GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Tennessee, Wisconsin, Minnesota, Illinois, South Carolina, South Dakota, and Louisiana!

THE MUTUAL

I was recently with the Board of Directors and senior management of a fairly widely-held community bank. The purpose of the meeting, as is customary this time of year, was to help the bank figure out what to do with its life. As I opened the meeting indicating that long-term planning involved the allocation of human and financial resources to enhance shareholder value, one of the directors indicated that he realized that was important, but the Board felt the real constituency for this particular organization was the community in which the bank was headquartered. As I began to poke them a little bit about this thought process (that the community, not the shareholders, was their main constituent), I began to realize that they were serious. Notwithstanding having hundreds of shareholders, they really viewed their purpose in life for the bank was to serve the community. I accused them of being a "mutual" (no shareholders) in disguise. That was actually fairly accurate.

As a result, the consensus of the meeting was that one important issue was managing the shareholder base of the holding company such that its primary shareholder base was local and smaller - i.e., no shareholder over 3% or 4% at the most.

Don't get me wrong, the Board of this organization believes that most of their shareholders would fully endorse this "community first" approach. It was actually refreshing to hear this out of a board of directors. My only caution to them was that in order to continue with this philosophy, they need to make enough money to serve the community and to keep the shareholders happy, which they are doing.

ACTIVIST SHAREHOLDERS

Over the last several months, I have worked with several institutions that have what can best be described as "activist shareholders." Some of them are the household name "activists" in the industry and others are not. Typically, an activist shareholder will work with a company that is SEC reporting and listed on NASDAQ. One way to get rid of the activist shareholder is to take the company private and delist the shares. Most of those activists do not want a private company as an investment. Think about this if you are in that type of situation. It may cure itself if the Board takes appropriate action regarding ownership and structure.

REGULATORY CONTRACT REVIEWS

Over the past couple of weeks, we have encountered what I think is a pretty interesting situation with one of the federal regulators. In this particular situation, we are representing an acquirer that is purchasing a couple bank branches from another community bank. These types of transactions are structured as purchase of assets and assumption of liabilities transactions and, like all other acquisitions, are governed by a contract that is negotiated and executed by the parties. In this type of situation, as with any bank acquisition transaction, the acquirer must file applications seeking regulatory approval of the transaction with the appropriate federal and, if applicable, state regulators. The regulatory application must include a copy of the Definitive Agreement for the transaction so the regulators can review the contract. As I have previously mentioned in *Musings*, over the past five or so years the regulators have significantly increased their scrutiny and subsequent comments with respect to the contractual provisions negotiated by the parties.

The Agreement in our transaction has a condition to closing that is similar to virtually all other acquisition agreements that essentially provides that one of the conditions to closing is the acquirer's receipt of all required regulatory approvals without any condition or other requirement that is unnecessarily burdensome on the acquirer or would cause the acquirer not to realize the economic benefits of the transaction. Obviously this condition to closing is important because it essentially gives the acquirer an out if the regulators condition their approval of the transaction on something that the acquirer determines will reduce or eliminate the benefits of the transaction.

In our current situation, the regulators came back to us and asked us to remove this condition to closing from the contract. The friendly federal regulator essentially said the contractual language was overbroad and not specific enough for inclusion in the contract. Our response to this request was (politely) "no." This contractual provision is something that was negotiated between the parties as a key element to the transaction. It is in there for the protection of our client in the event the regulators that are reviewing the transaction try to impose some condition on approval that does not make the transaction work for us. We are not simply going to walk away from that protection because the friendly federal regulator believes the language to be overly broad.

Keep in mind if you find yourself in this type of situation that there are limits to the regulator's powers. Your friendly federal regulator does not have carte blanche authority to make you amend your contract in any way they please. Their huge lever, however, is the refusal to approve the contract if you don't. Most of the time they back off.

COMMUNICATION WITH SHAREHOLDERS

For non-public companies, how much communication should you really have with your shareholders? The simple answer is "enough." That is, enough to keep them interested and enough to give them some idea of what is going on with the institution. For some of our clients across the nation, the only communication they have with their shareholders is when the dividend check goes out. Although I have never seen a shareholder send back a dividend check, it is likely that most of the shareholders would prefer a little something more, including perhaps a quarterly letter, a periodic newsletter, or something similar to let them know what is going on at the bank. Who knows - they may also refer you some business for a change.

409A COMPLIANCE

We were recently contacted by a community bank to assist in another acquisition transaction. We represent the target bank. This particular bank has director deferred compensation agreements that allow directors to either take their compensation as earned or to essentially put it into a deferral account that gains interest until the director's normal age of retirement. These types of deferred compensation agreements, as well as similar agreements, are common in community banks.

In these particular agreements, the Change in Control provisions essentially provide that on a Change in Control the director's account balance will be paid in full if the director has not reached normal retirement age or otherwise started receiving payments from the account. If, on the other hand, the director has started receiving payments on a Change in Control, those payments are to continue and become the responsibility of the acquirer. At the time these documents were drafted, this setup was not a problem. However, Internal Revenue Code Section 409A, which was introduced by Congress as a response to the Enron and other major corporate failures, makes this treatment subsequently illegal.

The problem in this transaction is these agreements were never reviewed for 409A compliance. We are looking to remedy the problem now, but it is slowing down the transaction. It is possible there also may be some penalties involved due to the lack of time between the amendment to the contract and the actual Change in Control. This would all have been prevented if these agreements had been previously reviewed for 409A compliance.

If you have any sort of deferred compensation agreements in your bank, make sure those are 409A compliant. If the agreements are not, they need to be changed sooner rather than later to get into compliance with 409A. If the amendments occur within a certain time of a Change in Control there are certain penalties that may be applied. Obviously it would be best to avoid those. Please let me know if we can assist you in reviewing these contracts for your bank.

BALANCE SHEET GROWTH

How much growth in the balance sheet is too much growth in the balance sheet? I suppose the answer is it really does not matter as long as the growth is profitable. If your institution is having significant balance sheet growth, which you either are having to leverage through transactions with the Federal Home Loan Bank or by ratcheting up deposit rates, and your profitability remains the same, is that a problem? Probably so. Do you really want to have your $300 million bank become a $600 million bank and make the same amount of money as it did at $300 million? Probably not. The board needs to make sure when discussing balance sheet growth that the bank is focusing on profitability with respect to that growth. You can have both, but you really have to work toward it.

NON-TRADITIONAL BANK ACQUISITIONS

Over the past couple months, we have been contacted by several companies that are looking for assistance in making an acquisition of community banks. The interesting thing about the companies that are contacting us is that I would describe them as “non-traditional” community bank acquirers. These are not community banks or groups of investors that are looking to make a bank acquisition. Instead, they are essentially fintech firms that are looking to acquire community banks to serve as a platform for the expansion of their business.

An increase in the number of fintech firms looking to acquire community banks has far reaching implications for the industry. Obviously it expands the pool of potential acquirers if you are looking to sell, but it also increases competition if you are looking to buy. It also significantly increases the chances that the business activities of a small number of community banks could look significantly different in the future than they do today. Thus far the regulators have generally shied away from being very supportive of these types of acquisitions. However, my expectation is that sentiment will slowly evolve over time.

I do not think that in the next 12 or so months we are going to see an onslaught of fintech firms acquiring community banks. However, based on what we have seen over the last couple months, there are certainly more fintech companies that are making a go at it.

CEO TRANSITION

How hard is a CEO transition these days? We are seeing a lot of them in a lot of our clients simply because the CEOs are finally retiring. As I kid them all, when I started in this business 30 or 40 years ago, they were all older than I am and most of them still are. So we are seeing a lot of transitions from the number two to the CEO. We have seen some that work extraordinarily well and some that do not work at all. A lot of it, frankly, depends on whether the roles are defined and whether the former CEO takes his or her hand off the wheel long enough to let the new CEO put his or her hands on the wheel and set the direction of the bank. It can work great, but again, you have to work at it.

SUBCHAPTER S TERMINATIONS

We received a couple inquiries over the past couple weeks about whether it makes sense to terminate a community bank's S election in light of the recent Congressional tax proposals. Our response today, as it has been in the past, is "no, now is not the time to terminate the S election." Based on our review of the tax proposals, we believe the taxation of S corporations, if implemented in a manner substantially similar to what is proposed, will continue to be preferable to taxation as a C corporation for community banks. However, at this point it is pure speculation. We do not know exactly what the final taxation of S corporation community banks will look like.

If you are an S corporation community bank, our recommendation is continue to stay the course. We think the S election will continue to be preferential to C corporation taxation going forward. However, if Congress does something that makes us think otherwise, we will certainly let you know.

CONCLUSION

Since *Musings* will not publish again before Thanksgiving, we both want to wish all you and yours a wonderful Thanksgiving holiday and weekend. Stay safe, enjoy the family, and we will see you in two weeks.

Jeff Gerrish *and* *Greyson Tuck*

