GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Minnesota, Montana, Wisconsin, Florida, and Tennessee!

BANK FAILURE

In the year-end *Musings* we commented on the unusual nature of a recent bank failure involving a small bank outside of Chicago. Our comment was in the nature of the fact that the bank seemed to be perfectly healthy based on its third quarter Call Report numbers, but it failed prior to year-end. The implication was that there was fraud involved.

An astute *Musings* reader pointed out another unusual element of that particular bank failure - the failure resulted in an insured deposit assumption by the acquiring bank from the FDIC. That's right, only insured deposits were assumed. This means, as a practical matter, anybody having over $250,000 in an account of the failed bank is now a claimant against the receivership estate (good luck with that!). Although insured deposit assumptions are not unheard of (I did a number of them when I was FDIC counsel in the 1970's and early 1980's), they are unusual in this day and time. The point made by this astute *Musings* reader was that if this had been a "too big to fail" bank, every deposit would have been insured, as a practical matter.

ALWAYS RIGHT

Can your board be held hostage to a board member who is "always right"? Of course it can, particularly if that particular board member has apparent authority, knowledge, persistence, and persuasiveness. I remember several years ago, the worst example of this was a community bank that added as a board member a former banker who had also been a former Banking Commissioner. This particular individual was "obnoxiously right." He so intimidated the board

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that everybody was afraid to cross him until the Chairman finally stood up and said "enough is enough." The board member was gone. The bank began to make intelligent strategic decisions, not just the decisions from Commissioner "Always Right," and the bank went on to be successful. Can your board be held hostage by a too strong-willed, too smart board member? Of course. It is the Chairman's job to deal with it.

TO SELL OR NOT TO SELL

I recently had an interesting meeting with a community bank board that was wrestling with the issue of whether to put the bank on the market, cash in their chips, and move on. The board made what I believe is the right decision for them, which was to remain independent for the long term, subject to the receipt of the "godfather offer" they could not refuse. The interesting thing was the discussion that led up to the decision-making. This bank did not have any large single shareholders or shareholder groups, so the board was truly acting as a fiduciary for all the shareholders, not simply representing or serving as a "shill" for the ownership group. Board members who were in favor of sale made their case - i.e., prices are higher than they have been in a long time, management is older, technology is more difficult, the regulators are not getting any easier, etc. The directors who felt it was inappropriate to put the bank on the market currently also made their case - i.e., the financial performance of the bank is good, where are the shareholders going to get a comparable investment (particularly for a cash sale), why would they do anything for stock when they would lose control of their future investment, the bank serves its community, it is the employer of choice, and the like. As noted, the discussion was a good one. For this particular bank with a good future ahead of it, the decision to remain independent was also appropriate.

THE NEW TAX ACT

As all of us know, prior to year-end the President signed off on the new Tax Cuts and Jobs Act reducing the corporate tax rate to 21%, among other things. As many of us have read, a lot of the larger banks and other financial institutions are providing bonuses to their employees. Most of those bonuses, it appears, are $1,000 per employee, as a way to share the wealth of the new tax expense reduction.

I was recently on a call with a community bank whose board of directors was having a discussion about what, if anything, the bank should do for its employees as a result of the reduced tax rates and increased income going into 2018. The discussion also involved the issue

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of what is in the best interest of the shareholders. The board recognized its obligation to enhance shareholder value. Does providing a flat bonus to all employees do that? Should the money be returned to the shareholders in dividends or distributions? Should the money be used to redeem shares and create share liquidity? The board wrestled with all these issues, but it primarily focused on the employee considerations for purposes of this discussion.

The general conclusion was that an across-the-board bonus is not really reflective of who this community bank is. Different folks in this particular bank provide different contributions, and the board felt across-the-board bonusing was not appropriate. What they did think was appropriate, however, was to "further invest" in their employees. This matter has been referred to a Board committee to determine how best to do that. It may be raising salaries, minimum wage, and the like, or it may be retooling the bonus pool.

Anyway, the discussion was interesting, and I think the conclusion was exactly correct, particularly for this specific bank.

INCENTIVE COMPENSATION ALTERNATIVES

We recently had a long-time client reach out to us to discuss incentive compensation alternatives. The client wanted to discuss all of the available alternatives for equity-based compensation. As many Musings readers know, such a list is very extensive. The available alternatives include qualified and non-qualified stock option plans, stock appreciation rights plans, phantom stock, restricted stock, employee stock ownership plans, stock grants, and other similar alternatives.

As we discussed these alternatives with the client, the question is not "what are the available alternatives?" Instead, the question is "what is the company looking to accomplish through implementation of the equity-based compensation?" It is really important that the goals of the program be identified and then the actual program be tailored to fit those goals. The overarching goal in most of these plans is an increase in the value of the common stock. However, there are many nuances underneath those goals that may make one of the alternatives more attractive than another.

If your community bank is thinking about some type of equity-based compensation, keep in mind the first thing to do is to identify the goals of the program. The second thing is then to figure out which of the available alternatives will best accomplish those goals. Please let us know if you have any questions on this, as we have extensive information on equity-based compensation alternatives.

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BAD ADVICE ON S CORPORATIONS

On Friday, January 5th, the *American Banker* had as its lead story an article titled "To Stay an S Corp or Not: Tax Law Puts Small Bank in a Bind." We normally do not publicly and directly attack the opinions of others. However, in this situation, clarification is warranted.

The article deemed the new tax rate for C corporations, which is 21%, to be advantageous to the tax rate of most S corporation shareholders, which is 29.6%. The problem with this statement is that it is not an apples-to-apples comparison. The 21% C corporation tax rate accounts for only one of the two levels of double-taxation. The 29.6% rate is the total taxation rate for S corporations. This would be akin to comparing the price of building two new homes when one of the prices is for full construction of the house while the other price gets only to the framing and the ductwork.

Our firm has always been a proponent of S corporations because it has always provided a financial advantage in taxation over C corporations. The new tax law does not change that. When you are looking at whether an S corporation makes sense, be sure to take all of the various factors into account. Do not just look at the first level of taxation for a C corporation. You have to take a look at what ultimately is more beneficial for your shareholders, and that, for virtually all community banks, continues to be an S corporation.

Also, the *American Banker* article was not entirely clear in some of its factual statements. The article started out by saying many S corporation banks are scrambling to determine whether they ought to retain their S corporation status "by the March 15th deadline." There is no deadline for an existing S corporation to terminate its election to be taxed as an S corporation. The March 15th deadline referred to in the article is the deadline for which an existing S corporation must terminate its S election for that termination to revert back to January 1st such that the company would be considered a C corporation for the entire taxable year. An S corporation can terminate its S election at any time during the year by simply failing to meet the requirements of an S corporation (i.e., having more than 100 shareholders, having an ineligible Subchapter S shareholder, etc.). Under this scenario, the S corporation would have a partial tax year taxed as an S corporation and a partial tax year taxed as a C corporation. If you are an existing S corporation, do not think that if you do not make a decision by March 15th it is impossible to terminate your S election.

We are currently reviewing S Corp versus C Corp status for a number of community banks. Let us know if you need help with this analysis.

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DEFERRED TAX ASSETS

We received a number of calls from clients that are concerned about the treatment of their deferred tax assets in light of the new tax law changes. For those C Corporation banks with deferred tax assets on the books, the reduction in the corporate income tax rate is going to result in a reduction of the value of the deferred tax assets. That write-down is going to cause a reduction in assets and a corresponding reduction in total equity. If you find yourself in this situation, do not fret too badly. What we are generally seeing is that the reduction in the deferred tax asset is going to be made up in relatively short order by the decrease in tax expense that will be experienced as a result of the reduction in corporate income taxes.

Obviously, each bank's situation is going to be different. However, we do not see the reduction in deferred tax assets causing a major problem for community banks for an extended period of time. Instead, we think this will be a short-term pain and long-term gain situation.

CONCLUSION

2018 is off to a blistering pace. We hope all you *Musings* readers, particularly those of you employed by banks, enjoyed your day off for Martin Luther King, Jr. Day. For those of you in the "frozen tundra," (which we seem to have been visiting regularly lately) please stay warm and safe. For the rest of you, enjoy your milder weather.

See you in two weeks.

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