GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from North Dakota, Iowa, Tennessee, Pennsylvania, and Illinois!

THE DIFFICULT DECISION

We are currently working to reorganize one of our clients into a bank holding company structure. This client has a very concentrated ownership group. The bank has a very small number of shareholders. It is essentially one family that represents ownership of about 95% of the bank stock, with the remainder owned by a very small number of other shareholders that are not family members.

While discussing the various possibilities for the holding company reorganization, we discussed the fact that the transaction could be structured to "cash out" all of the shareholders that were not members of the control family. This would require each of the shareholders to take cash in the transaction and would vest 100% ownership of the holding company and bank in the control family. This certainly seemed an attractive alternative at first. However, upon further consideration, the control family decided against it. Their reasoning was sound – they simply did not want to involuntarily cash out each one of these bank shareholders that have been with them a very long time. In other words, the relationship with these shareholders was more important than complete ownership of the organization.

Instead of forcing each one of these shareholders out, the organization is going to give them an option as to whether they want cash or holding company stock. This is certainly an honorable decision for the control family, and one that I believe will serve the organization well.

To ensure compliance with the requirements imposed by the U.S. Internal Revenue Service, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the U.S. Internal Revenue Code or (2) promoting, marketing or recommending to another party any transaction or tax related matters addressed herein.

BRANCH ACQUISITIONS

We are in the process of working on a couple of branch acquisitions for different clients. Most *Musings* readers understand a branch acquisition is significantly different from a whole bank acquisition. A branch is structured as a purchase of assets and assumption of liabilities. The only things you end up with after a branch acquisition are those assets you specifically agree to purchase and those liabilities you specifically agree to assume. The assets generally include the branch building, other fixed assets, furniture, fixtures, and the like. Sometimes possibly loans are included. The liabilities assumed are primarily deposit liabilities.

The big benefit of a branch acquisition over a full bank merger transaction is that the purchaser only gets what the purchasing bank specifically agreed to purchase or assume. Are there any exceptions to this? Possibly. We are currently working on a situation that involves compliance matters, and we are in the process of determining whether the bank has the responsibility to pick up a compliance issue tied to a new customer at the bank even though the bank did not assume the unknown liability. I will keep you posted on that one.

TYPICAL ACQUISITION ISSUES

For those of you who have not done an acquisition lately, in the current environment there are a couple of acquisition pricing issues that are paramount. These pretty much involve expenses at or post-closing that are incurred by the seller or incurred as a result of actions taken by the seller, such as terminating long-term contracts and the like. In virtually every transaction we have done lately, the cost of these items - which include data processing contract termination fees, associated conversion fees or deconversion fees (or both) as a result of data processing, termination of SERPs and other deferred compensation plans, retention bonuses for employees, change in control payments for employees, and the like - come right off the purchase price of the transaction. Most purchasers will determine an aggregate purchase price, for example $20 million, and go back to the seller and indicate that they will pay $20 million, which is approximately 133% of their $15 million core 8% capital, plus dollar-for-dollar for capital over 8%. Interestingly, in this type of transaction, the seller may have only $16 or $17 million of core capital once the above fees are expensed. The target bank in this example is required to maintain that $15 million capital level. The result, however, is that the target pays the fees and gets dinged on the purchase price for them.

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THE TRUMP EFFECT

We recently had an interesting regulatory situation. We were contacted by a long time client who has a bit of an unusual business model for a community bank. The bank is heavily concentrated in a particular area of commercial & industrial lending, as well as commercial real estate. Their asset quality is great, but the regulators have taken an exception to the concentration.

They contacted us because they wanted some representation at the meeting with the regulators. They were very concerned they were going to be hammered into oblivion for their concentration and the other issues, including bank liquidity. The surprise (which we may or may not attribute to the Trump effect) is that the meeting, while not completely described as a "love fest," was very pleasant. The regulators present actually seemed to be interested in the type of lending this bank was doing. No additional restrictions were put on it. There was not even any additional monitoring. Is this part of the Trump effect? Who knows. Let's hope so.

THE FUTURE OF FINTECHS

I recently read with interest an article regarding the future of fintechs. The title of the article, "Once a Threat to Banks, Fintechs Now Dismissed As Unviable" is a very apt summary of the article's slant towards the future of fintechs. The article essentially says that fintechs were once viewed as the death of banks, community banks in particular. However, the article points out that many of the fintech companies that are out there today are making credit decisions based on computer analytics and not relationship factors, and that is not a viable business model.

This article is very interesting to me because it echoes the public stance that I began taking on fintechs a couple years back. For a myriad of reasons, I do not think that fintechs will replace community banks. I think many of the fintech companies that are out there today will die on the vine, such as many companies in start-up industries do. There will obviously be some survivors, and I think those survivors will be the ones that learn how to work complimentary to banks, not in direct competition to banks. I simply do not believe that computers and technology that have no customer relationship will be able to supplant the community bank business model.

Please email Greyson at gtuck@gerrish.com if you would like a copy of the article. We will be happy to share it.

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THE TAXABLE "TAX-DEFERRED" TRANSACTION

As many of you *Musings* readers know, there is nothing in America that is "tax-free." Instead, everything that we commonly refer to as tax-free is more properly referred to as tax-deferred. Community bank acquisitions are no exception. A transaction that is either all-stock or part-cash and part-stock is tax-deferred to the extent of the stock received, provided the IRS "continuity of business" requirement is met.

The traditional line of thinking was that a transaction must have at least 50% of the total consideration as stock of the acquirer for the continuity of interest requirement to be met. In 2005, based on a change in the Internal Revenue Code (IRC) Regulations, the stock portion requirement has been reduced to 40% of the total compensation. The rule today is that a transaction must have at least 40% as stock consideration for the stock received in the transaction to be tax-deferred under the IRC Regulations.

I recently read with interest a transaction announcement for an approximately $75 million transaction where the transaction is 70% cash and 30% stock. This is interesting because, according to the change in the IRC Regulations, the 30% stock consideration will not be received by the selling shareholders tax-deferred. Instead, the stock portion of the transaction will be taxable. The value of the stock less the basis of the stock is the taxable portion. The stockholders will get a step up in basis, but they will have to use their after-tax dollars to pay the tax on any gain they realize.

We were not involved in the transaction. The parties that were involved were both represented by very capable advisors. I am sure there is some perfectly good explanation for the transaction structure. I am simply pointing out that it typically takes a very unique set of circumstances for a 70% cash and 30% stock transaction to be attractive to the selling shareholders.

THE ABSENTEE DIRECTOR

I recently received a call from the President of a community bank that is dealing with a difficult situation as it relates to one of their directors. This particular bank is fairly young (about 15 years old) and has had significant director continuity since organization and inception. Unfortunately, one of the initial organizers and directors that has been intimately involved in the bank since its infancy had a stroke in late 2016. This individual took a six month leave of absence in order to recover. Unfortunately, six months has not been enough. This director continues to spend the majority of time in rehab looking to recover from the stroke.

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The President recently called me to discuss what to do in this particular situation. The Board does not want to keep the director on a leave of absence forever. However, the Board also does not want to kick the director to the curb because he has been a great asset to the Bank and they would like him to be able to come back on the Board as soon as he recovers. We talked about the available options, and the Board has decided they are going to leave his director slot vacant for now. This Board is a staggered board, and there are three directors to be elected at the upcoming annual meeting of directors. The Board has determined to nominate two individuals to the Board of Directors and to leave the third slot vacant and open for this director's return. If the director recovers in a timely manner, the Board will appoint him to fill the vacancy, and life will go on as usual. If he does not, at some point in the future the Board will appoint a different individual to fill the board vacancy. I agree with the Board that this is the best solution for this difficult circumstance.

THE POTENTIAL STOCK RAISE

We recently received a telephone call from a client that indicated the Holding Company was looking to sell about $5 million of common stock in an unregistered private placement to accredited investors. The Company's executive officers made the decision this was needed to increase bank capital and asked us to review some of the business and securities issues.

As we got into the numbers and took a close look at the proposal, our thinking pretty quickly turned to this not being a great idea. We looked at the amount of stock to be sold and the benefits of such a sale, and we did not see any benefit of raising capital to the existing or new shareholders. Instead of having a capital problem, this particular bank has an earnings problem. The short of it is that the Bank is simply not earning enough money to keep up with its growth. Raising additional capital would have obviously increased the Bank's capital ratios, but it would have done much more harm than good to the Holding Company shareholders.

Instead of focusing their efforts on raising capital, the executive officers have redirected their attention to the development and implementation of an earnings improvement plan. We are going to assist the Bank in developing this plan by looking at all facets of their operations and closely scrutinizing their income and expenses to identify ways to make the Bank more profitable. This will be a much better outcome for the shareholders than that of unnecessarily selling additional shares of common stock.

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CONCLUSION

We hope everyone had a happy and safe Memorial Day weekend. It is now time to get back to work. See you in two weeks.

Jeff Gerrish *and* *Greyson Tuck*

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