
GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Tennessee, Georgia, Kentucky, Louisiana, Texas, and North Carolina!

THE STRATEGIC PLAN DOCUMENT

Do you need your strategic plan in a pretty format, buttoned up, or is content more important? Most of us would think the content was more important no matter what the plan looked like, i.e. spiral bound, gold leaf, whatever.

I had a recent call from a client, however, whose friendly federal regulator was pounding on about the fact that they needed a formally documented strategic plan. The plan they had, which consisted of minutes of their self-facilitated planning session, was viewed as not sufficient by the regulators. They did not seem to complain about any of the decisions made or any of the strategies established. They simply wanted it put into a format that they thought looked better.

I thought that was kind of absurd, but we are obviously happy to help. It appears the plan format is becoming a minor hot button for some of the friendly federal regulators. Several of them have put out information in the last several months about the importance of strategic planning, particularly as it relates to or is incorporated in corporate governance. In any event, it will be a minor inconvenience for this bank and a minor expense, but we will assist them in complying with the regulatory wishes.

THE OUTSIDE DIRECTOR'S DILEMMA

I was giving a speech recently about director issues at a trade association conference. After the speech, one of the audience members came up and introduced himself to me. He was an outside director for a fairly good-sized community bank. He had some concerns because he had heard that another larger bank holding company had made an offer through his Chairman and CEO to purchase his bank, yet that offer had never been conveyed by the Chairman or CEO to the rest of the Board to even consider. He asked me if that was appropriate. I told him based on what he had told me, that if the offer was made through the Chairman and CEO and was credible, and even if it was verbal, it should have been reported to the Board of Directors. I suspect this outside director will mix it up a little when he gets back to the bank. Interestingly, he told me that the way he found out about the offer is he got a call from the CEO of the prospective purchaser wondering why they had not responded.

THE WOULD BE ACQUIRER

I recently facilitated a strategic planning retreat for a community bank that is very interested in making an acquisition. In fact, this community bank has tried unsuccessfully to put a couple deals together over the past three to four years. During the planning retreat, we took a close look at all of the banks that fit their criteria for an acquisition. Unfortunately, the discussion was very short lived, as there were none. There are simply no potential targets that fit all (or even close to all) of the acquisition criteria. Unfortunately for this bank, their desire to be an acquirer is not a viable strategy. Luckily, they were able to adopt a number of other strategies to enhance shareholder value.

EMPLOYEE STOCK OWNERSHIP PLANS

I have recently had many discussions with a number of community banks about the implementation of employee stock ownership plans. What has been interesting is the different motivating factors for the discussions. In one situation, the ESOP will be implemented to pay off some holding company debt. In another, the ESOP will be used to repurchase holding company shares to facilitate a Subchapter S reorganization. In yet another, the primary motivating factor behind the ESOP is to provide liquidity for the holding company common stock. In a final situation, the ESOP will be implemented as a way to attract and retain young talent.

As you can likely tell, I am a big fan of ESOPs. They can be used for a number of different purposes, all of which are very helpful to the organization.

IRAs AS SUBCHAPTER S SHAREHOLDERS

I recently facilitated a strategic planning retreat where I encountered a common misconception. At this retreat, we were talking about the potential for reorganizing this C corporation as an S corporation. During the retreat, the management team indicated they had reviewed the holding company shareholder list and determined those shareholders that would have to come out to make the company Subchapter S eligible. They commented that it included all IRA shareholders. I indicated that was a common misconception, but not exactly the rule. The Subchapter S rules allow an IRA to be a Subchapter S shareholder to the extent the shares were owned by the IRA on or before October 22, 2004. In this situation, that distinction was extremely important, as it cut the required capital to redeem the shares in about half.

If you are contemplating a Subchapter S reorganization, be sure to keep this important distinction in mind. Any IRA that owned the shares prior to October 22, 2004 is an eligible Subchapter S shareholder.

Also, generally any IRA shares acquired at any time and held by insiders can be rolled into a newly-created ESOP or KSOP. As most of you know, an ESOP or a KSOP in a Subchapter S is so good it should be illegal. If you would like further information on any of these issues, please let us know.

WHAT ELSE COULD GO WRONG?

I was recently with a high-performing, closely-controlled, mid-size community bank. I had met with this Board and senior officer group a couple of years ago to assist them in trying to figure out what to do with the bank's life. They had done a very nice job. I came back this trip and since I had not had a lot of communication with them in two years, I asked at the beginning of the meeting what had occurred in the last two years that was of interest. I was met by the group collectively with kind of an interesting look. Finally, the CEO spoke up and indicated that since I was last at the bank, they had had a fire and a flood. My smart-aleck remark of course was "What, no locusts swarming?"

Seriously, this bank had had a rash of unfortunate circumstances over a very brief few month time period, in that they had both a fire in the bank and a broken pipe, on a holiday weekend of all times, which created a flood in the bank.

Other than that, everything seemed to be working on all eight cylinders. They had more than overcome the adversity from those two incidents.

THE UNSOLICITED OFFER

Best I can tell based on my calendar over the last month or so, it must be “unsolicited offer season.” Yes, it appears to be coordinating with the World Series for some odd reason.

We have had numerous clients in the last four weeks receive unsolicited offers from, for the most part, other community banks. Each of these clients had a strategy established at their last long-term planning session to remain independent “subject to the receipt of an unsolicited offer” so it fit right in their strategy. The issue, which we helped them determine, is whether the offer made any sense. The general consideration involves a) is the offer from a credible source, b) can the offering bank holding company “close” the transaction if we decide to go forward with it, c) is what is being offered - cash, stock, etc., appropriate, d) if it is stock, is the currency any good, and e) how is the price.

We spent a few days, and in some cases a couple weeks, reviewing all these issues for the respective Boards. It is likely some of these transactions will go through and some will not for a variety of reasons.

ONWARD TO THE BIG CITY

How difficult is it if you are a small rural bank fighting for your life in your rural area, and you decide to move to a “big city?” Not the whole bank, lock, stock and barrel, but to merge with somebody in the big city or to open an outpost through a loan production office or branch. We have had a couple of clients lately assessing these opportunities of moving to the big city for diversification and opportunity. Interestingly, one of the rural banks had a group of lenders from one of the big city banks come to them asking if they would open an outpost. It was very opportunistic for them and at the right time.

What do you need to think about if you are trying to make a move like that though? It seems a number of things come to mind, including a) culture, b) expertise (i.e., do we have the expertise to make the types of loans that are going to be made in the big city, such as C&I loans), and c) does it make sense strategically and enhance the value of our franchise.

There is nothing wrong with being opportunistic, as long as you do it with your eyes wide open.

ENHANCING SHAREHOLDER VALUE

As all of you know, I have been pounding the table for longer than I care to remember about enhancing shareholder value. Enhancing shareholder value generally means allocating financial capital and human resources to the benefit of the shareholders. This could be making a dividend payment, it could be redeeming shares, it could be acquiring another bank, it could be acquiring another line of business. Although none of us have unlimited capital resources in our banks (for the most part), it does not necessarily mean that these alternatives are mutually exclusive. It may depend on how you structure the deal as to whether you can acquire another line of business, pay a large dividend or distribution, redeem some shares, and/or acquire another bank or a branch. It is just a question of prioritizing capital resource allocation. That is the Board's job.

PROPOSED IRS CHANGES

Have you heard about the IRS' proposed changes to valuation methods of stock in closely-held and family corporations? If you have not, this could potentially impact you in a material way. From a 30,000-foot perspective, when valuing certain business interests, the IRS currently allows for the inclusion of minority and marketability discounts. This is typically seen in relation to family limited partnerships where the limited partnership interest gets discounted more heavily than the general partnership interest. The IRS' proposed changes are essentially going to eliminate these discounts.

If you are a Subchapter S community bank, this will not have any bearing on you since Subchapter S corporations can only have one class of common stock. However, if you are a C corporation that has used some of the estate planning techniques, this could potentially impact you in a major way.

Please let us know if you would like additional information on these proposed changes.

CONCLUSION

My calendar reflects that today is Halloween. That means tonight is Halloween night. Please be careful driving around tonight with all of the little people out. Also, keep your kids and grandkids close.

Have a great two weeks.

Jeff Gerrish

and

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