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# GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Texas, Wisconsin, Kentucky, Tennessee, Arkansas and Minnesota!

## BOARD'S FIDUCIARY DUTY

I have been with multiple community bank boards lately discussing the “Is now the time to sell the bank?” question. Remember that the board has no fiduciary duty to seek out a buyer. It simply has a fiduciary duty to do what is in the best interest of all the shareholders. Often a Board’s consideration will involve whether it should change the structure of the company, for example, from a C Corp to an S Corp, should the company do an acquisition, should it expand geographically, or should it sell. If the Board decides to pursue one strategic option to the exclusion of the others because the one option is the best way to enhance shareholder value and then that option disappears, can the Board simply pretend like none of the other options existed? I don’t think so. At that time, it is time to go back to the drawing board and again figure out what is in the best interest of the shareholders.

## CONFIDENTIALITY IN ACQUISITIONS

A community bank board member recently asked me whether I thought confidentiality in community bank acquisitions was important. It seems like kind of a silly question. My general response is, of course it is important. Normally, in a community bank acquisition, confidentiality is the norm and disclosure of discussions or contemplation of an acquisition is on a “need-to-know” only basis. Generally, as the transaction moves forward, then the need-to-know expands to members of the senior management group, but not always, depending on the ownership and

Board structure. It seems kind of ridiculous and short-sighted for someone who was not in the “need-to-know” circle to be upset about the fact they did not know what was going on until later.

One reason confidentiality is the norm in community bank acquisitions, and the reason the circle of need-to-know expands incrementally, is that many transactions that start at the discussion stage never reach the “meeting of the minds” stage. Obviously, if that is the case, why would you want to get your entire senior management team or staff upset about the Board’s contemplation of a transaction that will never occur?

### DO YOU NEED A BANK HOLDING COMPANY?

I was recently with a well-run community bank. This bank was family-based, although it had a fairly diverse (couple hundred) shareholder group. Its charter had been in existence for a long time, but it did not have a bank holding company and had never seriously considered converting to Subchapter S.

As I reviewed the material in preparation for the meeting, I told the principals involved that two things jumped out at me. First, they needed a bank holding company to support the capital of the bank without going back and asking the shareholders for cash, as well as to provide share liquidity for any shareholder who may want to get out. Second, because they paid a healthy dividend, Subchapter S made perfect sense for them. This would basically become a cash cow for all their shareholders, large and small, but particularly those at a lower tax bracket than the max. For a variety of reasons, this particular institution had not seriously contemplated either of those before, but hopefully it will at this juncture.

From a strategic standpoint, it is very important to get your bank in the right organizational structure (holding company) and to get your ownership into the appropriate ownership structure (Subchapter S), particularly if you want to remain independent over the long term.

As I mentioned in prior *Musings*, there have been a couple of larger regional banks that have ditched their bank holding companies. My comment was, just because a large regional does something that makes sense for them, does not mean it makes sense for you as a community bank. Our partner, Philip Smith, has written a longer article on this topic. If anyone would like a copy of the article, please contact us.

## GOING PUBLIC

I was with a community bank the other day that was pushing up toward the \$1 billion mark. Their Board of Directors is all “jazzed up” about the fact that they could go public. I had just started working with this bank, so as I became familiar with them, I discovered that the bank holding company had less than 50 shareholders, with two large shareholders each owning about 30%. For some reason the Board and senior management of this group believed going public was inevitable. I advised them for multiple reasons there are not many of our community banks these days that look toward “going public” as a solution to anything.

As I began to discuss with this group why they would want to go public, I had to disabuse them of the notion that they would have any access (more than they do now) to the public capital markets and that they would have more liquidity for their shares than they do now unless they went “really public” – i.e. 5,000 or so shareholders. My general recommendation to them was to contemplate converting to Subchapter S. They seemed to be the perfect candidate for it. Their concern was the bank’s rapid growth. Our firm is going to run some “down and dirty” numbers, but my guess is, as a Subchapter S in this particular state, they will probably retain as much, if not more, of their earnings to support their growth than they do as a C Corporation. We will see what happens.

## BANK STOCK VALUATIONS

We are currently assisting a couple community banks in different parts of the country by determining the fair market value of their common stock. We do these stock valuations for a number of different reasons, but these two valuations are being completed to assist the board in determining the fair market value of the holding company common stock for purposes of repurchasing the shares from larger shareholders. One of the questions that has come up in a number of valuations recently, including these, is whether the run up in bank stock prices that was experienced following the election and that has largely been sustained for larger banks “trickles down” to community banks. In short, the answer is yes. The run up in bank stock prices experienced in late 2016 and through 2017 for larger banks absolutely impacts the fair market value of community bank stocks by making them more valuable. This is because a large part of the fair market value determination is based on comparable stocks, and as the value of the comparables increases so too does the value of the community bank stock.

## M&A NEGOTIATIONS

Over the past several *Musings*, I have kept you up-to-date on the negotiations we are going through with an inexperienced community bank acquirer. These difficult negotiations have continued over the past couple weeks. The latest sticking point with the acquirer is the no-shop and superior proposal provisions of the contract.

Any time a community bank (or any bank for that matter) enters into a contract to sell their bank, the contract has a provision that says the bank will not solicit competing proposals. This essentially requires the sellers to cease negotiations with anybody they may be discussing a competing transaction with, and not to take any action in furtherance of a competing transaction. However, these provisions always have “fiduciary outs” for the selling board of directors that allow the board to accept an unsolicited superior offer. The idea is that if you are selling your bank for \$25 million in cash and somebody comes and offers you \$32 million, you need to accept the \$32 million offer because it is much better for your shareholders than the \$25 million. The buyer that is left at the altar in that situation is compensated with a breakup fee that is typically 3% to 5% of the original purchase price.

We have never seen a community bank acquisition definitive agreement that did not contain no-shop and superior proposal clauses. The one that was proposed by the buyer in this transaction did not. We added one, and apparently have gravely insulted the buyer. Having never done this before and having no perspective on what are the common issues in the industry, they are saying there is no way they can agree to the provision.

We are continuing to work through these issues with the buyer. I am hopeful we are getting close to some type of end on these negotiations. I will keep you updated.

## “TOUGH” STRATEGIC DECISIONS

We are currently assisting a board that I consider to be in a very fortunate position. This board runs a larger bank that is well-run, profitable, and in good banking markets. The bank has plenty of capital and pays a strong dividend. We are currently assisting the board in considering the sale of the bank or the reorganization of the bank into a Subchapter S corporation.

Both the sale of the bank and the Subchapter S reorganization project out very nicely. If the bank is sold, we believe it will bring a pretty strong sales price. If the bank reorganizes into an S corporation, the shareholders will take what is already fairly significant after-tax cash flow and increase it even further. These are the types of “difficult” strategic choices that this board is fortunate to have to consider.

We are working with the board through these issues. It really boils down to what is best for a majority of the shareholders. The board represents well more than a majority, so whatever the board wants to do will control. If the board decides they are ready to cash out and take a lump sum of cash for their stock, we will assist them in selling the bank. If the board decides they like the after-tax cash flow and want to consider sticking with the investment, the Subchapter S makes the most sense. Either way, this board is to be commended for working hard and putting themselves in a position where they have two great alternatives.

### WALK-IN REPURCHASE PROGRAMS

I have received a couple calls from clients recently regarding walk-in stock repurchase programs. These are simply programs where a holding company wants to offer liquidity to shareholders by setting a price at which the holding company will repurchase its common stock from any shareholder wanting to sell. The recurring question that often comes up is what level of formality is required to establish a walk-in repurchase program. Many have asked whether some type of lengthy formal policy has to be drafted. My response is no, there is no requirement for a lengthy policy. Instead, these programs are established by passage of a board resolution that essentially sets forth the total capital allocated to the plan, the number of shares to be repurchased, the repurchase price per share, and the date through which the President is authorized to repurchase the shares. Once that date expires, the board should then pass a resolution extending the program if determined appropriate.

If you are thinking about offering stock liquidity, do not make it harder than it needs to be. You can simply pass a board resolution authorizing the President to repurchase a certain number of shares at a certain price per share. That authorization should last through a date certain, which can be extended by the board.

Keep in mind that one of the obligations of the board of directors is to provide liquidity for the holding company shareholders. Redemption of stock may also be one of the better holding company capital allocation alternatives. It is certainly a lot less risky than buying another bank or branch. The redemption typically has a very positive financial impact on those shareholders who do not sell, including increased earnings per share, increased return on equity, and the illusion of liquidity (they walked in – the holding company bought their stock), and if the dividend policy is to pay a percentage of earnings in dividends, then the dividend may rise for the remaining shareholders as well. A win-win for everyone.

CONCLUSION

We are certainly keeping our community bank clients, directors, officers, staff, and other friends in Texas, particularly in the Houston area, in our thoughts and prayers. We ask you to do the same. We also ask that you have a good and safe Labor Day Weekend.

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*and*

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