
Presented by:
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Gerrish Smith Tuck, Consultants & Attorneys

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You can view or download Philip Smith’s materials for the Community Bankers of West Virginia’s Directors’ College from our website at www.gerrish.com.

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PHILIP K. SMITH. Mr. Smith is the President and a member of the Board of Directors of the Memphis-based law firm of Gerrish Smith Tuck, PC, and its affiliated bank consulting firm, Gerrish Smith Tuck Consultants, LLC. Mr. Smith's legal and consulting practice places special emphasis on bank mergers and acquisitions, financial analysis, acquisition and ownership planning for boards of directors, strategic planning for boards of directors, regulatory matters, bank holding company formations and use, securities law concerns, new bank formations, S corporations, going private transactions, and other matters of importance to banks and financial institutions. He is a frequent speaker to boards of directors and a presenter at numerous banking seminars. He received his undergraduate business degree and Masters of Business Administration degree from the Fogelman School of Business and Economics at The University of Memphis and his law degree from the Cecil C. Humphreys School of Law at The University of Memphis. He is authoring a monthly electronic newsletter, The Chairman's Forum Newsletter, which discusses key topics impacting financial institutions and, specifically, the role of the Chairman. Mr. Smith is a Summa Cum Laude graduate of the Barret School of Banking where he has been a member of the faculty. He has also served as a member of the faculty of the Pacific Coast Banking School, the Colorado Graduate School of Banking, the Southwestern Graduate School of Banking and the Wisconsin Graduate School of Banking.

Gerrish Smith Tuck Consultants, LLC and Gerrish Smith Tuck, 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 orders, 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. Gerrish Smith Tuck, PC, Attorneys has been ranked as high as third nationally by number of transactions in bank mergers and acquisitions.
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Independence?

Independence is not a condition – it’s an action

The Action That May Be Required Is …

Change
Are Things Changing?
What Is Driving Us To Change?

- Regulatory change
- Technology change
- Stockholder change
- Economic change

What Has Not Changed?
The Primary Role

To enhance / maintain stockholder value

What Does It Mean To Enhance Stockholder Value?

YOUR JOB IS TO:
- Increase earnings per share
- Maintain adequate return on equity
- Create liquidity for stock
- Provide adequate cash flow
- Maintain safety and soundness
Redefining Success

- Old metrics may be old
- Incent what you want (earnings, safety, capital)
- Long-term view of success

Board Level Issues

- Have a consent agenda
- Don’t only look backwards
- Make appropriate use of committees
- Ask for trending data, not minutiae

Board Meeting or Bored Meeting?!

- Whose meeting is it?
- Board succession issues
- Mandatory retirement
- Management succession
Get Back to Basics

- De-risk earnings stream
- Deconstructing the financial statements
- Pricing loans and deposits
- Source of non-interest income

Key Ways to Help Fulfill Your Role of Enhancing Stockholder Value

- Structure
- Stockholders
- Strategy

Focus on Ownership Structure

- Holding company
- Public
- Private
- Sub S
Focus on Organizational Structure

- Charter choice
- Branches?
- Products and services?

Stockholder Strategy

- Total number of stockholders
- Who are your stockholders?
- Public versus private
- S corporation?

Stock Repurchase Benefits

- Increase ownership percentage
- Increase return on equity
- Increase earnings per share
- Increase cash flow
- No cost to current stockholders
- Sellers receive cash
Strategic Planning Issues

Making the Most of Strategic Planning
1. Don’t focus too much on SWOT
2. Once your Mission Statement is set, leave it alone
3. A planning session is not a budgeting session
4. Address “real” issues
5. Don’t focus too much on process

Making the Most of Strategic Planning (cont’d)
6. Be honest (with yourself and others)
7. Make efficient use of time
8. Make the event enjoyable
9. One person should not dominate the meeting
10. Assign responsibility and follow-up

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Current Environment: The Impact on Strategy

- Time horizon focus
- Profitability focus
- Compliance focus
- Risk analysis focus

A Brand New Structure: A Plan of Plans?

- Capital Contingency Plan
- Liquidity Contingency Plan
- Board Succession Plan
- Management Succession Plan
- Problem Loan Workout Plan
- Profitability Plan

Independence: The Ultimate Decision

- Can we do a better job for our stockholders than another holding company’s stock or cash?
- Conceptual Board determination
- Proactive or reactive?
- Considerations:
  - Regulatory problems?
  - Can we fix it?
  - Dilution considerations?
  - Value considerations?
Buy, Sell or Remain Independent

The Dilemma

• I want to buy another bank
• I want to position my bank to sell
• I want to remain independent
• I want to do something
• I don’t want to do anything
• I have no idea what I want to do?

Survival?

• Can I? Will I have to sell?
• As a buyer, can I be opportunistic?
• How do I maximize value?
• How do I stay independent?
How the Current Merger and Acquisition Market Is / Will Be Different

• What will spur acquisitions?
• Cost focus
• Large banks versus small banks
• Succession and planning issues
• Difficulty and timing to get the deal done

The Fundamental Focus

• Enhancing stockholder value
• Can we do a better job in the future?
• Can we grow effectively?
• Can we maintain efficiency?
• Can we survive?

Five Common Mistakes of Buyers

• Getting the Board ahead of the numbers
• Not conducting adequate due diligence
• Not considering social issues
• Failure to lock up key individuals
• Why buy it if you can steal it? (consider branching or LPO)
Five Common Mistakes of Sellers

- Pricing expectations beyond what the market will bear
- Not understanding how banks are valued
- Structuring a merger of equals
- Trying to do it yourself
- Not considering bank holding company debt

Five Common Mistakes of Remaining Independent

- Assuming it can be done passively
- Not focusing on core profitability
- Not planning board and management succession
- Not keeping up with changing regulations
- Not creating value

Regulatory Issues and Trends
Key Commandment for Dealing with Regulators

Maintain a relationship of respect, not retreat

Five “Unspoken” Suggestions

• Stop whining / blaming the regulators
• Quit worrying about minority stockholders
• Cut your product and service anchors
• Measure and compensate for profitability
• Focus on efficiency: Bigger isn’t always better

The Short-Term Future May Not Be Pretty

• Dodd-Frank Act
• Consumer protection nightmare
• Unfair, deceptive, abusive
• Litigation against directors and executive management
A Bright Long-Term Outlook for Community Banks

- Long-term capital appreciation
- Long-term stockholder value
- Asset to your community
- Local loans, local decisions, local directors, local impact
- Independence is an action, not a condition


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# THE COMMUNITY BANK SURVIVAL GUIDE:
# STRATEGIES FOR A CHANGING ENVIRONMENT

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### VIII. Conclusion
METHODS TO ENHANCE SHAREHOLDER VALUE WITHOUT BUYING OR SELLING

There may not be one, surefire community bank survival guide. However, for most community banks, the way to maintain independence in a consolidating environment is to continue to do the things that enhance shareholder value. For a community bank or bank holding company, enhancing shareholder value generally means providing some reasonable level of investment liquidity to its shareholders and increasing earnings per share and a reasonable return on the investment compared to alternative investments that could be made by the community bank shareholder and some certainty of an adequate cash flow. So, these materials outline various tactics organizations can pursue to help enhance value and thereby maintain independence.

I. INTRODUCTION

As noted below, today’s short-term operating environment for financial institutions 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.

Congratulations on surviving the last five-year economic debacle and its adverse impact (through no fault of our own) on community banks and Main Street. To say the environment for community banks, both regulatory and economic, has changed over the last five years would be a massive understatement. Community banks are constantly bombarded by “pundits” screaming about “how much size matters,” by regulators and others wailing about “compliance issues” and by the difficulties associated with making an acceptable profit and return for our shareholders in an artificially long-term low-interest rate environment. Notwithstanding the environment and the issues, however, for those community bankers who want their banks to remain independent, the board must understand how to “plan” to enhance shareholder value with or without acquisition activity as the bank moves forward through the next several years when faced with the “New Truths” for community banks.

As noted later in this material, notwithstanding the economic environment and the new normal, the board and senior officer group’s obligation as directors and officers of a community bank is still to appropriately allocate financial and managerial capital to enhance or maintain the value for the bank or holding company shareholders. The failure
to do so will result in the shareholders looking for an alternative investment and the bank merging out of existence or engaging in an outright sale transaction. In order to Plan into the new normal, the bank’s directors and senior officer group need to understand both the short term and the long term environmental factors. Several factors will continue to play into the environment in the second half of 2013, including the following:

- **Asset quality snowball.** For most parts of the country, asset quality is continuing to improve, i.e. the asset quality snowball is beginning to melt.

- **Fatigue in general.** In 2013, we are continuing to see fatigue set in with bankers, borrowers and regulators. Borrower fatigue is reflected by operating in seriously down economic times for a long period of time. Banker fatigue is simply the result of fighting battles to keep their banks well capitalized and in good graces with the regulators for a long period of time.

  Interestingly, we are also beginning to see a bit of regulatory fatigue. This is translated into a modestly “kinder and gentler” regulator, certainly for the seriously troubled banks. It appears that not only have some of the bankers had all the fun they can stand, but also some of the regulators have as well.

- **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 projection that we can pretty much guarantee?). The only question is when. The Federal Reserve seems to continue to advance the ball down the field in the interest of keeping inflation low. We must be prepared for that interest rate risk, however, as we plan going forward. The preparation for an interest rate risk needs to focus not only on the loan portfolio but most importantly on the investment portfolio. With the loan demand slack, many banks have put their liquidity into investments in an attempt to eke out a reasonable yield. As rates tick up, those investments will rapidly get under water. That, in and of itself, could create some serious problems for some community banks. Be prepared.

- **Merger and acquisition wave.** Community bank merger and acquisition activity continues to contribute to significant consolidation of the industry. Every bank’s board of directors must consider the issues of, should the bank remain independent, should the bank buy another bank, or should the institution sell or merge. These issues, as noted later in this material, must be addressed in every planning session. It really fits in the category of “What are we planning for?” If the bank is planning for long-term independence, subject to the receipt of an unsolicited offer, that is one direction. If the bank is planning to sell as soon as possible, the plan will certainly be dramatically different. Although our firms are staunch supporters of independent community banks, we realize that each bank must address these issues in the best interest of enhancing the value for their shareholders.
In the current environment, this merger and acquisition discussion seems to always come down to the question of “does size matter?” In other words, can a small community bank survive in the current environment? The answer to that is, absolutely! The question is one of profitability, not survival. Some of the pundits, particularly those who want to combine banks into larger banks or get rid of community banks altogether, are pounding the table indicating a community bank must be $X (fill in the blank yourself) in assets to survive. We have heard as low as $500 million and as high as $1 billion. Our response to that is, “nonsense.” It is not a question of size. It is a question of profitability.

- Compliance. As you begin to think through your bank’s strategic planning process, the board and senior management need to make sure that the bank has a strong compliance function in the current environment. The best plan created by the board of directors will be derailed based on a bad compliance or CRA examination. A fair lending issue, e.g. discrimination, an unfair or deceptive/abusive practices claim or any other significant compliance issue will put the bank in the “penalty box” and derail virtually immediately any portion of the strategic plan that requires regulatory approval, e.g. establishing a branch or acquiring another bank.

- Focus on profitability. The Board needs to strategically set the overall business strategy. This is generally put in simple terms of, is the focus on profitability, balance sheet growth, e.g. do we want the bank to be bigger, or some kind of a mix? 2012 brought an interesting turn of events. As matters began to improve, many of our community bank clients across the nation turned their focus not to balance sheet growth, but to profitability. This primarily resulted in “asset reallocation”; the strategy of not growing the balance sheet, e.g. if we are $200 million today, do we care if we are $200 million next year, but growing the loan portfolio as a way to improve profitability.

- Other regulatory issues. Notwithstanding the compliance discussion above, other regulatory issues still remain. Presently, approximately one-third of the industry is under some type of enforcement action. If your bank is not under an enforcement action, formal or informal, with the regulatory agencies, congratulations! For those of you who are, as part of the plan, deal with the regulatory requirements of the enforcement action and plan to eliminate the enforcement action as quickly as possible. When dealing with the regulators, know your options. As a practical matter, the board is in control. If you have regulatory issues, review the information contained later in this particular handout.

- 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.
• Strategic/Action planning. Strategic planning has such a bad connotation that in our firm, we 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.

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.

II. LONG-TERM ENVIRONMENTAL ISSUES

The short term environment for community banks has been a challenging one, as noted previously in these materials. As part of the process to plan to enhance shareholder value, Boards of Directors and senior officers need to understand whether there is a future for community banks and if so, what does that future hold. The long-term future for community banks should be good, no matter their asset size. Some of the long-term issues that the Board, at the 30,000 foot level, needs to focus on when considering allocating capital to enhance shareholder value are set forth below:
A. INDUSTRY TRENDS

1. Consolidation of the Industry

Over the last 30 years, the number of bank charters has decreased from approximately 15,000 to just over 7,000. The industry has experienced unprecedented consolidation. Part of this consolidation over this 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.

2. Increased Utilization and Change in Branches

As the industry has consolidated dramatically over the last 30 years, the number of bank branches has increased from approximately 60,000 to approximately 100,000. 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, and as a result, branches are continuing to proliferate. The style and makeup of the branch of the future, however, will likely be significantly different.

3. Competition for Products and Services

Nothing will change in the competition arena except that it will be more intense and more technology driven in the future. 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, the prevalence of non-bank Internet lenders will increase, and the bigger banks will become more predatory (if that is
possible) with a wider array of products. And then there is the certainty that Wal-Mart will continue to expand its financial services.

4. Continuous Community Bank Advantage

Notwithstanding the large scale of the mega banks and Wal-Mart’s financial services (other than retail deposit taking), 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.

5. Dominance of Technology

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.

6. Ownership will be Important

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. In any event, if you can get 50% of the vote of your shares in favor of Sub S, you can convert your bank and holding company to Sub S. For further information regarding Subchapter S, please request Gerrish McCreary Smith’s Memo to Clients on Subchapter S.

B. CUSTOMER/STOCKHOLDER TRENDS

Four major customer/stockholder trends will be apparent over the long term:

- A less loyal shareholder/customer base
- The aging of the population and the resulting changes
- The changing population demographics
- The increased use of mobile technology

1. Less Loyal Shareholder/Customer Base

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.

2. Aging of the Population

Statistics indicate that currently, the fastest growing sector of the population by percentage is those individuals over 80. In the future, the “elderly” sector of the population (however that is defined) will be dominant.

In addition to the effect of the “graying” of the population, the shareholders and customers of community bank services will be more educated.

What is the impact on community banks of this aging of the population? The impact is at least fourfold:
• The 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 be dominant.

• Due to technology, this age group will have better access to information on the bank and its competitors.

• This group 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.

3. Ethnic Shift

One of the most dramatic changes in the demographic makeup of the United States over the long term will be shifting population segments among 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/Latino population of the United States, however, will increase dramatically.

4. Women-Owned Businesses

The population studies over the last several years indicate that women-owned businesses have been growing at a rapid rate. For those community banks desiring a targeted and emerging market, the market of women-owned and directed businesses would seem to be a good one.

5. Increased Use of Mobile Technology

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. As noted above, 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.

C. PRODUCTS AND SERVICES/LINES OF BUSINESS TRENDS

One of the jobs of the directors for planning for the future is to determine how to allocate capital. This allocation of financial capital and managerial capital
decision arises also in the context of lines of business. 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.

D. EMPLOYEE TRENDS

Attracting and retaining human capital in the future will be of paramount importance. The community bank employee of the future will be more well educated, more mobile, more technology oriented, more likely to have a different value system and work ethic than their supervisors, and more likely to demand benefits comparable to what the “mega” banks offer. The community bank of the future must determine that it will do what it can to attract and retain its human capital, even if it is a closely held bank.

E. REGULATORY TRENDS

As noted in the “New Truths” section of this material, 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.

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 the Board understands the future, it is time to refocus in the current environment on enhancing shareholder value with or without sale.
III. NEW TRUTHS ABOUT DIRECTORS, SHAREHOLDERS AND REGULATORS (INCLUDING COMPLIANCE)

There are many “truths” that, as directors and officers of community banks, we live by daily. Many of those truths are based on ancient maxims, biblical principles, and things we have learned from our fathers, grandfathers, mothers, grandmothers and the like.

In contemplating and deliberating with respect to “new truths about bank directors,” I arrived at multiple considerations as set forth below.

A. THE DIRECTORS

1. You cannot save yourself rich.

This maxim was presented to one of my partners 30 years ago by, of all people, a real estate developer. When asked why he was purchasing a piece of property in the middle of nowhere, his comment was, “Because you cannot save yourself rich. You must invest to grow wealth.”

The same philosophy applies to our community banks today. The bank’s profitability cannot be restored through cutting expenses only. It must involve topline revenue growth. Expense savings will not carry the day. FDIC’s recent quarterly statistical data indicates that bank profitability is up dramatically. In fact, first-quarter earnings of $40.3 billion are the highest level of quarterly earnings ever reported.

In the short run, profitability has improved dramatically as a result of expense savings, primarily in the nature of reduced provisions to the bank’s allowance for loan and lease losses. This will not last forever. In fact, it will not last for long.

This is basically just the theory that you cannot restore the profitability of your bank through cutting expenses only. It must involve topline revenue growth utilizing the secret formula of Revenue Minus Expenses Equals Profit. Expense savings alone will not carry the day.

2. A penny saved is a penny earned.

This old maxim, first reportedly espoused by Ben Franklin, basically acknowledges that although you cannot save yourself rich, when we look at the secret formula of Revenue Minus Expenses Equals Profit, then it is critical that the bank focus on the expense side of the equation as well. Many of us have bloated employee counts, bloated expense accounts and other accounts that need to be reviewed with a close eye. Many of our clients that have turned their focus on profitability instead of growth are
doing a complete top to bottom analysis of the bank, all its contracts and vendor relationships to make sure (a) that the relationships are appropriately priced and (b) (and more importantly) the bank is getting some benefit from continuing the relationship.

3. Pigs get fat, hogs get slaughtered.

This is an old maxim that can be applied in many ways in community banking. If the community banker attempts to “eke” out every last penny from a transaction or a customer, then the relationship foundation upon which the bank maintains that customer’s loyalty will probably erode. We cannot operate like the big banks in that regard. We must maintain relationship banking.

One of the differentiating strengths of community banks is not only their attention to high-quality service, i.e. we know your name when you walk in, but also the relationship with its customers. The community banking’s foundation is relationship. We must strive continuously to maintain and improve that relationship with our customers. If your customer becomes your friend and you become a trusted adviser, then when the bank makes a mistake, which it ultimately will, that customer is more likely to stay around, or at least not become a “silent walkaway.” They will talk to you about the problem and give you an opportunity to fix the problem and the like because you have a relationship. Bank profitability is built on relationship and we must preserve that relationship.

I have often seen jewelers with signs in their shops “We are out to make a living, not a killing,” this maxim must be the same for community banks. Although our primary job is to enhance shareholder value, we do not necessarily do that by becoming “hogs.” Hogs eventually get slaughtered and they will lose the relationship that formed the foundation for the profitability of the bank. Pigs get their fair share, but live to work another day.

4. Just say No or Know.

Being a bank director is an honor, but not an honor without responsibility. This is certainly being brought home during this day and time with FDIC as receiver of numerous failed banks bringing directors’ and officers’ liability litigation. Directors and officers have two basic protections from liability. #1 is just say KNOW. This means the directors must get education to understand their duties and responsibilities and liabilities. Numerous education alternatives are available from online training to audio conferences to webinars to live seminars to lengthy educational programs for directors. There is no shortage of educational opportunities.
In the perfect world (where none of us live), the board should have some type of director education policy. This would be similar to continuing legal education requirements for lawyers or medical education requirements for doctors or professional education requirements for CPAs. It is a policy that requires the board members to obtain a certain number of hours of education annually. Many of our clients are reluctant to establish such a policy for fear that if one or more of their directors do not “make it,” the regulators will criticize them for being in violation of their own policy. This concern is fully understandable, but the more important thing is that the directors do get the education.

The “just say NO” part deals with directors liability. As the chairman of a failed bank said shortly after his bank failed, “The next time you get in front of a group of directors, tell them that in the event a transaction comes before the board and they have a check in their gut or check in their spirit (however you want to characterize it), tell them to vote ‘NO’.” A no vote protects the director from any liability on that particular transaction. Don’t just vote with the majority to go along to get along if you have a problem with the underlying transaction. This particular chairman shared that when the transaction/relationship that resulted in the bank’s failure came into his bank, he had a check in his gut. He knew that he should not have done business with this particular individual but he voted to go along. As a result, he is a much poorer (financially) person today.

5. Understand why it happened, not just that it happened.

One enormous job for the board of directors is to take an oversight role over the bank. Having worked with literally hundreds of banks with difficulties over my career, in a troubled bank situation, the board often jumps to conclusions once it is recognized that something happened and does not explore why something happened. When the board jumps to the conclusion that something happened and they have a kneejerk reaction to it, it often involves “throwing the CEO under the bus.” This may be appropriate, but often it is not an appropriate or fair approach to take. The board needs to explore why certain things happened, not just the fact that they did happen. Part of that exploration of why it happened involves enterprise risk management, involves investigation and involves correction of the underlying concerns that gave rise to the problem that did happen.
6. Take time to contemplate and deliberate.

When faced with a difficult circumstance and one in which you are not quite sure what to do, the best advice is to “contemplate and deliberate.” As many of us know having been around for a while, often that emergency, which has likely been brought to you by someone else, will resolve itself as you are contemplating and deliberating. If not, typically, the delay while you actually think through and seek counsel on the issues does not make the situation any worse. It provides clarity to what is going on. As board members, it is incumbent upon us to contemplate and deliberate on issues at our bank. This particularly involves the current push toward enterprise risk management of community banks. That is nothing more than contemplating and deliberating our tolerance for risk and establishing those tolerances and then monitoring them through management going forward.

B. SHAREHOLDERS

1. The Board of Directors’ job is to “act for the good of the cause.”

This primarily means that the board of directors’ job is to enhance the value for shareholders. As noted previously in this material, enhancing value for shareholders involves primarily the allocation of financial and managerial resources, strategically to take actions that enhance the value for the majority of the shareholders. The test to determine whether the board is actually appropriately allocating human or financial capital to enhance the value for the shareholders is contained elsewhere in this material.

The confusion in many boards’ minds is that they have lots of constituents. There are minority shareholders. There are majority shareholders. There are categories of shareholders such as those who may stay in a Sub S and those who may be out of a Sub S that are temporary constituents. There is the community. There are the employees. There are the customers.

The bottom line for the board of directors is it must act for the “good of the cause.” That is the good of the majority. The minority shareholders should not govern the board’s thought process, particularly when it comes to matters such as Sub S conversions as described elsewhere in this material.
2. Change is difficult.

In general, change is difficult for many individuals and institutions. Many community banks 20 years ago were $50 million in total assets. Many of those are now $750 million in total assets. Often, there is a general tendency to continue to want to operate the bank the way it was 20 years ago. Change is difficult.

Unfortunately, as we all know, the entire environment has changed as have many of the drivers of our industry. Government is far more involved than it ever has been. Competition is ramping up. Capital is still fairly scarce. Times have changed.

My suggestion is that when directors and officers begin to talk about change and you are a participant in that type of meeting and you have an adverse reaction to what is being discussed, try and determine whether your reaction is as a result of the fact that the discussion involves change in the way things have been done, or your adverse reaction is because whatever is being proposed makes no sense.

Change is difficult. Without change, however, community banks will not progress. This is not simply change for change sake, but change to strategically allocate human and financial resources to enhance the value for our shareholders and do our jobs as directors and officers.

3. If you do not know where you are going, any road will lead you there.

This Yogi Bear truism is as true in community banking as it is in life. The board must plan strategically for the bank’s direction or it will not get there. As Einstein provided, the true definition of insanity is continuing to do the exact same thing over and over and expecting a different result. Elsewhere in this material is a lengthy discussion with respect to strategic planning or as we call it in our firms, long-term action planning. The board must engage in some type of long-term planning process. If it does not, then it is simply not doing its job.

As noted elsewhere in this material in connection with long-term planning, do not get bogged down in the process itself. Avoid the 11 indications that your strategic planning is a waste of time as set forth on pages 20 through 25.

4. Does size matter?

We have heard a lot over the last two years about how size matters and how the obituary has already been written for the small community bank. My response to that is “nonsense.” Would it be better if we were bigger?
Sure. Is it a question of survivability? No. It is simply a question of profitability.

We are facing some consolidation in the industry for sure. Banks are selling for a variety of different reasons. Some banks are selling for the traditional reasons, e.g. no management succession, no share liquidity, no board succession and the like. Some banks are selling simply because they are still impaired and the only way they can get capital is to sell the institution. There is, however, a new third category of banks that are selling, i.e. those who have “had all the fun they can stand.”

Your bank needs to decide whether it is going to buy, it is going to sell, or it is going to remain independent. Any of these three strategies can be viable if the board fully understands what it is doing. This means the board must understand the merger and acquisition marketplace and have a general overview of the bank merger and acquisition process. For further information on this, please see pages 46 through page 63 of this material.

C. REGULATORS

1. You can pick your friends, but you cannot pick your neighbors.

This maxim involves the real world of community banking and dealing with the regulators. The regulators are not there to be your friends, your consultants, your diagnosticians of the bank’s ills. They will never be your friends. They have a job to do and they will do it. Sometimes, they do it more zealously than any of us would prefer. It behooves us, however, to have good regulatory relations (however your bank defines that). Although the regulators may not be your friends, they will be your neighbors. They will be with you for a long time. There is no good to come from having poor regulatory relations, e.g. dumping garbage over your neighbor’s fence, because in the long run, it will backfire on you. That is not to say that if you have been wronged by a regulatory determination, that the bank should not consider appealing. Each of the regulatory agencies has an appeals process. Although, historically, the results of that appeals process have been heavily weighted toward the agency, it is still available.

2. The government is not always here to help you.

Many of you reading this may think that the government is “never” here to help you. For small bank holding companies, however, the Federal Reserve is still here to help and the federal government, through the Congress, has not done anything to disturb the help that small bank holding companies (under $500 million in total assets) receive from the Federal Reserve via the Small Bank Holding Company Policy Statement.
Notwithstanding Dodd-Frank, the recently finalized Basel III capital rules, the Qualified Mortgage Rule and all the other regulations that have been swirling around the last several years, nothing has disturbed the Federal Reserve’s Small Bank Holding Company Policy Statement. In fact, that particular statement has specifically been preserved.

The Small Bank Holding Company Policy Statement, in a nutshell, provides that if your bank holding company’s total consolidated assets are less than $500 million, that the holding company can still leverage capital into the bank for any purpose. What this means simply is the holding company can borrow money from a third party lender (institutional, individual or otherwise), bring that cash into the holding company and use it for any corporate purpose, such as injecting it into the bank, using it at the holding company to redeem shares, to acquire another institution and the like. This is possible because under the Small Bank Holding Company Policy Statement, “bank only” capital is tested under the capital rules. For example, if your bank is a national bank, the OCC only looks at the bank-level capital. The Federal Reserve, which regulates the bank holding company, does not look at the consolidated capital. If your bank is a state nonmember bank, then the State and the FDIC only look at the “bank-only” capital. The Federal Reserve, which regulates the holding company, does not test the consolidated capital. This allows borrowings at the holding company to be down streamed into the bank where they show up as pure equity capital. In this regard, the government is actually here to help you.

There are, of course, a number of times when the government is not here to help you. This primarily involves the compliance burden that has been placed upon community banks over the recent years. Compliance problems are expensive because all of them come with either reimbursement requirements or some type of civil penalty payment.

Although the government in some cases is here to help you as a community bank, it is not always here to help you.

3. We still live in a democracy.

Often, when we are dealing with a bank regulator, it seems as though we are not sure we live in a democracy. Their demands without due process often are enormously burdensome. (We can only hope they never have the opportunity to use “drones.”)

Keep in mind that the regulators cannot fully force any meaningful change in your bank if the board objects without providing the board with some due process. This involves all kinds of alternatives from appeals up the regulatory command to administrative hearings. For further
information on these alternatives, see pages 63 through 77 of this material.

4. This is not your father’s compliance.

This is not the compliance burden from the 70s and 80s which primarily dealt with hyper technical issues under Reg Z, Flood, etc. The compliance burden and issues that face community banks today primarily involve fair lending, unfair and deceptive and now abusive practices. A fair lending case, e.g. discrimination against a protected class or a UDAAP case, can put your bank in the penalty box for the long term. Once in the penalty box, it is virtually impossible to execute on your strategic plan, particularly if it involves any type of regulatory application for a branch, another bank acquisition, or anything else.

I hope the above material provides some philosophical content for us as community bank directors to live by. The specifics, e.g. the nuts and bolts of some of the issues, are contained elsewhere in this material.

IV. PLAN TO ENHANCE SHAREHOLDER VALUE

Each year, various members of our firm serve as outside facilitators for dozens of community bank and holding company strategic planning sessions.

A. TEN COMMANDMENTS FOR EFFECTIVE COMMUNITY BANK LONG-TERM ACTION PLANNING

I. KNOW THAT LONG-TERM ACTION PLANNING IS A BOARD OBLIGATION.

Long-term action 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 long-term action 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.

II. UNDERSTAND THE FOUNDATION FOR LONG-TERM ACTION PLANNING.

It is critically important for the board of directors to understand the foundation for long-term action 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 long-term action planning is to direct the allocation of capital for the next few years.

III. **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:

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.

IV. **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.

V. **Get Off-Site.**

Unless you simply cannot avoid it, do not conduct your long-term action planning at the bank. It just does not work (at least not very well). Everyone will be interrupted. Directors and senior officers are too close to their homes and offices. Get your group offsite and allow them to “bond” (board bonding may be a scary thought for some of the senior management group).

The planning process itself should not take much more than six to 10 hours. 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.

VI.  **DON’T WASTE YOUR TIME.**

One of the biggest mistakes of the long-term action planning process is wasting the directors’ time discussing items that are not board level decisions (getting in the “weeds”) or discussing items better left to another time (detailed financial planning). The long-term action 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.

VII.  **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.

VIII. **DISCUSS 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.

IX.  **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).

X. 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.

B. YOUR STRATEGIC PLANNING IS A WASTE OF TIME IF...

Your directors will not want to participate in the long-term action planning if they view it as a waste of time. Set forth below are numerous indications that your planning may be a waste of time. Make changes while you can.

1. Your planning is a waste of time if . . . there is no buy-in from the directors and officers.

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? 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!” 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. 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.

2. Your planning is a waste of time if . . . it is not 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.

3. Your planning is a waste of time if . . . the group focuses too much on the process itself.

As noted above, in our firm, we do not use the term “strategic planning.” We 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.
4. Your planning is a waste of time if . . . you spend the entire time on the SWOT analysis.

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.

5. Your planning is a waste of time if . . . the participants are not 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.).
6. Your planning is a waste of time if . . . one person dominates 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.

7. Your planning is a waste of time if . . . it turns into 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.

8. Your planning is a waste of time if . . . you focus too much 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.

9. Your planning is a waste of time if . . . you fail to focus on 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

10. Your planning is a waste of time if . . . there is no accountability and follow up for the actions taken and strategies established.

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.

11. Your strategic planning may be a waste of time if . . . you do not 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.

V. METHODS TO ENHANCE 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 and increasing earnings per share and a reasonable return on the investment compared to alternative investments that could be made by the community bank shareholder and some certainty of an adequate cash flow.

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

A. Formation, use and capital planning with the bank holding company.

B. Creating Stock Liquidity.

C. Considering Ownership Alternatives.

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D. Alternative lines of business.

E. Attracting and retaining human capital.

F. Enhancing value through appropriate corporate governance.

A. 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

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 $500 million since the bank and the holding company's financial statements are not consolidated for capital purposes by the Federal Reserve. The technique is useful on a more limited basis for those institutions with assets above $500 million. 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

B. 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?

1. 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.

2. 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.

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.

C. 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.

1. 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. For additional information, please request Gerrish McCreary 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, long-term strategic 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. 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.


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

In excess of one-third of the banks in existence at year-end 2012 were 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.

Any bank holding company that can obtain the vote of 50% of its shares can convert to a Subchapter S. This is done through a transaction structured as a “merger like” transaction.

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

- 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?

- 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?

- 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.
4. **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 began contemplating returning to private company status. According to the JOBS Act of 2012, a bank holding company must register as a public company if it has more than 2,000 shareholders in any class of shares. 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 holding companies will find themselves substantially below the increased registration threshold. For those 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, 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 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.

D. 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.

E. ATTRACTING AND RETAINING HUMAN CAPITAL

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.

1. **ESOPs**. An ESOP is also a means for a community bank to create liquidity as well as establish an employee benefit for the Bank's officers and employees.

   a. **Definition of an ESOP**. 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
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.

b. Mechanics of an ESOP. As operated under the statutory regulations, the mechanics of an ESOP can be very similar to a profit sharing plan. The ESOP differs from a profit sharing plan in one respect in that the benefits accruing to the benefit of employee/participants are employer stock. Other aspects related to the operation of an ESOP are listed as follows:

* Contributions to an ESOP by the employer are usually discretionary and determined by the Board of Directors.

* Employees who meet age and service qualifications participate in the plan.

* Employee accounts in the ESOP grow through:
  - Employer Contributions
  - Appreciation
  - Earnings
  - Forfeitures
  - Release of stock as collateral in a leveraged ESOP

* Employee benefits are determined under a vesting schedule based on the employee's years of service.

* Employees who terminate employment before they are 100% vested forfeit a portion of their account balance that can be reallocated to other participants' accounts.

* ESOP benefits are usually paid at the employee's death, disability or retirement.
* Participants have the right to demand stock when benefits are paid. However, as a practical matter, employees rarely demand stock since they need liquidity for retirement, etc.

* If stock is distributed and the stock is not readily tradable on an established market, the distributee must have a put option that allows the distributee to require the employer to repurchase the stock at fair market value within a fixed period of time.

* Stock that is distributed to ESOP participants or beneficiaries can be made subject to a right of first refusal that gives the employer the right to repurchase the stock before it is transferred to any third party.

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.

c. A Holding Company vs. an ESOP as the Purchaser in a Stock Repurchase Plan. An employee stock ownership plan (ESOP) is a specialized type of qualified retirement plan which invests in stock of the employer corporation. As stated above, an ESOP is generally a defined contribution plan which must satisfy the qualification requirements of the Internal Revenue Code and the regulations concerning employee eligibility, participation, vesting and nondiscrimination.

Carefully planned use of an ESOP may yield substantial tax, financial and strategic planning advantages. Tax-deductible contributions may be made to an ESOP in the form of cash to buy existing stock from shareholders, or new stock may be contributed or sold to the plan. Deductible cash contributions may be made to cover principal and interest payments on ESOP debt when an ESOP has borrowed money to purchase employer stock (a "leveraged ESOP").

It is possible to use a holding company, an ESOP or both vehicles in a stock repurchase or ownership restructuring program. Although there are a number of differences between the two techniques, most of the major considerations fall into the categories of (a) voting differences, (b) economic advantages and disadvantages, and (c) financing costs.
(1) **Voting Differences.** The use of a holding company (as opposed to an ESOP) to repurchase stock creates differences in the relative voting strengths of existing shareholders. Stock repurchased through the holding company becomes nonvoting treasury stock effectively increasing the relative voting strength of each remaining shareholder, friendly or unfriendly. Stock purchased by an ESOP (a "friendly" shareholder), however, continues as voting stock while the other shareholders have unchanged relative voting rights. The exact methods by which ESOP stock is voted are determined by specified rules and may vary depending upon the structure of the ESOP and the employer. Regardless of whether the stock is actually voted by the ESOP trustee(s) or the employees covered by the plan, the general effect will still be to have a "friendly" shareholder.

(2) **Economic Advantages and Disadvantages.** The major economic issue to be examined is having the stock purchase by the ESOP, where any increase or decrease in value will accrue to the employees, versus having the stock purchased by the holding company, thus passing the risks and benefits to the BHC's shareholders. Of course, repurchased shares may be divided between a holding company and an ESOP. Many institutions split stock repurchases between a holding company and its ESOP, making it difficult for affected parties to later criticize the transaction, since all parties received some benefits or shared the losses.

(3) **Financial Considerations.** The cost of financing the transaction is another major consideration in determining whether to use a BHC or an ESOP in a repurchase transaction. In this category, the advantage normally lies with the ESOP, because of substantial tax advantages including the ability to effectively deduct principal payments, as well as interest payments, on any ESOP loan. Many existing pension and profit-sharing plans may be converted to ESOPs with part or all their funds available for stock repurchases. Such conversions have substantial technical aspects, and experienced counsel must be consulted. *For additional information, please request Gerrish McCreary Smith material entitled "Utilization of Employee Stock Ownership Plans."*
2. **Incentive Stock Option Plan (ISOP)**

a. 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 (other than alternative minimum tax considerations). 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.

Features of the ISO are:

1. An employee will be entitled to capital gains when the stock is sold if he holds the stock for 2 years from the date the option is granted and one year after he receives the stock (unless he dies). If the stock is sold before these periods end, the employee has ordinary income. The taxable gain (whether capital gain or ordinary income) is the lesser of:

   - (i) the fair market value of the stock less the basis (cost) in the stock or
   - (ii) the amount realized on the sale less the basis (cost) of the stock).

2. The employer will be entitled to a deduction only if the employee pays ordinary income on his gain.

3. The employee must have been employed by employer at least 3 months before the exercise of the option (12 months if the employee is disabled).

4. There are basically nine requirements for an ISOP:

   - The written plan must be approved by the shareholders.
   - The option must be granted within 10 years after the plan is adopted.
   - The option must be exercised 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.
- 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.)

b. Under current tax laws, capital gains are now preferable to ordinary income for most taxpayers; therefore ISOPs have become preferable to Non-qualified Stock Option Plans (which can result in ordinary income to the option holder).

c. Incentive stock options are excluded from compliance with IRC Section 409A requirements for defined compensation type plans.

3. The Stock Appreciation Rights Plan (SAR)

a. The following is an example of how a typical Stock Appreciation Rights Plan might work:

On January 1, 2011, Bank Holding Co. (BHC) grants to B, a key employee of BHC & Bank, 1000 SAR units. Each SAR unit entitles B to the appreciation in value in one share of BHC stock over a 10 year period beginning January 1, 2011. If not exercised, the SAR units expire December 31, 2020. SAR units granted on January 1, 2011 may be exercised after December 31, 2016 (under a five year vesting schedule). At the time of exercise, B will receive cash based on the fair market value of BHC stock on the SAR exercise date. If on January 1, 2011 the value of BHC stock is $25 per share and
on January 1, 2017, when B exercises the SAR, the value of BHC stock is $50 per share, then B will receive $25 per unit for each SAR unit that 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.

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.

b. A summary of the steps involved and the key factors that would be included in a typical SAR plan are:

(1) The Board of Directors approves the initial plan and the annual allocation of units to Bank management employees under the plan.

(2) For ten years, units representing shares of bank holding company ("BHC") common stock are assigned to management employees with a value per share based on common stock value.

(3) Employees receive no vote nor ownership rights with units assigned.

(4) Employees' units increase in value by (1) appreciation in BHC stock, (2) dividends paid on BHC stock.

(5) Employees receive annual reports on the value of their SAR account.

(6) Annual valuations of stock will determine rights to appreciation.

(7) 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.
(8) If an employee's employment with the Bank terminates, either voluntarily or involuntarily (not for cause), he is entitled to cash in his vested units only at death, disability or upon reaching age 65. No appreciation accrues and no dividends shall be posted to his account after such termination. At the Bank's option, the employee may be cashed out at the time he leaves.

(9) If employee is terminated for cause (fraud, embezzlement, etc.), or if an employee competes with the Bank, he shall have no rights to receive any of the value assigned to his units and his interest in the SAR plan shall be revoked and terminated.

(10) If substantially all of the assets of the Bank or controlling stock of BHC or Bank is acquired by any other owners, the SAR rights previously granted to participants may be exercised immediately regardless of whether they have been held for five years. Also, if that event occurs or is about to occur, the Board of Directors may immediately grant any authorized but unassigned SAR rights that may also be immediately exercised by the participants.

(11) The tax consequences to the employee are:

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

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

c. 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.

d. 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.

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

   a. 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.

   b. 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.

   c. The SAR can be exercised only when the market price of the stock exceeds the exercise price of the ISO.
5. 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.

6. 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. The 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. An example of how a Restricted Stock Plan works is as follows:

1,000 shares of non-transferable stock might be issued to the executive of the bank, subject to the restriction that, if he leaves the employment of the bank within five years, he will forfeit all the stock. Assuming that this condition constitutes a “substantial risk of forfeiture”, the executive will not be required to recognize income under IRC §83 until the restriction of forfeitability lapses in five years. Another condition could be that the restriction does not lapse until certain levels of earnings or other financial goals are reached.
The executive will be taxed on the value of the stock when the restrictions lapse and the conditions are met, however. Thus, if the value of the stock has gone from $30 a share to $50, he will have $50,000 of ordinary income in the fifth year. Because he might not want to sell his stock at that time, this could impose an extreme cash flow hardship.

If, instead, the executive makes an "83(b) election" as authorized under the Internal Revenue Code, he would have had to include $30,000 in his income in the year of receipt of the restricted stock, but would have been able to defer recognition of the $20,000, (due to the increase in the stock's value), until the stock was sold, which might be 10 or 15 years later. The $20,000 would be taxed at capital gains rates. The numbers in this example are such that the immediate inclusion of $30,000 in taxable income would normally be very unattractive. However, if the current price of the stock was low, say $15 per share in the above example, 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.

A modification of the above example would be for the company to sell the restricted stock to the executive for $30 a share (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 $30,000 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.
### Restricted Stock v. Stock Options

<table>
<thead>
<tr>
<th></th>
<th>Restricted Stock</th>
<th>ISOs</th>
<th>NSOs</th>
</tr>
</thead>
<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>
<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>Is employee taxed at grant?</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>Is employee taxed at vesting?</td>
<td>Yes, unless employee made an 83(b) election at grant.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td>Is employee taxed at exercise?</td>
<td>N/A</td>
<td>No.</td>
<td>Yes.</td>
</tr>
<tr>
<td>Can tax be deferred until sale?</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>Does the employer get a deduction?</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>Does the employee get dividends?</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>Are there voting rights for employees?</td>
<td>Can be attached to restricted shares before restrictions lapse.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td>Is there value if the share price goes down below grant price?</td>
<td>Yes.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td>Do the awards affect dilution and EPS calculations?</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>Can employees delay exercise after vesting?</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>How is value affected by decrease in stock value below date of grant value?</td>
<td>Value of stock decreases, but not worthless.</td>
<td>Worthless.</td>
<td>Worthless.</td>
</tr>
<tr>
<td>Does the employer recognize an expense in its income statement?</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>How is the compensation expense recognized?</td>
<td>Accrued on the vesting or performance period.</td>
<td>Accrued on the vesting or performance period.</td>
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</tr>
<tr>
<td>Can the employer reverse compensation expenses for forfeited awards?</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>
</tr>
</tbody>
</table>
### Questions and Answers Regarding Restricted Stock Plans

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
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<tbody>
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<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>
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<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>
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<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>
</table>
F. ENHANCING VALUE THROUGH APPROPRIATE CORPORATE GOVERNANCE

A majority of community banks are not public SEC reporting companies subject to Sarbanes-Oxley. Those community banks and bank holding companies that are subject to Sarbanes-Oxley certainly know who they are and have had 11 years to implement appropriate corporate governance activities.

The real question for corporate governance for nonpublic community banks is, should the community bank follow best practices as long as it does not cost a lot of unnecessary money?

The general answer to that is although a community bank that is nonpublic is not required to engage in any type of best practices for corporate governance, to the extent it is economically feasible, there are a number of issues that community banks can address, including the following:

1. Take a fresh look at the way the corporation operates, its committee structure, its nominating process, its qualification for board members and the like. Don’t be afraid to change.

2. Try and have a majority of independent directors.

3. Establish a Code of Ethics for the bank and the holding company that binds not only the employees but also the directors.

4. Have effective committee structure and effective committees. This would include Audit, Compensation and Nominating/Corporate Governance.

5. Have appropriate committee charters for the committees so they know what they are supposed to do.

6. Let the Board rely on the committees instead of reinventing the wheel when the committee report comes in.

7. Consider effective board compensation.

8. Structure the board meetings so there is sufficient time to consider strategic and enterprise risk management issues, not just looking at issues in the rearview mirror, e.g. what did we do last month, last quarter and last year.

9. Use a consent agenda for the board meeting.

10. Require continuing education for the directors.
11. Focus on board and management succession.

12. Communicate regularly with your shareholders.

VI. BUYING OR SELLING SECRETS: ENHANCING SHAREHOLDER VALUE THROUGH PURCHASE OR SALE

In 1980, there were 14,870 independently chartered banks in the United States. At the end of the first quarter 2017, there were approximately 5,860. 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?

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.

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1 For a more extensive handout regarding mergers and acquisitions, please request Gerrish McCready Smith materials regarding “Buying and Selling Secrets.”
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
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. CHANGE IN ACCOUNTING FOR ACQUISITIONS

Accounting for acquisitions has changed dramatically over the last ten years. A decade ago, the preferred method for accounting for acquisitions was “pooling of interest accounting.” If the acquisition qualified for the pooling of interests method, the acquiror accounted for the target’s assets, liabilities, and net worth at the same book value those items had on the target’s financial instruments without regard to the fair market value of the target’s assets or liabilities or the fair market value of the consideration the acquiror issued in exchange for the assets. Therefore, under the pooling of interests method, no new “goodwill” was created. To qualify for the pooling method, an acquisition was required to meet a number of complex requirements, including that: (1) acquiror voting stock must be the principal consideration, (2) acquiror and target must not be subsidiaries or divisions of another company, (3) consideration paid by the acquiror could not include an earn-out or other contingencies, and (4) the acquiror could not intend to dispose of any significant portion of the target’s or its own assets. If an acquiring bank could not meet the requirements of the pooling method, the acquisition would be accounted for under the purchase accounting rules. In 2001, the pooling of interest method was completely replaced by the purchase accounting rules.

From 2001 to 2008, acquisition transactions were accounted under the purchase accounting regime. In that situation, the target’s old accounting book values are not relevant. The target’s asset book values are generally stepped up or down for their current fair market value. This results in higher (or lower) post acquisition depreciation and amortization. To the extent the acquiror’s purchase price for target exceeds the fair market value of target’s assets; goodwill is created and treated as a new asset on the balance sheet of the acquiror. The bad news then, was that the buyer had to record goodwill on its books. The good news was that the goodwill was no longer amortized against future consolidated income of the buyer, unless it was deemed to be impaired after being tested.

The purchase accounting rules were changed once again effective December 15, 2008. Financial Accounting Standards Board Pronouncement 141(R) made a number of changes to the methods of accounting for an acquisition. The most significant impact of this new pronouncement is that a target’s assets and liabilities are now transferred to an acquiror at their “fair value”. This value can be difficult to ascertain when evaluating a potential transaction, which adds more uncertainty to the transaction. Also important is the new requirement that all costs incurred in connection with an acquisition transaction must be expensed in the period in which
they are incurred. This changes the rule that acquisition expenses could be capitalized. Other FASB 141(R) changes include the requirement that contractual contingencies and non-contractual contingencies must be recorded at their fair value at the time of the acquisition and bargain purchases (a transaction where the purchase price is less than the difference between the fair value of the assets and liabilities acquired) must be booked as a gain on the acquiring company’s income statement. *For a more detailed discussion of FASB 141(R), please request material regarding Accounting for Bank Acquisitions – FASB 141(R) from Gerrish McCready Smith.*

D. **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**

      (1) 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?

(2) 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 organizations, the two combining banks can determine the relative values of the stock to each other.
(3) 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. 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 acquiror. Whether or not the acquisition will be accretive or dilutive to the acquiror 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 acquiror 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 acquiror’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 acquiror. The target generally gets no credit for revenue enhancements, which are items that the acquiror brings to the table, i.e. the ability to push more product that the acquiror 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 acquiror 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:

- Out of Market Acquisition 15 to 20%
- Adjacent Market Acquisition 20 to 30%
- In Market Acquisition 25 to 40%

Once the pro forma earnings stream for the target after the acquisition by the acquiror has been determined, it is fairly easy to determine how many shares or dollars the acquiror 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.

(4) Critical Contract Considerations With Respect to Pricing a Stock-for-Stock Transaction

(i) 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.

(a) 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.

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

(ii) 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.
(a) 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.

(b) 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.

(c) 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.

(iii) As noted later in this material, pricing a failed or troubled bank is an art unto itself. The adage that there is no such thing as a free lunch is never truer than in a failed bank acquisition. Therefore, careful attention should be paid to the pricing of a failed or troubled bank transaction because a discount is not necessarily a bargain, and careful attention to pricing can ensure that the bank is receiving the latter.
The key to accurate pricing of a troubled bank is due diligence. To arrive at an appropriate price, the acquirer must have an accurate picture of the overall condition of the target bank.

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:

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

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 acquirer. 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**

a. 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.

b. 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.

c. 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.

d. 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 stock appraiser or investment banker 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:

a. Term Sheet  
b. Definitive Agreement  
c. Proxy Statement and Prospectus  
d. Tax and Accounting Opinions  
e. Due Diligence Report on Buyer  
f. Fairness Opinion  
g. 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%. Historically, 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:

a. The sale must occur through a broker.

b. 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).

c. An affiliate is subject to a holding period of six months, during which, sale of the securities is disallowed.
E. 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 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.

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.
VII. UNDERSTANDING REGULATORY ENFORCEMENT ACTIONS’ IMPACT ON ENHANCING VALUE

As noted previously in this material, the short-term operating environment is more challenging today than ever. It is imperative that as directors and officers of our community banks, we fully understand how to address the significant regulatory overlay on our industry in this challenging environment. If our goal is to continue to serve our shareholders and communities, then within the regulatory context, long-term independence needs to be assured.

The short-term issues in the marketplace will continue to be difficult. Regulatory issues have again and will continue to be paramount for community banks. The regulatory perception (perception is reality) regarding increased asset quality issues will drive a significant number of enforcement actions by the regulators in the short term. 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, and will divert significant financial and managerial resources to dealing with actions which will not sustain the profitability or the long-term franchise value for the institution.

A. REGULATORY ISSUES - GENERAL

In this volatile environment, it is critical for the bank’s board and management to understand their rights and how to effectively, in a variety of circumstances, deal with and "manage" the regulators and/or an adverse regulatory exam. The commercial banking industry remains one of the most regulated industries operating in the United States. Although structural choices may provide some choice of regulators, the typical community bank is at least regulated to a certain extent by one of the following: the chartering state, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and/or the Federal Reserve Bank (FRB). Each of these regulatory agencies has its own methods and its own agenda. It is imperative to know the bank's and director's rights and how to manage each agency, whether you are seeking to respond to an examination, trying to deal with the regulators in a problem bank environment, or attempting to understand your duties as directors and officers.

B. REGULATORY ENFORCEMENT ACTIONS

1. Introduction

Contrary to the belief of most bankers, regulators cannot force a bank to do much of anything in either the safety and soundness or compliance area (except possibly under the prompt corrective action provisions discussed below) without giving the bank substantial due process rights. The only way a federal regulator can require a "well" or "adequately" capitalized bank to
charge off a loan or take any other affirmative action is either the bank, through its board of directors, voluntarily agrees to take that action, or the bank is required to take action after exercising its due process rights.

Because of the limited tools available to both the state and federal regulators, a substantial degree of regulatory enforcement is accomplished through "jawboning" or intimidation. This is completely understandable since, if the regulator can jawbone or intimidate a bank into consenting to an action, then the regulator does not need to go through its own very cumbersome and lengthy procedures to require a bank to take a certain action, or to give a bank its day in court. Although the power of the federal regulators was enhanced significantly by the enactment of sweeping legislation in the late 80s and early 90s, the requirements of due process were not totally abandoned.

One of the most important reforms as a result of some of that legislation was the requirement that all written agreements, final orders issued in connection with enforcement proceedings and any modifications or terminations of either of the above be available as a public document. Additionally, the legislation required that all enforcement hearings be made open to the public unless closed by the regulatory agency upon motion of the bank.

2. Regulatory Enforcement Options

In order to understand its rights, a bank must understand the agencies regulatory enforcement alternatives. These apply to both safety and soundness and compliance matters. Although each of the regulatory agencies has certain lesser alternatives that they may designate by different names, the basic alternatives fall into the following categories:

a. Informal: Board Resolution or Commitment Letter. The least stringent regulatory alternative is to request that the board of directors pass a resolution committing to take certain corrective actions or take certain affirmative steps to solve the bank’s problem. Of all the alternatives, this is the least risky to the bank and its directors. Since a "resolution" is simply an informal moral commitment by the board, it is not enforceable in federal court and its breach is not subject to civil money penalties.

b. Informal: Memorandum of Understanding or Letter Agreement. A Memorandum of Understanding (MOU) or letter agreement is an enforcement tool proposed by bank regulators in a situation where they do not believe that the more formal and more effective Consent Order or Formal Agreement is warranted. A Memorandum of Understanding is simply a written agreement between the commissioner of banking, or the regional administrator for national banks, or the regional director for the FDIC region, as appropriate,
and the board of directors of the bank. The memorandum of understanding has no more force or effect than a board resolution as long as it is not formally designated as a "written agreement with the agency."

c. Formal: Formal Agreement or Written Agreement. A Formal Agreement or Written Agreement is, as its name implies, a more formal and binding regulatory tool. It is a notch above the MOU and a notch below the Consent Order. A bank bound by a Formal Agreement (a favorite of the OCC) or a Written Agreement (a favorite of the Federal Reserve), may be subject to civil money penalties for breach of the agreement. Violation of the agreement may also be the basis in and of itself for a cease and desist proceeding as discussed below. Both the Formal Agreement and Written Agreement are public documents.

d. A Section 39 Action. This is a regulatory tool that is only occasionally used (primarily in the mid-west) as an additional regulatory enforcement action. This action is somewhat of a hybrid that is a little more severe than an MOU but yet a little less severe than a Formal Agreement or cease-and-desist order. The primary benefit to the regulators is that it streamlines their process for ultimately converting the action to the more formal cease-and-desist order if there is a need. However, our experience has shown that only a few of the districts are employing this tool and most prefer to simply issue an informal MOU or proceed with a more formal cease and desist action. Although there is some gray area, it appears the Section 39 action is an informal proceeding that is not subject to publication or judicial enforcement and is of questionable constitutionality.

e. Formal: Section 8 – Consent Order and Cease-and-desist Orders (C&D). Section 8(b) of the Federal Deposit Insurance Act (12 U.S.C. 1818(b)) is the authority for all banking agencies to bring formal enforcement actions. Section 8(b) provides an action to impose an order may be brought by an appropriate federal banking agency, when, in its opinion, "any insured depository institution, bank which has insured deposits or any institution-affiliated party is engaging or has engaged, or the agency has reasonable cause to believe that the bank or any institution-affiliated party is about to engage, in an unsafe or unsound practice in conducting the business of such bank, or is violating or has violated, or the agency has reasonable cause to believe that the bank or any institution-affiliated party is about to violate, a law, rule or regulation, or any condition imposed in writing by the agency in connection with the granting of any application or other request by the bank or any written agreement entered into with the agency . . . ." 12 U.S.C. Section 1818(b).
During 2009, one major victory that resulted from actions of the Chairman of the Board of Gerrish McCreary Smith Consultants and Attorneys, Jeff Gerrish, and his interaction with FDIC Chairman Bair, was the universal replacement by the FDIC of the Cease and Desist Order with a Consent Order (affectionately known as the “Gerrish Order”). The Consent Order, although still public, eliminates virtually all the inflammatory (obnoxious) language in the former Cease and Desist Order. This change would not have occurred without Chairman Bair’s personal involvement.

As a result of the above, beginning in 2009, the FDIC, following the efforts of Gerrish McCreary Smith, changed its policy on Cease-and-desist Orders. If the bank now consents to a formal enforcement action (instead of exercising its right to go to an administrative hearing), then the resulting document will be called a Consent Order (rather than the more ominously named Cease-and-desist Order). Also, the Consent Order will omit most of the inflammatory boilerplate language contained in the Cease-and-desist Order (including language stating that the bank will cease and desist from operating with inadequate management and board of directors, engaging in hazardous and lax lending practices, and the like).

Cease-and-desist Orders are still available to the FDIC. Basically, it will use the Cease-and-desist Order when the bank will not consent.

Regulators also have authority to issue a "temporary" cease-and-desist order. The temporary cease-and-desist order, which is effective immediately ("temporary" is a misnomer), may require the bank or party against whom it is directed to cease and desist from any violation or practice and to take affirmative action to prevent insolvency, dissipation, or prejudice pending the completion of the proceedings. The temporary cease-and-desist order may also be imposed whenever the records of an institution are so incomplete and inadequate that the regulatory agency cannot determine the institution's financial condition. The institution or individual subject to the temporary order may challenge the order in federal district court.

Please note, regulators cannot issue a Consent Order or a Cease-and-desist Order, other than a temporary Cease-and-desist Order, unless (1) the bank consents to the order or (2) it is imposed on the bank subsequent to a hearing before an administrative law judge. It is current FDIC policy to (1) issue a Consent Order when the bank consents, and (2) issue a Cease-and-desist Order when it is imposed by an administrative law judge after a hearing.
As a practical matter, each of the regulatory agencies attempts through jawboning or intimidation to obtain consent to desired enforcement action. This consent is from the bank's board of directors as a result of an informal procedure generally involving a face-to-face board meeting. This informal procedure usually involves providing the board of directors with a draft of the proposed Order or Agreement and meeting with the board of directors at the bank or at the regional office. If the regulatory agency can obtain consent to the proposed order through this process, it can avoid going through the lengthy and time consuming process of giving the bank its day in court as provided by the federal statute.

Many of the orders and agreements are consented to simply because the board of directors does not realize that it has any reasonable alternative. Not only do most members of the board of directors not realize that there is an alternative to consenting, they also do not realize that they have substantial room to negotiate over a period of weeks or months as to what, if anything, the board on behalf of the bank will ultimately consent to. The usual consent meetings, particularly without counsel present, are designed primarily to intimidate the board into executing the consent agreement. All aspects of a proposed order are negotiable, including the capital provisions.

Unlike any of the informal alternatives, (a Resolution, Memorandum of Understanding, a Letter Agreement) an Order, Formal Agreement or Written Agreement has regulatory teeth. Although a Memorandum of Understanding is a totally unenforceable document, an Order or Written Agreement can be enforced by the appropriate banking agency in the federal district court for the district in which the bank is located. In addition, a violation of an Order can serve as the basis for the assessment of a civil money penalty against an insured depository institution or an institution-affiliated party (including a director) who aided, abetted or allowed the bank to violate the Order. Also, as a practical matter, unlike a Memorandum of Understanding, it is difficult to get the regulatory agencies to terminate an Order. The Order will generally be on the bank for at least two examinations prior to termination.

These considerations, as well as the content and proposed requirements of the Order, must be factored into the decision making process of any board which is considering consenting to an Order or Agreement.
A board of directors should never consent on behalf of the bank to an enforceable Order or Agreement without assurance from the chief executive officer and senior management team that all provisions of the Order or Agreement can be complied with within the allowed time limits.

f. Termination of Deposit Insurance. Although the ultimate sanction for a problem bank is for the Federal Deposit Insurance Corporation to bring an action to terminate its deposit insurance, such actions, as a practical matter, are no longer necessary now that FDIC has prompt corrective action authority, as discussed below.

A termination of insurance action historically was commenced after an examination by the bank's primary regulator where the regulator determines that the bank is a 4 or 5 rated bank on the CAMELS rating system, and has a capital to assets ratio below 3 percent.

Procedurally, a termination of insurance action is commenced by the notification of the institution's primary regulator of the FDIC's determination that the institution has engaged or is engaging in unsafe or unsound practices in conducting the business of the institution. The notice is required to be given to the institution's primary regulator not less than 30 days before the FDIC's notice of intention to terminate insurance is issued. This time period is granted to the primary regulator to attempt to correct the problems detailed by the FDIC.

At the end of the 30 day period, if the problems have not been corrected, the FDIC will issue a notice of intention to terminate insured status. The bank has the opportunity to file an answer to the notice of intention to terminate insured status and present its evidence at a private administrative hearing prior to the FDIC's Board of Directors determining whether insured status should be terminated.

As noted, a termination of deposit insurance proceedings are generally no longer pursued because of the regulators prompt corrective action authority as discussed below.

g. Prompt Corrective Action. In order to resolve the problems of insured depository institutions at the least possible long-term loss to the insurance fund, the FDIC Improvement Act established a system of prompt corrective action which the regulators are required to follow.
Prompt corrective action orders generally require the bank to raise a significant amount of capital within an unrealistic, e.g. 30 day, period of time. As such, prompt corrective action orders, which are generally referred to as PCAs are known otherwise as “Probably Can’t Achieve.” PCA orders have been virtually useless as a prompt for the industry and for individual banks to increase capital. By the time the bank receives a PCA order, it has usually done everything in its power to raise capital and is headed south fast.

Pursuant to this system, financial institutions are divided into the following categories:

1. Well Capitalized: institutions that significantly exceed required minimum capital levels. (Total Risk-Based Ratio 10 or above; Tier 1 Risk-Based Ratio 6 or above; Tier 1 Leverage Ratio 5 or above)

2. Adequately Capitalized: institutions that meet required minimum capital levels. (Total Risk-Based Ratio 8 or above; Tier 1 Risk-Based Ratio 4 or above; Tier 1 Leverage Ratio 4 or above)

3. Undercapitalized: institutions that fail to meet any of the required minimum capital levels. (Total Risk-Based Ratio under 8; Tier 1 Risk-Based Ratio under 4; Tier 1 Leverage Ratio under 4)

4. Significantly Undercapitalized: institutions that are significantly below any of the required minimum capital levels. (Total Risk-Based Ratio under 6; Tier 1 Risk-Based Ratio under 3; Tier 1 Leverage Ratio under 3)

5. Critically Undercapitalized: institutions that fail to meet either the required leverage limits or risk-based capital requirements.

Please note that some of these PCA category thresholds will change as of January 1, 2015 due to the recently adopted Interim Final Rules under Basel III’s revised capital structure. For more information about the revised capital rules, please request Gerrish McCreary Smith Memorandum to Clients and Friends related to Basel III.

An institution that is not “Well Capitalized” may not solicit, accept, renew or roll over brokered deposits. This prohibition will not apply to an institution that is “Adequately
Capitalized” if the institution requests a waiver of the prohibition in writing to the FDIC Board of Directors and such request is granted. The Board of Directors may grant such a request only upon a showing of good cause.

The rule allowing only “Well Capitalized” and certain “Adequately Capitalized” institutions to deal in brokered deposits is problematic, as it puts banks in the position of having to raise money locally, often at a higher cost, at a time when they can least afford to do so.

Based upon the above-classifications, the regulators are required to take specific actions aimed at protecting the insurance fund.

Institutions classified as "Undercapitalized" will be required to submit an acceptable capital restoration plan to the appropriate Federal agency which must specify the steps the institution will take to become adequately capitalized, the levels of capital to be attained and how it will comply with the restrictions imposed by the Act. These restrictions include restricted asset growth and prior approval for all acquisitions, branching and new lines of credit, along with any other discretionary safeguards the regulators may feel are necessary.

A "Significantly Undercapitalized" institution, or one that is "Undercapitalized" and has failed to submit or comply with a capital plan, will be subject to one or more of the following regulatory actions:

(a) required capital raising activities;

(b) restrictions on transactions with affiliates, interest rates paid, asset growth and activities;

(c) with limited exceptions, the removal of directors and senior officers; and

(d) a prohibition on accepting deposits from correspondent banks.

Additionally, the regulators may prohibit the bank's holding company from making any distributions without Federal Reserve Board approval, and may require the holding company to divest or liquidate any subsidiary in danger of
insolvency or which poses a significant risk to the institution, including the "Significantly Undercapitalized" institution, if the regulators feel divestiture would improve the financial institution's condition and future prospects. The regulators are also given the authority to require any other action necessary to carry out the purposes of the Act.

With regard to an institution classified "Critically Undercapitalized," these institutions are required to comply with numerous activity restrictions. At a minimum, these restrictions include prohibiting the institution from doing any of the following activities without prior regulatory approval:

(a) entering into any material transaction outside the course of normal business;

(b) extending credit for a highly leveraged transaction;

(c) amending its charter or bylaws;

(d) making any material change in accounting methods;

(e) engaging in any covered transaction (a transaction with an affiliate);

(f) paying excessive compensation or bonuses; and

(g) paying interest in excess of certain limits.

The appropriate Federal regulator will have 90 days from the date an institution is classified "Critically Undercapitalized" to appoint a receiver or take whatever action it deems necessary.

h. **Interest Rate Restrictions.** All banks that are considered to be less than well-capitalized for purposes of 12 C.F.R. Part 337 are subject to restrictions on the maximum permissible interest rates that may be offered and paid on deposits. Banks that are less than well-capitalized are prohibited from paying deposit interest rates that exceed the national rate caps, which are updated weekly on the FDIC’s website. The national rate is defined as a simple average of rates paid by all insured depository institutions and branches for which data are available. The prevailing rate in all market areas is considered to be the national rate. The FDIC then adds 75 basis points to the national rates determined for various types of deposits of comparable size and maturity to establish the national rate caps.
or maximums that may be paid by banks that are less than well-capitalized.

A less than well-capitalized bank that believes it is operating in a high-rate area may use the prevailing rates in its market area only after seeking and receiving a written FDIC determination that the bank is operating in a high-rate area. Until such a determination is received, the bank must comply with the national rate caps. Also, banks receiving a high-rate area determination must continue to use the national rate caps for all deposits outside the designated high-rate market area.

The FDIC uses standardized data (i.e. average rates by state, metropolitan statistical area, and micropolitan statistical area) for the market area in which the bank is operating to determine if the bank is operating in a high-rate area. If the standardized rate data for the bank’s market area exceed the national average for a minimum of three of the four deposit products reviewed by at least 10%, the FDIC may determine that the institution is operating in a high-rate area. In performing this analysis, the FDIC uses rate information on money market deposit accounts, 12-month CDs, 24-month CDs, and 36-month CDs that are less than $100,000.

i. Closing the Bank. When a bank gets in trouble, the first question we normally get from directors is, “Is the bank going to close?” Our standard response is the following: “The bank will not close as long as (a) management can guarantee bank liquidity, i.e. the ability of the bank to meet the demands of its depositors, and (b) capital does not erode below 2%. The bottom line in most troubled banks, even severely troubled banks, is that the board will have time to raise capital or correct the problems before either the state or federal regulator closes the bank, neither of which will happen absent a liquidity crisis or a leverage capital ratio below 2%.

j. Civil Money Penalties. Civil money penalty actions may be initiated by the federal bank regulatory agencies, and several state regulatory agencies as well, under many situations. A civil money penalty action may be brought for the violation of any law or regulation, final or temporary order, written condition imposed by the appropriate regulatory agency or any written agreement between the institution and the regulatory agency. Penalties can be as much as $1,250,000 per day.

The process for the regulatory agencies to initiate a civil money penalty is generally to issue a “15 day letter” to the director, officer or affiliated party who is the target of the proposed penalty. The
letter generally indicates the agency has investigated and believes a civil money penalty is warranted based on certain facts as disclosed in the letter. The letter gives the target “15 days” to respond to the agency and indicate why the target thinks the penalty should not be issued. The letter also gives the target the opportunity to provide his or her financial statement to the agency. Rarely do we recommend a financial statement be provided at this point in the process (if ever). A civil money penalty, similar to other regulatory enforcement actions, cannot simply be “imposed” on the director, officer or affiliated party. If a penalty is assessed, a Notice of Assessment is formally sent indicating the amount of the penalty. If the target objects to the assessment and files a formal request for a hearing, then the assessment does not become final until the target either consents to it voluntarily or it is imposed as a result of an administrative hearing involving the target and the agency.

k. Removal Action. Many of the worst problem banks or problem asset situations are attributable to abusive insider transactions, poor management, or both. In appropriate circumstances, the federal bank regulatory agency can bring an action to remove an institution-affiliated party from participating in the affairs of the bank under Section 8(e) of the Federal Deposit Insurance Act.

Procedurally, the appropriate federal banking agency may serve the target party written notice of its intention to remove the party from office or prohibit any further participation by that party in the conduct of the affairs of the insured institution. The target party files an answer and the customary administrative procedures follow.

A temporary suspension order also may be issued by the appropriate banking agency pending resolution of the removal action, if the institution-affiliated party's actions meet the requirements of a removal action and such suspension is necessary for the protection of the institution or its depositors. Like a temporary cease-and-desist order, this action may be challenged in an appropriate United States District Court. Regardless of the outcome of the suspension order, the institution-affiliated party is still entitled to a full administrative hearing as to whether or not the removal action is proper.

The law also provides that state criminal indictments and convictions constitute further grounds for suspension or removal of an individual. A similar provision also exists with respect to federal charges under other laws.
C. MISCELLANEOUS ENFORCEMENT RELATED ISSUES

1. Publication of Enforcement Action.

Agencies are required to publish and make available to the public all final enforcement orders and any modifications or terminations regarding the orders, unless the agency determines in writing to delay publication for a reasonable time to safeguard the safety and soundness of an insured institution.

The bottom line is that if your bank or holding company consents to a Formal Agreement or a Consent Order, it will be public. It will be published and disseminated on the regulatory agency’s website. It will be available to any customer, shareholder, or competitor who desires to read it in its entirety. The publicity aspects of a formal enforcement action need to be considered by the board of directors. If the board determines to consent to an enforcement action which will become public, then the board also needs to have a plan for countering the adverse publicity which will be generated.

In connection with the FDIC’s change of policy on its Cease-and-desist Orders to move toward the more user-friendly Consent Order in the event the bank desires to consent, it also changed its policy with respect to publicity of administrative proceedings. The administrative proceeding, as noted earlier in this matter, commences with a Notice of Charges, a document similar to a civil complaint. Prior to the summer of 2009, Notices of Charges for banks who declined to consent to the previously available Cease-and-desist Order were not public. Although the administrative hearing was public, as noted later in this material, the Notice of Charges is not. For the first time, in August of 2009, the FDIC began to publish Notice of Charges. This creates another publicity event for the bank.


Any material supervisory determination, whether it be any one of the component ratings, the CAMELS rating, a request to increase the Allowance for Loan and Lease Losses, a classification or the like, is available for appeal by the bank. The appeals process for each federal and state supervisory agency generally follows the same process.

Banks seeking to appeal a material supervisory determination should first seek resolution of the problem with the examiner in charge while he or she is still at the examination site. If the issue cannot be resolved at this stage, the bank should request a meeting with the examiner in charge and his or her supervisor. These meetings usually take place at the supervising agency’s local field office. If the meeting at the local field office does not resolve the dispute, the bank should present its appeal, preferably in
writing, to the head of the agency’s regional office. If the head of the
regional office is unable to reach a satisfactory conclusion, the bank may
appeal the decision to the agency’s Director either in Washington, D.C. or
the state’s capital.

The heads of an agency’s regional office generally prefer to resolve a
dispute at the regional level rather than at the federal or state level.
Problems that make it to the top get a fresh look and are many times
resolved in favor of the bank. The regulatory leader of a region generally
seeks to avoid a bank’s appeal to the Washington, D.C. office because it
reflects adversely upon the region when their decisions are overturned by
those with the authority to do so. Our clients have had good success with
the appeals process in the past.

Unfortunately, any bank subject to a formal enforcement action (or even
one proposed) loses its right to participate in the agency appeals process.
This is under the theory that the bank has a right to its day in court if it
would like and the formal administrative process is the bank’s due
process.

3. Agency Approval of Officers and Directors.

Troubled financial institutions, newly chartered institutions and
institutions that have undergone a recent change in control are required to
give 30 days prior notice to the appropriate federal bank regulatory agency
before appointing senior executive officers or directors. The agency then
has the power to approve or disapprove such appointments within the
period. Extensive biographical and financial background information may
be required by the regulators prior to approval.


Once a bank is designated as “troubled” or “problem” bank by a federal
regulatory agency (even before any enforcement action is proposed), the
bank is subject to restrictions on its ability to pay an executive officer what,
under the regulations, could be deemed to be a “golden parachute” payment.
This often arises in the context of either the sale of a bank that is designated
a problem bank when the executives have change in control provisions in
their contract which are triggered by the sale, or when the executive who
presided over the time period during which the bank got in trouble reaches
an agreement with the board to depart which under the executive’s contract
would trigger some type of a departure payment. To the surprise of many of
the executives in either of these contexts, the sale or voluntary/involuntary
departure, the payment to the executive will likely be deemed a parachute
payment under the regulations which will be prohibited without specific
regulatory approval. Our experience has been that generally, regulatory
approval will not be forthcoming, even in the context of the sale of the entire
institution. There have been a couple of executives who have unsuccessfully attempted to litigate this with the federal agencies.

5. Administrative Hearings and Procedures.

A bank that challenges a proposed enforcement action may expect between a four and eight month period between the date of examination and a trial in connection with a cease and desist proceeding and as long as 12 months or more from the examination to the final decision of an administrative law judge or the agency with respect to the imposition of an order. The length of this period is largely dictated by the administrative law judge's calendar and the complexity of the matter. During the time period, various stages will take place. After the Notice of Charges and Hearing is served on the bank, the bank will file an answer, then both sides will exchange documents, proposed witness lists, proposed exhibits, proposed findings of facts and conclusions of law and trial briefs. Each exchange will be at a set interval prior to the trial. Negotiations commence at or before the proposed cease-and-desist order is presented to the bank. Depending on the particular situation, negotiations will generally continue up to trial date.

Enforcement proceedings are required to be open to the public, unless the agency, in its discretion, determines that holding a public hearing would be contrary to the public interest. Keep in mind, however, that the administrative law judge presiding over the hearing retains the discretion to close the hearing as needed to protect the interests of the institution's depositors and borrowers. Over the years, our firm has probably tried more bank administrative cases than any other group. Our experience has been that only the parties actually show up for the hearing, even though it is technically open to the public.

**VIII. CONCLUSION**

The directors’ and officers’ real job is to take appropriate actions allocating financial and managerial capital to enhance the value for their shareholders. Although most boards have been sidetracked understandably over the last five years from enhancing value, it is time to return in the new normal to the fundamental obligation of the board which is to appropriately enhance the value for the shareholders. We hope this material helps.
**Main Contact Information:**

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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 Smith Tuck 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.

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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.*

**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.

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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 Smith Tuck at (901) 684-2339, e-mailed to gst@gerrish.com or mailed to the mailing address listed on this form.
January 13, 2017, Volume 336

Dear Subscriber:

Greetings from Florida, Wisconsin, Tennessee and Georgia!

DATA BREACH

As noted in prior Musings, a number of our clients were subject to a data breach in 2016 that was caused by one of our friendly federal regulators. On behalf of these clients, we took the regulator to task, the same as we would any other vendor. We, on behalf of one of the clients, recently received somewhat of a “mea culpa” letter from the D.C. office of the regulator. In this particular case, the regulator admitted they were the cause of the breach (i.e., one of their departed employees caused the breach), that they had taken steps to prevent it in the future, and that they had turned it over to the Inspector General for that particular agency. Their letter back to the bank reminded me of any other letter from a vendor who had been taken to task for a problem. Good vendor management on the bank’s part I suppose. I will keep you posted.

RENEWED INTEREST IN ESOPs

In the last quarter of 2016 and the first part of 2017, we have seen a renewed interest from our client base in forming an ESOP or a KSOP. As I am sure Musings readers know, an ESOP is an Employee Stock Ownership Plan, and a KSOP is an Employee Stock Ownership Plan connected to your existing 401(k) plan.

The motivation for many of our clients moving toward ESOPs and KSOPs is varying. Some simply want an employee benefit and for the employees to “think like owners.” Others are looking to use the ESOP or KSOP as a liquidity mechanism for existing shareholders desiring to...
sell. This works well because it simply transfers shares from the shareholders desiring to sell to the ESOP or KSOP Trust, which holds the shares for the benefit of the employees and results ultimately in employee ownership of the holding company. (In other words, you swap out a shareholder who wants to sell for an employee who wants to own.) Other of our community bank clients are utilizing ESOPs or KSOPs to generate capital for the organization. An ESOP or a KSOP can be leveraged the same way a holding company can be leveraged. The difference is when the holding company borrows money, the holding company receives a tax deduction for the interest expense on the loan, which helps to shelter the bank’s earnings (because the bank and holding company file a consolidated tax return). If the ESOP or KSOP takes out the loan and uses it to buy stock in the holding company thereby creating cash which can be contributed to the bank as capital, as a practical matter, both interest and principal are tax deductible as the loan is paid back since the repayment of the ESOP loan is made with compensation expense, which is 100% tax deductible.

I am a big proponent of ESOPs/KSOPs for a variety of reasons, some of which are set forth above. If anybody wants any further information, please let me know.

**CONFLICT OF INTEREST**

In our firm’s business, and in the community banking business, it is important to avoid conflicts of interest or even the appearance of impropriety. That is why every time I see a transaction announcement where the investment banker who went out and found the deal, brought it in to the Board, convinced them to do it, and then also said it was “fair” from a financial point of view, I see an inherent conflict. It does not seem to bother them much, but it does bother us. We perform financial advisory services for our clients, including rendering fairness opinions, providing valuations, and the like. Our general rule is, however, we will not provide these services for a transaction in which we are otherwise involved or being compensated because (drum roll) it creates a potential conflict of interest. Think about it. Particularly if you are selling your bank or buying another, don’t you think you need an outside independent third party to give you a true answer as to whether that transaction is fair or appropriately priced or not? Keep it in mind.
TIME FOR A TUNE-UP

As many of you know, every couple weeks I produce a blog for Banking Exchange. The next blog is about the need for community banks to have a “tune-up.” You can read the blog [here](#). The general theory is that the first of the year is a good time to go back and look at things that none of us ever look at, like our bank and holding company corporate governing documents, bank Loan Policy, other bank procedures, and the like. It is also not a bad idea to have an independent third party assist in that review. I will not replay the blog here, but take a look at it because I think it may provide you with some good ideas as a way to start the year off.

CONFIDENTIALITY

The issue of confidentiality in our boardrooms is still raising its ugly head. I have addressed this previously in Musings, but based on the emails I have received over the last month or so, it appears to be a continuing problem. Keep in mind, as directors and officers of our community banks we have three major duties: the duty of care, the duty of loyalty to the institution (avoiding conflicts of interest), and the duty of confidentiality. What happens in the boardroom stays in the boardroom. The last thing you want to do is have somebody who is a director or officer running their mouth in the community about confidential information from your boardroom, whether it is a loan issue, an acquisition issue, or anything else. It cannot do anything but sully the reputation of the bank. If you have not discussed directors’ and officers’ duties at your board level recently, then again, the first of the year is a good time to have those kind of fundamental discussions.

ATTRACTING AND RETAINING KEY PERSONNEL

I had a healthy discussion with a community bank board recently about the tools they needed to attract and retain key personnel. They were looking for some type of equity “tool” to attract someone into a new slot created at the bank, as well as to keep the existing personnel. We of course discussed ESOPs and KSOPs as noted above. There are also some other alternatives most banks can use. These include stock options, restricted stock, phantom stock, or stock appreciation rights. Each of these is a little bit different. As most of you know, if you give your employee a stock option, they actually have to come up with the money to exercise it. If you give them restricted stock, then it is basically a stock grant with the ability to put whatever kinds of restrictions on it that you want. The employee does not own the stock until the restrictions come off. If your community bank holding company is closely-held, then the owners probably
do not want to give anybody stock for anything. That is where phantom stock comes in, which is not really stock at all, but simply the right to receive cash based on the value of the stock. Stock appreciation rights are similar. With stock appreciation rights, the employee receives the right to receive cash based on the appreciation of the stock over a period of time. If anybody wants any further information on any of these incentives, please let me know.

**THE “IMPOSSIBLE” NEGOTIATION**

Over the past couple of months we have been assisting one of our community bank clients in the potential acquisition of what I would describe as a very troubled community bank. This bank is losing money at a pretty rapid pace and does not have any real capital cushion to absorb the losses. In short, this bank is not long for the world. It is a unique situation because, for a slew of reasons, this bank is partially owned by a government agency. In fact, the agency has a controlling interest in the bank, meaning it is calling the shots as it relates to the future of the organization.

Our client recently made a very fair offer to purchase the bank. There are lots of different issues at play here, and the offer addressed those issues in what we saw as an appropriate manner. Along with our client, we evaluated all of the risks associated with the transaction and worked our best to distribute those risks in a way that makes sense for both parties.

To put it plainly, the government agency that is the control shareholder was not interested in any type of risk allocation. The agency essentially said that if our client wanted to buy the bank, it was going to have to come up with a pretty hefty purchase price. The government agency also required that our client pay the selling bank’s professional fees and data processor contract termination fee, which were well into the millions of dollars. The government agency also said that there was zero chance it would be willing to provide any type of indemnification for any future losses associated with potential litigation. No surprise, the agency also created a real sense of urgency and said it had to know in 24 hours whether our client would accept the deal or whether it needed to move on to “Plan B.”

Our client was smart and avoided falling into the trap of a bad deal. It was very frustrating for our client because it was looking to negotiate an equitable transaction. This particular government agency was not. Unless this agency can find someone that is willing to overpay for this bank, my guess is that the bank will end up failing, leaving the government agency with nothing. Our deal would have at least provided them something. It is very
frustrating when you are trying to negotiate with a party that simply has no interest in negotiating.

**SUBCHAPTER S IN 2017**

Since Donald Trump’s election as President, we have been asked a number of different times whether a Subchapter S election makes sense in 2017. Many people asking this question are under the impression that Donald Trump’s plan to significantly reduce corporate income tax rates somehow means that the Subchapter S tax structure is no longer attractive. We have taken a look at the issue very closely and, for a couple reasons, believe Subchapter S will continue to make sense in 2017. First, it is widely expected that if there is a significant reduction in the corporate tax rate, there will be a corresponding change to the Tax Code that essentially places a ceiling on the tax rate of pass-through income (i.e., Subchapter S income) at a rate that is equal to the highest corporate tax rate. In other words, corporate income will be taxed at the same highest rate regardless of whether it is taxed at the corporate level or the individual shareholder level. Second, even if the tax ceiling on pass-through income is not imposed, corporate income tax rates have to get very low and individual income tax rates have to get very high in order for a C corporation to be more tax advantageous than an S corporation.

We have created a chart that determines whether a C corporation or S corporation is more advantageous under a number of different corporate and individual effective income tax rates. Please feel free to email us if you would like a copy.

**D&O “TAIL COVERAGE” EXPENSE**

When one community bank buys another community bank, the acquirer typically provides indemnification to the target company’s directors and executive officers. This indemnification essentially provides protection to the target’s directors and executive officers in the event they are ever sued for any act or omission as a director or officer of the target bank. In order to minimize the acquirer’s liability for this indemnification requirement, every transaction requires the target’s directors’ and officers’ liability policy to have an extended reporting or “tail coverage” period. This is essentially an extension of the target’s existing directors’ and officers’ policy providing a continuation of coverage for the target’s existing D&O policy for some period of time past the closing of the transaction.

One of the issues that always comes up in an M&A transaction is who pays for the extended D&O policy. The answer is that there is no correct answer. It is a matter of
negotiation. In some instances, the target pays for their own tail coverage policy. In other instances, the acquirer picks up the bill. My experience has been the party that brings it to the table first and requires the other to make the payment is usually the “winner” in the negotiation. If you are thinking about a M&A transaction, be sure you understand this issue, because you may be able to save yourself some money.

**FORECLOSURE OF “CONTROL” SECURITIES**

We recently assisted a bank in what is a fairly common but pretty technical securities transaction. In this instance, our client made a loan to an individual that is the president of a rather large corporation. This individual was also a larger shareholder of this corporation, and the loan was secured by a number of shares of the corporation’s common stock. We became involved when the loan went bad and our client determined they were ready to foreclose on the stock and sell it to apply the sale proceeds to the loan balance. This all seems simple enough. This is actually a fairly complex transaction because the shares owned by the borrower are technically “control” securities in accordance with federal securities law. The sale of any control securities into the market must meet some pretty technical requirements. If the sale does not meet these requirements, the owner of the shares could be found to be in violation of the securities laws, and the purchaser could receive “restricted” securities, which further limits the purchaser’s ability to sell the shares. Obviously this is an outcome that all of the involved parties wanted to avoid.

If you are ever in a situation where you are foreclosing on stock as collateral and the owner of the stock is an executive officer, director, large shareholder, or other affiliate of the corporation that issued the stock, be sure you appropriately navigate all of the securities issues. In this situation, it is very easy to trip up and create a problem.

**CONCLUSION**

We hope everybody had a great start to the New Year and is up and running at full speed. We certainly are. Think about the “tune up” for your bank noted above and let us know if we can assist. See you in two weeks.

Jeff Gerrish and Greyson Tuck
Happy New Year! As we start a new calendar year, for many of us it is a time of cleaning out and checking in. We often go through the ritual of cleaning out files, cleaning out our desks or cleaning out our lives. Similarly, we start checking in on where things stand perhaps with last year’s resolutions, where we are financially, how close we may be to retirement, and similar factors. Likewise, we often do this in our businesses and it is really an appropriate time for Chairmen to take a full assessment of their Board of Directors, their organization as a whole, and to look to the future on what can be done differently or what things loom on the horizon to improve the organization in 2017.

In this year’s first edition of The Chairman’s Forum Newsletter, we take a look at some of those types of things that would help you tune up your bank, check in on its status and keep things running smoothly. We also look at a few situations we have encountered that may be important for you as Chairmen as we head into the new year. We hope you enjoy this edition and let us know what questions or comments you have or any ways that we can help.

Happy Reading!

Philip K. Smith

and

Jeffrey C. Gerrish

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www.gerrish.com
Chairman’s Summary

♦ Set a course for strategic planning.
♦ Refresh your basic corporate documents.
♦ Consider an organizational study and/or corporate governance evaluation.
♦ ESOP trustees beware.

Getting Your Arms Around the Big Picture

As we head into a new year, as Chairmen you should have the big picture of your organization in mind, knowing what your strategic direction is for the year, understanding the priorities and longer term objectives you hope to achieve, knowing the goals that have been set for the management team to measure your community bank’s and holding company’s success throughout the year, and other typical strategic initiatives. If you failed to conduct a strategic planning session in the second half of 2016, the start of the year might be an appropriate time to get your arms back around the big picture. For example, as Chairmen, do you think your organization should be looking at M&A transactions in 2017, are you looking for further expansion of lines of business or contraction, do you need to focus on creating liquidity for aging shareholders who want cash? All of those are the
types of big picture strategic questions that can greatly impact your organization throughout the year, and it is better to have a plan to meet them rather than handling them on an ad hoc basis.

For strategic planning purposes, our firm, of course, does scores of formal strategic planning sessions each year for banks of all sizes all across the country. However, you do not necessarily have to have a guy in a suit ride in from out of town to help you facilitate your planning session every year. Some of our clients, for example, might have us facilitate a formal planning session every other year, but, in the in-between years, the bank takes an informal approach to simply getting the Board and senior management together one afternoon in the boardroom to review what has been done in the past, talk about the vision and goals for the coming year, and to make sure everyone is merely on the same page. The important thing as Chairman is not to necessarily get everyone offsite for two days each year, but to ensure that your Board and management team are all pulling in the same direction. An outside facilitator like our firm can certainly help in that regard, but a more informal approach can be beneficial for organizations as well. We encourage you as Chairmen to require your Board and management team to discuss those types of issues each year at least informally.

Corporate Document Basics

One of the banking “tune-up” items we typically recommend on a periodic basis is to review your corporate organizational documents. This
typically means the Articles of Incorporation/Charter, as well as the Bylaws of both the bank and your holding company. We often find that an organization will decide to move forward with a new transaction, but has not considered whether their corporate documents, which probably have not been reviewed in a while, might not even permit the type of activity they are considering. For example, a bank decides to finally raise some additional capital to take advantage of growth opportunities in the market and to ensure that capital levels remain appropriate given its anticipated asset growth. However, it may get a long way down the road toward the process of selling new shares and then realize that the company has preemptive rights which prohibit the issuance of new shares unless all other shareholders are provided the opportunity to acquire a pro rata portion.

So the idea is to constantly fine-tune and update your corporate documents to ensure that they meet your needs for the coming year in terms of their technical and practical application. This may even include things like the ability of the Board to remove a director, the ability of stockholders to call a special meeting of stockholders, or some other corporate governance procedure. Many times we find that unless a bank and holding company have gone through a check-up and review of their core organizational documents, the institution may not be able to pursue the types of transactions that it desires.

Organizational Assessments

One of the somewhat new and “trendy” undertakings by many banks that seemed to start last year was what we would describe as “organizational
studies.” By this, we mean that organizations may have undertaken a board governance and structure study to look at committee structures, size of the board, board succession techniques, board evaluation processes, or something similar. Additionally, we saw those types of governance and board studies expand to include areas such as an interest rate risk analysis of the organization, a lending function top to bottom review, or something else similar in the nature of a “check-up.” As Chairman of the Board, you probably do not want the bank spending a ton of resources to do an entire organizational review of every aspect of the company, because if things were that bad, you would not be a healthy bank to start with. But an occasional review of various components within the organization such as board structure, the lending function, or something similar may be appropriate. Keep in mind how you might improve any weak links in your chain through those types of reviews and analysis.

**Renewed Focus on ESOPs**

An issue that we initially highlighted last year was the Department of Labor’s increasing focus on the Trustees of Employee Stock Ownership Plans (ESOPs) which are normally board members, and the interrelation of the fiduciary duty as a Trustee of the ESOP, with typical board service. In particular, in the heightened M&A environment we are experiencing, there seems to be a renewed focus on whether the ESOP Trustees have received separate independent advice as it relates to the fairness of transactions to the ESOP. As a result, when our firm is representing a seller, for example, we will seek out a third party to provide the fairness opinion to the ESOP Trustees. On transactions where we are not otherwise involved, our firm
often is the party that would render this third party fairness opinion related to the ESOP. The notion is that the board members who serve in those dual capacities need to wear separate hats and need to truly advocate on behalf of the ESOP holders to ensure fairness in transactions and otherwise. The Department of Labor seems to be stepping up its focus on that level of independence. Therefore, as Chairmen, it would certainly be a wise move to take extra caution in how the ESOP governs itself, and to seek outside assistance from parties not otherwise tied to a transaction anytime necessary to prevent further problems.

*Exploit Corporate Formalities: Use Corporate Formalities to Your Benefit*

Sometimes as Chairmen you may need to exploit your corporate formalities to your benefit. Consider a situation we recently encountered where the bank desired to remove some problem directors at the bank level, but wasn’t sure how to do that. However, the Chairman of the Board, whose family owned the majority of the stock of the holding company, agreed that the directors needed to be removed. As a result, we talked through the fact that once the holding company Board of Directors is selected by the shareholders (even if these problem directors are voted onto the holding company board), a simple majority vote of the Board of Directors of the holding company to elect the directors of the bank would be sufficient and the other directors could simply use their majority control of the Board to not re-elect the troublesome directors to the bank board. Likewise, the
Chairman and his family could exercise voting power to not even elect the problem directors to the holding company. So, majority rules still apply in most cases and sometimes you need to exploit that corporate formality to streamline your Board and organization.

**Meeting Adjourned**

So, we are off and running with tidbits of information, cautions, warning signs, and hopefully, some sound strategic advice to help you and your organizations in 2017. We welcome your calls, questions or comments at any time, and we will look forward to seeing many of you throughout the year. We look forward to helping you.

Until next time,

Philip K. Smith and Jeffrey C. Gerrish
PLEASE SEND YOUR EMAIL ADDRESS TO:
sloudermilk@gerrish.com

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

As many of you may already be aware, beginning January 1, 2017, the names of our firms were changed to Gerrish Smith Tuck, PC, Attorneys and Gerrish Smith Tuck LLC, Consultants. This name change was the result of a couple of changes within our firms.

First, our long-time partner, Frank McCreary, who has been with our firms since their inception, has retired. We are grateful for the presence he has been in our firms, as well as his service to our firms’ clients and the industry as a whole.

In addition to Frank’s retirement, the name change to Gerrish Smith Tuck, PC, Attorneys and Gerrish Smith Tuck LLC, Consultants reflects Greyson Tuck’s contributions to our clients and the community banking industry as a whole. We are excited to be a part of this milestone with Greyson, and we invite you to congratulate him.

Regardless of what changes occur, our legal and consulting firms will continue to operate in the manner in which they have operated in the past—always putting the client’s needs first. We very much appreciate the relationship we have with each of you, and we look forward to continuing to provide you the best legal and consulting services in the industry.

If there are any matters with which we can be of assistance to you or your financial institution, please let us know. We remain always happy to help!

Sincerely,

Gerrish Smith Tuck
Attorneys and Consultants
With the new executive administration in place, it seems almost every industry and market segment is waiting to see the true, full impact of a Trump presidency. Community bankers in particular are waiting in hopeful anticipation. Interest rates are expected to continue to rise, but overall economic growth is still below the Federal Reserve’s mark. Taxes are also expected to move in a favorable direction, but where they will actually land has yet to be determined.

One particularly relevant perspective is the impact of the new administration’s policies on community bank mergers and acquisitions. Industry consolidation has continued aggressively over the past few years. Even though momentum—both in number of deals and pricing—slowed down somewhat in 2016, we now have fewer than 6,000 financial institutions in the nation. The new administration will undoubtedly impact merger and acquisition activity for community banks, but the reality is the knife will cut both ways. To fully assess the impact, it is necessary to view the matter from both a sell-side perspective and a buy-side perspective.

**Less Incentive to Sell**

As it relates to a seller’s perspective, the short-term impact of the new administration is already being felt. There are many deals “in contemplation” across the nation that are already experiencing a slowdown. At minimum, the strategy has been to push more formal discussions further into 2017. Most industry experts expect the new administration to lower corporate tax rates, possibly landing somewhere in the 20% to 25% range. Also, recent executive orders have already signaled that regulatory overhaul could take place. With most industry players hoping for more favorable tax treatment and an eased regulatory environment, deals in contemplation are slowing to a stroll.

For those community banks contemplating a sale (but not yet involved in a transaction or discussions), our firm has seen a halt to essentially all forward movement. The reason for this is most sellers are adopting a “wait-and-see” approach as to what the Trump administration will ultimately do as it relates to community banks. One of our firm’s clients in particular put the matter succinctly—“If Hillary Clinton had won the election, our bank would have begun marketing itself for sale in 2017. With Trump in the White House, however, we are going to wait and see what happens.”

This phenomenon is fairly easy to understand considering the traditional underlying causes of community bank mergers—namely, lack of management succession, lack of board succession, lack of share liquidity, lack of adequate cash flow off the shares (i.e., dividends), and lack of economic growth in the bank’s market. In addition, the enormous regulatory burden placed on community banks since the middle of the Great Recession has created a strong impetus for community banks to sell over the past nearly 10 years.

(cont’d on pg. 3)
If tax rates actually decrease in a significant way, the decreased tax liability would have a direct and positive impact on overall bank profitability. Local economies would also likely benefit from tax cuts, largely in the form of increased small business activity. As the lender preference for the majority of small businesses, community banks stand to benefit the most from such increased activity. Similarly, if the regulatory burden decreases, community banks are some of the largest beneficiaries. The influx of post-Recession regulation has had a disproportionate impact on smaller banks in the nation, so regulatory relief is expected to have a similarly disproportionate impact. These two elements combined could mean a significant boost in community bank operations and profitability, which could allow community banks to sustain independence a little longer while taking time to address some of the bank’s internal issues, such as finding succession options for existing management and directors. Increased profitability could also flow through to the shareholders in the form of increased dividends. In other words, the “traditional” reasons for sale could be mitigated, at least in part, as a result of the new administration’s policies. Thus, it makes perfect sense why, for the short-term, sell-side community bank deals are slowing down.

Again, assuming the Trump administration enacts the policies it promoted on the campaign trail, such as a reduction in regulatory burden, job growth, economic growth, and the like, it makes sense that the trend of community bank mergers and acquisitions would slow down. Keep in mind, for every bank whose long-term strategy is to buy, there must be a bank whose strategy is to sell. If, indeed, “happy days are here again,” then it seems there will be a significantly smaller number of banks whose long-term strategy is to sell.

More Capacity to Buy

From a buy-side perspective, our firm is also noticing some delayed activity, but it is much more of a situation that institutions are much less willing to buy into “uncertainty.” With so many potential changes on the table, many buyers are also adopting a “wait-and-see” attitude that will result in a short-term slowdown in community bank mergers and acquisitions.

In large part, however, the counter-point to the sell-side slowdown is that larger banks’ stocks have improved with the post-Trump election bump, which means they have more valuable currency to utilize in acquisitions. Translation: larger banks can pay a higher price for the smaller banks because their currency of choice is worth more. Considering that larger, often regional, organizations are the primary purchasers of smaller community banks, it is expected that many larger banks may actually pursue smaller institutions more aggressively in the short term to take advantage of bank stock optimism.

In that case, an interesting phenomenon comes into play—no matter what a community bank’s strategy is, the community bank’s board of directors has to do what is right for the shareholders. If a larger bank presents an offer to acquire the bank for a good price with a stable, marketable stock as currency, the board may have a fiduciary obligation to sell, or at minimum to begin shopping the bank. Our firm refers to this situation as the “Godfather offer”—the one that the Board cannot refuse. If such an offer is put on the table, then the community bank is going to either take it, negotiate it, or at the very least, put the bank in play.

Therein is the double-edge sword of the Trump presidency as it relates to community bank mergers and acquisitions.
acquisitions. The same factors that make long-term community bank independence more viable also give larger banks more opportunity and improved currency to acquire community banks. What, then, is the appropriate response for community bank boards of directors? In short, discuss and identify your bank’s independence strategy in light of current factors (currency values, economy, profitability and growth outlook, etc.) and stick to it.

If your strategy is to remain an independent community bank for the long-term, then plan for independence by 1) adopting and implementing a realistic business plan for the coming years, and 2) adopting an unsolicited offer policy setting forth protocol (factors—both financial and non-financial—for the board to consider when analyzing the offer’s viability, threshold amounts or metrics below which the board will refuse the offer outright, etc.) in the event one of those larger regional banks comes knocking. This latter component is particularly helpful because it forces the board to think through its expectations for unsolicited offers before one is even put in play.

If your bank’s strategy is to buy another bank or sell to another bank, then identify an appropriate time frame and begin making preparations. This may mean hiring a consultant to begin the process of marketing the bank for sale. It may mean having that consultant run pro forma financials on prospective business combinations with various targets in your bank’s market. Regardless of whether you are considering buying or selling, get the right professionals involved sooner rather than later. It will allow the bank to act more quickly when an opportunity arises.

Whatever your bank’s role in the current mergers and acquisitions environment, the Trump administration will certainly create an interesting dynamic as it relates to industry consolidation. Make sure your board adopts the right strategy for your bank and your shareholders. If our firm can be of any assistance, please let us know.

Philip Smith of our firm has written and produced a three-DVD series for director training that is available through the Independent Community Bankers of America (ICBA) Community Banker University:

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 righthand column, then click “Resources” near the top of the page), or go to www.gerrish.com/pubs.php.

Despite all of the merger and acquisition activity occurring in the industry, for many community bank holding companies seeking to maintain long-term independence, there are very few, if any, acquisitions available that will improve earnings per share and return on equity more than the simple alternative of repurchasing the institution’s own stock. In fact, many institutions are currently realizing that such repurchases are the most efficient deployment of excess capital or leveraging ability. This is particularly true for community bank holding companies where such repurchases can generally be accomplished at reasonable prices.
Why do community bank holding companies undertake stock repurchase plans?

A holding company’s motivation to undertake a voluntary stock repurchase program is often unique to that organization’s specific needs. However, there are a few overarching motivations worth identifying.

First, community bank holding companies normally will undertake stock repurchase plans when stockholders need or desire share liquidity—that is, the ability to convert shares to cash. This could be due to the stockholder base aging, shift in generational needs/expectations, stockholders leaving the community, or any number of reasons. Regardless, stockholders’ need for cash now will often result in a company repurchasing its own shares when the community bank holding company has no other market liquidity.

A second motivation for stock repurchase programs is if a company believes its shares are otherwise undervalued. By initiating a stock repurchase program, it is able to provide a price support for the stock.

Third, a community bank holding company might also repurchase shares in an effort to consolidate ownership for purposes of electing Subchapter S status or otherwise consolidating the stockholder base.

What are the benefits of a stock repurchase?

A properly priced stock repurchase program has multiple benefits to an organization. Stockholders who desire to sell receive cash and, thus, instant liquidity for their shares, while the stockholders who do not sell become aware that the holding company has the ability to create a market and achieve “psychological” liquidity for their shares. The remaining stockholders also typically receive enhanced earnings per share and return on equity, as well as an increased ownership percentage in the company. Also worth mentioning is if the company continues to pay cash dividends in the same “gross” amount to the smaller stockholder base, the remaining stockholders will receive an increase in cash flow in the form of dividends. Significantly, all of these benefits to remaining stockholders require no action or financial outlay on their part. Overall, the transaction normally allows the company to consolidate ownership further, deploy excess capital effectively, improve stock performance metrics, and make the stockholders who sell happy, all while benefitting stockholders who choose not to participate in the repurchase program.

Are there any risks to stock repurchase plans?

The biggest challenge is not knowing how many stockholders will participate. A company might spend time, effort, and money to set up and initiate the program and then have no stockholders participate. Some Boards also struggle with setting the repurchase price per share. For a voluntary repurchase plan, our firm usually does not recommend that private companies get a valuation to set the price. Rather, our firm will typically conduct a financial analysis to determine the break-even point at which the price paid for all shares to be repurchased results in a neutral earnings per share position based on any funding required for the repurchases, debt servicing (cont’d on pg 6)
requirements, and similar factors. Then, the Board of Directors can set the price within its fiduciary duty at any point less than the breakeven point.

**What were the key components of such a plan?**

Because voluntary stock repurchase plans do not obligate stockholders to sell their shares, the Board can largely dictate terms and components of the specific program. With that said, there are a number of key elements every Board should consider, including:

1. The total amount of funds to be allocated to repurchase shares.
2. The price per share to be offered.
3. How long the stock repurchase program should stay open. (The SEC’s “anti-fraud” rules require a stock repurchase program to be open a minimum of twenty (20) business days, but most community banks will set some time frame such as sixty (60) or ninety (90) days—long enough to allow stockholders to consider the transaction, but short enough to create some impetus.)
4. How shares will be repurchased. For example, whether repurchases are made on a first come-first served basis until funds are depleted, whether they are prioritized from smallest number of shares tendered to largest number of shares tendered until funds are depleted, or some other prioritization.

Again, for privately held community bank holding companies whose stock is not registered with the SEC, the Board has wide discretion in setting the terms of the program. The directors’ fiduciary duties require the Board to operate with a certain level of prudence when it comes to setting the price per share, for example, but overall the Board has control of the program.

**What steps are involved in the repurchase process?**

If your Board is considering implementing a stock repurchase program, the first step is identifying the ultimate purpose for the repurchase plan, such as providing liquidity, deploying excess capital, or improving per share earnings performance. These factors will inform not only the size (i.e., dollar amount) of the offering, but also some of the underlying terms and priorities.

Next, our firm often conducts a detailed financial analysis to analyze the financial implications of repurchasing a given number of shares at a range of prices with various means of funding in order to determine the appropriate financial structure.

Then, once the Board has considered the available alternatives, the Board should approve by Board Resolution the proposed terms and conditions of the stock repurchase program. At that point, all legal, corporate, securities, and regulatory work should be undertaken to ensure compliance with applicable securities laws, filing of any requisite regulatory applications or approval requests, and adherence to any corporate formalities contained in the organization’s Articles and Bylaws.

Once all of the t’s are crossed and i’s dotted, detailed stock repurchase materials providing relevant financial
and operational data on the organization will be pre-
pared and distributed to stockholders to allow them to
make an informed investment decision on whether to
sell their shares. Upon expiration of the repurchase
program, stockholders are notified if their shares are to
be acquired, and, if so, appropriate documentation is
provided to them to submit their stock certificates along
with verification of ownership in order to receive their
cash payment from the organization.

In short, repurchasing its own stock is one of the most
efficient and beneficial uses of capital currently avail-
able for community bank holding companies with a de-
sire to remain independent. If your Board has any inter-
est in considering a stock repurchase program for your
organization, please let us know.

Several members of Gerrish Smith Tuck,
Consultants and Attorneys, facilitate strategic
planning sessions for community banks all over
the nation. Now is the perfect time to schedule
your board’s 2017 planning session. If you would
like Gerrish Smith Tuck to facilitate your next
strategic planning retreat, please call (901) 767-
0900 or email Jeff Gerrish at
jgerrish@gerrish.com, Philip Smith at
psmith@gerrish.com, Greyson Tuck at
gtuck@gerrish.com, or Doc Bodine at
dbodine@gerrish.com to secure a date.

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

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STRATEGIC PLANNING NOW

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dbodine@gerrish.com to secure a date.

Jeff Gerrish
jgerrish@gerrish.com

SCHEDULE YOUR
STRATEGIC PLANNING NOW
Gerrish Smith Tuck 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
- Key Employment Contract Provisions Utilized by Community Banks

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

**A Director’s Guidebook to Effective Board Compliance**
**A Fresh Start: Shareholder Value for a New Environment**
**A Positive Look at Community Banking**
**Corporate Governance**
- 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)
- The Community Bank Survival Guide: How to Survive and Thrive
- The Pros and Cons of Converting to Subchapter S
- Strategic Planning: Don’t Make Me Do It!
- Understanding the Director’s Role

If you are interested in any of these memos or publications, please call or email Shelley Loudermilk at (901) 684-2306 or sloudermilk@gerrish.com.

Please visit our website at: www.gerrish.com
Gerrish Smith Tuck, LLC, Consultants and Gerrish Smith Tuck, 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:

**Areas of Service**

**Financial Advisory/Consulting Services**
- Acquisition Financial Analysis
- Fairness Opinions
- Transaction Pricing 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

**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 Smith Tuck also has recently provided speakers for the following trade associations on a wide variety of topics:

- 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
- North Carolina Bankers Association
- Pennsylvania Association of Community Bankers
- Pennsylvania Bankers Association
- South Carolina Bankers Directors College
- Tennessee Bankers Association
- Virginia Association of Community Banks
- Washington Bankers Association
- Western Independent Bankers

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 Smith Tuck, Consultants and Attorneys, is also available to facilitate strategic planning retreats and proprietary director training designed for your Board of Directors.
### Recent Transactions

<table>
<thead>
<tr>
<th>Company</th>
<th>Bank Holding Company for</th>
<th>Acquired</th>
<th>Financial and Legal Advisors</th>
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<td>Milan, Illinois</td>
<td>TCB Mutual Holding Company</td>
<td>Tomahawk, Wisconsin</td>
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<tr>
<td>First Port Byron Bancorp, Inc.</td>
<td>Port Byron, Illinois</td>
<td>TCB Mutual Holding Company</td>
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<td>Terre Haute, Indiana</td>
<td>Hardware State Bank</td>
<td>Franklin Grove Bank</td>
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To discuss your institution’s strategic transaction opportunities, please contact Jeff Gerrish at jgerrish@gerrish.com, Philip Smith at psmith@gerrish.com, or Greyson Tuck at gtuck@gerrish.com.
Recent Transactions

First State Bancshares of Dekalb County, Inc.  
Bank Holding Company for  
First Bank of the South  
Fort Payne, Alabama  
has acquired  
First Rainsville Bancshares, Inc.  
Bank Holding Company for  
Rainsville, Alabama  
Gerrish McCreary Smith, Attorneys, served as financial and legal advisors to First Rainsville Bancshares, Inc. and First Bank of the South.

Planters Holding Company  
Bank Holding Company for  
Planters Bank  
Indianola, Mississippi  
has acquired  
Covenant Financial Corporation  
Bank Holding Company for  
Covenant Bank, Clarksdale, Mississippi  
Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Covenant Financial Corporation and Covenant Bank.

Docking Bancshares, Inc.  
Bank Holding Company for  
Relianz Bancshares, Inc.  
Bank Holding Company for  
Wichita, Kansas  
Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Docking Bancshares, Inc. and Union State Bank.

Community Financial Corp.  
Bank Holding Company for  
Garnavillo Bank Corporation  
Bank Holding Company for  
Garnavillo, Iowa  
Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Garnavillo Bank Corporation and Puget Sound Financial Services, Inc. and Fife Commercial Bank.

Olympic Bancorp, Inc.  
Bank Holding Company for  
Puget Sound Financial Services, Inc.  
Bank Holding Company for  
Canton, Illinois  
announced its intention to acquire

Henry State Bancorp, Inc.  
Bank Holding Company for  
HENRY STATE BANK  
Henry, Illinois  
Gerrish Smith Tuck, Consultants and Attorneys, served as financial and legal advisors to Henry State Bancorp, Inc. and Henry State Bank

To discuss your institution’s strategic transaction opportunities, please contact Jeff Gerrish at jgerrish@gerrish.com, Philip Smith at psmith@gerrish.com, or Greyson Tuck at gtuck@gerrish.com.
Recent Transactions

**TS Contrarian Bancshares, Inc.**
Bank Holding Company for

**TS Bank**
Treynor, Iowa

has acquired

**First Federal MHC**
Mutual Holding Company for

**1st Federal**
Mattoon, Illinois

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Washington Savings Bank.

**Tioga Bank Holding Company**
Bank Holding Company for

**The Bank of Tioga**
Tioga, North Dakota

has acquired

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Tioga Bank Holding Company and The Bank of Tioga.

**Sargent Bankshares, Inc.**
Bank Holding Company for

**FNB Bankshares, Inc.**
Bloomer Bancshares, Inc.
Peoples State Bank of Bloomer.

has acquired

**Security Financial Services Corporation**
Bank Holding Company for

**security financial bank**
Durand, Wisconsin

has acquired

**Bloomer Bancshares, Inc.**
Bloomer, Wisconsin

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Bloomer Bancshares, Inc. and Peoples State Bank of Bloomer.

**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 Milnor and Lisbon**
Milnor, North Dakota

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to FNB Bankshares, Inc. and First National Bank of Milnor.

Effingham, Illinois
has acquired

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Washington Savings Bank.

Keota, Iowa

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Farmers Savings Bank.

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

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The Client’s Needs Come First