GERRISH'S MUSINGS

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February 28, 2019, Volume 387

Dear Subscriber:

Greetings from Iowa, Texas, North Carolina, Pennsylvania, Kansas, Florida, Utah, Arizona, and Georgia!

SHARE LIQUIDITY

We have been with a couple of community banks over the last couple of weeks where the issue of whether the Board of Directors has an obligation to provide share liquidity to holding company shareholders was discussed. Our general response to this issue is that the Board needs to understand its fundamental obligation to enhance the value for all shareholders. Typically, enhancing shareholder value involves five components: growing earnings per share, maintaining a decent return on equity, providing share liquidity, providing a reasonable after-tax cash flow from the stock, and doing it all within the constraints of safety and soundness. Right in the middle of those five issues is providing share liquidity.

Does that mean that every time a shareholder requests the repurchase of shares the holding company must do so? The answer is no. Allocating capital to share liquidity is simply a fiduciary obligation of the Board to determine whether that is or is not the best allocation of capital. If the bank is not growing, has no acquisition opportunities, and is already maxed out on its dividend as a practical matter, then allocating capital toward redeeming shares is generally a win-win for all involved. For most banks, this means simply establishing a "walk-in" program for share liquidity. Some, however, will allocate a definitive amount of capital and proactively approach their shareholders to see if any of them would like to sell their shares on a voluntary basis.

The fundamental obligation of the Board is to provide share liquidity but it has to be within the constraints of what is best for the overall franchise and what is the best use of available capital.

JUMPING STATE LINES

A number of banks lately are operating their world headquarters very close to a state line of another state. The question that often comes up is whether the bank can simply branch into the other state and what are the ramifications of that. No matter all the bad things that Dodd-Frank did, it did allow for interstate branching to the extent that any bank within that target state could branch. So if the target state has full interstate branching for a bank located within that state, then any bank from out of state can branch into that state as well. Your bank will have to deal with some different laws and provide notice to (and sometimes file an application with) the new state's regulator if you are a state-chartered bank, and a few other issues, but it should not be an insurmountable strategic impediment.

BRANCH LOCATIONS

Our firms have worked with a number of banks lately that are looking to relocate existing branches or to establish de novo branches. Yes, brick and mortar is still very much alive, although much different than it was even five years ago. These branches tend to be much smaller, more technology-oriented, and staffed by universal bankers for the most part. Banks approach branching in a couple of different ways. One is "our gut tells us that is the best place to put a branch." The other is to get some independent third party whose specialty is branch location to assist. Getting assistance is expensive, but in the long run it may be very worth your while. We have been working with a number of clients on branch location projects. Our only suggestion is don't be penny-wise and pound-foolish when it comes to putting up an "expensive billboard" for your bank.

THE ENGAGED BOARD

We recently had the opportunity to meet with what could only have been described as an excellent, engaged board for the purpose of discussing an acquisition transaction. We were retained to provide financial advisory services and legal services in connection with the acquisition of a sizeable target by this particular bank holding company. We made a presentation to our client's Board of Directors with respect to both the financial and legal issues that resulted from the due diligence of the target. The Board was extremely engaged and asked excellent questions. It was really seeking after information to make sure that this transaction was fully in the best interest of the bank and its shareholders.

It is good to see a board that is something other than rubber stamp. This Board was engaged, interested, and experienced.

NEXT RECESSION?

We hear a lot from a lot of quarters about the next recession/downturn. Are we making the same mistakes we made in 2005, 2006, and 2007, particularly as it relates to commercial real estate and even agriculture? Those bankers on the ground that we visit with do not think so (hopefully they are not in denial). They honestly believe they are more appropriately underwriting commercial real estate and working with the agricultural customers in an already down market. We suppose if there was another "black swan" event (i.e., the collapse of the real estate markets) then we could be back in the same boat as we were in in 2008 and 2009. Let's hope not. Let's hope we have learned from experience and are better prepared this time.

NOT SO NEW FDIC CHAIRWOMAN

Most of the banks in the country are directly regulated by their friendly federal regulator, the FDIC. Some of you are national banks regulated by the OCC and some by the Federal Reserve. Most of the banks, however, are still regulated by the FDIC. As of June 2018, the FDIC has a "new sheriff in town," Chairman Jelena McWilliams. Chairman McWilliams has an incredibly interesting story to tell and is very appreciative of community banks. We have included a link to one of her recent speeches if you want to glance through her background.

https://www.fdic.gov/news/news/speeches/spjan3119.html

She also seems to be saying all the right things about burdensome regulation and complicating a very simple business model. We will see whether she can have any impact on the rank and file.

THE ROLE OF THE BOARD

This week we had the opportunity to conduct a very detailed director and corporate governance study for a larger community bank. This was an in-depth review of the board's composition, methods of operation, and corporate governance procedures. The Board held the general belief that the bank had outgrown its board and corporate governance procedures, so they wanted an outside review and our opinion based on our observations and recommendations.

The final meeting of the on-site portion of the study was with the President and CEO and Board Chairman. During this discussion, the President and CEO asked for our thoughts on the role of the board relative to executive management. We believe it all boils down to strategic direction and risk tolerance.

We believe the first component of the board's relationship to management is one of setting strategic direction and risk tolerances. The board should set the big picture strategic action items for the organization. The board should then set the organizational risk tolerance that defines the acceptable level of risk in decision making. Once those two items are set, it is management's job to define the operational and tactical plans to achieve these strategic action items within the appropriate risk tolerances.

The second aspect of an appropriate board and management relationship is one of advice. The directors of a community bank have been selected as directors based on their business experience and acumen. This is a valuable asset that should not go to waste. Bank management should use the directors' business experience and acumen by seeking their advice and input on whatever may be the problem or topic de jour. The directors should provide advice based on their experience.

As *Musings* readers know, there are many different hats that directors wear. However, as it relates to the relationship with bank management, we think the fundamental components of a sound relationship are setting the strategic direction and defined risk tolerances and being a sounding board to provide advice when appropriate.

DIRECTOR NON-COMPETES

We are currently involved in a number of M&A transactions on each of the buy and sell side. Pretty much each one of these deals involves director non-competes. These are agreements by the selling directors that they will not engage in a competing business in any close geographic area for a specified amount of time as either a director, officer, employee, major shareholder, consultant, or other material capacity. The typical restricted area is 50 miles, and the typical timeframe is two years. However, these specifics are a matter of negotiation.

A couple different times lately we have been asked whether non-competes are really appropriate in acquisition transactions. We think they are. The buyer in these types of deals has a very legitimate interest to protect, particularly when paying a premium for a business. It is in a buyer's best interest to be sure that the selling bank directors and officers do not take cash and simply walk across the street and open up shop to compete in a similar business. There are a number of nuances relative to the specifics of the agreements, such as the time and geography, whether state law will allow it, and the like. Still, overall, we see them as appropriate for community bank acquisition transactions.

S ELECTIONS

We recently received an email from a client that is taxed as an S corporation. This community bank provided us with a recent article from a banking publication regarding the election to be taxed as an S corporation. The article itself did not take a position as to the desirability of the continuation of the S election. It certainly did not champion the continuation of the S election, but nor did it suggest S banks should terminate their S election. It simply noted that the S election is something that should be considered, particularly in light of the additional information on the interpretation of the 2017 Tax Act.

We have done it previously and will do it again here. We will officially take the position that the S election is and continues to be the beneficial tax structure for almost all community banks. We have looked at it a number of different times under a number of different scenarios and have not seen a set of circumstances where we have recommended to a client that they terminate the S election. The only set of circumstances we think makes sense for the termination of the S election is a community bank that is in a high growth and high capital retention mode that does not highly value the shareholders receiving an increase in the basis in their stock. Under these narrow set of circumstances, the termination of the S election may provide a more favorable tax structure. Absent this specific set of circumstances, we think the S election continues to be preferable to taxation as a C corp.

GOING PUBLIC

We recently received an email from a community bank indicating some of its directors have begun to wonder whether going public makes sense for the bank. This particular community bank has about 500 actual shareholders. The bank is traded on the Pink Sheets, and the board is a little frustrated that they are not getting appropriate growth in the market value of the stock notwithstanding excellent performance.

Our general belief under this scenario is that going public will not provide any meaningful increase in the market value of the common stock. We do not believe there will be a material change in demand for the shares by trading on the NASDAQ or some other market as opposed to the Pink Sheets. In our opinion, 500 shareholders simply do not provide enough movement in the shares to gain true market liquidity. We have always thought that you need about 4,000 shareholders in order to get enough trading in the shares to have any appreciable amount of volume. (There are plenty of community bank holding companies out there that are traded on NASDAQ and still do not have appreciable trading volumes.)

Our recommendation is that this holding company not look to go public. Instead, we think they ought to do what they are currently doing - supporting share liquidity through a repurchase program. There is no official way to delist from the Pink Sheets, so we believe they will continue to stay there. We just do not see picking up the time and expense associated with SEC reporting as providing them any type of corresponding benefit in the increase in the value of the shares.

CONCLUSION

This month has been short, at only 28 days. March is right around the corner. We look forward to seeing many of you at the upcoming ICBA Convention starting on March 18th.

Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*