
GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Minnesota, North Dakota, Illinois, Wisconsin, Texas, Georgia, and Kentucky!

CLAIRVOYANCE IS NOT OVERRATED

We must be clairvoyant. As you will recall, we put a brief article in *Musings* about a month ago about the possibility of smaller community banks sharing services. On October 3rd, right after the release of the last *Musings*, all of our friendly, federal regulatory agencies (including the National Credit Union Administration) issued a joint statement on banks and credit unions sharing resources to improve efficiency and effectiveness, particularly as it relates to Bank Secrecy Act compliance. Who would have guessed they would act so quickly after seeing it in *Musings*? If anybody would like a copy of the joint statement, please let me know. We are happy to send it on.

CULTURE CULTURE CULTURE

We have been having multiple discussions lately with various clients about the importance of culture, particularly in the acquisition environment. Some do not think it is that important. Some think it is the most important part of an acquisition.

We pretty much side with the latter group that thinks it is a very significant part of the acquisition. We have been involved in transactions where the credit cultures were so diametrically opposed that the deal could not even get put together. We have been involved in

other transactions where the management culture was so different that the sides could hardly work together.

Even though culture is somewhat of a “squishy” term, it is important to understand the culture of both banks as they come together to determine which one will survive and move forward, and whether it is feasible to put the two together. Just a thought.

THE FAMILY BANK

We have worked with multiple family-controlled banks over the last several weeks. While some of this discussion involved acquisition issues, most of it simply involved long-term planning for the direction of the bank. The patriarchs and matriarchs involved in these banks, for the most part, are savvy enough to sit back and listen to the discussion, particularly by outside directors and senior management - i.e., those who may be even closer to the bank than they are. When it comes down to making the final strategic decision, however, it is obviously their choice. When they finally make that choice, it is generally very helpful to the management team, who now has concrete direction (or at least some direction) as to what the outer limits may be with respect to acquisition growth, expansion, or whatever the topic may be.

CAPITAL ALLOCATION

One of the most significant issues facing most community bank boards of directors, particularly at the holding company level, is allocation of capital. Some allocation of capital is always required. We call those a fixed cost. Balance sheet growth is certainly one example of a fixed cost. If your \$500 million community bank wants to grow its balance sheet at 10% (i.e., \$50 million), then there is a fixed cost of \$5 million in capital that has to go against that to maintain a 10% capital ratio. A fixed cost.

Other costs may seem “variable,” like the dividend or distribution in Subchapter S, but the reality I have found working with community banks over the years is that these items are really a fixed cost as well. It is very difficult to get the shareholders to eliminate the dividend (absent troubled times) or otherwise reduce it to allocate that capital toward something else that may be more productive for the company. Dividends and distributions in a Subchapter S are opiate-like in their addictive nature. It seems the best we can do in a lot of our banks, where the capital could be better utilized but the shareholders are dependent and/or addicted to dividends, is to slow the rate of growth of the dividend. This will allow the company to at least decrease the percentage of income paid as dividends, provided the company needs to grow.

Actual variable costs, in my mind, include redeeming shares and acquiring banks or other companies. The dividend and balance sheet growth, however, are definitely fixed costs. If you don't view them that way, then you should.

ARE BRANCHES RELEVANT?

Lots of ink has been spent over the last 25 years deciding whether or not branches are relevant. Years ago when the internet banks first were created, the theory was they would put brick and mortar locations totally out of business. Obviously, that has not happened, but they have been good competitors.

In recent planning sessions we have had the same discussion about what is the relevance of the branch for the future. The general consensus, at least anecdotally from our client base around the country, is that brick and mortar branches are still relevant, although they need to be much smaller, staffed with Universal Bankers, and particularly nimble at solving problems, since that is pretty much the only time they will see a human.

If the large banks are any guide (maybe they shouldn't be), they are still building new branches at a pretty good clip, albeit they are the smaller/store-type variety, but they are buttoning up some of their rural branches. We will all see what the future holds, but it seems to us that brick and mortar branches are likely here to stay, although in a different format.

DIRECTORS' LIABILITY

I had the opportunity today to participate in a significant director education event sponsored by the ICBA. This was their Annual Directors Conference held in Savannah, Georgia. Fortunately, Savannah was spared from the hurricane destruction. My topic involved directors' liability, corporate governance, and strategic planning. If anybody wants the PowerPoints from that, please let me know.

After the discussion, I got a number of questions about directors and potential conflicts of interest. Can simple things create a conflict? For example, is it a conflict to want to buy stock from another shareholder when the company's strategy is to redeem as many shares back into the bank holding company as possible? Is it a conflict to recommend a loan to a new customer who is not a director but owes a director money? Those are good questions. My general advice to the group and to the individuals that asked was when dealing with director conflicts, take the most conservative approach possible. If you have to raise the issue of whether it is a conflict, it probably is. Treat it as such. At the very least, the director involved should not participate in the

decision making, and there should be full disclosure of the conflict. The rest of the board also has to make sure they are doing what is in the best interest of the bank overall, not in the best interest of the director necessarily, although their positions may be aligned. A conservative approach is the watch word for director conflicts.

DATA PROCESSOR AGREEMENTS

A word to the wise for those community banks nearing the end of their contractual period or those in the process of negotiating a data processor contract. If your board has any thought that your bank may be sold during the life of the next contract, be sure to give consideration to the contract termination fee provisions. If the bank finds itself in the position where it may be sold, then the termination provision should be one aspect of the contract that is negotiated the hardest. If you fail to take this into account, you are likely costing your shareholders a lot of money. We were reminded of this reality recently when one of our clients asked us to “run the numbers” on the potential acquisition of another community bank. In looking through the target bank’s information, one of the things that jumped out was the fact that it had just signed a multi-year data processing contract that had a termination provision in the millions of dollars. The cost associated with termination of the data processing contract has to come from somewhere, and it will come directly from the selling shareholders’ pockets. The fact that the bank signed a long-term data processor contract does not make the bank any more valuable. The bank is worth what it earns, regardless of the length of its contracts. All this lengthy contract does is add another expense to the transaction, which is ultimately going to reduce the amount of cash received by the selling shareholders.

If you are negotiating a data processor contract and you think your bank might be sold, do not forget to negotiate the termination provisions to where they make sense for your shareholders. Otherwise it could end up costing them a substantial amount of money.

A PRIME EXAMPLE OF OVERREGULATION

We have been assisting one of our community bank clients in addressing what we believe is a classic example of overregulation. In this particular instance the bank has a trust department that administers the trust of one of the bank’s former directors. This particular director also happened to be the bank’s largest shareholder. The director was a staunch supporter of the bank and its independence.

The terms of this particular trust were drafted in such a way as to very clearly allow and support the holding company's repurchase of the holding company common stock. The trust included all the typical language you would expect to see in this regard, including waivers of any conflict of interest, direct language allowing the repurchase, and the like.

During this bank's recent examination, their friendly federal regulator gave quite a bit of scrutiny to this trust setup and the planned repurchase of holding company common stock. Notwithstanding the language in the trust, the trust examiner wanted some informal written support from the bank's legal counsel (Gerrish Smith Tuck in this case) that the contemplated transaction complied with all laws and regulations. We have been working with the bank on this situation for some time, so we provided all of the requested documentation. After doing so, the bank regulators came back and essentially said what we had previously provided was not enough, but they instead needed a formal legal opinion on the matter.

We view this as a prime example of overregulation. The terms of the trust document clearly allow what was contemplated, and the trust examiner saw that. They then asked for written support from us as legal counsel that the contemplated actions were legal, which we provided. They then took it one step further and said that our informal letters were not enough, they needed a formal attorney opinion. It seems like quite a bit of overkill to us.

THE "STRATEGIC PLANNING" SESSION

I recently had the opportunity to facilitate a strategic planning session for a community bank for the first time. In fact, our firm has never previously provided any type of strategic planning assistance for this particular community bank. Instead, this bank's previous "strategic planning sessions" were facilitated on a complimentary basis by an investment banking firm. In assisting the bank through this year's strategic planning process, which included reviewing the prior "Strategic Planning Report," it became apparent that this bank's previous sessions were not strategic planning sessions. Instead, they were lengthy pitches on behalf of the investment banking firm as to why the bank ought to buy or sell. These previous sessions were really of no practical benefit to the board, as the bank really does not consider itself a buyer or seller. Worse, they did not spend any time talking about other opportunities to enhance shareholder value.

As you are thinking about your strategic planning, keep in mind the ultimate goal of the planning session is to establish a strategy to enhance shareholder value. That certainly could involve buying or selling, but for many banks it does not. Also keep in mind whether the

facilitator has a vested interest in the outcome of the decisions at the planning retreat. Those biases can either create problems or make much of the process a waste of time.

BRANCHING IS NOT DEAD II

Are technology and the changing habits of customers killing community bank brick and mortar branches? Based on our activities over the past couple weeks, the answer is a resounding no! In one day last week we filed two different branch applications for two community banks, as well as an application to relocate a community bank's existing branch office. This is an anomaly, as it is not typical for us to file three different branch applications in a single day. However, this, coupled with the other branch applications we have recently filed and the banks we are working to assist in evaluating new branch opportunities, leads us to believe that the community bank branch is far from dead.

As we have previously relayed in *Musings*, we believe community banking has been and will continue to be a relationship-based business. Technology is certainly impacting the relationships we have with our customers, but we do not believe technology is replacing those relationships. We think the community bank branch will continue to be an important aspect of the overall product delivery channels in the near and long-term future.

CONCLUSION

Fall is here or at least coming in most parts of the country. Hopefully, the hurricane season is winding down. It is our understanding there was snowfall in the Upper Midwest today, so winter can't be far behind. We look forward to seeing many of you as we go through our fall activities and client meetings. Have a great two weeks.

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