
GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Louisiana, California, Minnesota, Florida, Georgia, South Dakota and Kentucky!

EXCESS CAPITAL

We have been retained over the last couple of weeks by a couple of new community bank clients wanting assistance with how to appropriately allocate excess capital. The first step, of course, is to determine whether the bank really has any excess capital. This involves considering present issues, such as short-term asset growth and shareholder distributions, and looking into the future to determine whether the holding company needs to keep any of its “powder dry.” After that determination, then the question becomes what to do with the excess capital.

As we like to say in our firm, you either need to provide a return on equity to your shareholders (i.e., a use for that capital) or a return of equity to the shareholders (i.e. a distribution to them in some fashion). The general alternatives for returning equity to the shareholders are either through an extraordinary dividend (or distribution if you are a Subchapter S) or through the redemption of shares. Obviously, a dividend or distribution goes to all the shareholders. A redemption of shares simply goes to the shareholders whose shares are being purchased, but likewise benefits the shareholders who do not sell. Other alternative uses for excess capital, of course, are acquisitions of other banks, organic balance sheet growth, or other lines of business, all of which are generally lumped into the return on equity (hopefully) category. The Board’s job, with senior management input, is to determine how best to allocate the capital to provide a good return to the shareholders and keep the bank independent.

MORE ON TERMINATING BANK HOLDING COMPANIES

I recently received and read with interest the transcript of a speech delivered by First Deputy Comptroller of the Currency Keith Noreika. As many of you are probably aware, Keith Noreika was appointed by the President as the “Acting” Comptroller of the Currency. The President then nominated Joseph Otting to that position. When he was confirmed, Mr. Noreika moved to First Deputy Comptroller, a position for which I believe he served for one full day. On his last day on the job, he delivered this speech. The title of the speech was “Is the Bank Holding Company Act Obsolete?” As the title suggests, the speech was essentially addressing whether the bank holding company structure continues to make sense in today’s banking and regulatory environment.

First Deputy Comptroller Noreika’s delivered remarks were about nine pages in length. It is difficult to summarize nine pages into an appropriate length for *Musings*, but the very general summary is that First Deputy Comptroller Noreika took the view that the bank holding company may not make sense for most community banks today. He used as evidence to support his argument the example of Bank of the Ozarks, an approximately \$15 billion “community bank.” He went on for two or three pages about why Bank of the Ozarks terminated its bank holding company and why it may make sense for most community banks to do the same.

The problem with First Deputy Comptroller Noreika’s remarks is that they are completely out of touch with the reality of community banking. His remarks did not address at all the approximately 90% of banks in America that are less than \$1 billion in total assets and, as such, beneficiaries of the Small Bank Holding Company Policy Statement. His remarks did not address even in passing the benefits of a bank holding company for a community bank as it relates to capital raising through debt at the holding company and improved share liquidity. Frankly, I was a little astonished that he would indicate the termination of the bank holding company to be something community banks should consider when he completely failed to address the significant benefits of the Small Bank Holding Company Policy Statement that are applicable to approximately 90% of the banks in the country.

To put it plainly, we could not disagree more with First Deputy Comptroller Noreika’s remarks. Applying the logic of terminating the bank holding company for a \$15 billion publicly-traded institution is a completely different analysis than considering the termination of a true community bank holding company. The holding company still absolutely continues to make sense for community banks, and anyone that tells you different is wrong. Please contact us if

you would like a copy of First Deputy Comptroller Noreika's prepared remarks or our firm's Memo to Clients & Friends on why a bank holding company makes sense for community banks.

DIVIDEND REINVESTMENT PLANS

Over the past couple months, we have had several clients ask about dividend reinvestment plans. The general question is whether a dividend reinvestment plan makes sense. The benefit of a dividend reinvestment plan is that it gives shareholders the alternative of foregoing a cash dividend in lieu of accepting additional shares of holding company stock. The downside is that there are significant securities registration and shareholder disclosure issues involved. The choice by a shareholder to forego a cash dividend in lieu of a stock dividend is viewed under the securities laws as a "sale" of the securities that is subject to registration or an available exemption including the accompanying disclosure requirements.

Our recommendation is that instead of doing a dividend reinvestment plan, if you want that type of alternative, give your shareholders both a cash dividend and a stock dividend and allow them the opportunity to resell all or a portion of the stock to the holding company at some appropriate purchase price. This will put the shareholder in the same position as choosing to receive the cash dividend in lieu of the stock dividend. However, the stock dividend and subsequent repurchase is not subject to the securities laws to the same extent as a dividend reinvestment plan. It is a much cleaner transaction using that structure. Please let us know if you have any questions on how this might work in your organization.

KINDER, GENTLER REGULATORS

I recently attended the board meeting of what can only be described as an extremely troubled bank. This bank has earnings, asset quality, capital, and liquidity issues. The board meeting I attended was also attended by the bank's federal and state regulators, including a representative from the FDIC Division of Receivers and Resolutions ("DRR").

For those of you that do not know, a bank failure process begins with the DRR asking the bank's board of directors to pass a resolution authorizing the DRR to market the bank in a failed bank transaction. The resolution essentially gives additional authority for the DRR to come in and take the bank's information and put it into a marketing package. At the height of the downturn, the regulators were extremely harsh during these meetings. I have sat through many where there was table pounding, yelling, etc. This meeting was the exact opposite. The regulators, frankly, were very nice. They were encouraged that our firm was assisting the bank

to find some way to work through these problems absent FDIC intervention. There was no screaming, no table pounding, no name calling, or anything of the sort. I will not say it was an enjoyable experience, but it was certainly better than others I have been through. It is evidence of somewhat of a kinder, gentler regulator, particularly in these situations.

DIRECTORS' DEFERRED COMPENSATION

In prior *Musings* we mentioned that if you have a Directors' Deferred Compensation Agreement you need to take a look at it for a variety of reasons. One reason is compliance with 409A of the Internal Revenue Code. Another reason is just to make sure that the documents are up to snuff in the event that you ever decide to sell or merge your bank with another bank. A couple of the recent transactions we are engaged in on behalf of clients have involved the reworking, retooling, redoing, or terminating the Directors' Deferred Compensation Agreements. It is much easier to get these items straightened out before you get in an acquisition context than it is after.

MANAGEMENT SUCCESSION

We often rail on in *Musings* about making sure you have appropriate management succession. That is often easier said than done. The failure to obtain management succession will likely result in the sale of the bank, so it is an important issue if you want to keep your bank independent.

I was recently with a well-run, high-performing community bank that had done a nice job of transitioning from existing management to new management. New management was not necessarily home grown, but it had been brought into the bank a couple years earlier to provide the tune-up to move into the CEO slot. The transition appears to have gone smoothly. As I have mentioned in prior *Musings*, one of the big issues with management succession is what happens to the previous CEO. Most will want to stay involved to keep an eye on what is typically their most significant investment. The bank just needs to make sure there are appropriate ground rules so the new CEO can maintain his or her position of authority.

THE CRIMINAL TRIAL

I spent part of the last two weeks in a criminal trial. To the surprise of many of you, no, I was not a defendant. I was not even a lawyer in the criminal trial. I was a witness. The trial involved allegations by the United States against the defendants, alleging bank fraud,

falsification of bank records, and the like. Interesting situation that is yet unresolved, although I was one of the last witnesses, so there should be a verdict sometime before the next *Musings*. I will let you know what happened.

THE QUICK SUBCHAPTER S

We were recently requested by a client to complete a Subchapter S conversion prior to year-end 2017 so it could be effective at January 1, 2018. The initial question was, of course, can you get it done? Our answer: absolutely. This is not the first significant Subchapter S conversion (i.e., one where there are several hundred shareholders and you have to do a merger transaction to eliminate them) that we have done starting in late November. We will absolutely get this completed prior to year-end, hopefully with no difficulties on either our side or the client's, but the good news is it will allow them a full tax advantage of the year 2018, whatever those tax laws might look like.

CONCLUSION

We hope all had a great Thanksgiving. We certainly did. It was a good time to see family and friends.

We are now in the fourth quarter of the fourth quarter push. In our firm, this means getting transactions completed by year-end and wrapping up a number of other appropriate issues. Same for you and your community bank. Have a great two weeks.

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and

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