GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Canada, Hurricane Irma/Florida, Texas, Wisconsin, and Missouri!

SUBORDINATED DEBT

I have railed on about subordinated debt in the past. It is not that I do not like it, it is just that I think the purveyors of subordinated debt are selling a "bill of goods" to the smaller community banks. I recently read a press release by one of the West Coast investment banking firms touting an $8 million issuance of subordinated debt they placed with a single investor on behalf of about a $350 million community bank. They touted the fact that it counted as secondary capital at the holding company. What they did not mention is that because the bank is under $1 billion in total assets, it does not need "secondary capital" at the holding company because it is not tested for capital adequacy at the holding company level. What they also did not tout is the fact that this bank holding company could very likely have simply borrowed $8 million from any reliable source at about 4.5% instead of paying 6.5% or 7% on the subordinated debt. Yes, the subordinated debt is unsecured i.e., not secured by the bank's stock - and yes, the rate is typically fixed for ten years, but still. That is a significant interest cost that the company could have avoided.

MULTI-BANK HOLDING COMPANY

I was recently with a well-run, multi-bank holding company. This is simply a bank holding company that has multiple subsidiary banks. The collective organization was a pretty good size for a community bank, but the subsidiary banks were all relatively small. The holding company and the subsidiary banks had been wildly successful in the markets in which they operated due to the fact that from outward appearances each subsidiary bank was a "stand-alone" community bank in that community. As part of the discussion of what to do with the organization's life, we talked about consolidating the back office for some of these subsidiary banks. This is a typical trend in an effort to increase efficiency and save money once a multi-bank holding company gets to a certain point in its consolidated operations.

The critical issue, of course, is how to do this and not lose the community bank feel. It was interesting in listening to the discussion that the community bank presence and feel far outweighed any cost savings that could be obtained, at least at this stage.

OTHER THAN YOUR CORE BANKING BUSINESS

I recently met with a high performing institution's board of directors and senior management group to help them figure out what to do with the bank's life over the next few years. One of the topics discussed was whether the bank should do anything other than its core banking business. The bank, through its core banking business, is high performing. It is located in a market that is expanding. It has more loan demand than it can handle. It lays off loans and participations to its community bank friends. The general consensus was "why should we do anything differently?" I encouraged them to look ahead to when times may not be so rosy and they may need to diversify their earnings stream. Frankly, though, I did not encourage them very hard because it seems for the next multiple years they will continue to have strong loan demand and be able to retain their high performance position primarily through their core banking operations. Why get involved in insurance, securities brokerage, wealth management, trust, or anything else that you do not have now if for the foreseeable future you can do very well doing what you know best?

THE DYNAMITE FACTORY

Over the Labor Day Weekend I had the opportunity to be out of the country speaking to a group of United States community bankers. It was a nice Canadian setting, and the group of bankers was excited to be there. Part of the structure for this particular conference was that on the last day the group held a panel discussion with three or four of the main conference speakers and the bankers who were still there on the last day. The discussions were very interesting and focused primarily on the risks in the business currently. One of the bankers indicated that he views the banking business currently as "similar to running a dynamite factory, except that every employee has a lit torch." I thought that was a pretty good analogy (albeit somewhat scary).

Think about it, particularly the "every employee has a lit torch" part of the saying. One employee could mess you up on BSA, fair lending, etc. It is a risk issue.

IS SUBCHAPTER S STILL A GOOD THING?

As we have noted previously in *Musings*, it is our opinion that pretty much notwithstanding whatever happens to the tax code (if anything), Subchapter S is still the best long-term mechanism to enhance shareholder value and preserve the independence of your community bank for as long as you would like to.

I was recently visiting with a long-time client who reminded me that we had converted his bank to a Subchapter S shortly after Subchapter S became available for banks and their holding companies. He and I were trying to pin down the date, but I think it was 1999. His comment was "that is the best thing that has ever happened to our bank." They have been highly successful, served as a cash cow for their shareholders, been able to serve their community, and remained independent as a Subchapter S. It is always good to get positive feedback on long-ago strategic recommendations.

THE "BORING" BANK

I recently facilitated a strategic planning session for a director and officer group that collectively described themselves as a "boring" bank. They called themselves boring because they are a slightly less than $100 million, single-branch institution that is focused only on routine community bank products and services. They do not have out-of-market loans, advanced technology, or exotic lending products, and otherwise do not take any unnecessary risk. They also do not have any type of holding company debt, but at least said that would be considered in the right situation. What struck me about their "boring" description is the fact that this bank has continually seen appreciable growth in total assets and net income. This bank was profitable all throughout the recession and has no asset quality problems.

The board and director group described themselves as boring. I think they are more appropriately described as pretty good bankers. They have certainly done a good job for their shareholders in terms of making an appropriate return and increasing the value of the investment. As we mentioned a number of times during the planning session, slow and steady wins the race. This was a great community bank to spend some time with.

SHAREHOLDER PREEMPTIVE RIGHTS

We are currently assisting a community bank holding company in figuring out how to decrease their holding company debt. This particular bank holding company has a number of different issuances and types of debt instruments at the holding company level - specifically, a couple issuances of Trust Preferred Securities and a bank stock loan. The board is looking to the future and has some concern about the two Trust Preferred issuances maturing within a couple years of each other. It is looking to go ahead and begin knocking out some of that debt now to ease the burden down the road.

We have discussed with the board all the available alternatives, including the sale of additional stock or refinancing the multiple debts into one debt instrument with a definite repayment schedule. The board has decided on the sale of common stock. They would like to do a $20 million or so offering that is not registered with the SEC, but instead relies on a securities registration exemption.

There are a couple different securities registration exemptions we can rely upon to assist in the sale of the stock. The complicating factor is the fact that this holding company has shareholder preemptive rights. As you likely know, this requires the holding company to first offer each shareholder the right to purchase enough stock to maintain their pro rata ownership in the company. This is great in theory, but for all practical purposes makes compliance with the applicable securities registration exemptions much more difficult. The technicalities are beyond the scope of this *Musings*, but we are happy to discuss them with you if you would like. The most important thing to keep in mind is that shareholder preemptive rights are great in theory, but they generally cause more harm than good when you are actually trying to raise capital.

S CORPORATION SHAREHOLDER AGREEMENTS

I recently received an inquiry from a long-time client that is an S corporation that currently has what I would describe as a very restrictive Shareholders Agreement. This Subchapter S Shareholders Agreement essentially prohibits the transfer of any of the holding company's stock and instead requires the shareholders to offer any stock that they would like to transfer to the holding company for repurchase. This not only includes transfers to third-parties, but also inter-family transfers, such as a transfer from parents to children or a transfer upon death. The rule is essentially the shareholder can own the stock as long as they would like, but when they are ready to transfer ownership it has to go back to the holding company.

This setup worked well for this holding company for a number of years. However, now that some of the shareholders are getting older and are getting closer to actually wanting to transfer the shares, they are rethinking things a little bit. They are considering a number of very specific scenarios in which shareholders could transfer shares. These scenarios would place limits on the number of shares to be transferred, the number of transferees that could receive the shares, the certain shareholders that could transfer shares, and the like. When they approached us with these alternative scenarios, our first concern was that these specific limitations might cause the stock to be considered a second class of stock, which would terminate the S election.

We researched these issues. Inserting provisions in the Shareholders Agreement that allow the transfer of the common stock under certain limited circumstances will not cause the stock to be considered a second class of stock and therefore result in termination of the S election. In an S corporation, in determining whether there is more than one class of stock, the IRS essentially looks to the Articles and other governing documents to determine whether all of these shares have the same distribution and liquidation rights. The IRS has pretty detailed regulations on the issue, but it essentially boils down to the fact that all shares will be treated as one class of stock if all of the shares have identical rights to distribution and liquidation proceeds, regardless of what other differences they might have.

If you are in an S corporation, keep this in mind. If you are looking to do some things with your stock, make sure it is not going to create a difference in distribution or liquidation rights, which would cause the stock to be treated as a second class of stock. Otherwise, the IRS regulations allow for some differences which may prove appropriate for your circumstances.

THE SHARE REPURCHASE DILEMMA

We are currently assisting a smaller community bank holding company in considering a redemption of a rather large block of its common stock. The shares that are being considered for repurchase represent about 30% of the total shares outstanding. The owner of these shares is the former President of the bank and current Chairman of the Board. In order to make sure all things related to the transaction are on the up and up, the board bought an independent fair market value determination for the stock. The valuation came in a little bit higher than the board anticipated. The board's question to us was essentially whether they had to pay that higher valuation in the repurchase. Our answer was absolutely not. The board is under no legal obligation to repurchase these shares at all, and it is certainly not obligated to repurchase shares at some price it does not agree with. Our advice instead was that the board should use the figure as an upper limit on the amount it would be willing to pay and as one of the tools for negotiating the transaction.

A privately-negotiated share repurchase transaction is exactly that – a privately-negotiated transaction. There is no requirement at all that you put the value of the shares to be repurchased in the hands of a third-party. You can certainly go out and have a valuation completed to assist you and provide you information in your negotiation. However, there is no requirement to do so.

In this situation, our advice to the client was that they could go out and negotiate whatever they thought to be appropriate. If they reach a deal with the Chairman, that is great. If not, the Chairman can either continue to hold the shares or can go out and find someone that is willing to pay his price. We will keep you updated on what happens.

CONCLUSION

It has been an interesting two weeks. We have had Hurricanes Harvey and Irma. Both these hurricanes have impacted a number of our community bank clients across the country, as well as some of the members of our consulting and law firms. Fortunately, all have survived and will be just fine going forward. We appreciate all of your kind comments and considerations as the country begins to pull back together.

Have a great two weeks.

Jeff Gerrish *and* *Greyson Tuck*