The

Chairman's Forum

Opening the door to new ideas **Newsletter**

Gerrish Smith Tuck, Consultants and Attorneys

October 2017

Welcome to Fall! We hope in your part of the country that the leaves are at least beginning to fall and that cooler weather is on the way. As we approach the end of the year, we begin to look at some corporate governance issues in *The Chairman's Forum Newsletter* that help us reexamine how we have always done things and look at some unusual circumstances that might help you consider governance procedures in your own organization.

We also want to remind you of the upcoming Community Bank Chairman's Forum in Hilton Head, South Carolina scheduled for November 6 and 7. There are still a few spots remaining, but total number of participants will be limited. So, we encourage you to go ahead and sign up for this open forum discussion facilitated by Jeff Gerrish and Philp Smith. If you have never attended, we think you will find it worthwhile and we often have numerous repeat attendees. For more information, visit the following link or contact us directly:

https://myicba.icba.org/eWeb/DynamicPage.aspx?WebCode=EventInfo&Reg_evt_key=8f6d80f2-b48c-4360-b79b-f26baf78d140&RegPath=EventRegFees

We look forward to seeing many of you later this Fall in planning sessions and in Hilton Head.

Happy Reading!

Philip K. Smith and Jeffrey C. Gerrish

Gerrish Smith Tuck
700 Colonial Road, Suite 200
Memphis, TN 38117
Phone (901) 767-0900
www.gerrish.com

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Chairman's Summary

- Is a classified Board necessary?
- How can you deal with undervalued / overvalued shares?
- Can your stockholders handle the "earnings" truth?
- Address the issues of mandatory retirement and succession with an annual review and evaluation of directors.

Is a Classified Board Necessary?

Recently, when facilitating a planning session, a question was raised by one of the Board members who wanted to know why the organization had a "classified" Board of Directors. This organization was structured like a lot of institutions that had a Board composed of nine total individuals where the Board was divided into classes so that three directors were elected each year to serve for a three-year term. The director who raised the question was a relatively new director who wanted to know why the organization did not just elect all nine directors each year to a one-year term or even to a three-year term.

His question raises a good point in terms of corporate governance for the Chairman of the Board because we often have a lot of these types of operating procedures that have been in place for some time and occasionally it's good to ask the question "why" so that we are not simply doing things because that's the way it has always been done. Importantly, also, if the Chairman is constantly asking the question of "why", then we ensure that we are following the most up-to-date corporate governance procedures for the benefit of the stockholders.

A "classified" Board of Directors is really a business continuity and anti-takeover provision. The idea behind it is to prevent the entire Board of Directors from being removed at a single annual or special stockholder meeting and thereby dramatically effecting the strategic direction of the organization. For example, you would not want a group of stockholders banding together and voting against all directors slated for election and then voting to replace them with themselves and new directors and then immediately voting to sell the organization. A classified or "staggered" Board of Directors means that, at worst, only a portion of the existing Board of Directors could be replaced each year. Generally speaking, we rarely see circumstances where there is an attempt made to remove an entire Board of Directors, but maybe that is because so many organizations have this type of provision. It is probably one that, while rarely ever needed, is always good to keep in place to ensure that it does not have to be used.

Undervalued / Overvalued Stock

An interesting issue has arisen out of the post-crisis return to growth and profitability for many community banks, but it takes the opposite forms for different banks. For some banks, they are finding that their stock may be undervalued compared to what is happening in the market around them. On the other hand, some banks are arguing that their stock is overvalued in the sense that it is trading at multiples greater than what can truly be supported. What do you do in either case?

For community banks that are non-public and really have little liquidity in their stock, there are a couple of options to support a greater value for the price of the stock if you find that, to the extent the stock trades at all, it is trading at less than its true value (or perhaps even at less than book value). The first and most candid option if there are sellers for the shares at less than true value or even less than book value, the first candid options might be for the holding company to go in and become the "purchaser of first resort" and buy as many of the undervalued shares as it can. Doing so will result in a tremendous economic benefit to those stockholders who do not sell in the form of increased earnings per share, increased return on equity, increase in cash flow per share and even increase in ownership percentages. Strategically, the organization might even consider initiating repurchase transactions or offering to purchase shares at a great value, but that is still a discounted value in order to provide those benefits if there are sellers at those prices.

But if the organization wants to support a greater price, it can simply offer to repurchase shares at the greater value that still produces earnings per share accretion and other benefits, and thereby the privately held organization can be a price support for its own stock and move the trading value upward. If the organization desires to provide the greater price support as a way of perhaps generating more interest for potential sellers, then the organization can still continue to buy those shares as a good economic value so that it benefits non-selling stockholders through an increase in organizational value and benefits the selling stockholders by creating a good liquid price that they might not otherwise experience. Therefore, all parties are happy.

On the other hand, we have had a couple of organizations who felt their shares were overvalued because there were private trades being conducted between stockholders at values that the organization did not think could be supported. While generally the value of a share is whatever a ready, willing buyer and ready, willing seller will pay, there was some concern that these particular buyers and sellers may not understand the true value and, therefore, the trading prices did not reflect actual value. Interestingly, one of the ways the organization can combat this is to again go to stockholders with a voluntary offer to repurchase shares (which, in this case, would be at a price lower than what the other trading values are) as a way of demonstrating to stockholders that perhaps a more reasonable trading value is only what the company is offering. Often, an organization might want to do that as a way of pushing down the value of the shares so that the organization itself could be a viable purchaser of the shares. However, if an organization thinks the value is out of line, it should not just randomly assume that. We recommend running financial modeling and analysis to determine the impact of purchasing shares at the price that it is otherwise trading with other stockholders to determine if the organization still ought to be a buyer at that level. Sometimes the organizations are surprised at the true benefit repurchasing the shares can have even at the greater price.

Occasionally, organizations might look to do stock splits or something to try to moderate the value of shares, but for privately held organizations the best strategy may often simply be to educate the stockholder base.

Being Honest With Your Stockholders?

There is the famous line from the Jack Nicholson and Tom Cruise movie where one yells to the other "You can't handle the truth!" Is that perhaps true of your stockholders as well. Can they handle the truth about the performance of the organization? Can they handle the truth about the earnings performance of the organization? Naturally, your reaction is, of course they can and we are always honest with the stockholders in that regard. But are you?

We find that it is quite common for community banks to structure their stockholder dividend policies in ways that, argumentatively, shield the stockholders from the true earnings performance of the organization. For example, if your organization were to implement a dividend policy that required the Board of Directors to distribute 25% of earnings each year to stockholders in the form of cash dividends, what do you think would be the reaction of stockholders in years when earnings were down? Many of our clients don't tie dividend payments directly to earnings performance, but rather the Board has a dividend policy that perhaps allows them to pay within some range of earnings and the Board may only adhere to the range to the extent that dividends can be increased each year. In reality, no matter what the dividend policy actually says, many Chairmen and their Boards will choose to pay a dividend that is greater than the last dividend regardless of its impact on earnings.

We have even seen companies declaring a dividend increase of as little as one-half of one cent, probably for the mere reason that the Board wants to be able to say they have increased dividends every year for a set number of years. In actuality, it's arguable that it is almost a bit of a bribe to stockholders whereby we are suggesting that they should continue to be happy with the Board and management and the overall performance of the organization because their dividends are going up. For those organizations we believe the mindset is to tacitly tell the stockholders, "Never mind that page 12 of the financial statements shows an increase in the allowance for loan losses, more loans placed on non-accrual and an overall decrease in profitability this year, your dividends still increased so please don't read the fine print". So, are we concerned that our stockholders can't handle the truth of having their dividends ebb and flow with overall profitability? Are we afraid that it exposes us to more questions at the annual meeting? Give some critical thought to how you are dealing with your stockholders and how your earnings and dividends flow together.

Mandatory Retirement and Succession

As many of you know, generally speaking, our firm is not a proponent of setting a mandatory retirement age for Boards of Directors. We would rather see an organization evaluate directors on a periodic basis and make the difficult determinations as to whether an individual director is meeting the requirements and demands of his or her position whether they are 55 or 75. That being said, if an organization is unable or unwilling to implement a director evaluation program, then mandatory retirement may be appropriate provided that you really use it and then do not “grandfather” all the Board members.

Interestingly, we rarely think about mandatory retirement for our officers, though. We generally think that the officers, of course, will at some normal course in their lives choose to voluntarily retire. But consider a circumstance we recently encountered where members of the Board of Directors were subject to mandatory retirement with the exception that they were not subject to the mandatory retirement as long as they were still an executive officer of the organization. You might see what could possibly happen in that situation where a CEO who is also a Board member continues to serve in an executive officer position, and, therefore, is able to avoid mandatory retirement at the Board level, yet all the outside Board members are subject to the mandatory retirement age. Maybe that’s not a bad thing because it gives us turnover on the Board with a continuity of management, but perhaps it also has the potential of being counterproductive because an individual wants to continue to serve the organization as a Board member, but realizes if he or she retires from the day to day operations at the bank they will be required to resign from the Board also. That could be an impediment to other members of management hoping for the natural progression of management succession that is stymied by a Board policy. A simple process of reviewing and evaluating directors on an honest basis each year might be a better approach. That might let the management team follow a normal retirement process and yet still remain active members of the Board of Directors in appropriate circumstances.

Meeting Adjourned

As we move into the final quarter of the year, many of us are wrapping up strategic planning sessions and looking for ways to improve the governance of the organization in the coming year. We hope that some of the items in this month's edition of *The Chairman's Forum Newsletter* will be beneficial to you and if we can answer any questions or be of service, please let us know.

Until next time,

Philip K. Smith and Jeffrey C. Gerrish

Gerrish Smith Tuck
700 Colonial Road, Suite 200
Memphis, TN 38117
Phone (901) 767-0900
www.gerrish.com