GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from New York, Florida, Michigan, Alabama, Oregon, and Washington!

BOARD SUCCESSION

A lot of ink in *Musings* and other places has been spilled regarding board succession. The general thrust of most articles is how to obtain new qualified board members for the community bank board. Recently, however, we have been in several situations where the issue is not getting qualified board members on the board. Rather, the issue is getting unqualified board members off. What would your bank's board do if it had to get a board member off but he or she refused to resign voluntarily? Do the Holding Company's Articles of Incorporation give you any options as to what to do with that director without going back to the shareholders? At the bank board level should you just kick the director off the bank board (after all, your Holding Company is likely the sole shareholder)? If you do that, then do you have to leave them on the Holding Company board?

It is a good idea to review the Articles and Bylaws of the Holding Company, as well as state law, to determine whether any adjustments would be appropriate for purposes of removing directors. Many Holding Companies, in an effort to protect their initial board, make director removal more difficult than it probably needs to be. As a matter of practice, would it really be so bad if a director could be removed from a Holding Company board with or without cause by a majority of the board of directors (or even two-thirds)? Food for thought.

ACTIVIST SHAREHOLDERS

With the Spring Annual Meeting season coming up, it is time to think about dealing with activist shareholders. These are not all activist-activist (i.e., professionals); some of these are just annoying investors. There are those that think even though they do not sit on the board of directors and do not hold a large block of shares, they should be able to set the strategic direction for the Company. My general recommendation is to "play nice" with these types, particularly ones who are not "professionals." Give them the information they need, and let them know the Board is doing its job. Just remember it is not the Board's job to turn the direction of the Company over to individuals who are not elected by the shareholders to set strategic direction.

THE HIGH QUALITY BOARD

We recently had the opportunity to spend a good portion of the day with a very high quality, high energy, engaged Board of Directors for a mid-size community bank. The characteristics I used to describe this Board (i.e., high quality, high energy, etc.) would not be unusual for a community bank board but for the fact that the average age of this particular board was a bit on the high side. That fact notwithstanding, even the oldest board members were engaged, interested, and had a wealth of experience on the topics being discussed.

BOARD SUCCESSION PART 2

As most *Musings* readers know, I am not a big fan, in concept, of mandatory retirement. This is primarily because it is so arbitrary. Why pick age as a criteria? Why not pick I.Q.? How about blood pressure? How about weight? Now that's a good one. How about "hand size" as discussed in the recent election? None of those are meaningful criteria. If you want to decide who should be on or off your board of directors, why don't you utilize some type of evaluation process or leave it up to a strong Chairman to make the determination? We need to cull board members who are not productive or are even destructive to the decorum and inner workings of the board of directors. We do not need to cull them with an arbitrary bright line in the sand. Let's do something that makes more sense.

BANK ACQUISITIONS

We have run into a number of situations recently where some of our smaller community bank clients have received pretty "outsized" offers to purchase from individuals or entities who are simply looking for a bank charter.

There are always a couple of questions that come to mind when these folks come along (many of whom have the word "tech" somewhere in their name or resume). First, do the potential purchasers have the money? That question, not surprisingly, seems to be pretty easy to answer. Most often, they either do or can get it. The second question is, can they get regulatory approval? That one is a little more dicey to assess and really requires an understanding of what the purchaser's business plan is as it relates to the institution, whether they are going to change the bank's current plan, export it to a different geography, put a technical overlay on it, etc. The friendly federal regulators are not the most creative, but they are the most highly suspicious. If you are dealing with one of these situations, just make sure that everyone that is involved, including the purchaser, understands what is going to happen to the institution post-closing. Any unfulfilled representations from the buyer to the regulators are generally met with some pretty harsh blowback from the regulators in the nature of civil money penalties and the like.

SKIN IN THE GAME

How important is it for directors of our community banks and holding companies to have skin in the game? In other words, how important is it that they own stock and have their own personal money at risk if they are going to be directors of a community bank? Our response - extremely important. We like to see a community bank board that controls somewhere between 20% and 30% of the stock, as a general rule. Obviously, there are some that control 100% of the stock, which is fine too. The bank board I served on many years ago had a skin in the game requirement that was not insignificant. Everybody had to step up and put their money where their mouth is. The strategic decisions we all made dealt with, in large part, our own personal investments. Skin in the game is important. Your community holding company board may want to determine whether the current minimum investment required is significant enough. Many boards will establish a minimum investment and then allow it to phase in over a period of years. Some allow the directors to reach the minimum investment through purchasing stock with board fees or accepting stock in lieu of cash for board fees. There are lots of alternatives, but think about the skin in the game issue as it relates to your community bank.

REGULATORY CONFUSION

We are currently assisting one of our clients with a repurchase of a fairly significant block of their stock. In this situation, the holding company is repurchasing shares from a shareholder that owns a little bit more than 10% of the total shares outstanding. The bank has plenty of capital, and the holding company repurchase is going to be funded by existing excess bank capital through an extraordinary dividend.

Throughout the process, I have reminded the client of the need to receive regulatory approval to pay the special bank dividend. The client indicated they would handle that piece of the transaction. When it came time to ask for approval, the client called their friendly federal regulator and explained that the holding company was repurchasing a large block of stock and needed approval for the dividend to be able to do so. The regulator indicated that the banker was right, not only did they need approval for the dividend, this also constituted a "change in capital" that required shareholder approval as well.

When the client called us to relay the regulator's opinion that shareholder approval was required, we informed them that was not correct. If this was a redemption of bank stock (which it is not - it is holding company stock), the bank's shareholders would be required to approve the transaction. Here, all that is occurring is a dividend from the bank to the holding company. The bank's shareholders do not have to approve any special dividend.

To summarize the story, we got on the phone with the friendly federal regulators, and it was clear they were "confused." The regulators thought all along the banker was talking about repurchasing shares of bank stock. The banker was not. The banker was talking about making a special dividend from the bank to the holding company and repurchasing holding company shares. We clarified that the only thing the regulators needed to approve was a bank special dividend. Once that was clarified, the regulators approved that very quickly, and the transaction closed the next day.

If you are talking to your regulators about any type of strategic transaction, make sure your regulators understand exactly what is happening. Although things may seem like a given to you, the regulators may not see it that way. You can avoid a lot of confusion, worry, and potential problems if on the front end you are very specific to your regulators regarding exactly how a transaction is going to be structured and what exactly you are asking them to approve.

UNSOLICITED OFFERS

The month of January may go down in history as the month of unsolicited offers. For whatever reason, we have had numerous situations so far this year where we have been involved in unsolicited offers by assisting either the potential buyer or seller. What is interesting to me is the stark difference in some of the approaches taken in these potential transactions.

As we have relayed in *Musings* before, our recommendation on an unsolicited offer is to put your best foot forward early in the process. If you are looking to make an unsolicited offer, we do not recommend coming in on the cheap. Instead of picking up a deal, what typically happens is the potential target, who is not out looking to market their bank, gets offended at the proposed valuation and is instantly turned off to the potential of the transaction.

In the potential offers we have seen this year, the split on putting your best foot forward is about 50/50. In a number of these deals, the potential acquirers have stepped up on the front end and proposed transactions with nice valuations that make sense for the seller. In others, the potential acquirer has not put their best foot forward and has instead focused on trying to pick something up on the cheap. Given my experience, my belief is that unsolicited offers where the potential acquirer comes out strong have a much better chance of actual consummation. We will keep you updated.

KEEPING THE POWDER DRY

We were recently approached by a smaller community bank that asked us to assist them in looking at the acquisition of a small community bank (i.e., less than $30 million in total assets). We were happy to oblige, and we ran the numbers on the potential transaction. The numbers actually looked pretty good. The projected earnings per share accretion was very strong at about 30%, even when running the numbers at a level we thought to be a pretty high valuation and required holding company debt. The return on investment was good enough at about 8%. From a financial perspective, this deal certainly made sense.

Our financial analysis was provided to the board to allow them to review and consider the opportunity. Last week we participated in a special meeting with the board to consider the opportunity. The board engaged in a great discussion on the pros and cons of the transaction. We discussed at length the financial benefits. We also discussed at length the fact that this acquisition would take up most of this bank's "excess capital" and would basically sideline them from any other transaction for the next two to three years.

In the end, the board decided to take a pass on the transaction. It was simply a matter of the allocation of capital. They liked the transaction from a financial perspective. What they did not like is the "opportunity cost" associated with the transaction. They saw a couple other opportunities potentially coming down the pipeline over the next three or so years that they thought made much more strategic sense. The board decided to forego the financial benefits of a transaction that did not make a ton of strategic sense for the opportunity to potentially engage in other transactions that they thought would make better strategic and at least as good financial sense for the shareholders. Overall we thought it was a great discussion and an appropriate decision by the board.

COMMON SENSE WINS

Two or three editions ago we relayed to you a regulatory issue where one of the friendly federal regulators was considering requiring a bank with only six shareholders to have a special meeting of shareholders and provide four public notices in order to strictly satisfy the statutory requirements for this particular transaction. As you may recall, we requested the federal regulator consider whether it could provide any regulatory relief in this area. We are happy to report that common sense has ruled the day (still a fairly unusual occurrence with friendly federal regulators). Instead of requiring four public notices for these six shareholders and an actual shareholder meeting, the friendly federal regulator accepted a written consent in lieu of a special meeting, which is essentially a document all the shareholders signed that approved the transaction.

Although this is certainly not the extent of "regulatory relief" we are hopeful to see in the community bank segment of the industry, it is at least an example that all common sense has not been lost within the regulatory agencies. It also saved this community bank the hassle of running a public notice, which, while not a concern from a time or cost perspective, could have created an unfavorable perception in the community and raised a multitude of questions about why there were four public notices for a special meeting related to this particular reorganization. That would have been quite the "event" for this bank.

CONCLUSION

Where has January gone? It is hard to believe it is 2018, let alone nearly the 1st of February. It has been cold most places we have traveled. It has been warmer in some, and we do enjoy those boards who decide that South Florida is a great place to hold a meeting in February.

Jeff Gerrish *and* *Greyson Tuck*