Tax and Accounting Opinions
- Due Diligence Report on Buyer
- Fairness Opinion
- Miscellaneous Closing Documents

It is advisable to use some kind of term sheet in a merger or acquisition. A term sheet not only provides a moral commitment, but more importantly, it evidences that there has been a meeting of the minds with respect to the basic terms of the transaction. The definitive agreement is the “big agreement”. The definitive agreement generally runs from 40 to 60 pages and is full of legalese, including significant representations and warranties as well as pricing provisions, covenants that must be obeyed by the selling institution from the time of the signing of the agreement until the closing, and conditions to closing. The conditions to closing generally include financing in a cash transaction, regulatory and shareholder approval in all transactions (since they are generally structured as mergers), the receipt of a fairness opinion and the fact that there has been no material adverse change from the date of the agreement to the date of closing in the target (in a cash transaction) or in either company (in a stock-for-stock transaction).

10. **Dissenting Stockholders**

Since virtually all transactions will be structured as mergers to enable the acquiror to acquire 100% of the target’s stock, the target’s shareholders will generally have dissenters’ rights. In a transaction structured as a merger, the vote of the target shareholders of either 2/3rds or 50%, depending on the applicable law, will require 100% of the shareholders of the target to tender their stock to the acquiror in exchange for either the cash or stock being offered unless such shareholders perfect their dissenters’ rights. The perfection of dissenters’ rights by a shareholder does not permit the shareholder to stop the transaction or keep his stock. It only entitles the shareholder to the fair value of his or her shares in cash. In very few transactions are dissenters’ rights actually exercised for the simple fact that in a stock-for-stock transaction with a listed security, the dissenters can generally sell the stock received and obtain their cash very quickly. In a cash transaction or a stock transaction for a less liquid security, most dissenters do not have a large enough position to make it economically feasible to exercise their rights and pursue the appraisal and other remedies available. Historically, most transactions were conditioned upon no dissent in
excess of 10%. This was due to some requirements for pooling of interest accounting. Even with the disappearance of pooling of interests accounting, it is likely that most transactions will retain a 10% or less dissent limitation in order to give the Buyer some certainty as to the price that will be paid and the support of the shareholder base for the transaction.

It should be noted that by exercising its dissenters’ rights, a shareholder is committing to accepting the value of the shares as determined by a Court. This can be a gamble. If the Court determines that the stock is worth less than what is being offered by the acquiring bank, the shareholder receives less.

11. Aspects of Securities Law Issues

Although a thorough discussion of securities law issues is beyond the scope of this outline, virtually any acquisition, including a stock exchange by Selling Bank shareholders for a Buyer’s security, will need to be approved by the Selling Bank shareholders. This will require the preparation of a prospectus (for the issuance of the stock) and a proxy statement (to obtain the vote of the shareholders). There is often a temptation from the Selling Bank to allow the Buyer, particularly if it is a larger holding company, to totally handle the disclosure process for the prospectus-proxy statement. The Seller must remember that to the extent the document is a proxy statement for a special meeting of the Seller’s shareholders, it is also a securities disclosure statement of the Selling Bank and must contain all material and proper disclosures about the Selling Bank. As a result, it is imperative that counsel, accountants, and management of the Selling Bank be actively involved in the disclosure process.

Of more practical importance than the preparation of the disclosure material to the Board of Directors and shareholders of a target company in a stock-for-stock acquisition is whether their stock will be restricted from immediate sale once received. As a practical matter, in most stock-for-stock acquisitions with larger holding companies that are listed on an Exchange, a condition of the transaction is that the stock be registered by appropriate filings with the Securities and Exchange Commission. Registered stock, once received by shareholders of the target company who are not “affiliates” (insiders) of the target, can be sold immediately. Affiliates of the target, defined as directors, executive officers or shareholders holding in excess of 5% of the target’s stock, are restricted from sale under the Securities and Exchange Commission Rules 144 and 145. Although these Rules are lengthy and complicated, as a practical matter, an affiliate receiving restricted shares in connection with an acquisition only can dispose of those shares under the following basic conditions:

- The sale must occur through a broker.

- The affiliate cannot sell more than 1% of the stock of the acquiring company in any three-month period (this is usually not a problem since typically, no shareholder in a community bank receives more than 1% of the acquiring company’s stock as part of the transaction).
- An affiliate is subject to a holding period of six months, during which, sale of the securities is disallowed.

F. **Directors’ and Officers’ Liability Considerations**

Directors of a corporation (a bank and/or its holding company) are elected by shareholders and owe those shareholders the fiduciary responsibility to look out for the shareholders’ best interest. Directors fulfill this fiduciary responsibility by exercising to the best of their ability their duties of loyalty and care. A director’s duty of loyalty is fulfilled when that director makes a decision that is not in his or her own self-interest but rather in the best interest of all shareholders. A director’s duty of care is fulfilled by making sure that decisions reached are reasonably sound and that the director is well-informed in reaching those decisions. In traditional settings, courts will rarely second-guess a Board of Directors’ decision unless a complaining shareholder can clearly prove self-dealing on the part of the Board of Directors or that the Board of Directors behaved recklessly or in a willfully or grossly negligent manner. The burden is on a complaining shareholder to show that the Board did not act properly in fulfilling its fiduciary duties.

In sale transactions (sale of business, merger, combination, etc.), Boards of Directors are subject to “enhanced scrutiny” in reaching important decisions regarding the sale of the business. Boards of Directors must be able to demonstrate (1) the adequacy of their decision-making process, including documenting the information on which the Board relied on reaching its decision, and (2) the reasonableness of the decision reached by the directors in light of the circumstances surrounding the decision. In a sale of business setting, the burden shifts to the directors to prove that they reasonably fulfilled their fiduciary duties. The following is a partial list of actions that would be appropriate for a Board of Directors to take in reviewing or in making a decision whether to merge and/or be acquired or accept a tender offer in most situations:

1. The Board should inquire as to how the transaction will be structured and how the price of the transaction has been determined.

2. The Board should be informed of all terms within the merger agreement, acquisition agreement or tender offer.

3. The Board should be given written documentation regarding the combination, including the merger agreement and its terms.

4. The Board should request and receive advice regarding the value of the company which is to be bought and/or sold.

5. The Board should obtain a fairness opinion in regard to the merger.

6. The Board should obtain and review all documents prepared in connection with the proposed merger, acquisition or tender offer.

7. The Board should seek out information about national, regional and local trends on pricing a merger or acquisition.
8. Finally, the Board members should be careful not to put their own interests above the interests of the shareholders. If directors’ deferred compensation or other agreements exist between the corporation, they must be negotiated but not serve as a block to a transaction that would otherwise be in the best interests of shareholders.

The whole concept of “enhanced scrutiny” has arisen from (and, for that matter, is still being developed) by a number of Delaware Supreme Court decisions relating to hostile and/or competitive acquisition transactions. A great amount of material has been written attempting to explain the impact of these Delaware Supreme Court decisions. Not everyone agrees on exactly what these decisions mean, and lawyers and Boards of Directors continue to grapple with exactly what Boards must do to survive the “enhanced scrutiny” that courts will place on Boards of Directors in a sale of business transaction. Despite the lack of absolutely clear guidance on what Boards must do to survive the test of enhanced scrutiny, a number of general rules are becoming apparent. These include the following:

1. In a sale of business transaction, the Board of Directors must assure itself that it has obtained the highest price reasonably available for the shareholders, but this does not necessarily mean that the Board of Directors must conduct an “auction” to obtain that price.

2. The Board of Directors is obligated to “auction” the business if there is a “change in control.” For example, if the selling shareholders will trade their shares of stock for shares of the acquiror and the acquiror has a dominant, control shareholder, then an auction is required to assure that the selling shareholders receive the highest price and the best type of consideration.

3. In the absence of a large control shareholder, an auction is not necessarily required if the selling shareholders receive stock of the acquiror and that stock is freely tradable on an established market.

4. If the shareholders are to receive cash in exchange for their shares, an auction may be required. At a minimum, the directors must determine that they have agreed to the best available transaction for shareholders. Directors may be able to rely on publicly available pricing data for comparable transactions in reaching this conclusion.

5. In any case, directors should obtain a fairness opinion from a qualified valuation expert as to the fairness of the transaction to shareholders from a financial point of view. Directors can use this fairness opinion as a major component in satisfying their duty of care to the shareholders and surviving the “enhanced scrutiny” that the courts will impose.

Boards of Directors involved in any type of sale process or sale evaluation must take extra steps to assure that they are fulfilling their enhanced fiduciary responsibilities to the shareholders. Using board committees, specialized counsel and consultants to help the Board structure the “process” of evaluating a sale is absolutely critical to fulfilling the Board’s responsibilities.
II. ACQUISITION ACCOUNTING UNDER FASB 141(R)

Prior to 2002, Accounting for bank transactions used the pooling of interests method. This was a fairly simple method where the acquiror basically combined the balance sheets for the two institutions and went on their way.

In 2002, the pooling of interests method was replaced by the Purchase Method of accounting. That method was used until the end of 2008, when it was replaced by the “Acquisition Method” beginning in January 2009. The Acquisition Method and the Purchase Method are very similar, with some minor differences.

The first step in acquisition accounting is determining the acquiror. Each and every bank transaction (even a “combination” between two mutuals) must have an identified acquiror and an identified target.

After the acquiror has been identified, the second step is determining the acquisition date. This is typically the day the Articles of Merger are filed, or the date specified in the Articles of Merger as the transaction effective date. This date is important because everything in the transaction is tied to the acquisition date.

The third step in accounting for a bank transaction is valuing each of the target’s assets and liabilities. FASB 141(R), the accounting pronouncement that implemented the Acquisition Method of accounting, requires that the target’s assets and liabilities be transferred to the acquiror at their “fair value” on the acquisition date.

One of the difficulties in accounting for a bank merger is determining the fair value of the assets acquired as of the date of the transaction. Certainly cash is not hard, but this task can be difficult when acquiring securities or, more importantly, loans.

The fair value of loans is not necessarily what the target bank paid to acquire the loan or the face value or ledger balance of the amount outstanding. Instead, the loan’s fair value is determined by an accountant following the transaction, and is dependent on a number of factors, including, but not limited to:

- Interest rate of the loan;
- Term of the loan;
- Loan type;
- Collateral;
- Borrower credit ratings;
- Adjusted vs. fixed rate; and
- Premium/discount on interest rate variances.
The rules for purchase accounting allow some homogeneous loan pools to be valued on an aggregate basis. However, FASB 141(R) requires the more complicated commercial loans to be individually valued. This will certainly drive up acquisition costs because it will require more professional labor.

After the initial valuation of the loans, the bank is required to record, adjust and track the “difference” between the face value and fair value of each loan or loan pool. These periodic adjustments result in income or expense based on the initial valuation, and whether the loans were valued at less or more than the outstanding balance at the time of the acquisition.

Generally, a bank’s liabilities are easier to value. The fair value of a deposit liability is generally thought to be the amount owed on the account. There may be some variation for other liabilities, but for the most part, the liabilities are what they are as presented on the balance sheet.

Once an acquiror has determined the fair value for a target’s assets and liabilities, it can determine the equity and whether any goodwill will be recognized. The equity in a bank transaction is the net difference between the fair value of the assets and the fair value of the liabilities. For example, where the fair value of the target’s assets is determined to be $88 million and the fair value of the liabilities is determined to be $80 million, the equity would be $8 million, the difference between the two.

Once the amount of equity has been identified, the next step is valuing the purchase consideration. According to FASB 141(R), there are two separate components to total consideration. These include (1) the fair value of the consideration offered on the date of purchase (cash, acquiror stock or something else) plus (2) the fair value of any non-controlling interest the acquiror may hold in the acquiree (for example, if a bank holding company owned 25% of a bank and bought the other 75%, the fair value of the 25% ownership would be included in the purchase price). FASB 141(R) requires that the consideration be valued as of the acquisition date.

The requirement that the consideration be valued as of the acquisition date is a departure from the old accounting rules. Formerly, acquirors could choose a “convenience date” somewhere close to the date of acquisition or could use an average of some time period close to the acquisition to value the consideration. This was especially helpful when stock was used as consideration. FASB 141(R) did away with such “convenience accounting” and now requires that the stock consideration (or other consideration) be valued as of the date of closing.

After establishing the target’s equity and the value of the consideration, the final step in the acquisition accounting method is to determine whether the transaction results in negative goodwill or goodwill. A transaction results in negative goodwill if the purchase consideration is less than the equity. The negative goodwill is equal to the difference between the two. For example, an acquiror would recognize $500,000 in negative goodwill if they completed a purchase of a target with $9 million in equity for $8.5 million. FASB 141(R) requires the negative goodwill to be recognized as income immediately.
As a practical note, if a bank determines that a transaction will result in negative goodwill, FASB 141(R) requires that the bank go back and reestablish fair values for the assets and liabilities before the negative goodwill is recognized as income. This requirement serves as a “double check” to make sure the assets and liabilities have been valued properly.

Most transactions will typically not result in negative goodwill. Instead, it is more likely that the purchase price will exceed the target’s equity. In this situation, the excess of the purchase price over the equity (which is referred to as the “purchase premium”) will be split between two intangibles: a core deposit intangible and goodwill.

The core deposit intangible represents the amount a bank may be willing to pay for the opportunity to acquire core deposits. This asset is amortized over the useful life of the asset for book purposes (generally seven to 10 years), and is amortized over a 15-year period for tax purposes.

The amount of goodwill an acquiror must recognize is equal to the purchase price premium minus the amount allocated to the core deposit intangible. Goodwill is not amortized, but is rather tested periodically for impairment.

It is impossible to determine exactly what amount of a purchase premium is attributed to the core deposit intangible and what amount will be attributed to goodwill using some mathematical formula. Instead, the accounting firm handling the transaction will perform a core deposit intangible study to determine the value of the intangible. These values are generally based on the cost to acquire the deposits, as well as the income that may be attributable to them.
III. BUYING OR SELLING A BRANCH

Buying or selling a branch of a bank may initially appear to be a relatively simple and straightforward task. However, because of the unique circumstances presented from selling or buying only a single unit of a bank, the process can contain as many, or more, stumbling blocks as would an acquisition of the entire bank. Yet, the acquisition or sale of a single branch or a limited number of branches rather than merging or acquiring an entire bank can prove to be a very profitable venture for your bank. Community banks, especially, may find that the acquisition of a branch of another bank is the best strategic alternative for expanding its geographic reach without engaging in a merger with some other entity and without the consideration of interstate banking or branching. Likewise, larger banks and regional banks often find it helpful to spin off less profitable branches or branches from a recent acquisition in order to streamline operations and concentrate the bank’s focus on more limited areas.

Whatever the circumstances, the initial step in any decision to purchase or sale a branch bank is an analysis of all the relevant factors which help determine whether the branch acquisition or sale will be profitable. Moreover, as part of the decision making process, significant consideration should also be given to the premium (if any) to be paid, the regulatory application and approval process, accounting considerations and operational issues. Each of these issues is discussed further in the material that follows.

A. Analysis

The analysis for buying or selling a branch generally focuses on financial issues, strategic issues and managerial or operational issues.

1. Financial Issues.

From a financial standpoint, a potential buyer should, obviously, seek transactions which provide advantages for earnings per share appreciation, increases in the bank’s price/earnings ratio and which provide appropriate utilization of excess capital. Likewise, potential sellers, by analyzing these factors, can quickly ascertain those candidates which are likely to provide the seller with the best offer.

2. Strategic Issues.

Strategic issues are also a key in analyzing any potential purchase or sale of a branch. The decision to purchase a branch may provide advantages for new market entrance and growth potential, economies of scale, elimination of competition and enhanced image and reputation.

New market entrance is often the key factor motivating a decision to acquire a branch. Such an acquisition allows your bank to extend its market reach into new areas without engaging in a costly construction and chartering process for a new bank and facility. Often, banks will look for branch acquisition candidates in markets from which the bank is already drawing some limited loan or other type of business. In this manner, your bank can be seen as trying to improve customer relations by bringing the bank to the customer rather than asking the customer to come to the bank. Thus, your bank is able to become an active competitor in an area where, perhaps, the bank has had only limited access in the past. Most targeted branches are those in which management of the acquiring bank anticipates growth potential to be significant. As an initial branch acquisition strategy, your bank might want to consider the acquisition of branch banks in communities where members of management or directors have their residence. This often provides the bank with an instant marketing tool by having someone with an established reputation in the community who can bring immediate credibility, name recognition and business to the branch and its lead bank.

b. Economies of Scale.

Economies of scale may be another key advantage that a potential acquiror should analyze in making a branch acquisition. The ability to minimize per unit operating costs and other overhead items while increasing profitability could be of significance with large branch acquisitions or multiple branch acquisitions. This factor may not play as prominent a role, though, with small branch acquisitions.

c. Elimination of Competition.

One of the most common reasons for branch acquisitions is the simple elimination of competition. Assuming a transaction does not run afoul of regulatory anti-trust concerns, the elimination of competition may be one of the best ways for the bank to increase its profitability.

d. Enhanced Image and Reputation.

The one intangible advantage that may be gained through branch acquisition and which should be considered in the initial analysis, is the potential for enhanced image and reputation. The acquisition of a branch gives the acquiring bank an image of stability, success and profitability. Unlike merger transactions in which it often may appear that each party is losing something or, at best, that each party benefits equally, a branch purchase by your bank only improves your bank’s image as growing, successful and profitable.

From a seller’s standpoint, each of these areas can, conversely, be reasons for disposing of a branch. For example, selling a potentially unsuccessful branch or a branch that is constantly a drain on earnings may free up additional capital and sources of funds in order to allow the bank to make entrance into other
new markets. Likewise, a selling bank may have a need to acquiesce as a competitor in one geographic area through the sale of its branch in order to more effectively compete in other areas in an attempt to limit competition there. The sale of a branch may also help a bank enhance its image and reputation, if handled appropriately, especially if the branch had become a drain on the bank’s earnings. The elimination of unprofitable ventures is always a sign that management is in the business of maximizing shareholder value.

3. Managerial and Operational Issues.

Managerial and operational issues should not be overlooked in analyzing a decision to buy or sell a branch. In making an acquisition, one of the things you may or may not be buying is personnel. It is often beneficial for an acquiring bank to retain one or more employees of a branch in order to provide continuity in the office and the community by having someone who is knowledgeable of the market area and who will provide customers with a recognizable face. Maintaining such personnel often helps an acquiring bank maintain many of the elements which made the branch an attractive candidate in the first place, e.g. strong loan demand, established deposit base, healthy fee income. However, an acquiring bank should also be aware that the selling institution may be unwilling to sacrifice key personnel in an acquisition or the employees may be unwilling to change their employer. Accordingly, an acquiring bank should anticipate at least a small runoff in the loan demand and deposit base as a result of an acquisition.

Each of these areas of analysis should help banks frame the issues of concern in choosing acquisition targets or potential buyers, formulating an acquisition or sale strategy and in proceeding to the next step of reaching an offer or sale price.

B. Premium (Purchase Price)

The acquisition or sale of a branch, unlike a merger, is structured as a purchase of assets and assumption of liabilities or “P&I” transaction. A purchase and assumption transaction implies that the transaction will be accomplished through a purchase of the branch’s assets (primarily loans and other earning and non-earning assets, including fixed assets) and, in turn, an assumption of the branch’s liabilities (primarily deposit accounts). The amount which an acquiring bank pays over and above the differential of the assets purchased as offset by the liabilities assumed is known as the premium. The premium to be paid is a negotiated amount which is often subject to adjustment based on the purchaser’s due diligence review of the branch.

In conducting a due diligence review, the most obvious, but primary, questions to ask are: What assets do I want to purchase? What liabilities do I want to assume? Which employees do I want to retain? Are there any regulatory concerns specific to this branch?

1. Assets Purchased.

Because the purchase price may be adjusted by the number and volume of loans purchased and/or the number and volume of problem loans retained by the selling
bank, an acquiring institution should carefully scrutinize the branch’s assets. In a purchase and assumption transaction, it is not mandatory that all assets be purchased or that all liabilities be assumed. Commonly, though, all deposit liabilities are assumed and all non-problem loan and earning assets are purchased. Thus, a purchase and assumption transaction should be structured with specific provisions relating to the quality of assets which requires the selling institution to buy back loans which, within a designated time frame, are considered to be problem loans and/or uncollectible loans. Any due diligence review of assets, therefore, should also include a review of the selling bank’s past due list, watch list and nonaccrual list. If the acquiring bank “puts back” any problem loans or if the seller agrees to retain certain loans or other assets, an appropriate adjustment will be made to the purchase price.

Additionally, an acquiring and selling bank must decide which fixed assets will remain with the branch in order to reach an appropriate purchase price. A branch acquisition may (but need not) include the acquisition of the actual building, real estate, equipment and furniture of the branch.

2. Liabilities Assumed.

As stated above, in most circumstances, all deposit liabilities are assumed along with other specifically enumerated liabilities, and accordingly, there is limited due diligence review relating to this area. However, lease contracts, service contracts and other similar obligations should be reviewed in light of the premium to be paid. Also, the failure to assume all deposit liabilities in a transaction will often prompt heightened regulatory scrutiny.

3. Regulatory Concerns.

Regulatory concerns should be the other primary focus of a due diligence review and in consideration of an offering or selling price. A purchaser should specifically review the selling bank’s CRA Statement as it relates to the branch and the seller’s CRA file. As a purchaser, if you detect CRA problems, this should affect the proposed purchase price for the branch. On the other hand, if the selling bank has an excellent CRA record and, especially if the branch is in a low to moderate income neighborhood or has a high degree of CRA loans, the purchase and assumption transaction will face further regulatory scrutiny to insure that the acquiring bank can continue to meet the needs of the community. Accordingly, the purchase price may need to be adjusted to account for the purchaser’s increased liability and regulatory burden.

C. Regulatory Approvals and Applications

Depending on the nature of the purchaser and seller in a branch acquisition, the transaction could be subject to regulatory scrutiny by one or more of the Federal Reserve, the FDIC, the OCC and state banking departments. The table below sets forth the regulatory agencies which would typically be involved in a branch purchase and assumption transaction, depending on the nature of the parties involved.
### Regulatory Process Table

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<th>Purchaser</th>
<th>Seller</th>
<th>Regulatory Agencies</th>
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<td>State Bank</td>
<td>FDIC, State Banking Department</td>
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<td>State Member Bank</td>
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<td>State Member Bank</td>
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<td>State Nonmember Bank</td>
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<td>National Bank</td>
<td>Thrift</td>
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As you can see from the table above, completing the regulatory process appears, at first blush, to be a daunting task. However, the most prominent agency in the regulatory process will be the acquiring bank’s primary regulator. In most instances, the other regulators will simply request a copy of the primary regulator’s application form and will give the application a cursory review. In these circumstances, the secondary regulators will generally defer to the review of the acquiring bank’s primary regulator, unless some extraordinary reason not to approve the transaction is discovered.

Submitting copies of the applications to the secondary regulators simply notifies them of the transaction. For example, if a state non-member bank is acquiring a national bank branch, the FDIC and the acquiring bank’s state banking department are its primary regulators. The OCC, as the primary regulator of the selling institution, may request a copy of the State and FDIC applications, but because the OCC has no actual authority to approve or deny the application, the OCC will defer to the judgment of the State and FDIC. The OCC simply needs to be notified that a national bank branch will no longer be in existence. Likewise, if a national bank is acquiring a branch of another national bank, although the OCC is the primary regulator of
both entities, the state banking departments will often request a copy of the OCC application in order that they may keep track of the number of bank branches in their state, even though they have no actual review authority over the transaction.

The Federal Reserve becomes an active participant in the regulatory process whenever the purchasing bank is a member of the Federal Reserve System. Although the Federal Reserve will, again, simply request a copy of the application of the acquiring bank’s primary regulator, the Federal Reserve will perform an independent review of the application and provide its own comments on the transaction.

The total time to obtain regulatory approval, regardless of the regulatory agencies involved, is generally between 60 and 120 days. During this review period, two primary concerns of the regulators will be the financial impact of the transaction on the acquiring bank and any anti-competitive anticipated effects that may result.

1. **Financial Impact.**

One of the primary regulatory concerns for a branch acquisition relates to the financial impact on the acquiring bank as a result of the transaction. The regulatory agencies will closely scrutinize the ability of the acquiring bank to appropriately fund the acquisition and maintain its capital adequacy. Each regulatory agency will require the entities involved in a purchase and assumption transaction to provide specific data regarding the pro forma financial results of purchasing the branch assets and assuming the branch liabilities. The regulatory process will also require the purchasing entity to provide projections as to any anticipated increase in income and operating expenses resulting from the branch acquisition.

2. **Anti-Competitive Effect.**

Secondly, and perhaps equally as important, the regulatory agencies will scrutinize the transaction to determine whether there will be any resulting anti-competitive effects. As a result, the regulatory applications will often require the purchasing institution to provide an analysis of the deposit base in the market area of the branch to be acquired, detailed statistical information regarding local economic activity and information regarding the proposed lending activities, interest rates and fee charges the acquiring bank intends to implement. The focus of this element of the regulatory review process is to determine whether the acquisition will tend to lessen competition in the area to such a degree that the acquiring institution would have too much of a concentration of the market deposits, assets and the like.

In order to accurately assess the anti-competitive effects of such a branch transaction, the applicant will be required to complete a Herfindahl-Hirschman Index (HHI). The HHI worksheet provides the regulators with a thumbnail sketch of the total market share of deposits of the acquiring institution as a result of the transaction. If the bank, as a result of the acquisition of the branch, will have a market share of deposits in the relevant market area in excess of 20 percent, the acquiring institution must then follow other technical steps in the Herfindahl-Hirschman worksheet to determine whether the acquisition will result in a concentration of deposits such that anti-competitive effects
would be presumed to occur. If the market share is less than 20 percent, the acquiring institution will automatically “pass” the test and, subject to other regulatory scrutiny, can proceed with the acquisition. Accordingly, the more rural the area for the proposed acquisition and the fewer number of banks there are, the more likely it is that an acquisition will cause anti-competitive effects by allowing one institution to have a dominant share of market deposits. The efforts by the regulators are an attempt to allow relevant market areas to remain unconcentrated in terms of deposits and the number of banks.

D. Operational Issues

Some of the key operational issues that are confronted in buying or selling a branch have been previously discussed in these materials. Other issues include the sensitive issues of trying to determine which employees of the branch will be retained and how to adjust their compensation and any retirement benefits into the purchasing bank’s system. Likewise, the due diligence review may turn up difficulties in adapting the branch’s loan files, operating systems and other functions into the purchasing institution’s systems. Oftentimes, the conversion process can be one of the more difficult aspects of the transaction.

Another key operational issue which is often overlooked is the relationship among the purchaser and seller following the transaction. Of primary concern will be the ability of the seller to reestablish a branch or similar facility in the area in which the branch has been sold. In order to alleviate concerns in this area, it is most beneficial to have the parties execute a non-compete agreement.

Generally, such an agreement would prohibit the selling institution from opening a branch office, loan production office or any other banking facility within a designated geographic area for a specified period of time. The legality and enforceability of such non-compete agreements will depend upon the reasonableness of the geographic scope and time limitations in the agreement.
IV. CONCLUSION

Regardless of how many changes occur in the banking industry, every director and officer of the community bank is charged with allocating financial and managerial capital to enhance value for the community bank’s shareholders. As the industry continues to consolidate and banks across the nation seek new areas of growth, it is incumbent upon community bank directors and officers to strategically position their bank for success now and in the future. It may be impossible to predict what new regulations or economic changes will occur over the next 20 years, but one thing is certain – community banks, regardless of size, always have and always will play a critical role in the nation’s success. Although the worst of the Great Recession is behind us, the nation has yet to fully recover. Although there are new challenges, community banks remain in the optimal position to strengthen the communities and small businesses that serve as the backbone of our nation.

We hope these materials assist your bank’s board of directors and senior management team in its achieving success in the future. If our firm can ever be of any assistance, please do not hesitate to let us know.
BIOGRAPHICAL INFORMATION

JEFFREY C. GERRISH. Mr. Gerrish is Chairman of the Board of Gerrish McCreary Smith Consultants, LLC and Gerrish McCreary Smith, PC, Attorneys. The two firms have assisted over 1,500 community banks in all 50 states across the nation. Mr. Gerrish's consulting and legal practice places special emphasis on strategic planning for boards of directors and officers, community bank mergers and acquisitions, bank holding company formation and use, acquisition and ownership planning for boards of directors, regulatory matters, including problem banks, memoranda of understanding, cease and desist and consent orders, and compliance issues, defending directors in failed bank situations, capital raising and securities law concerns, ESOPs and other matters of importance to community banks. He formerly served as Regional Counsel for the Memphis Regional Office of the FDIC with responsibility for all legal matters, including all enforcement actions. Before coming to Memphis, Mr. Gerrish was with the FDIC Liquidation Division in Washington, D.C. where he had nationwide responsibility for litigation against directors of failed banks. He has been directly involved in fair lending, equal credit and fair housing matters, in raising capital for problem financial institutions and in numerous bank merger transactions. Mr. Gerrish is an accomplished author, lecturer and participates in various banking-related seminars. In addition to numerous articles, Mr. Gerrish is also the author of the books "Commandments for Community Bank Directors" and "Gerrish's Glossary for Bank Directors". He writes a regular blog, “Gerrish on Community Banking,” for the Banking Exchange, www.bankingexchange.com. He also is or has been a member of the faculty of the Independent Community Bankers of America Community Bank Ownership and Bank Holding Company Workshop, The Southwestern Graduate School of Banking Foundation, the Wisconsin Graduate School of Banking, the Pacific Coast Banking School, the Colorado Graduate School of Banking and has taught at the FDIC School for Commissioned Examiners and School for Liquidators. He is a member of the Board of Regents of the Paul W. Barret, Jr. School of Banking. He is a Phi Beta Kappa graduate of the University of Maryland and received his law degree from George Washington University's National Law Center. He is a member of the Maryland, Tennessee and American Bar Associations, was selected as one of “The Best Lawyers in America” 2005 through 2014 and as the Banking Lawyer of the Year, Best Lawyers Memphis, 2009. Mr. Gerrish can be contacted at igerrish@gerrish.com.

Gerrish McCreary Smith Consultants, LLC and Gerrish McCreary Smith, PC, Attorneys offer consulting, financial advisory and legal services to community banks nationwide in the following areas: strategic planning; mergers and acquisitions, both financial analysis and legal services; dealing with the regulators, particularly involving troubled banks, memoranda of understanding, cease and desist and consent orders, and compliance; structuring and formation of bank holding companies; capital planning; employee stock ownership plans, leveraged ESOPs, KSOPs, and incentive compensation packages; directors and officers liability; new bank formations; S corporation formations; going-private transactions; and public and private securities offerings including trust preferred securities.
### Mergers & Acquisitions
- Analysis of Business and Financial Issues
- Target Identification and Potential Buyer Evaluation
- Preparation and Negotiation of Definitive Agreements
- Preparation of Regulatory Applications
- Due Diligence Reviews
- Tax Analysis
- Securities Law Compliance
- Leveraged Buyouts
- Anti-Takeover Planning
- Going Private Transactions
- Financial Modeling and Analysis
- Transaction Pricing Analysis
- Fairness Opinions

### Bank and Thrift Holding Company Formations
- Structure and Formation
- Ownership and Control Planning
- New Product and Service Advice
- Preparation of Regulatory Applications
- Financial Modeling and Analysis

### New Bank and Thrift Organizations
- Organizational and Regulatory Advice
- Business Plan Creation
- Preparation of Financial Statement Projections
- Preparation of the Interagency Charter and Federal Deposit Insurance Application
- Private Placements and Public Stock Offerings
- Development of Bank Policies

### Financial Modeling and Analysis
- Financial Statement Projections
- Business and Strategic Plans
- Ability to Pay Analysis
- Net Present Value and Internal Rate of Return Analysis
- Mergers and Acquisitions Analysis
- Subchapter S Election Analysis

### Bank Regulatory Guidance and Examination Preparation
- Preparation of Regulatory Applications
- Examination Planning and Preparation
- Regulatory Compliance Matters
- Charter Conversions

### Taxation
- Tax Planning
- Tax Controversy Negotiation and Advice

### Alternative Dispute Resolution
- Arbitration
- Mediation*

*J. Franklin McCreary is a Rule 31-listed Mediator*

### Strategic Planning Retreats
- Customized Director and Officer Retreats
- Long-Term Business Planning
- Assistance and Advice in Implementing Strategic Plans
- Business and Strategic Plan Preparation and Analysis
- Director Education

### Capital Planning and Raising
- Private Placements and Public Offerings of Securities
- Bank Stock Loans
- Capital Plans

### Subchapter S Conversions and Elections
- Financial and Tax Analysis and Advice
- Reorganization Analysis and Restructuring
- Cash-Out Mergers
- Stockholders Agreements
- Financial Modeling and Analysis

### Problem Banks and Thrifts Issues
- Examiner Dispute Resolution
- Negotiation of Memoranda of Understanding and Consent Orders
- Negotiation and Litigation of Administrative Enforcement Actions
- Defense of Directors in Failed Bank Litigation
- Management Evaluations and Plans
- Failed Institution Acquisitions
- New Capital Raising and Capital Plans
- Appeals of Material Supervisory Determinations

### General Corporate Matters
- Corporate Governance Planning and Advice
- Recapitalization and Reorganization Analysis and Implementation

### Executive Compensation and Employee Benefit Plans
- Employee Stock Ownership Plans
- 401(k) Plans
- Leveraged ESOP Transactions
- Incentive Compensation and Stock Option Plans
- Employment Agreements-Golden Parachutes
- Profit Sharing and Pension Plans

### Estate Planning for Community Bank Executives
- Wills, Trusts, and Other Estate Planning Documents
- Estate Tax Savings Techniques
- Probate

### Other
- Public Speaking Engagements for Banking Industry Groups (i.e., Conventions, Schools, Seminars, and Workshops)
- Publisher of Books and Newsletters Regarding Banking and Financial Services Issues
POWERPOINT PRESENTATION
The Future of Community Banking

Jeffrey C. Gerrish
Gerrish McCready Smith, Consultants & Attorneys
jgerrish@gerrish.com

2015 IBA Bank Management Conference
Embassy Suites on the River, Des Moines, Iowa
March 11-12, 2015

Overview

• Voices from the Past – Predictions from 2000

• The Current Environment

• Current Predictions/Success for the Future
Predictions from the Year 2000: Community Banking 2020

- Prediction: Community Banks will be Alive and Well
- Prediction: Aging and Well-Educated Population with Elderly Dominant and Desire for Yield and Share Liquidity
- Prediction: Dramatic Increase in Hispanic Population
- Prediction: Rapid Technology Expansion
  - Actual Prediction — “It is likely the computers will be like Timex watches”
  - Be a fast follower

Predictions from the Year 2000: Community Banking 2020 (Cont’d)

- Prediction: Increased Competition
  - Actual prediction — More intense and more technology driven
  - Credit unions are larger
  - Bigger banks more predatory
  - Community banks must be niche player

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Page 2
Predictions from the Year 2000: Community Banking 2020 (Cont’d)

- Prediction: Consolidation would be over – boy, that was wrong!
  - Apparently missed the unanticipated Great Recession
  - 6,500 banks (close today)
- Prediction: Increased de novo banks
  - Accurate through year-end 2007 (956 de novos from 2000 to 2007)
  - Since beginning of 2008, 96 de novos (only 3 since 2010)

Predictions from the Year 2000: Community Banking 2020 (Cont’d)

- Prediction: More leisure time for the masses
  - Less loyal customer base
  - Less ties to the community
- Prediction: Communications will be cut to split seconds through one instrument that will serve as a phone, a pager, Internet connection and who knows what else
- Prediction: Increase in Sub S institutions/liberalization of requirements

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Page 3
Predictions from the Year 2000: Community Banking 2020 (Cont’d)

• Prediction: One-stop shopping – third party vendors
• Prediction: Trade association consolidation
• Prediction: No taxation of credit unions

The Current Environment

• Improving Overall Financial Performance
• Continued Consolidation
• Regulators Are Lightening Up on Safety and Soundness
• Community Banks Continue to Focus on Profitability
• Balance Sheet Growth is Not the Norm
• Interest-Rate Risk is Coming… Still
• Compliance is Here to Stay
How to be Successful in the Future

- Focus on Your Constituents
  - Shareholders: Enhancing Shareholder Value
  - Employees: Become the employer of choice
  - Customers: Become “the” community bank
  - Community: Be the good corporate citizen

How to be Successful in the Future (Cont’d)

- Plan for it or it will not happen
- Focus on Making Money
- Build Relationships that Last
  - Use of Technology
  - Use of In-Person Business Development
- Get in the Right Structure/Ownership
  - Holding Company
  - Sub S
  - Public/Private

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Page 5
How to be Successful in the Future (Cont’d)

- Consider an Acquisition Strategy
  - Buy
  - Sell
  - Remain Independent – an “Active” Strategy
- Develop Young Leadership
- Get the Right Board – Assure Management and Board Succession

How to be Successful in the Future (Cont’d)

- If you are a family bank, deal with the family ownership succession and management succession issues
- Understand how to obtain capital and don’t be afraid of it
- Remember always – the regulators will be regulators
Predictions for 2030

- Competitive Advantage for Community Banks – Small Business Ag Lending/Relationship Banking
- Fewer Overall Banks (5,000 or so)
- More Tech/More Mobile
- Fewer and Smaller Bank Locations, Branches, Kiosks and the Like
- Continuing Evolving New Payment Systems and Methods
- Delivery Mechanisms That We Have Not Yet Contemplated
- The Survival of the Numerous Family-Owned Banks
- Larger Community Bank Size

Conclusion

- Community banking has a strong future
- Plan for it or it will not happen
- Be a significant part of it in your community
- Community banks have been through the “worst” – the sow’s ear. Now, go for the best – “the silk purse.”
Contact

Please contact us if we can be of service to you or your organization, or if you simply have further questions where we may be of assistance.

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The Future of Community Banking

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2015 IBA Bank Management Conference
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IOWA BANKERS
ASSOCIATION

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Page 8
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**The Bank Directors’ Bible:**

**Commandments for Community Bank Directors**

Now in its third edition, this 221 page book represents a compilation of the noted “Ten Commandments” articles published by Gerrish McCreary Smith over the years. Topics include Commandments for Bank Directors, Commandments for Enhancing Shareholder Value, Commandments for Strategic Planning, Commandments for Dealing with Regulators and other topics.

**Price:** $99.00 for first book  
$49.00 for each additional  
(plus applicable shipping and handling)  
$295.00 for “searchable PDF” for Board portals

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**Gerrish’s Glossary for Bank Directors**

Now in its second edition, this is a 203-page dictionary of key words, acronyms and terms (and, in some cases, a slightly irreverent look at some of the terms) typically used by bank directors and executives. Examples of defined terms include: accrual, ALCO, dependency ratio, financial holding company, kiting, liquidity risk, OAEM, private placement and many others.

**Price:** $99.00 for first book  
$49.00 for each additional  
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**Gerrish’s Musings**

Gerrish’s Musings is designed for CEOs and board members of community banks. Gerrish’s Musings reflects our firm’s insights and experiences as we travel weekly visiting with community bank clients from coast to coast. The newsletter is delivered by e-mail twice a month to subscribers.

**This is a free publication.**

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**The Chairman’s Forum Newsletter**

The Chairman’s Forum Newsletter is designed specifically for Chairmen of the Board. The newsletter is the response to the overwhelming success of the Chairman’s Forum Conference hosted by Jeff Gerrish and Philip Smith twice yearly. The newsletter is published electronically each month governing topics unique to the changing role of the Chairman of the Board.

**This is a free publication.**

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Please feel free to contact us at (901) 767-0900 if you require any further information or assistance. This form may be faxed to Gerrish McCreary Smith at (901) 684-2339, e-mailed to gms@gerrish.com or mailed to the mailing address listed on this form.

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January 15, 2015, Volume 289

Dear Subscriber:

Greetings from Wisconsin, Florida, Tennessee, Maryland and District of Columbia!

WELCOME TO 2015!

It is not every year that our consulting and law practice with community banks starts off with a bang. This one has, however. Between the last week of December and the first week of January, we have had no less than six new acquisition transactions that began to gel. We anticipate we will be announcing several of these in the first quarter, so we will keep you posted. Although many of these have been germinating for a lengthy period of time, they now seem to be coming to fruition. Part of that is because it often takes the seller’s board members some period of time to get themselves comfortable with the fact that they are actually going to let their institution go. It also takes some time for the buyer’s board members to determine whether they have the appetite for the risk of doing the transaction. Anyway, the year started out with a bang. I look forward to it continuing.

REGULATORS LIGHTENING UP

As many of you know, I cut my teeth 40 years ago with the FDIC prosecuting enforcement actions against community banks and suing directors when their banks failed. As a result of my background, the firms are still assisting a number of community banks on enforcement actions and defending a number of failed bank directors. Failed bank work has not changed much, but the enforcement action work has changed significantly since the end (?) of the Great Recession.
The regulators have definitely gotten kinder and gentler. Although a formal enforcement action is never fun for anybody, the approach taken by the regulators in a couple of the recent ones has actually been halfway reasonable. I know they are experiencing some regulatory fatigue – they are tired of and less excited about issuing the same cookie-cutter enforcement actions. Regardless, the beneficiary of this fatigue is community banks.

THE FAMILY-OWNED BANKS

We have had a rash of engagements related to family-owned banks. In fact, I have a couple of new ones coming up this month. The issues are all the same, but because of the personalities, the engagements are all completely different.

I was recently engaged by a family-owned bank that had always treated the bank not so much as a personal piggybank but as their contribution to the community. They never had professional management, and they did not care a lot if they made money. They just wanted to have it there in the community for the community’s benefit.

Three or four years ago, toward the middle of the Great Recession, they found themselves in need of professional management. They brought in a CEO with 40 years’ experience who has literally not only turned the bank around but educated the board that there may be some opportunities to hold on to this bank and actually make some money off it (and even pay dividends – how surprising).

I will be working with this bank in the first quarter to interview the family groups, get the family groups together and get together the board to see what they want to do with the bank. It is again one of those “Do we buy? Do we sell? Do we attempt some type of merger of equals (a sale)?” or “Do we maintain the status quo and continue to grow the bank?” The family dynamic always adds interesting choices.

THE NEW SMALL BANK HOLDING COMPANY POLICY STATEMENT

Although I have mentioned this previously in Musings, it bears repeating. As a result of a bill passed by Congress and signed into law by the President, the Small Bank Holding Company Policy Statement has now changed its threshold from consolidated bank and holding company assets of $500 million to $1 billion. This will open up some significant debt leveraging opportunities for those community banks in the $500 million to $1 billion range that had not been able to significantly leverage their holding companies previously.
If anybody needs any further information about this, please let me know. We have created a new “Memorandum to Clients and Friends” on this very issue.

**SUBCHAPTER S DISTRIBUTIONS**

An issue that often comes up this time of year (this year is no exception) is the issue of Subchapter S distributions. As I have explained in *Musings* before, Subchapter S corporations should make both “tax equivalent” and “dividend equivalent” shareholder distributions. The tax equivalent distribution is intended to provide the shareholders cash to pay tax on their pro rata portion of corporate income at the highest federal and state marginal tax rate. The dividend equivalent distribution is intended to provide shareholders the same amount of cash that would have been paid as a C corporation dividend.

The specific issue that often comes up this time of year is the appropriate allocation of a dividend for shares in a Subchapter S corporation that have been sold throughout the year. As you likely know, in a Subchapter S, the income is allocated among the shareholders based on their ownership of the shares throughout the year. A shareholder that is in a Subchapter S corporation that sells their shares halfway through the year still receives a K-1 for a portion of corporate income for that year. This is often the source of trouble.

Shareholders of a Subchapter S corporation should keep the split of distributions in mind when selling shares of an S corporation throughout the year. Most shareholders simply agree to prorate the distribution based on the time of ownership. Others may choose to simply increase the purchase price to account for the distribution, with the purchasing shareholder keeping the entire amount of distribution when it is paid. Regardless of the resolution that is agreed upon by the buyer and seller, the important thing is that it is considered. You will likely end up with an unhappy former shareholder if you allocate corporate income to them for shares that were sold throughout the year and the shareholder does not receive any cash over and above the sales price to pay tax on that allocated income. We have drafted several agreements for the split of a distribution, so please let me know if we can help.

**YES, IT IS A STOCK OFFERING**

It is not uncommon at all that we run across a bank or bank holding company that tells us about a prior sale of common stock to individuals that are closely associated with the organization, such as directors, officers or existing stockholders. Bankers typically indicate that
they have sold “Treasury shares” to these individuals just as a way to provide them the opportunity to purchase some additional shares. There is nothing wrong with this at all, provided the appropriate securities laws are followed. The problem is these securities laws are often overlooked.

For some reason there seems to be a notion that the sale of Treasury stock is somehow not a stock issuance that needs to either be registered or made pursuant to a valid registration exemption. That is incorrect. Any time your bank or bank holding company sells stock with the proceeds from the sale coming directly to the bank or holding company, that is an issuance that needs to be registered or made pursuant to a valid registration exemption. If you are selling shares to directors, officers or existing stockholders, the registration exemptions are usually a no-brainer. Keep this in mind in 2015 and beyond.

CAN WE REFINANCE THAT?

I was recently with a community bank that issued Preferred Stock to the United States Treasury pursuant to the Small Business Lending Fund. The dividend rate (which is essentially an interest rate) on the Preferred Stock is dependent on the bank’s increase in small business lending for up to five years. Following the fifth year, the dividend rate increases to 9%.

In today’s environment, bank stock loans are not carrying anywhere close to a 9% interest rate. The rates today are more like half of that, at about 4.5%. The board that issued this SBLF Preferred Stock asked whether the holding company could go out and borrow enough money at 4.5% to pay off the Preferred Stock when it kicks up to 9%. My response: Absolutely!

We are currently working with this bank to arrange a bank stock loan that will provide them enough cash to pay off their 9% debt. Although we have not put the deal together, based on similar deals I anticipate the interest rate on the replacement debt will be about 4.5%. This bank is cutting the cost of this particular piece of capital in half by refinancing the obligation. If you have SBLF Preferred Stock, TARP Preferred Stock or some other high-priced bank holding company liability, you should consider doing the same.

CAN A CONTRACT REPLACE PERSONAL TRUST?

We are currently working with a couple of different community bank buyers and sellers in putting together a contract for either the purchase or sale of an institution. The drafting and negotiation process for a community bank contract is the same as any other contract negotiation.
Putting my “lawyer hat” squarely on, my responsibility as a lawyer is to balance the protection of our client’s interest against our responsibility to get the transaction closed. Based on my recent experience, as well as having done this for the past 30 years or so, I am firmly of the conclusion that contractual provisions cannot replace trust between the parties. Although lawyers can draft provisions that contain legalese all day long, those contractual provisions can never give the parties the same level of comfort as does a genuine trust between the two. If you are considering either buying or selling, give serious consideration to the trust factor you have with your counterparty. That is a very significant factor in determining the success of a merger transaction. It also makes for a much more timely contract negotiation, as it avoids drawn out negotiations on topics of immaterial importance.

THE OBNOXIOUS DIRECTOR

I was recently facilitating a community bank planning session and was faced with what could best be described as the “obnoxious director.” This was a director who was smart, had done a good job in his own business, was fairly wealthy but had the temperament of a pitbull. For the most part, the directors got along and had a good discussion until this particular individual would begin to raise a point. Because of his historically obnoxious behavior, as soon as he opened his mouth, all of the other directors shut down. They did not want to hear what he had to say. He received no respect from his fellow directors, and unfortunately, although many of his points were good, they were lost on the group simply because nobody wanted to hear them.

I called the Chairman aside after the meeting and discussed the issue with him. Obviously, he was aware of the situation with the obnoxious director but really had not been willing to take it on. I suggested to him that part of the Chairman’s role is to provide leadership to the organization, and part of that meant sitting down with the obnoxious director and having a frank discussion with respect to his behavior. I do not know if that will take place or not. Even if it does, it would likely be a multi-year rehab before anybody begins to listen to this guy again. It is a shame because he actually had some pretty good ideas. The moral of the story is when you have an issue like that that involves dissident personalities, the chairman needs to hit it early on.
CONCLUSION

As noted above, our firm is off and running in 2015. I anticipate your banks are as well. We recently completed our firm’s planning session. If your bank is looking for a planning session for 2015, please contact us early so we can get you on the calendar.

Sincerely,

Jeff Gerrish
2014 was a continuing year of evolution for the role of Chairmen and the actions of community banks as most of us emerged from the financial crisis. After many long hours and numerous miles on the road and in the air this past year, we thought it might be best to provide a summary of certain observations, comments, issues and circumstances we have seen to recap some of the highlights (or lowlights) of the year for Chairmen and their banks.

As we move into the holiday season, we wish you, your organizations and employees, and all of your families a very Merry Christmas and a Happy New Year. We look forward to having the opportunity to work with many of you in 2015 and beyond.

Happy Reading!

Philip K. Smith

and

Jeffrey C. Gerrish
Chairman’s Summary

♦ Consider new strategies for succession planning.
♦ Your directors have real liability, make sure they know it.
♦ Plan a course for the future now that times are better.
♦ Beware of new regulatory actions and lead with the sword, if needed.
♦ Be on the lookout for merger and acquisition opportunities as a buyer or seller.

Board and Chairman Succession Planning

Perhaps the hottest topic this past year among community bank boards and Chairmen has been the notion of succession planning. We continue to see an evolutionary trend of more organizations moving away from standard mandatory retirement ages and more toward substantive and objective evaluation of Chairmen and the directors to provide appropriate turnover, to remove unproductive members and to provide succession planning. As you move into the new year, continue to look for ways to promote a healthy Board of Directors even if that means finally making the tough decision to eliminate unproductive directors.
The Long Goodbye

Sometimes it takes longer to say goodbye (or longer to finally resolve something) than you might think. As we approach the end of 2014, one client’s circumstance is of particular note for Chairmen and directors. We were asked to represent a bank in 2010 that was close to facing the death penalty of having the bank closed by the regulators. Part of the problem involved allegations of potential fraud by officers that could jeopardize the bank. The bank ultimately failed in 2010. You would think for the outside board members that would simply be the end of it. While they hated that the bank failed, these outside directors were somewhat innocent bystanders to some of the problems that resulted in the bank’s downfall. However, some two years later, the outside directors were sued by the FDIC under all the typical arguments the FDIC makes.

This case has been vigorously defended on behalf of the outside directors by us and by specialized litigation counsel and now, some two years later at the end of 2014 (more than four years following the bank’s actual failure), it looks like there might finally be a settlement of the case where, in fact, the outside directors will not be found liable and will incur no monetary or other penalty whatsoever. But, as you can see, it has taken over four years to get to this point. Certainly a long goodbye.

The moral of this story for all of us is, as economic times continue to improve, we must continue to be good stewards of the bank’s money, continue to exercise fiduciary duties and ask the right questions in order to
have directors who are on the ball, know what they are doing, and focused on organizational success. Your service on the board means something, but there also is real liability attached to it. If the worst case scenario happens, it is never as simple as simply stepping off the board and making everything go away.

**Uncertainty and What Now?**

One of the positive things about 2014 has been that most community banks emerged fairly healthy from the recession and 2014 was a year of beginning to ask what the options are for doing positive things rather than merely treading water. We saw many banks begin to look to explore acquisition opportunities as either buyers or sellers, we saw banks initiating capital raises, we saw banks implementing stock repurchase programs, we saw banks buying branches of other banks, we continued to see smaller banks moving toward Subchapter S status and we continued to see banks dive eagerly into the strategic planning process in order to chart a positive course for the future. So, in the midst of the confusion coming out of the financial crisis, 2014 represented a year for boards, as led by in-tune Chairmen, to begin to explore positive initiatives to set the course for their organizations for years to come. We hope 2015 will see many of those actions come to fruition and we know many of you are leading the charge of your organization in that regard.
The Next New Headache

2014 also saw an emergence of a new headache for many community bankers in the form of compliance, Bank Secrecy Act, anti-money laundering and the like. For many organizations that have spent the past several years keeping their noses to the grindstone to ensure asset quality and safety and soundness, it seemed like a sucker punch they were not expecting when suddenly compliance issues or Bank Secrecy Act issues came onto the radar screen of the regulators and the banks found themselves facing an enforcement action for issues that had never been criticized before. In one horror story from the past year, the organization we represented, as led by its Chairman of the Board and the CEO, were faced with dealing with an aggressive regulatory agency citing the bank for multiple Bank Secrecy Act violations to the point of determining that their overall BSA program was fundamentally flawed to such an extent that there were safety and soundness concerns for the bank. The organization, in essence, was found to have “material pillar violations”.

The interesting thing that makes this such a horror story is that the bank had received a safety and soundness examination and received the highest possible rating and, in fact, received a BSA exam and received satisfactory ratings. Following the exam, the bank self-reported to the agency some concerns it had with some items that had been identified through its BSA program where it felt there could be a problem. The bank outlined what the problems were and how it was addressing them in order to just keep the agency in the loop with what they were doing since they,
obviously, were a very healthy and strong bank. The result was that the agency sent a different BSA examiner back into the bank who, in essence, determined that the previous examiner had no idea what they were doing and, in fact, the BSA program had material violations that could threaten the whole organization.

The result was a lengthy negotiation process with the regulatory agencies to have the Chairman and President agree to the execution of a very “soft” enforcement action, but to get to that point the Chairman and the President had to stand up to the regulators, argue with them, take them to task where they were wrong, point out the blatant errors, omissions and incorrect statements of the regulators in order to get them to back down. Candidly, that is the fun part for us when we get to mix it up with the regulators! 2015 may see more of that type of approach needed by a strong Chairman when faced with ridiculous enforcement actions by the regulators. Be prepared to lead with the sword if necessary.

**The New M&A Environment**

In 2014, the new merger and acquisition environment emerged and we dealt with many of you in considering acquisition opportunities as both buyers and sellers. Looking into 2015, we think many of you, as Chairmen, will need to continue to be prepared to deal with unsolicited offers, to respond to shareholders demanding higher levels of returns and to have a plan of action for dealing with other banks that might want to partner with you in the nature of a merger of equals.
**Meeting Adjourned**

Thank you for the opportunity to communicate with you throughout the year and look for some new changes coming to *The Chairman's Forum Newsletter* in 2015. In the meantime, we wish each of you a Merry Christmas and a Happy New Year and, if we can ever be of assistance, please let us know.

Until next time,

Philip K. Smith

and

Jeffrey C. Gerrish
GERRISH McCREARY SMITH NEWSLETTER

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If you would like to be added to our database of clients and friends who receive this publication by email free of charge, please contact us or leave your business card with the speaker.

GERRISH McCREARY SMITH
Consultants and Attorneys
The Board’s Role in Mergers and Acquisitions

As the steady stream of merger and acquisition transactions continues among community banks, many organizations are “testing the waters” to see whether a good deal is available that would increase profitability and enhance value for the organizations’ shareholders. Though each institution’s role in the consolidating environment is unique, one area of commonality among all transactions is the board’s role in the process. In hopes of avoiding a detailed, formulaic checklist of issues each board of directors should consider, provided below are a number of practical things the board should bear in mind as it tests or navigates the merger and acquisition waters.

1. Do your job.

When considering acquisitions, the board’s real job is still to enhance shareholder value. An acquisition can be “just another deal” or it can be a true strategic maneuver to boost the franchise value and enhance shareholder value. Keep an eye on how the acquisition will improve the bank’s financial performance over a baseline as it relates to earnings per share, return on equity, liquidity for the shareholders, and dividends. It can be easy for a board, particularly one with little merger and acquisition experience, to get overwhelmed. Despite the details, do not take your eye off the principal obligation to enhance shareholder value.

2. Iron out the social issues first.

Notwithstanding the financial meltdown the country has experienced over the last seven years, for a community banker to sell his or her bank can still be a traumatic, emotional experience for everyone involved. A recent survey of bank insiders in the industry revealed that cultural and social issues are the most likely reason a deal would go sour. Among such cultural and social issues that need to be addressed are who will be the CEO, who will make up the senior management team, who will remain on the board of directors, what will the company be called, where will the world headquarters be located, will the seller bank be merged so it becomes a branch, will director fees still be paid, and the like. To avoid potentially unnecessary negotiation and expense, identify and address social issues first. They are more likely to derail a transaction than the financial issues.

3. Understand how you price an acquisition.

The bottom line is when your bank acquires that other bank, your shareholders need to be better off than they would have been had your bank not acquired the other bank. This means if your bank is giving cash as consideration, your bank needs to get more earnings out of that bank than the cost of the cash given up. If your bank is giving up stock, it needs to get more earnings per share than it would have had on the baseline to justify giving up more shares. A community bank with non-traded and non-listed stock that is buying another community bank with non-traded and non-listed stock for stock also needs to understand the relative values of the two companies. In other words, if the target thinks its bank is worth 1.2 times book value and you think your bank is worth 1.8, the relative values are different. Understanding these financial aspects is critical to getting your shareholders the best deal.

(cont’d on pg 2)
4. Assess the bank’s capacity.

Do not head down the acquisition road if it is simply not possible. To test the waters when your organization does not have the capacity is simply a waste of time and expense. It may be that your bank is in the regulatory penalty box due to a compliance or fair lending issue, or it may be that your bank does not have adequate capital. The market is currently at a pricing disequilibrium where buyers want to pay less than sellers want to receive. Understand where your board’s comfort level is on the spectrum before committing to the process.

Also, test the board’s capacity for debt or an exchange of stock that would result in a large shareholder. Many boards talk a good game about debt financing acquisitions, but when it comes down to actually doing it, they balk. Others balk when they realize that the target shareholders are going to have a large portion of the resulting organization. Yet these issues early on. It will save your bank valuable resources.

5. Know your exposure.

Do not take your eye off director’s liability. Acquisition transactions are subject to heightened scrutiny, requiring the board of directors to be able to demonstrate (1) the adequacy of its decision-making process, including documenting the information on which the board relied on reaching its decision, and (2) the reasonableness of its decision in light of the surrounding circumstances. In more simple terms, the scrutiny generally is with respect to the “process,” not necessarily the final decision. Establish an appropriate board process. This may involve the establishment of an independent acquisition committee and will most likely involve obtaining a fairness opinion from a qualified valuation expert.

Boards of directors involved in any type of sale process or sale evaluation must take extra steps to ensure that they are fulfilling their enhanced fiduciary responsibilities to the shareholders. Using board committees and consultants to help the board structure the “process” of evaluating a sale is very helpful to fulfilling the board’s responsibilities.

6. Do not forget due diligence.

Even with the industry’s improved asset quality, due diligence remains paramount for both buyers and sellers. Today’s due diligence involves not only asset quality issues, but compliance issues as well, particularly in the area of unfair, deceptive, and abusive practices and fair lending. Make sure you do an effective compliance due diligence, particularly in the common trouble areas of unfair, deceptive, and abusive practices and fair lending. Due diligence is not just has the target bank filed its tax returns, are there environmental issues, is the target up-to-speed on employee benefits, and is the target’s allowance correct? It is a holistic assessment of the target organization to make sure your bank knows what it is getting into on the front end.

7. Get professional help.

Other than being shameless self-promotion, if your bank and holding company do not get professional help early on, you may need professional help of the psychiatric variety later. Since the Great Recession, seemingly every attorney or consultant who has stepped into a bank claims to be “able” to do a bank deal. Make sure you are dealing with someone who understands the acquisition process and environment and has a track record to back him or her up. We stand ready to assist on all sides of the transaction, including financial advisory and legal.

Gerrish McCready Smith

Director Training Materials

Philip Smith, Gerrish McCready Smith, has written and produced a three-DVD series for director training that is available through the Independent Community Bankers of America (ICBA) Education Department:

Key Issues for Community Bank Directors
• Tips for Strategic Planning (26 minutes)
• The New Merger and Acquisition Market (28 minutes)
• Compliance for Bank Directors (23 minutes)

The DVD series is available for ordering on the ICBA’s webpage at www.icba.org/education (click the “Director” link in the lefthand column), or go to www.gerrish.com/pubs.php.
The Advantages of a Bank Holding Company

For years, our firm has recommended that community banks reorganize into a bank holding company structure. This structure, which is currently utilized by approximately 80% of the nation’s banks, offers numerous benefits to community banks, including increased capital flexibility and additional opportunities for shareholder liquidity, as well as flexibility in acquisitions, branch expansion, capital raising, and new products and services.

Since 1980, these benefits have been enhanced by the Small Bank Holding Company Policy Statement ("Policy Statement"), which, in summary, provides that small bank holding companies are tested for capital only at the bank level instead of both at the bank and on a consolidated basis. While the benefits of a bank holding company structure are available to all banks, thanks to recent legislation, now even more institutions will be able to benefit from the Policy Statement.

Benefits of Bank Holding Companies

The key strength of bank holding companies is flexibility. For example, one opportunity provided by the bank holding company structure is the ability to offer additional products and services at the holding company level. According to federal regulation, bank holding companies may engage in any activity that is “closely related to banking,” such as acting as an insurance agent or broker for certain types of insurance, making or acquiring loans that the bank is unable to make or acquire, leasing personal or real property, providing data processing services, or offering consumer financial counseling, among numerous other permissible activities. Thus, the bank holding company structure not only increases capital flexibility for the bank, but it also provides holding companies with an opportunity to offer additional products and services to supplement consolidated income and permit the bank to retain more of its earnings for other purposes.

Another opportunity afforded to holding companies is capital flexibility. Since a holding company is simply a state-chartered corporation, it can utilize virtually any type of equity structure (except for an S corporation, which can only have one class of stock), such as preferred stock, common stock, and different classes of each. As an added benefit, bank holding companies also have flexibility in the ability to repurchase shares of stock. Whereas banks that are not owned by a holding company typically have to receive approval from the regulators and the bank’s shareholders before repurchasing bank stock from shareholders, a repurchase of shares by a bank holding company does not require any approval unless the repurchase, when combined with any other repurchases within the last 12 months, is for greater than 10% of the company’s consolidated net worth (and certain other exclusions from prior approval are not met). As a result, the bank holding company can create a market for its stock and provide liquidity to shareholders that may, for whatever reason, be in a position where they need to sell their shares of the company stock.

In addition to flexibility in issuing and repurchasing equity, a holding company also has flexibility in that it may utilize various forms of debt. For example, the holding company can use traditional, collateral-backed notes, and it can also use long-term debentures. In either case, the holding company is able to deduct the interest cost while pushing the money down into the bank as new equity capital.

Again, regardless of the structure or features of the debt, holding companies have the ability to push leveraged funds down into the bank as capital. For larger organizations above $1 billion in consolidated assets, even though capital is tested on a consolidated basis, the organization benefits in that the Federal Reserve generally requires a Consolidated Leverage Ratio of around 5% to 5.5%, whereas the subsidiary bank is required to have a Tier 1 Leverage Ratio of greater than 8% or 9%. For smaller organizations, on the other hand, this debt-financed capital structure is even more attractive because capital is not tested on a consolidated basis, which brings us to the Small Bank Holding Company Policy Statement.

(cont’d on pg. 4)
The Small Bank Holding Company Policy Statement

As noted above, new legislation was enacted that increases the Policy Statement’s asset threshold for being considered a “small bank holding company” from $500 million to $1 billion in consolidated assets, which, according to the Federal Reserve, will result in almost 90% of all bank and savings and loan holding companies falling within the scope of the Policy Statement. Assuming certain requirements are met, those 90% of bank and savings and loan holding companies will be tested for regulatory capital purposes only at the bank level, not on a consolidated basis.

In order to take advantage of the Policy Statement’s benefits, a bank holding company must not engage in any significant non-banking activities, must not conduct significant off-balance sheet activities, and must not have a material amount of debt or equity securities outstanding that are registered with the Securities & Exchange Commission. Also, the Policy Statement requires parent holding companies to retire any new debt within 25 years of the time the debt is incurred and to reduce its debt-to-equity ratio to 30% or less within 12 years of the date the debt is incurred. So long as these requirements are met, the Policy Statement allows these smaller bank holding companies to take advantage of the traditional benefits of the bank holding company structure without being tested for capital on a consolidated basis.

Again, all bank holding companies can take advantage of the share repurchasing flexibility, but for those institutions with less than $1 billion in consolidated assets, the Policy Statement offers an additional advantage in that the repurchases can be funded by debt at the holding company level without negatively impacting the bank’s capital ratios initially. The bank will be required to dividend funds to the holding company on a periodic basis to service the debt, but the share repurchases can effectively be financed over time without taking a large chunk of capital out of the bank on the front end.

Moreover, regarding products and services offerings, institutions with less than $1 billion in consolidated assets can continue to offer new products and services at the holding company level, but losses

(continued on pg. 5)
from those activities do not threaten bank-only capital ratios. On the other hand, income from such activities can be pushed down into the bank as capital.

Overall, the increase in the Policy Statement’s asset threshold is a significant win for community banks across the nation and enhances many of the benefits of the bank holding company structure for community banks with less than $1 billion in consolidated assets.

For those institutions meeting the Policy Statement’s requirements that currently have less than $500 million in consolidated assets, Policy Statement revisions open the door to additional growth opportunities without fear of a shift in capital reporting requirements as a result of crossing the $500 million asset threshold (though certain corporate governance issues must still be considered if your institution plans to cross that threshold).

For those organizations meeting the above criteria that currently have greater than $500 million in consolidated assets but less than $1 billion in consolidated assets, congratulations! Your organization now falls under the Policy Statement and is exempt from the consolidated capital guidelines applicable to larger bank holding companies and is subject to less frequent and simpler regulatory filing requirements.

If any of you would like any additional information on the Policy Statement or the general benefits of a bank holding company structure, please let us know.

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**BASEL III’S AOCI “OPT-OUT” ELECTION**

As of January 1, 2015, all community banking organizations are subject to the revised Basel III capital framework. According to Basel III, accumulated other comprehensive income, such as gains and losses on available-for-sale securities, is included in regulatory capital for all institutions by default. Under such an approach, fluctuations in the value of available-for-sale securities would impact the organization’s capital ratios, for better or for worse.

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**SCHEDULE YOUR STRATEGIC PLANNING NOW**

Several members of Gerrish McCreary Smith, Consultants and Attorneys, facilitate strategic planning sessions for community banks. It is not too early to think about scheduling your 2015 planning session! Please call Linda Dandridge at (901) 684-2323 to secure a date for your Board’s retreat.
Despite this default treatment, financial institutions with less than $250 billion in assets may “opt-out” of accumulated other comprehensive income’s inclusion in regulatory capital by making a one-time election on its Call Report for the period ended March 31, 2015. Banks that choose to “opt-out” of the Basel III treatment will continue to have their regulatory capital calculated in the same manner as all previous quarters. Banks that fail to make the one-time election will cause accumulated other comprehensive income (i.e., an unrealized gain or loss on securities) to be included in the organization’s regulatory capital calculation. Such a change would be a departure from the current method of calculating regulatory capital.

Community banks that choose to “opt-out” of the organization’s accumulated other comprehensive income being included in regulatory capital must enter “1” for “Yes” on Item 3.a. to Schedule RC-R Part I.B. on the Call Report for the period ended March 31, 2015. Moreover, while not a formal requirement, the federal regulators also expect the institution’s board of directors to take some type of action to direct management or the appropriate individual to make the “opt-out” election. Our firm has assisted numerous organizations in preparing board resolutions memorializing the board’s desire for the bank to “opt-out.” If your organization would like assistance in this regard, please let us know.

Once an initial election is made, the organization cannot change its election unless it merges with or acquires all or substantially all of the assets of another institution that made a different election. For this reason, an organization’s election should be a strategic, long-term decision by the board of directors and senior management team. Based on our discussions with numerous community banks across the country, we anticipate the overwhelming majority of community banks will elect to “opt-out” of accumulated other comprehensive income’s inclusion in regulatory capital. While choosing not to make the election may benefit the bank’s capital in certain circumstances, the lack of election also exposes the bank’s capital levels to potentially significant downside risk. As such, our firm believes community banks will be in a significantly stronger position to succeed in the long-term by making an affirmative “opt-out” election.

If any of you need additional information regarding the accumulated other comprehensive income election or the interim final rules generally, please email Jeff Gerrish at jgerrish@gerrish.com.

THE CHAIRMAN’S FORUM NEWSLETTER

The Chairman’s Forum Newsletter is a complimentary monthly email newsletter exclusively designed for Chairmen. The Newsletter is the response to the overwhelming success of the ICBA’s Community Bank Chairman’s Forum Conference hosted by Gerrish McCreary Smith twice yearly.

If you would like to subscribe, please contact Carolyn Martin at (901) 684-2326 or cmartin@gerrish.com.

GERRISH McCREARY SMITH AFFILIATED RESOURCES

Over the last 30 years or so of exclusively helping community banks across the nation, we have developed relationships with various service providers who we believe provide the best services in their particular niche. This includes bank branch location specialists, IPO managers, securities transfer agents, loan review specialists, auditors, bank technology specialists, executive placement firms, and the like.

If you need any of these services, or others, and are not sure who to call, please let me know and we will provide some recommendations.

Jeff Gerrish
jgerrish@gerrish.com
As discussed in this Newsletter, whether the community bank is the buyer or the seller, the bank's board of directors has an irreplaceable role in merger and acquisition transactions. Although there are a number of critical issues for the board to consider, one issue is the issuance of a fairness opinion with respect to the transaction. A fairness opinion in an acquisition transaction is simply an opinion by a valuation professional that the transaction is fair to the selling shareholders (or in some cases, the buying shareholders) from a financial point of view. Fairness opinions are generally prepared by investment bankers, financial advisory firms, such as Gerrish McCreary Smith, Consultants, and others.

According to a recent mergers and acquisitions survey, approximately half of the surveyed institutions indicated a preference for a mix of stock and cash as consideration in a sale-side transaction. As such, it is often the case that a potential buyer brings its stock to the negotiation table. When assisting with a community bank merger or acquisition transaction involving stock, our firm always stresses to our client the importance of getting a fairness opinion related to the buyer’s stock—regardless of whether the client is the buyer or the seller.

As noted above, the fairness opinion is simply a written opinion from a financial advisor that the transaction, as structured, is fair to the seller's shareholders from a financial point of view. When a community bank sells, particularly for stock, and often for cash, the selling board usually gets a fairness opinion. When a purchasing bank is purchasing for stock, it too will often get a fairness opinion to make sure that the stock it is issuing to the target shareholders still is a fair purchase price for its own shareholders. The fairness opinion is generally issued at the time the definitive agreement is signed for an acquisition transaction, and often receiving an update to that opinion is a condition to closing.

The fairness opinion ultimately helps to protect the directors from any later shareholder complaints with respect to the fairness of the transaction or claiming that the directors did not do their job. Conditioning the transaction’s closing on the receipt of an updated fairness opinion will further protect the seller by permitting it to terminate the transaction in the event of a significant, negative change in fair value between the time the contract is signed and the closing.

While the function of a fairness opinion is clearly beneficial, the traditional issuer of such opinions is inherently conflicted. In the financial services industry, the investment banker or financial advisor that the bank hires to find the buyer or seller and then put the deal together is often the same party the bank hires to issue the fairness opinion. In other words, the firm that structures and negotiates the transaction (and often receives a “success fee” for doing so) is responsible for opining that the transaction is “fair” to the shareholders from a financial point of view.

Our firm has always viewed this as a conflict of interest within the community banking sector—as have a number of courts. Our suggestion is this: if your bank is going to use an investment banker or financial advisor to find and structure the transaction, either get a fairness opinion from a separate party, or get a second fairness opinion to “double-check the checker.”

While our firm has issued a number of fairness opinions related to community bank transactions, and while we are happy to consider the fairness of a transaction for your organization, the reality is the board needs to be protected, and it needs to be protected by an independent third party, whether that is our firm or another.

Whether a transaction is fair to the shareholders from a financial point of view depends on both subjective and objective factors, but one of the subjective factors should not be the provider of the opinion. The board of directors deserves more objective protection than that. Accordingly, for the board's benefit and the benefit of the shareholders, make sure the fairness opinion is independent.

We stand ready to assist.
Gerrish McCreary Smith has created numerous Memos to Clients and Friends on various topics (available free of charge). Set forth below are sample Memos to Clients and Friends:

**Acquisitions**
- Responding to Unsolicited Offers
- Restrictions on Stock Received in a Merger or Acquisition Transaction

**Employee Benefit Issues**
- Incentive Compensation Plans
- Requirements of Employee Stock Purchase Plans

**Raising and Allocating Capital**
- Raising Capital Without Registering with the SEC
- Stock Repurchase Plans

**Regulatory**
- Qualified Mortgage Rule
- Civil Money Penalty Process
- Basel III’s Capital Conservation Buffer

**Subchapter S**
- Maintaining a Subchapter S Election
- Use of S Corporations by Financial Institutions

**Miscellaneous**
- Loan Production Offices
- Efficient Conduct of Board Meetings
- Enterprise Risk Management
- Tax Allocation Agreements
- Institutions with Over $500 Million in Total Assets

Gerrish McCreary Smith, in connection with various speaking engagements around the country, has created high quality “handout” booklets. The publications below are available for a nominal charge:

- The Community Bank Survival Guide: How to Survive and Thrive
- A Fresh Start: Shareholder Value for a New Environment
- Understanding the Director’s Role
- Corporate Governance
- A Director’s Guidebook to Effective Board Compliance
- Directors’ Responsibilities in Mergers & Acquisitions: Responding to the Unsolicited Offer
- Evaluating Bank Options: Remaining Independent or Preparing to Merge
- Family-Owned or Closely-Held Bank Issues
- How to Flourish in a Dodd-Frank World
- Is a Holding Company in Your Bank’s Future?
- Mergers & Acquisitions Are Back: Don’t Miss Your Opportunity
- New Truths About Directors, Shareholders and Regulators (Including Compliance)
- A Positive Look at Community Banking
- The Pros and Cons of Converting to Subchapter S
- Strategic Planning: Don’t Make Me Do It!
- Succession Planning and Other Truths About Directors, Shareholders, and Regulators

If you are interested in any of these memos or publications, please call or email Linda Dandridge at (901) 684-2323 or ldandridge@gerrish.com.

Please visit our website at: [www.gerrish.com](http://www.gerrish.com)
Areas of Service

Gerrish McCreary Smith, LLC, Consultants and Gerrish McCreary Smith, PC, Attorneys are committed to the delivery of the highest quality, timely and most effective consulting and legal services exclusively to community financial institutions in the following areas:

Financial Advisory/Consulting Services

- Acquisition Financial Analysis
- Capital Planning
- Subchapter S Financial Modeling
- Directors’ Liability
- Mergers and Acquisitions
- Executive Compensation
- Acquisition Pricing
- Employee Benefits
- Bank/Stock Valuation Analysis
- Estate Planning
- Strategic Planning
- New Bank Formations
- Tax Planning
- Going Private
- Subchapter S Corporations
- Expert Witness
- Transaction Pricing Analysis
- Fairness Opinions

Legal Services

- Mergers and Acquisitions
- ESOPs
- Dealing with the Regulators
- Securities Offerings
- Going Private
- Director and Officer Liability
- Private Securities Placements
- Fair Lending
- Subchapter S Formations
- Executive Compensation
- Holding Company Formations
- Federal and State Taxation
- New Bank Formations
- General Corporate & Securities
- Regulatory Enforcement Actions
- Probate
- Employee Benefits
- Estate Planning for Executives

Custom Director Programs & Presentations

In addition to facilitating numerous strategic planning retreats and proprietary director and officer training sessions, Gerrish McCreary Smith also has recently provided speakers for the following trade associations:

- Alabama Bankers Association
- American Bankers Association
- Arkansas Community Bankers
- Bank Holding Company Association
- California Independent Bankers
- Community Bankers Association of Georgia
- Community Bankers Association of Illinois
- Community Bankers of Iowa
- Community Bankers of West Virginia
- Independent Bankers of Colorado
- Independent Community Bankers of America
- Independent Community Banks of North Dakota
- Independent Community Banks of South Dakota
- Indiana Bankers Association
- Iowa Independent Bankers
- Michigan Association of Community Bankers
- Montana Independent Bankers
- Nebraska Independent Community Bankers
- Pennsylvania Bankers Association
- South Carolina Bankers Directors College
- Tennessee Bankers Association
- Virginia Association of Community Banks
- Washington Bankers Association
- Western Independent Bankers

Topics include strategic planning, mergers and acquisitions, enhancing/maintaining shareholder value, dealing with the regulators, employee benefits, mediation, corporate governance, and similar topics.

Please email us or visit our website at www.gerrish.com for a complete listing of upcoming conferences and seminars at which we will be providing speakers. Gerrish McCreary Smith, Consultants and Attorneys, is also available to facilitate strategic planning retreats and proprietary director training designed for your board of directors.
Recent Transactions

WSFS Financial Corporation
Bank Holding Company for
WSFSbank
Wilmington, Delaware
has acquired
First Wyoming Financial Corporation
Bank Holding Company for
the First National Bank of Wyoming
Wyoming, Delaware

Security Financial Services Corporation
Bank Holding Company for
SFB
Dunand, Wisconsin
has acquired
Bloomer Bancshares, Inc.
Bank Holding Company for
Peoples State Bank of Bloomer
Bloomer, Wisconsin
Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Bloomer Bancshares, Inc. and Peoples State Bank of Bloomer.

TS Contrarian Bancshares, Inc.
Bank Holding Company for
TS•Bank
Treynor, Iowa
has acquired
Tioga Bank Holding Company
Bank Holding Company for
The Bank of Tioga
Tioga, North Dakota
Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Tioga Bank Holding Company and The Bank of Tioga.

Libertyville Savings Bank
Fairfield, Iowa
has acquired
Keota Farmers Savings Bank
Keota, Iowa
Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Farmers Savings Bank.

Washington Savings Bank
Effingham, Illinois
has announced its acquisition of
First Federal MHC
Mutual Holding Company for
Federal
Mattoon, Illinois
Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Washington Savings Bank.

To discuss your institution's strategic transaction opportunities, please contact Jeff Gerrish at jgerrish@gerrish.com or Philip Smith at psmith@gerrish.com.
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