

The



Chairman's Forum

Opening the door to new ideas

Newsletter

Gerrish Smith Tuck, Consultants and Attorneys

January 2019

Happy New Year! As we kick off 2019 (and actually are, unbelievably, already, unbelievably, just starting February), we are excited about the level of Chairmen, director and executive officer participation in continuing education for their organizations. On January 17 and 18, we hosted the Annual Community Bank Chairman's Forum where Chairmen, Vice Chairmen, directors and other executive officers from around the country met in a unique open forum discussion of key topics critical to their organization. There were 18 different states represented at this meeting and a wonderful interchange of thoughts, comments and ideas for how to improve Boards of Directors and the organizations they serve.

In this month's edition of *The Chairman's Forum Newsletter*, we focus on a number of the topics and questions that came out of that event. We think you will find many of these relevant to your own organization.

Recognize that 2019 will bring new challenges and opportunities for you and your organization. Throughout the year, we hope *the Chairman's Forum Newsletter* and our firm's other publications can provide valuable insight and assistance to you, but anytime you have further questions or comments on any matter, please do not hesitate to contact us. We are always happy to help.

Happy Reading!

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Chairman's Summary

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- ◆ How do we create more stockholder liquidity?
- ◆ How do you keep your bank independent?
- ◆ Do we need an in-house counsel?

Chairmen Have Concerns That Are Far and Wide!

If there is one thing that the Chairman's Forum always highlights, it is that the concerns and issues being faced by Chairmen of community banks from across the country are far and wide and diverse and similar all in the same fashion. We will discuss a few of these later in this newsletter, but while a discussion in this newsletter of every topic that was presented at the Chairman's Forum would not be possible, we thought you might enjoy seeing a listing of the types of concerns and questions that were addressed by Chairmen and other attendees.

Here are the types of topics and questions Chairmen brought to the discussion:

- How many independent directors should we have and what requirements should there be in recruiting directors?

- How do I handle merger and acquisition questions and concerns with board members when it seems some may want to sell and others want to remain independent?
- What are the appropriate levels of CEO compensation and types of incentives?
- If our bank is not public, how can we create liquidity for stockholders who are demanding it?
- If we are a larger and growing community organization, should we consider going public as opposed to being private?
- Is there anything in the new tax act that should make us terminate our Subchapter S status?
- Are there special techniques the Chairman should use in managing crisis situations?
- What are the best tips for strategic planning and what role does the Chairman play in that process?
- If acquisition growth is not a possibility, what ways are other Chairmen finding growth initiatives for their organization?
- Should the Chairman be promoting board diversity in terms of age, race, gender or other areas?
- What are boards doing to prepare for board succession beyond mandatory retirement ages?
- Should all of my directors live in the community where our bank exists?
- What are appropriate levels of board compensation?

While a discussion of all those topics is outside the scope of this newsletter, we will pick off a few critical areas and discuss those below.

How Do We Create More Stockholder Liquidity?

The idea of creating liquidity for stockholders (simply meaning having a ready and willing buyer to pay cash for shares whenever stockholders want to sell) continues to be a theme for many organizations and a concern for many Chairmen. The core answer is normally easy. The idea is that, to create liquidity, if you are not a public company on a national securities exchange then the organization simply needs to find a buyer for a stockholder who is willing to sell shares. But the complicating factor is deciding who that buyer should be and how to structure something. Should the holding company buy the shares from the individual? Should the Board of Directors simply divide the shares among directors who want to purchase shares? Should the President simply keep a list of buyers and sellers in his or her desk drawer and match those up whenever the circumstances are appropriate? Should we use some type of third party service that attempts to make a market of buyers and sellers for private companies.

As you can see, there are multiple options and, frankly, all of those might be appropriate in certain circumstances because they all accomplish the core goal of providing a willing seller of shares with a ready buyer. However, there are some priorities and preferences that we would suggest. First, as a general rule of thumb, we recommend that you utilize your bank holding company as the “purchaser of first resort”. By this, we mean any time you are able to have the holding company acquire shares from a selling

stockholder, it provides the greatest amount of benefits. More specifically, with some exceptions, the bank holding company can normally provide instant liquidity by simply writing a check to the stockholder and acquiring the shares. Since the holding company acquires the shares, there are now fewer total shares outstanding and many economic benefits flow to the stockholders who did not sell typically including greater earnings per share, an improved return on equity, if the same dollar amount of dividends are paid over fewer shares, then dividends per share are increased, and perhaps, most importantly, all remaining stockholders have their ownership percentages increased (since there are fewer shares outstanding), but no one had to spend their own money. It really is a win-win for both the selling stockholder and all other stockholders. To fund the repurchase, the holding company could use existing bank holding company cash balances, a special dividend from the bank to the holding company or the holding company could borrow funds from a third party such as a correspondent lender.

Beyond that structure, we generally advise boards that there is nothing wrong, necessarily, with board members acquiring shares, but you want to avoid a circumstance where, for example, the President tells a particular director about an opportunity to buy shares and that director makes the acquisition and the other directors are not aware of it. Full disclosure in advance should be the preferred method. We would specifically recommend you avoid having the President match buyers and sellers, at all costs. That puts the person facilitating that transaction in the middle of a deal acting as a bit of a broker-dealer and we would assume in most cases that individual would not be licensed as such. If you simply want to provide names of

parties to the various buyers and sellers, that is fine (although not as preferable as some of the options outlined above), but do not have your executive facilitating price discussions.

We also believe it would be important for the Chairman to consider having the organization proactively create liquidity scenarios rather than having the organization merely be reactive to individuals who are asking for liquidity. As such, the organization can create its own market by instituting formal stock buyback or stock repurchase programs. These are structured by the holding company designating a certain pool of funds that will be allocated for the acquisition of a certain number of shares at a designated price. The “offer” is then generally made to all stockholders who can voluntarily choose to accept the cash offer or retain their shares. Because the company is merely making an offer for stockholders to sell voluntarily, there is no true requirement for setting the acquisition price at any certain level. It simply needs to be a great enough price to get some interest. You do not have to get a formal valuation of your stock, but in making disclosures to the stockholders to sell you must provide all relevant information including recent trading prices, any other valuation you might have (such as for an ESOP), any impending dividend payments and similar items. By creating your own stock buyback program, you often will find that to be the most effective use of your own bank capital to fund the acquisition. In essence, you are buying your own bank rather than buying someone else’s bank. Make sure you give full consideration to that type of liquidity opportunity for your stockholders.

How Do You Keep Your Bank Independent?

Perhaps one of the most encouraging questions and comments we had at the Chairman's Forum was around the topic of how the Chairman and the board can continue to structure the organization properly to maintain its independence. This is continuing evidence that the community banking industry is not about to "wither on the vine" and there are plenty of small, family-owned, community and even larger community banks across the country doing everything they can to maintain a strong vibrant community bank market and maintain independence. So, don't feel as though you are alone if you continue to have a strong belief in the long-term success and viability of the bank in your community. Stop listening to the pundits talking about the death of community banking (we intentionally avoided the term "fake news" here). So, are there specific things Chairmen and organizations can do to promote independence? The answer is a resounding YES!

The primary theme that is needed to promote independence for community banks is a continuing and strong focus on core profitability. Now, let's be clear, it is not the role of Chairmen or board members to figure out asset liability management, loan and deposit pricing, salaries for tellers or other operational aspects that have a direct bearing on core profitability. However, it may be the Chairman's role to look at the big picture and push the organization on difficult, but fundamental, questions such as:

- Why are we continuing to offer products and services that are not profitable?

- Why are some of our branch locations no longer viable and should we consolidate some of our branches, close branches, or do we need to allocate more resources to make a branch profitable?
- Why have we failed to grow and expand into new markets when other banks have done so successfully?
- Why is our efficiency ratio so much higher than our peers?

Additionally, the Chairman can help promote long-term independence by forcing discussion on often difficult questions of board succession, management succession and, perhaps more often overlooked, ownership succession. When those handful of large stockholders at your bank pass on, are you 100% confident the children are going to want to continue to own those shares even though they no longer live in your community? Those are the kinds of discussions you need to have. If it is likely those succeeding generations are simply going to want cash for their shares, then it becomes a capital planning issue in the current environment to be able to provide them that liquidity or else there will have to be a sale of the organization to fund those needs. Better to plan for that now by having those discussions, creating liquidity opportunities, etc.

Promote independence, also, by learning to say “no”. In today’s M&A environment, just because someone presents you with an unsolicited offer, even if it is a fairly strong offer, does not mean the organization has to accept it. The question is whether your organization can do a better job in the short-term and long-term continuing to operate as it has in the past, rather than accepting whatever is being offered (cash, stock or some combination). Sometimes the receipt of an unsolicited offer can be a wake-

up call to the board and management that the organization has value to someone else and, therefore, we need to be creating that value ourselves. Likewise, a robust discussion among directors about future succession may also be necessary. We are not in favor of kicking all the old guys off the board. But, let's be honest. Look at those boards that have taken the difficult steps to add elements of diversity to their boards, look at the organizations that have intentionally brought in a new generation of board members who bring a different perspective to things, look at the boards that are looking at new technology partnerships as a way of continuing to advance their banks in an era when fewer people are coming into banks. Don't lose the long-term expertise of seasoned board members, but don't let their continuing service keep you from promoting a vibrant succession plan. If you need to, utilize your holding company structure and allow aging board members to serve at that level so that you maintain their knowledge and expertise in the organization, they continue to focus on long-term strategic benefits to the organization, but perhaps we free up more board seats at the bank level for a new generation of directors who are not hoping to have a liquidity event in the coming years, but are looking for ways to acquire more shares, build their own personal net worth, grow the bank, etc.

Do We Need An In-House Counsel?

We will leave you with one final question that was asked at the Chairman's Forum which was, at what asset size should a community bank be before it really starts seeing the need to have its own in-house counsel? Our immediate response was \$5.64 zillion trillion! Obviously, that got a big laugh out of the group who recognized that, as lawyers and consultants, we

were perhaps trying to protect our own turf! However, as we seriously discussed, the question was a good one (and candidly does not affect our organization since we generally do not act as general counsel for financial institutions, do loan collections, etc.), so we threw the question out to the group in general. The typical response is that once an organization probably begins to creep into the \$600 to \$750 million range, it might be appropriate to consider an in-house counsel to help with contracts, regulatory compliance and a host of other areas. Interestingly, one attendee even commented that using an in-house counsel did not necessarily lower their expenses related to lawyers because the individual brought to light many other areas where they needed to use outside counsel or other areas that needed special attention, but yet the bank felt that it had been an invaluable addition in order to give the organization more structure, more compliance and more confidence in what they were doing. Food for thought for those of you who are beginning to see your organizations grow into and past those thresholds.

Meeting Adjourned

As you can see, we only scratched the surface in this month's newsletter with some of the topics that were outlined. In the coming months, we will continue to hit on current events that are happening as we always do, but will continue to revisit some of the topics that were raised at the Chairman's Forum as well. We hope many of you will look to attend

next year's Chairman's Forum and we will be providing more information on that in the future. In the meantime, stay warm if you are in the middle of the Arctic blast, do not send pictures of yourself at the beach to other people if you are in southern California or south Florida, and let us know anytime we can help.

Until next time,



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