# GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Florida, Wisconsin, Arizona and Tennessee!

## BROKER/DEALER ISSUES

We recently received a call from a bank president that was very quickly working his way into a potentially big problem. This president recently received a call from a financial advisor to one of the holding company shareholders. The financial advisor said he would like to find someone to buy the shareholder's holding company stock. Our client indicated he would be happy to assist with that, and he placed a call to the holding company chairman, who was the last individual to buy shares. The chairman indicated he was not in a position to buy more shares but had a friend who would be interested in buying them. That friend called the president, and the president then worked with that individual and the financial advisor to try and arrange the sale of the shares.

During the course of the transaction, and before the deal was actually consummated, some intervening events occurred that gave the president pause. He called us to talk about these issues. Our advice to the president was pretty simple: get out of the transaction right now! We told the president he needed to call both parties and indicate that he would be withdrawing from any further discussions regarding the transaction and would in no way work to facilitate the transaction.

The problem is that this president was acting as a broker/dealer when he was not licensed or registered to do so. In these types of situations, our recommendation is to simply provide a name and telephone number for the potential purchaser, and then allow the buyer and seller to work it out between themselves. It is never a good idea to take it upon yourself to try and facilitate the transaction. You are not licensed to do so, and there are a whole slew of negative consequences that could result.

## HOLDING COMPANY LOANS

Over the past couple weeks we have assisted a number of our clients in reviewing holding company loans. When we take this type of work on, it is typically assisting a holding company in obtaining some type of credit. However, the past couple of weeks or so has been the exact opposite – we have been assisting our bank clients in reviewing holding company loans where our client will be lending money to another bank holding company. We have reviewed the loan documentation and have also assisted in some of the underwriting and other evaluation issues.

One of these deals had a bank holding company borrower that had a particularly convoluted capital structure. They had all of the "bells and whistles" at the holding company, including Trust Preferred Securities, Subordinated Debentures, and other holding company debt. One of the issues that was central to the credit decision was where the lender stood in the capital hierarchy in the event the loan went south. It took a while, but the matter was eventually negotiated to our client's satisfaction. The loan documents were not specific on standing at the beginning, but they were reworked to provide our client senior creditor status by the time of execution.

If you are considering funding a holding company loan, make sure you understand what it is that you are getting. These loan documents are typically a little bit different than what the loan officers see on a day-to-day basis. It is obviously important for a number of reasons to understand all aspects of the transaction to make sure your organization is getting exactly what it thinks it is getting.

## SUCCESSION PLANNING

I recently met with the Chairman of the Board of a community bank. He was concerned that he was going to lose his current CEO who is 65 years old. When I asked if there was any internal succession for him, I was met with the response that both the number two and the number three in the bank are 63 years old. This began an earnest discussion with respect to management succession. The bottom line of this organization, not unlike many, is there will be a retiring CEO with no real long-term replacement. There are a couple of younger bankers that may be suitable, but probably not for another 10 years. This is going to require some succession planning to get through the interim time period, or it is likely this bank will be sold.

## CONFLICT OF INTEREST

We are currently assisting one of our bank clients that has an ESOP in doing a private placement of ESOP debt. This ESOP is looking to borrow $1 million to $2 million from the bank's directors and other existing shareholders. The president of the bank recently let me know that the board would like to incorporate a prepayment penalty into the ESOP debt. My response to the president was "no" because that would very clearly be a conflict of interest. In essence, these directors, who are going to fund a substantial portion of the debt, were looking to impose a prepayment penalty on the debt to create a disincentive for the ESOP paying it off early. This was clearly a conflict of interest because the directors were looking to add this term for their personal benefit to the detriment of the ESOP. Our advice to the ESOP was not to include a prepayment penalty and to prohibit these directors from participating in approval of the terms of the ESOP debt if they were also going to be on the other side of the transaction as creditors to the ESOP.

## HIGH PRICE?

I was recently reviewing some material for a client who is contemplating an acquisition. The material had been prepared by another professional and contained the statement that bank sales are priced on a multiple of earnings. I do not want to break it to you *Musings* readers, but that is just flat-out wrong. Bank sales are priced based on the earnings stream obtained by the buyer. They are not based on some arbitrary multiple of earnings calculation. In fact, once the purchase price is determined based on the earnings stream that the seller brings to the buyer post-transaction versus what the buyer has to give up, then the transaction pricing is translated into a multiple of earnings. For example, historically, a multiple of earnings of about 20 times used to be a pretty decent transaction. Is a multiple of earnings of 35 times a great transaction? Not if the bank has no earnings. Don't be fooled by some of the "stuff" that is floating around about pricing these days.

If you have a target bank with virtually no earnings and you agree to acquire them based on the earnings stream you think your organization can create post-acquisition, the transaction will likely end up with a high multiple of earnings. That situation is fine. (Just be aware that it will probably end up with a low multiple of book value almost by definition.)

  

## DE NOVO BANKS

We have received a couple of inquiries lately for individuals wanting to start de novo banks. For those of you who are not familiar with the fancy French term "de novo," it means "new." We also had a lengthy interview with *Bank Director Magazine* about de novo banks, and we will see what comes of that. The most recent individuals who came to us wanting to start a new bank of course are those who are somewhat involved in the technology industry who need a bank charter to move forward with funding their operation with what they hope is low cost deposits. My general comment to most of these folks is "good luck." Even though the bank regulators are promoting the chartering of de novo banks (we have had very few in the last five years), they are not going to give away charters and deposit insurance to folks looking simply for a low cost funding source. That has not changed.

## DIRECTOR EMERITUS

Although we do not see it terribly often anymore, I am still a firm believer that Director Emeritus is a valuable concept for some of your more well-seasoned directors. It allows them to continue to attend board meetings, receive board fees (possibly), in some cases continue to receive benefits (depending on what the Board decides), and go out with some honor and dignity. We have had a number of clients in the last few months that have put together Director Emeritus programs for some of their senior directors. Although I am not a big fan of mandatory retirement because I think there are better ways to get people off the Board, if you do have either mandatory retirement or directors who need to be "promoted," think about creating a Director Emeritus structure.

## "MERGER OF EQUALS"

Several times over the past couple weeks I have been involved with a board that is considering a "merger of equals." As most *Musings'* readers know, I view a merger of equals with a healthy dose of skepticism. It is almost impossible to successfully complete a merger of equals. According to the accounting rules, somebody has to be labeled the acquirer and somebody has to be labeled the target. More importantly, somebody's culture, policies, executive officers, and the like are going to survive.

My general recommendation to a board that is considering a merger of equals is to put that terminology out of your mind and instead evaluate the transaction as either an acquisition or sale. My recommendation is to pursue the strategic transaction if it makes sense from that perspective. If the viability of the transaction is dependent upon the transaction being a merger of equals, the transaction likely does not make sense. If it makes sense from a buy or sale perspective and then ends up actually being a merger of equals, all the better, at least from the "seller's" perspective.

## FR Y-6s

Please consider this our annual public service announcement and reminder that the due date for your holding company's annual FR Y-6 submission is coming up in about six weeks. As most of you know, this is the annual report to the Federal Reserve that must be submitted to the Federal Reserve within 90 days of December 31st. For most holding companies, the submission of the FR Y-6 is a non-event. However, there are some specific disclosures regarding your directors' business activities that could take a while to put together. Please just keep this in mind and prepare accordingly. Please also let us know if you have questions on any aspect of the FR Y-6 or need our assistance in any way.

## CONCLUSION

We hope everyone remembered and had a good Valentine's Day yesterday. We are optimistic spring may come a little bit early this year, at least for some in the Midwest. See you in two weeks.

*Jeff Gerrish* *and* *Greyson Tuck*