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

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Dear Subscriber:

Greetings from Iowa, Wisconsin, Louisiana, Alabama, California and New Mexico!

THE TROUBLED BANK ACQUISITION

We have been assisting a client in considering the acquisition of a severely troubled bank for about the past year or so. This is one of those "on again, off again" type transactions where the seller has come to us about three or four different times saying, "If we do not do a deal with them, they are going to do a deal with someone else." That has yet to happen.

The selling bank is what I would appropriately describe as a very troubled institution. They have very low capital ratios and are losing money at a fairly rapid pace. The seller will not be long for this world if they are not able to find a buyer. With that in mind, they have come back to our client again with what we think may be a last-ditch effort for selling the bank at a very low price.

Our client asked whether I thought they should do the transaction. We talked about a number of considerations, one of the most important of which was whether they actually had somebody that had the capacity to spend the time necessary to turn this bank around and return it to profitability. Based on some recent changes in management at the bank, they did not have a specific individual in mind they thought had enough time to lead the charge in turning this bank around. As soon as I heard that, I recommended they stay away from the acquisition, regardless of what the purchase price would be.

If you are thinking about making any acquisition, particularly one for a troubled bank, the financial considerations are important, but they do not completely control the decision on whether to buy. If you do not have a management team in place or cannot get your hands on one

that can spend the time necessary to fix the troubled bank, stay away completely. I do not care what the purchase price is. If you are buying a troubled bank without a management team that has the time to fix it, it is not a good deal.

THE OVER-THE-TOP MERGER AGREEMENT

We are currently representing a community bank that is in the process of selling to another community bank. Unlike most other deals where we act as both the financial advisor and attorney and work on negotiating the transaction and bringing it together, in this transaction we are serving only as legal counsel. We were not responsible for finding a buyer or otherwise involved in the marketing process for this bank.

The acquiring bank recently provided to us the proposed transaction agreement. We reviewed the agreement and identified about five "major" issues in the agreement. Among these trouble spots include a proposed holdback of approximately 40% of the purchase price for an extended period of time, provisions requiring payment by the seller of certain fees the buyer previously agreed to pay, and minimum allowance requirements that were never discussed. Needless to say, what was offered in the agreement was a far cry from the "good deal" that was apparently discussed in the initial discussions regarding the transaction.

We are working with the buyer and its counsel to address each one of these major issues. I am hopeful that we can reach agreement on them to everyone's satisfaction. If we are able to do so, it will only mean additional time and expense for the transaction. If we are unable to do so, it will mean that the bank needs to essentially start back at square one in the sales process. Neither are a great result, but the second is certainly worse than the first.

If you are thinking of being a buyer or seller, be sure to reach agreement on the key points of the transaction prior to spending the time and money to draft the lengthy transaction agreement. As many of you know, this is typically done through an indication of interest, term sheet, or other similar document that sets forth the key terms of the transaction. This step saves a lot of time, effort, and headache in bringing a deal together.

THE STOCK PRICE DILEMMA

One of our clients is dealing with somewhat of an unusual issue. The board of directors of this particular holding company has authorized a walk-in stock repurchase program at a pretty healthy premium to book value. This is essentially a program where any shareholder can walk in and sell their shares to the holding company at about 140% of book. Based on the financial

analysis the board has done with its advisors, the board believes this to be an appropriate fair market value for the common stock. This holding company's "problem" as it relates to the market value in its common stock is the fact that the shares are trading in the market at about 180% of book value. Obviously this is a significant premium above where the board believes to be the appropriate market price. Certainly an increased stock price is not a terrible thing. However, the board is wrestling with whether there is any sort of problem with the market believing the fair market value of the stock to significantly exceed what the board and its advisors believe to be an appropriate value.

We are working with the board to figure out whether they want to take any action as it relates to this particular issue. It is certainly not the worst problem to be wrestling with as a director!

MORE HOLDING COMPANY DISSOLUTIONS

As many of you *Musings* readers will recall, several months ago we relayed the fact that a fairly large regional bank had determined it was in the shareholders' best interest to terminate its bank holding company and "reorganize" itself in a bank-only structure. Apparently similar bank holding companies are thinking it may be appropriate to follow suit. There is an approximately $15 billion regional bank in the South that also announced it has chosen to terminate its bank holding company and "reorganize" into a bank-only structure.

These two corporate actions may have community bankers wondering whether the termination of their bank holding company is an appropriate corporate transaction. Our advice is absolutely not! The benefits of the bank holding company to community banks are simply too great to even consider eliminating your bank holding company. The ability of the holding company to borrow funds at the holding company level to create capital at the bank, the efficiency of providing share liquidity in a holding company structure that is not available to banks, the ability to diversify net income by engaging in activities closely related to banking, and multiple other benefits of the bank holding company are simply too good for community banks to pass up.

To completely avoid any confusion, our recommendation is that every community bank in the country be in a bank holding company structure. The benefits of the holding company to a community bank are worth any additional regulatory or corporate effort that the holding company requires.

Keep in mind, just because a multi-billion dollar bank holding company moves forward with a strategic initiative that they believe is in their company's best interest, it does not mean that something similar should be in every community bank's best interest. Frankly, both of the banks that have announced that they are eliminating their holding companies have either had difficulty with the Federal Reserve in obtaining acquisition approvals or faced long delays in connection with those approvals. Our guess is that is what drove their strategy.

OWNERSHIP SUCCESSION

We have discussed, through *Musings* and other venues, board succession and management succession on a regular basis. We do not often discuss ownership succession. I have been with several banks in the last couple of months that have had elderly (to be polite) principal shareholders. I remember asking one of the CEOs what the plan was for the shareholder's stock when he passes to the Great Beyond. Frankly, I got the wrong answer. The answer was "we have no idea."

Part of our job as directors and officers is not only to deal with management and board succession, but also to deal with ownership transition. Notwithstanding how close to the vest many of our principal shareholders keep their estate plans, the holding company through its Board of Directors needs to know what those plans are so the holding company can determine whether to keep powder dry to repurchase shares or redeem shares to provide cash to the estate for tax purposes. If the holding company is a Subchapter S, additional issues will arise with respect to maintaining an estate as an eligible Subchapter S shareholder for a limited period of time.

Bottom line: ask the hard questions about ownership succession and transition.

THE NEXT CHAIRMAN

We have a number of community bank clients across the nation who, as the Board becomes older and the Chairman becomes older, are considering the possibility of moving the Chairman to emeritus status and going through the selection process for the next Chairman. In some cases, it is the person with the right last name, the oldest director, or the senior statesperson on the Board. Our recommendation is that is not the best way to select the next Chairman. The Chairman has a lot of duties and obligations. Especially post-Great Recession, the position of the Chairman has become more important than before. The Chairman should be selected for his

or her ability to fulfill the Chairman's duties and responsibilities. If anybody is interested in further information on this, just let us know.

BOARD MEMBER VOTING

We have run into a couple of situations recently involving whether an individual board member can vote on an issue in which he or she has an obvious conflict of interest. Interestingly, in the different states in which this arose, we reviewed the state laws and found they did not prohibit the individual board member from voting in connection with a situation that the board member had an obvious conflict of interest. Of course, in some circumstances, such as Reg O loans, the regulation prohibits the board member's participation. In other circumstances, state law and federal regulatory guidance is silent.

Our recommendation generally is to follow the rule that "there should not be any appearance of impropriety." Review what is to be voted on and who is voting on it as though you are doing so with 20/20 hindsight. Any complaints in the future will certainly be with 20/20 hindsight, so you should view it that way on the front end. If there is a conflict of interest, then the interested director should simply abstain from the vote. Keep that 20/20 hindsight review in focus when you are making the decision as to what to do.

FACILITATING YOUR OWN PLANNING

I have had a couple of emails in the last two weeks from community bank CEOs with whom I had not previously worked. Both of them had, over the past several years, facilitated their own long-term planning. Both of them told me the same thing - they were "sick of it." It is very difficult for an insider to facilitate planning. There is simply too much baggage, history, and personalities in the mix. Generally, an outside facilitator can cut through that, either through skill or ignorance, one of the two. If you have not used an outside facilitator before, or even recently, you might want to consider it. We facilitate planning for a tremendous number of community banks each year. Let us know how we can help.

NO ACQUISITION EXPERIENCE

I was recently with a good-size community bank whose senior management had no acquisition experience to speak of. They were smart enough to realize they needed some specialized expertise, which is why we were called in. It was actually refreshing to meet with a senior management group who is not afraid to ask questions about how things actually work in

the real world since they had not been down this path before. Our plan is to shepherd them through the process and see if an acquisition makes financial and cultural sense for them.

THE PREEMPTIVE BID

I was visiting with a client the other day about unsolicited offers. They had not actually received one, but they had noticed in the press that there have been a few that have been made public. They were curious as to what constitutes a preemptive bid. A preemptive bid is when you receive an unsolicited offer that is so high you can basically accept it with little negotiation and no shopping or testing the waters as to other bidders. With respect to the question of what constitutes a preemptive bid, I am not sure I have the answer, other than "I will know it when I see it." The reality is, I have not yet seen one in any circumstance that I have been involved in over the last 35 years. Most offers, if they are going to go anywhere, will require some negotiation and some testing of the waters to make sure that, in fact, that it is the best offer. You really do not want to get up at a shareholders' meeting and have a shareholder comment, "Well it is nice you took this offer; who else did you talk to?" and you have to answer "No one." Unsolicited offers are certainly getting more prevalent in the current acquisition environment.

RETIRED DIRECTORS

I was with a Chairman of a board of a fairly good sized community bank. We were talking about getting directors on and off the board. This basically was a discussion on board succession, including things like mandatory retirement, hard conversations, etc.

The chairman announced that his position was that they would retire any director as soon as they died. I told him that was pretty charitable. I thought we had gotten better on this "directorship for life" in our community banks, but apparently not this particular bank.

CONCLUSION

Greyson and I have both had the opportunity to meet with "a lot" of community bankers over the past two weeks - Greyson as a speaker at the Western Independent Bankers Mergers and Acquisitions Conference in Napa (tough duty), and me as a speaker at the Independent Community Bankers Association of New Mexico Annual Convention held at a beautiful resort outside of Albuquerque (also not tough duty). Meeting with community bankers in their home state continues to remind us why we do what we do every day. Salt of the earth people.

Have a great two weeks!

Jeff Gerrish *and* *Greyson Tuck*