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# GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Nebraska, Wisconsin, Minnesota, Florida, Iowa, Indiana and Ohio!

## PUBLICIZING LETTERS OF INTENT

As has been described in *Musings* many times before, the typical process for a community bank acquisition begins with both the buyer and seller entering into a non-binding indication of interest or letter of intent. These documents are typically two to three pages in length and summarize the material terms of an acquisition, including price, type of consideration, structure, treatment of target employees and the like. These non-binding documents are always subject to due diligence.

The non-binding indication of interest or letter of intent is typically not made public because it is non-binding, subject to due diligence and often times does not result in a consummated transaction. At least two times over the past week, I have seen community bank acquirers that “buck the trend” and have publicly announced entering into a non-binding indication of interest. I am a little perplexed as to why these acquirers would do this. I am more perplexed as to why the seller would allow it to happen. There is a tremendous amount of reputational risk involved for both parties if the transaction does not ultimately close. If that happens, we are almost always left wondering why one party or the other could not get it done. Speculation in those types of situations is never a good thing.

If you enter into a non-binding indication of interest or letter of intent, my recommendation is to keep that private. I do not recommend publicly announcing the transaction

until the actual definitive merger agreement is signed. In the event the transaction falls apart prior to signing the definitive merger agreement, which is certainly not unheard of, this will save you a lot of headache.

### ATM SKIMMING SCHEMES

Over the past couple of weeks, we have had two separate clients in the same part of the country that have been victims of ATM skimming schemes. These schemes are exactly what you think they are. They are simply criminals coming in to their ATM locations at some point during the night and placing skimmers and a small video camera on the ATM. The skimmers record card data and the video records the customer entering their pin number to access their cash. The criminals then put the card and pin number together, and sell it on the internet. The purchaser then typically goes to a random ATM and requests an account balance. Once they figure out how much money is in the account, the next step is simply to take it out.

Keep an eye out for these ATM skimming schemes at your bank. As you likely know, any loss a customer may incur as a result of this scheme is ultimately the responsibility of the bank. Some insurance policies cover this type of loss. Some do not.

### THE SMALL BANK HOLDING COMPANY POLICY STATEMENT

I met with a couple of banks in the last couple of weeks whose boards were very confused (with the help of some investment bankers) as to the need to raise holding company capital. Both of these holding companies are between \$500 million and \$1 billion in total assets, both are subject to the Small Bank Holding Company Policy Statement, and both have been approached by investment bankers about doing a subordinated note offering at the holding company level. As most of you probably know, the Small Bank Holding Company Policy Statement provides that if a bank holding company's consolidated assets are less than \$1 billion, then its capital ratios are not tested on a consolidated basis. That is a long and roundabout way to say a community bank can leverage its holding company to generate cash to put into the bank as capital or buy back stock or to do anything else, and however the community bank leverages it and the instrument the community bank uses as leverage does not really matter because the instrument used does not need to be considered capital at the holding company because there is no holding company consolidated capital test.

Both of these two companies had been convinced by the investment bankers to do a subordinated note offering at the holding company level. Subordinated debt is considered

secondary capital at the holding company level because it is subordinated. Due to the Small Bank Holding Company Policy Statement, for banks with less than \$1 billion in total assets, this secondary capital really means nothing for the organization. There is no problem with subordinated debt – except that its rate is usually 200 to 300 basis points higher than a simple bank stock loan. I was with another client this week who had just received a quote on a significant bank stock loan to their holding company at a rate of Prime minus 25 basis points. Both of these clients were contemplating issuing subordinated debt at the 7% to 8% range. That is a fairly significant difference for something you do not need to do.

The other issue with subordinated debt is you get it all at once. If you are going to do a \$7 million sub-debt offering, you are going to get \$7 million on the day it closes. If you do a bank stock loan, or better yet, a bank stock line of credit, then you only draw down as much as you need.

When contemplating capital planning, it is critical to understand how the world works, not how somebody who is going to get a commission off of the sale wants it to work.

### ADA COMPLIANT WEBSITES

Is your website ADA compliant? No, I am not kidding. Apparently, website compliance with the ADA is a new “hot topic” for one plaintiff’s law firm in particular. This law firm is apparently sending letters to many community banks (and other businesses) indicating their website is not ADA compliant. At least this law firm is being gratuitous in offering to assist them in making their website ADA compliant for a small fee. To date, we do not know of any litigation that has actually been filed on this issue. We think it is very likely just a new revenue source for this particular law firm. Please contact us if you would like more information regarding what makes a website ADA compliant.

### BOARD SUCCESSION

Over the last couple of months I have been with a number of banks who are wrestling with board succession. Although I have never personally been a big fan of mandatory retirement for community banks (I believe you ought to just do the right thing - when it is time for somebody to go off the Board, the Chairman should just let them know they need to get off), I have seen mandatory retirement work well in several of our clients recently. Because for the most part community bank directors and Chairmen are “too nice” to tell somebody they need to get off the board, mandatory retirement does that dirty work for them. If you are going to use

mandatory retirement (and this may sound counterintuitive to my usual speech), put the age at something reasonable like 75 or less. I have seen it work and avoid some serious heartburn at the board level.

### MANAGEMENT SUCCESSION

In addition to director succession, as noted above, I have also been involved with a number of banks assisting them on dealing with management succession. As the CEO base is getting older, the succession issue becomes real. One bank I was with recently decided they did not want to hassle with the succession issue and they would rather just sell. Obviously, management succession, share liquidity, regulatory burden and a number of other issues factored into that decision, but I think in this case, management succession was the main one.

My recommendation generally is if you are going to have a management succession issue, begin to work on it a couple years before it becomes a real issue and your choices become more limited.

### LONG-TERM INDEPENDENCE

As most of you know, through our consulting and law firms, we facilitate dozens of community bank planning sessions each year. Although we try to utilize a specific agenda for each bank to deal with their unique situation, there are some common issues. One of those is the long-term plan to remain independent. Obviously, the Board cannot just say “we are independent no matter what.” It has to be a strategy of independence subject to the receipt of an unsolicited offer. We generally put that on the front of the agenda because if the bank is going to market itself for sale, as opposed to remaining independent subject to the receipt of an unsolicited offer, then the plan will likely be much different than if the long-term strategy was independence. I am a staunch supporter of independent community banks, but I realize there are times when a combination of circumstances, either management succession as noted above, lack of share liquidity, lack of cash flow, lack of board succession, regulatory burden, and typically a combination of all of the above, will push a bank toward sale. My only suggestion is that when the Board contemplates the possibility of proactively selling the bank, consider not just your primary constituency, the shareholders, but also the impact on others, including employees, customers, and the community.

## THE TURNAROUND

I recently met with a bank that I had not had much contact with for the last seven or eight years. In fact, the last time I was with them was shortly before the “Great” Recession. They had significant asset quality problems that they worked through, are now back to a CAMELS 2 rating, have had a successful management succession/transition, and while their earnings are not great, they are off and running in the right direction. It was a breath of fresh air to see this group work through its issues and look toward the future. After operating as a somewhat “dirty bank” for a period of time, it is nice that the bank can now focus on improving profitability and taking even better care of its shareholders.

## DO YOUR CUSTOMERS KNOW WHAT YOUR BANK OFFERS?

I was recently with a well-run, well-managed larger community bank discussing issues with the Board and senior management, when one of the outside directors raised the issue of “Do our customers and potential customers really know what we have to offer.” This was raised in the technology context, but it would apply in every context. It is difficult to ask people to subscribe to your services when they do not know what type of services you offer. Frankly, we run into this often in our two firms in that some community bankers think we are simply consultants, some think we are simply lawyers, and some do not know who we are at all (hard to believe). In the community bank context, it seems appropriate that we need to make sure that in our marketing and PR material that we let people know what it is we do in the products and service area, as well as in the technology area. It is tough for them to subscribe if they do not know it exists.

## CONCLUSION

Time flies. It is hard to believe we are at the end of the third quarter of 2016 already. Most of our clients are having a good year or a very good year, and we are thankful for that. My travels have taken me up north where the leaves are changing, and it is certainly looking and feeling like Fall (45 degrees as I dictate this). I anticipate Winter will be right around the corner. See you in two weeks.

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and

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