GERRISH'S MUSINGS

Jeffrey C. Gerrish
Greyson E. Tuck
Gerrish Smith Tuck
Attorneys/Consultants
700 Colonial Road, Suite 200, Memphis, TN 38117
♦ (901) 767-0900 ♦ Fax: (901) 684-2339
♦ Email: jgerrish@gerrish.com ♦ gtuck@gerrish.com ♦ www.gerrish.com

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 offices' 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*

