GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Virginia, Arkansas, Georgia, Minnesota, Iowa, and Tennessee!

COMMUNITY BANK INDEPENDENCE

Greyson recently presented a nationally broadcast webinar entitled "Ten Strategies to Maintain Community Bank Independence." As the name suggests, the webinar presented ten practical steps for community banks to consider if they have established a strategy of independence. Based on the attendance at the webinar, this topic qualifies as a "hot topic" in the community banking industry. There were a great number of community banks that participated.

Despite the very active community bank mergers and acquisitions market, many community banks that have established and are actively pursuing a strategy of independence. This is in direct contrast to all of the naysayers out there that predict the death of community banking. Please email Greyson at gtuck@gerrish.com if you would like a copy of the slides from the presentation. We are happy to provide them.

THE VALUE OF EXCESS CAPITAL

A client recently approached us to ask for our assistance in "running the numbers" on the acquisition of another community bank. These are two community banks that, when combined, will be about $250 million in total assets. The potential target in the transaction has a balance sheet that is anything but traditional. They are extremely liquid, have a relatively small loan portfolio, and are overcapitalized by any stretch of the imagination (almost a 20% Tier 1 Leverage Ratio and Risk-Based Capital Ratios through the roof, and it is not a mutual!).

In running our financial analysis, the question came up as to the value of this excess capital. Our response is that there is none. Having this much capital does not provide any benefit to the institution and its directors except for making for an easier examination exit meeting.

We have seen a number of community banks that believe they can hold high levels of capital in their bank and get paid a premium on that capital at the time of closing. As well-seasoned *Musings* readers know, corporate value is all about earnings. The acquirer is buying your earnings stream, not your book value. Excess capital makes for an easy examination, but it does not do anything for your market value.

CHANGE IN CONTROL AGREEMENTS

Many community banks have Change in Control Agreements in place with key employees as either standalone agreements or part of an employment contract. These agreements are typically thought of as an employee retention tool. These agreements pay employees some amount of cash if, as the name suggests, there is a Change in Control of the holding company or bank. The idea is to "bribe" these employees by paying them a material sum of money if they stick around through closing to make sure a transaction gets completed. This is one of the most effective employee retention tools available if your bank is an acquisition target.

This past week we ran across a twist on the Change in Control Agreement. Instead of a Change in Control Agreement being an employee retention tool, this agreement was an attraction tool. One of our clients was looking to make a key hire, and the individual that is to be hired thought the characteristics of our client's bank were such that it was a prime acquisition target. Our client assured this individual that the bank was not for sale, and that independence was the chosen strategy. In order to put its money where its figurative mouth is, our client offered a Change in Control Agreement to this particular employee that was good for the next three years. This essentially is an agreement that provides a cash payment to this employee in the event there is a Change in Control within three years of his hiring.

In this situation, the Change in Control Agreement was not intended so much to keep someone at the bank (employee retention) as it was intended to bring them into the bank (employee attraction). Kudos to this bank for being willing to put weight behind its word and provide this new hire comfort that the bank was not going to pursue a Change in Control any time in the near future. We see that as a win-win for all involved.

REPRESENTATIONS AND WARRANTIES

As many of you know, every community bank acquisition transaction will have multiple pages of representations and warranties by both the buyer (very short, in most cases) and the seller (very extensive). Representations and warranties by a party in a community bank acquisition transaction are simply where the party represents that certain facts are true - e.g., the bank does not have any environmental problems, the loan loss reserve is adequately funded, the bank has filed all their corporate documents, has the appropriate licenses, etc. In the old days, representations and warranties never survived the closing of an acquisition transaction. The general thought process back then was that in most of the transactions, even if you had a claim on a rep and warranty post-closing, there was no way to get the money back. Post-recession, most of the transactions do have some nominal survival of the reps and warranties. These are often tied to an escrowed pool of money so there is at least some way to get the money back.

We recently conducted research on behalf of a client we were representing on the "buy side" as to whether the survival of a representation and warranty, does any good in this day and time, with or without an escrow. There is actually a fair amount of law on this. The bottom line is that if the representations and warranties were designed to survive in perpetuity, then they are limited by the applicable contract statute of limitation. If they are shorter than that (e.g., the contract statute of limitation is six years and the reps and warranties survive for a year), then the shorter period applies. This treatment may vary from state to state. Nonetheless, this seems to be a continuous negotiation point in current acquisitions, so you might keep it in mind.

THE REGULATORY REQUEST

We are currently assisting one of our clients in responding to the findings and criticisms contained in their recent Report of Examination. This bank did very well in all the CAMELS components but one - Liquidity. As indicated in prior *Musings*, liquidity has become more of a regulatory hot button these days. The regulators are concerned with respect to "on balance sheet" liquidity and contingency sources of funding (all of which dry up when you need them).

In our review of the Report of Examination, we noted it contained a number of ratios that analyzed the bank's liquidity. Both our firm and the client were recalculating some of the ratios and could not come up with the same number as the regulators. We all thought the logical thing would be to go to the regulators and ask how that particular ratio was calculated, so we did so. Not totally surprisingly - but certainly a little bit surprisingly - the regulators refused to provide the information on the basis on which they calculated the ratio! Must be some kind of a United States Government-Classified Secret! For many of you who have been around a long time, this is the same response we used to get when the regulators would indicate the allowance for loan and lease losses reserve was too low or calculated inappropriately. We used to ask them, "How should we do it, and how much should it be?" The answer was always, "You figure it out." Same situation here apparently.

MUSIC TO MY EARS

It was music to my ears when I received a phone call the other day (yes phone call, not email) from a former outside director of a bank that we had assisted as financial adviser and legal counsel in a sale a few years ago. This was a pretty good-sized bank, and this guy got a pretty decent chunk of change as a result of the sale. Apparently, he has been sitting on that pile of money and has decided that he and some of the other business leaders in town would like to start a new bank. Yes, a "de novo." Music to my ears. As most of you know, although our firm participates in a lot of sell-side community bank transactions, we are still strong proponents across the nation of independent community banks. We are glad to see some recent activity with respect to independent banks and really glad to see that our consulting and law firms are going to be able to provide turnkey services for those who want to form new independent community banks. We are not ready to announce where this bank is going to be located, but stay tuned.

WHAT WERE THEY THINKING?

We have had a number of situations recently where bank employees, even some very senior ones, have done some things that were just totally bizarre and out of their character. Some of them have just been, for lack of a better term, "stupid." Others, likely criminal. You look at some of these activities that some of these executives at these banks have taken, and you wonder "What were they thinking?" No rational human being would do what these folks in multiple cases in different community banks have done. My caution to community bankers and others is this: before you take whatever action it is you are thinking about taking, think how you would like to see it in broad daylight on the front page of your local paper six months after you have done it. If you can survive that test, it is probably ok. If you can't, then go do something else.

COMMUNITY-MINDED

I recently had a meeting with the owner of a fairly good size community bank. This particular owner was very philanthropic-minded and very community-minded (in a good way). He has some children, none of whom want to come in and run the bank, but he still wanted the bank to survive over the long term in the community after his death. Instead of giving the bank to the children, we are setting up a structure where the bank will transition over time to the employees through a KSOP and to the community. This will be a sale transaction (not a giveaway), but it will nonetheless achieve the desired result. In the long term, this bank will survive in the community, being owned by the employees through the KSOP, and by community members who step up to purchase some of the remaining shares.

CONCLUSION

You may have noticed that Philip Smith is now contributing to *Gerrish's Musings*. As most of you know, Philip and I have been partners in the consulting and law firms for nearly 30 years. Greyson and I are glad to have Philip on board with this every-two-week publication.

Keep in mind, schools are getting out and the kids are going to be roaming around. Be careful. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*