GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Texas, Florida, Minnesota, Wisconsin, Tennessee and Indiana!

WHO IS IMPORTANT?

I was invited to be a panelist at a large banking conference. The topic of discussion for the panel was mergers and acquisitions. I represented the financial advisory, consulting and legal piece, and the other two panelists were bankers. As part of the panel discussion, the group discussed the importance of culture in bank acquisitions, which, of course, involved a significant discussion of people, installation of culture, and the like. During this section, one of the other panelists, who is the chairman of his community bank, made the point about who is the most important person in the bank. His comment was that he could "leave the bank for three weeks and no one would know he was gone, but if a teller left his or her station for 15 minutes, there would be chaos." The critical takeaway is that our people are the most important, and they need to come first.

THE LINGERING CEO

I recently met with a community bank client regarding some pinpointed strategic issues. This is a well-performing bank that had recently gone through a CEO succession process. As is often the case in community banks, the current CEO was previously an executive officer at the bank with 20 years' experience under his belt. As I was having discussions with him, the problem became clear - although he is the current CEO, the former CEO was still "lingering" around, stayed on the board, and maintained an office in the bank. You get the picture. It is very difficult for the new CEO to be in charge when the former CEO is still lingering. Although I have seen the situation work, probably more often than not, where the former CEO remains on the board (it is a good way to keep institutional knowledge, among other things), there are some issues that need to be addressed on the front-end as to who plays what role.

NON-INTEREST INCOME

With margins compressed and interest income difficult to come by due to competition, many of our community bank clients across the nation are focusing on non-interest income. This often involves creating or expanding lines of business other than the community bank's core banking business. Generally when I think of other lines of business, I think of securities brokerage, trust services, full-blown wealth management, and possibly mortgage origination (although that is pretty close to our core banking business).

I had the opportunity to meet with a high-performing bank that decided it needed to expand one of its other lines of business. To this bank's credit, the board decided to utilize the committee that was responsible for supervising that line of business and invite any other directors who wanted to participate in a discussion of its strategic expansion to the meeting. Virtually all of them showed up even though they were not on that specific committee. The group had a good discussion and set a track for this particular line of business, including placing limitations on what they wanted to do with it and what they did not want to do with it. The point is that, to this bank's credit, they focused on it in a separate meeting and determined how to develop it for their particular bank.

THE COMMITTEE COMPOSITION

In the last couple of months, we have received a couple of calls from community bankers from different parts of the country about the composition of various bank committees. In each of these calls, the underlying strategy was that they wanted to add an individual to a board-level committee when that individual was not a director of the bank. The first step in this type of analysis is to determine whether the state law provides any guidance as to whether a non-director can serve on a bank board. Each time this has come up, the state law has surprisingly yielded some fruit. The state laws we reviewed in each situation allowed for a non-director to serve as a committee member.

Although that answers the legal question, there are some practical questions as well, such as whether you compensate the person (and whether it is the same as other committee members), and what kind of confidentiality agreement the individual needs to be under since he or she is not a director and does not have the fiduciary duty of confidentiality. As community banking gets more specialized, I anticipate we will see more outside non-directors being added to community bank committees, particularly in the area of audit, M&A, technology, and risk management.

BEWARE! THE INVESTMENT BANKERS

As I hope most of you know, our firm serves in a financial advisory role when called upon for smaller community banks across the nation. This involves basically an investment banking role for these banks. We have prided ourselves, however, on taking an approach through our consulting and law firms to help the board of directors determine what is in the best interest of their particular community bank. Unlike the investment bankers whose sole goal is to get you to engage in a transaction (i.e., typically selling your bank) to earn a fee, we approach the issue in a more holistic manner.

We have had several calls over the last several months from clients who have brought investment bankers into their board room. It is always nice because the investment banker will generally come for "free." They will also bring a nice, little "book" analyzing your bank and the possibilities it has for both buying and selling. Unfortunately, the last page of that book will be what they think they can sell your bank for in the marketplace (whether they actually can or not). Sometimes this activity results in the board determining to sell the bank, and the investment banker getting a nice fee. Often it does not. It simply involves stirring up the board of directors, creating conflict, controversy, and angst among the directors and senior officer staff, which often lasts for months. My only caution to you is be careful letting the camel's nose under the tent because the camel is not far behind.

PRIVATE EQUITY DIRECTORS

A number of our clients around the country have, for a variety of reasons, and particularly during the recession and shortly thereafter, kind of "cut a deal with the devil" by taking private equity money. Along with private equity money comes private equity investors. I have dealt with a lot of these guys and gals, and they are pretty decent folks. The only problem for most of them is that their sole goal is to maximize their investment at whatever cost. If you let that private equity investor on your board of directors, you will also have someone advocating constantly to sell the bank, or at least "test the waters." As noted, their goal is to maximize their investment, not to serve the community. Think about it.

CAPTIVE INSURANCE SUBSIDIARY

I have had a number of conversations with clients lately about the possibility of creating and owning a captive insurance subsidiary (typically formed in Nevada) which would, among other things, write insurance for the bank. The insurance company is owned 100% by the holding company (as a financial holding company). We have assisted a couple of community banks across the nation with this particular endeavor. There are significant financial benefits, tax benefits, and other benefits from this structure. If you have any interest or would like further information, please let me know.

DUTIES REGARDING UNSOLICITED OFFERS

One of our long-time community bank clients was recently released from their formal regulatory enforcement action. This is typically a non-event. However, for whatever reason (maybe it was a slow news day), the termination of the enforcement action got a little bit of publicity. This publicity resulted in the bank president receiving a number of calls regarding a number of issues related to the bank. One of the calls was a request for a meeting from a competitor bank that was, in no uncertain terms, a first meeting to move towards an unsolicited offer.

The bank president accepted the meeting. He spent about an hour with the president of the bank that was looking to make the acquisition. They had all of the usual discussions one would expect to have in this type of meeting. However, our client was very clear to the potential acquirer that the bank's board of directors had adopted a strategy of independence and was not looking to sell the bank. With that said, the president also recognized that the acquirer could make any unsolicited offer he chose to make.

This bank president's actions are a perfect example of fulfilling the fiduciary duty to shareholders. This president took a meeting to discuss a transaction that could potentially be more beneficial to the shareholders than remaining independent. He also clearly stated the board's adopted strategy. We will see if this goes anywhere. The important thing is that this president can rest easy at night knowing he handled the situation very well.

SHAREHOLDER APPROVAL OF ACQUISITIONS

As I have previously mentioned in *Musings*, we are currently working on putting two "sister banks" together. These are two small banks that have overlapping ownership and have worked closely with one another over the last 20 to 30 years. The boards have finally decided it is time to put the two banks together.

The merger transaction is a stock-for-stock swap. That in and of itself is not unusual. However, what is a little bit unusual in this case is the fact that both the acquiring bank and the target bank shareholders must approve the transaction. In most acquisitions, only the target bank shareholders, who are either selling their stock for cash or are exchanging their current stock for another stock, are required to approve the transaction. The requirement that the acquiring shareholders approve the transaction is a matter of state law, and it is basically due to the fact that the current shareholders are being diluted by more than 20%. We do not expect any issues with the acquiring shareholders approving the transaction. It is just unusual.

FAILED BANK ACQUISITIONS

Over the past couple of weeks, we have been very involved in assisting a client with a failed bank acquisition. (Yes, those are still happening in today's environment, although not nearly at the pace they were a couple of years ago.) There are two things that have particularly struck me about the failed bank process. First, it is very clear the FDIC is experienced in selling these failed banks. They have the process down pat. All aspects of the transaction have really been very efficient. Second, I am reminded of how many different alternatives are available when acquiring a failed bank. There are a number of different structural alternatives, and there are numerous available options within each of the alternatives. For example, the failed bank acquirer can assume all deposits or only the insured deposits. The acquirer can also buy the other real estate or leave it with the FDIC. The acquirer also has the option of whether it wants to buy the failed bank's actual locations. All of these choices make for a number of different decisions in figuring out how to structure the best bid.

WEALTH MANAGEMENT

A number of our community bank clients, particularly those who have decent sized (over $100 million in assets under management) trust departments already, are contemplating expanding into more of a wealth management arena. Wealth management can mean everything from basic trust services to maintaining a psychiatrist on bank staff to assist folks with the emotional piece involved with generational wealth transfer. (Yes, this is true. At least one bank I am aware of does it.) The reality is if your bank wants to get into wealth management, it needs to decide what it wants to be, who it wants to serve, and whether it can make any money doing it.

CONCLUSION

The third quarter of 2016 is almost here. Hard to believe. We have noticed the weather changing in our travels. It is still hot and humid in the South, but there is definitely a Fall chill in the air up North. We are looking forward to the Fall colors and a little bit of cool down. See you in two weeks.

Jeff Gerrish *and* *Greyson Tuck*

P.S. from Greyson,

My partner Doc and I recently had the opportunity to be a part of this year's ICBA Lead Forward Conference. This conference is best thought of as the ICBA national convention for younger bankers. What struck me the most this year was the participant engagement in the roundtable discussions. The roundtable session is always voluntary, but virtually every one of the conference attendees actively participated in the roundtable discussions this year. The discussion was lively, and there was no set agenda as to what would or would not be discussed. The participants discussed what they wanted to discuss without specific instruction.

This young banker participation is symbolic of the community banking industry today. We are not a passive group. We are actively engaging in discussions and our business activities in order to be our best for our shareholders, customers and even the regulators.

