GERRISH'S MUSINGS

Jeffrey C. Gerrish
Greyson E. Tuck
Gerrish Smith Tuck
Attorneys/Consultants
700 Colonial Road, Suite 200, Memphis, TN 38117
♦ (901) 767-0900 ♦ Fax: (901) 684-2339
♦ Email: jgerrish@gerrish.com ♦ gtuck@gerrish.com ♦ www.gerrish.com

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Dear Subscriber:

Greetings from Hawaii, Pennsylvania, West Virginia, Iowa, Tennessee, and Nevada!

OWNERSHIP RESTRUCTURING

I was recently with a banker that was very proud of the fact that he had restructured a very difficult ownership situation at his bank holding company. I was happy for him. He also informed me that his holding company owned less than 100% of the bank. I suggested to him that he needs to focus on the second restructure, which is eliminating the bank shareholders. It is actually pretty easy to do through either a reverse stock split or a cash-out merger, although the reverse stock split is usually cheaper and easier. In that scenario, the holding company, as the largest single shareholder of the bank, simply calls a shareholders meeting, the purpose of which is to increase the par value of the bank's shares. The result from the increase in par value is that all shareholders other than the bank holding company become fractional shareholders. A corresponding amendment to the governing documents is adopted and approved that prohibits fractional shares. Bingo, the holding company owns 100%.

Part of the board's job is to make sure the ownership structure is appropriate. The bank holding company owning 100% of the bank is appropriate for multiple reasons.

CULTURAL ISSUES

We are in the process of conducting organizational/governance studies and reviews for a couple of community banks around the nation. The interesting thing about these reviews is that the culture of the bank and holding company really come through in connection with discussions with senior management and board members. As you might expect, the culture for each organization is different. One of the banks we are reviewing has what we consider to be much more of a "cowboy, let it all go" culture. The bank has grown rapidly and it wants to continue to do so. One of the others we would identify as a very conservative, typical, traditional community bank culture. Very thoughtful and progressive as it relates to moving forward on various issues. The point is they were totally different. You might take a look at the culture of your organization and make sure it is where you want it to be.

THE "STRING ALONG" ACQUISITION

For multiple years now, we have been working with the board of a particular community bank client that has floated the idea of selling to another institution. One institution in particular has expressed significant interest over the years. After having listened to representatives of this institution talk about their desire to put something together, only to see them follow through with no concrete activity (e.g., no numbers, no letter of intent, or anything else), I really think for some reason this is some kind of a string along deal. I do not know what is going on with the potential purchaser. Maybe they have other priorities. Maybe they have some regulatory problems. Maybe they have one of those "undisclosed" fair lending issues such that they know they could not get regulatory approval. Regardless of the reason, this seems to be quite a string along acquisition issue. We have advised our client to terminate discussions and move on to other opportunities.

THE VALUE OF EXCESS CAPITAL

I was recently facilitating a planning retreat for a bank that enjoys extremely "comfortable" capital levels. This bank's Tier 1 Leverage Ratio exceeds 13%, and the Risk-Based Capital Ratios are well in excess of that. During the planning session we talked about the value of this excess capital. I gave the board my opinion, which is that the bank's capital levels are good for making a comfortable examination exit interview but not much else. I then gave my arguments against the excess capital, namely that it decreases return on equity and makes for a less efficient investment of the shareholders' money. The board had never really had anyone give them this type of perspective. Frankly, they have always thought that these capital levels made their bank one of the "best" community banks around.

It would not be correct to say that my comments were a total epiphany to the board. However, they are certainly warming to the idea of the possibility of excess capital and, more importantly, are considering their options for deploying this excess capital in a way that provides true value to the shareholders.

If your bank is a bank that operates with extremely high Tier 1 Leverage Ratios (i.e., north of 12% of so), give consideration to whether that is an appropriate strategy for your bank. Many banks operate with these levels of capital and have a shareholder base that is completely fine with that. However, the reality is that excess capital does not give much value to the shareholders, and could be put to use in a number of beneficial ways. Remember, the board's obligation is either to provide a return "on" equity or a return "of" equity.

THE LUCRATIVE EMPLOYMENT AGREEMENT

Our firm is currently assisting a client in purchasing a community bank. This is a little bit of a non-traditional community bank acquisition since the acquirer is not another community bank. Instead, we are representing a group of investors that are coming together to buy a community bank. Once the bank is bought, the investor group is going to install new leadership into the organization. The individual they have identified as president recently provided his "wish list" for the terms of his employment agreement.

The president's wish list for his employment agreement squarely fits into the camp of "if you never ask for it, you will never receive it." The president's requested compensation and other benefits were, frankly, well beyond what would make sense in any community bank. As we told the client, if this wish list was followed, this president would undoubtedly be one of the top ten highest paid community bank presidents in the country.

The interesting thing about the president's wish list is that he justified it based on what he was going to bring to the new bank. By his account, he would bring over $60 or so million in new loans almost immediately, which, at least in his mind, completely justified the amount of compensation he requested.

We have heard promises like this previously. We have seen a number of instances where individuals that are coming to a new job make pretty substantial claims about what it is that they can do in terms of bringing over new business. We have seen numerous instances where the promises made were not promises kept, and the actual amount of new business was much less than what was promised. Based on this experience, our recommendation to the client was to put an appropriate base salary in place and then put appropriate incentive compensation that would provide compensation in the event this individual can actually deliver what it is they say they can deliver. We believe that is a much better position for our client than irrevocably committing to a very lucrative salary with the hopes that the president can develop the type of business he claims he is able to develop.

STOCK REPURCHASE PROGRAMS

As many of you longtime *Musings* readers know, we are big fans of stock repurchase programs. We have recently assisted a number of clients in what we coin “voluntary stock repurchase programs.” These are programs where the holding company approaches the shareholders on a proactive basis and essentially gives the shareholders the opportunity to sell the holding company common stock in accordance with the terms of the program. This proactive approach is distinguished from a “walk-in repurchase program,” which is more of a reactionary program where the board authorizes the company president to repurchase shares by any individual that approaches the holding company looking to sell.

Over the past couple months we have assisted a number of clients in developing stock repurchase programs. As we work through these programs we inevitably get questions regarding the allowable terms of the program. Companies always want to know what they are allowed to do and cannot do in setting the terms and conditions of the program. The great thing about a stock repurchase program (for a non-SEC reporting company) is that there are essentially no terms and conditions that must be followed, except the requirements to hold the program open 20 days and to properly disclose the terms of the program. The board is free to set any other conditions of the program relative to price, the number of shares to be repurchased, the purchase priority of shareholders, and the like.

If you are thinking about a stock repurchase program, keep in mind that you have great latitude as it relates to the terms and conditions of the program. The board is free to set pretty much whatever it wants to set as terms and conditions of the program, so the program can be tailored to accomplish the board’s goals.

TECHNOLOGY DOES NOT REPLACE RELATIONSHIPS

We have recently been devoting quite a bit of time to assisting community banks in considering technology investments and developing what are essentially technology strategic plans. In focusing our efforts in this area recently, we have come to the conclusion that technology is necessary, but technology does not replace relationships. Your community bank should be thinking about your strategic plan as it relates to technology. In thinking through this plan, do not fall into the trap of thinking that technology is a substitute for customer relationships. It is not. Technology is certainly another avenue through which we can provide our products and services, but it is not an offering that will prove successful if the strategy is to use it in lieu of developing customer relationships.

FAMILY CULTURE

I was recently visiting with a fairly closely held good size community bank. The banker was discussing the “family” culture that is maintained in their bank. The bank has a number of things to promote this family culture throughout the bank. The one I found the most interesting was the fact that if any bank employee has a son or daughter that is in college, the son or daughter is automatically guaranteed summer employment and holiday employment at the bank. What a way not only to get some good, loyal, potential future employees, but what a way to make mom or dad happy with the bank as well. The same bank also has a mentoring program (that actually works). It is a three year program through which they put approximately 20 recent college graduates. The program provides the new employees opportunities to work in all parts of the bank. I have participated in a lot of discussions with banks regarding mentoring programs over the years, but I have not seen one that apparently is as successful as this one. Congratulations to this bank.

CONCLUSION

It has been great to see many *Musings* readers at the ICBA Annual Community Banking Convention in Las Vegas this week. We appreciate many of you searching us out and your kind comments on *Musings*. (We are glad somebody reads this stuff.) Have a great Convention and a great two weeks.

Jeff Gerrish *and* *Greyson Tuck*

