Mergers and Acquisitions: You’re Doing It Wrong!

Presented by:
Philip K. Smith, President
Gerrish Smith Tuck, Consultants and Attorneys

2019 ICBA Community Banking LIVE!
National Convention
Music City Convention Center
Nashville, Tennessee
March 18 – 22, 2019

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About The ICBA

The Independent Community Bankers of America, the nation’s voice for community banks, represents community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers they serve.

With nearly 5,000 members, representing more than 24,000 locations nationwide and employing over 300,000 Americans, ICBA members hold more than $1.2 trillion in assets, $1 trillion in deposits, and more than $750 billion in loans to consumers, small businesses and the agricultural community.

ICBA is the only national trade association that tailors its educational programs exclusively to meet the needs of directors and staff members of community banks. The ICBA Education Department is committed to developing and providing educational products and services that exceed the ever-changing needs of today’s community bank.

To that end, seminars and workshops are scheduled annually across the country to help community bank directors and employees develop effective strategies and keep abreast of current issues, new technologies, changing regulations and the latest in client services. Members of the ICBA Bank Education Committee review regularly the course content for each of the seminars and workshops to ensure a quality educational solution. In addition, instructor selection is based upon his or her past and current experience with community bank needs. We feel that this constant concern for maintaining relevant course material, combined with expert instructional staff, assures you of the best community bank training available today.

The ICBA representative(s) or workshop instructor(s) on site at each of ICBA’s seminars and workshops are always available to answer your questions and ensure that you are receiving the highest quality education available. If you have any additional questions or comments, or would like more information on ICBA’s educational products and services, please call the ICBA Education Department at 800/422-7285 or visit the ICBA website at www.icba.org/education.

Thank you for your continuing support of ICBA’s educational products and services.
You can view or download the materials for Philip Smith’s presentation at the 2019 ICBA Community Banking LIVE! National Convention from our website at www.gerrish.com.

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Mr. Smith is the President and a member of the Board of Directors of the Memphis-based law firm of Gerrish Smith Tuck, PC, and its affiliated bank consulting firm, Gerrish Smith Tuck Consultants, LLC. Mr. Smith's legal and consulting practice places special emphasis on bank mergers and acquisitions, financial analysis, acquisition and ownership planning for boards of directors, strategic planning for boards of directors, regulatory matters, bank holding company formations and use, securities law concerns, new bank formations, S corporations, going private transactions, and other matters of importance to banks and financial institutions.

Mr. Smith is a frequent speaker to boards of directors and a presenter at numerous banking seminars. He received his undergraduate business degree and Masters of Business Administration degree from the Fogelman School of Business and Economics at The University of Memphis and his law degree from the Cecil C. Humphreys School of Law at The University of Memphis. He is authoring a monthly electronic newsletter, The Chairman's Forum Newsletter, which discusses key topics impacting financial institutions and, specifically, the role of the Chairman. Mr. Smith is a Summa Cum Laude graduate of the Barret School of Banking where he has been a member of the faculty. He has also served as a member of the faculty of the Pacific Coast Banking School, the Colorado Graduate School of Banking, the Southwestern Graduate School of Banking and the Wisconsin Graduate School of Banking. Mr. Smith can be contacted at psmith@gerrish.com.
**Mergers & Acquisitions**
- Analysis of Business and Financial Issues
- Target Identification and Potential Buyer Evaluation
- Preparation and Negotiation of Definitive Agreements
- Preparation of Regulatory Applications
- Due Diligence Reviews
- Tax Analysis
- Securities Law Compliance
- Leveraged Buyouts
- Anti-Takeover Planning
- Financial Modeling and Analysis
- Transaction Pricing Analysis
- Fairness Opinions

**Bank and Thrift Holding Company Formations**
- Structure and Formation
- Ownership and Control Planning
- New Product and Service Advice
- Preparation of Regulatory Applications
- Consulting Advice on Best Uses and Practices

**New Bank and Thrift Organizations**
- Organizational and Regulatory Advice
- Business Plan Creation
- Preparation of Financial Statement Projections
- Preparation of the Interagency Charter and Federal Deposit Insurance Application
- Private Placements and Public Stock Offerings
- Development of Bank Policies

**Financial Modeling and Analysis**
- Mergers and Acquisitions Financial Modeling and Analysis
- Subchapter S Election Financial Modeling and Analysis
- Stock Repurchase Financial Modeling and Analysis
- Financial Statement Projections
- Business and Strategic Plans
- Ability to Pay Analysis
- Net Present Value and Internal Rate of Return Analysis
- Stock Valuation Analysis
- Fairness Opinions

**Bank Regulatory Guidance and Examination Preparation**
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- Examination Planning and Preparation
- Regulatory Compliance Matters
- Charter Conversions

**Problem Banks and Thrifts Issues**
- Examiner Dispute Resolution
- Negotiation of All Formal and Informal Enforcement Actions
- Defense of Directors/Officers in Failed Bank Litigation
- Failed Institution Acquisitions
- New Capital Raising and Capital Plans
- Appeals of Material Supervisory Determinations
- Expert Witness and Litigation Support Services

**Subchapter S Conversions and Elections**
- Financial and Tax Analysis and Advice
- Reorganization Analysis and Restructuring
- Cash-Out Mergers
- Stockholders Agreements
- Financial Modeling and Analysis

**Customized Facilitation of Director and Officer Retreats**
- Customized Director and Officer Retreats
- Long-Term Business Planning
- Assistance and Advice in Implementing Strategic Plans
- Business and Strategic Plan Preparation and Analysis
- Director Education

**Capital Planning and Raising**
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- Financial Analysis, Capital Plans and Policies
- Going Public / Private Transactions

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- 401(k) Plans
- Leveraged ESOP Transactions
- Incentive Compensation and Stock Option Plans
- Employment Agreements—Golden Parachutes
- Profit Sharing and Pension Plans
- Compensation Studies and Analysis

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- Recapitalization and Reorganization Analysis and Implementation
- Customized Board and Officer Training and Education Sessions
- Management Studies, Evaluations and Succession Planning
- Corporate Governance Studies
- Unique Family Bank Planning Issues

**Taxation**
- Tax Planning
- Tax Controversy Negotiation and Advice
- M&A Tax Advice and Planning

**Estate Planning for Community Bank Executives**
- Wills, Trusts, and Other Estate Planning Documents
- Estate Tax Savings Techniques
- Probate

**Other**
- Public Speaking Engagements for Banking Industry Groups (i.e., Conventions, Schools, Seminars, and Workshops)
- Publisher of Books and Newsletters Regarding Banking and Financial Services Issues
- Expert Witness and Litigation Support Services
Mergers and Acquisitions: 
You’re Doing It Wrong!

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We Are In A Consolidating Environment

- Reduced Number of Banks
- Lack of De Novos
- Future of Community Banking
Current M&A Environment 2019

- Steady Activity
- Improved Pricing
- Healthy/Profitable Banks
- Availability of Capital to do Deals

Consolidation Drivers

- Lack of Succession
  - Management
  - Board
  - Ownership
- Improved currencies from larger banks / price
- Continuing regulatory concerns
- Overall fear of the future
Consolidation Inhibitors

• Expectation of Regulatory Relief
• Continued Optimistic Economic Outlook
• Continued Rising Interest Rates
• Greater Profitability
• Short Memories

So, Where’s the Problem? What Are We Doing Wrong?

• Wrong Assumptions
• Wrong Expectations
• Wrong Views of Pricing
• Wrong Strategic Approach
• Wrong Direction
Wrong Assumptions

• We can’t survive
• Our bank is unique
• They’ll be happy with our offer
• There are no other options

Wrong Expectations

• We are not selling, it’s a merger of equals
• There are tremendous cost savings we will generate in the deal
• Our partner says they don’t expect any material changes
• We have a strong culture and they will want to be a part of it
Wrong Views of Pricing

- Our strong capital position will drive the acquisition price up
- We have an extensive branch network that adds value
- We don’t have to pay a premium because they are lucky that we are interested
- We will use our stock to buy them since we’re such a good bank

Wrong Strategic Approach

- We are a larger bank and, therefore, we will control the negotiations
- Since we are the smaller bank, we have no negotiating leverage
- Here is an LOI, let us know by Friday
- That bank has always been interested in us, let’s only talk to them
Wrong Direction

- It's expensive, but everyone else is buying a bank
- We needed liquidity for some of our stockholders and that's why we sold
- Family management is ending, so we are selling

Historical Acquisition Pricing

- Average Price / Book (%)
- Average Price / Earnings (%)

** Source: S&P Global Market Intelligence
Acquisition Pricing: All Bank Transactions

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* Through January 28, 2019
** Source: S&P Global Market Intelligence

Term Sheet / Letter of Intent

- Non-binding, executed by each party
- Summarizes material terms of transaction
  - Don’t negotiate it to death
  - But it must be accurate and make sense
Common Mistakes of Buyers

Not Being Proactive

• Target what you want and go after it
• Opportunistic may not be enough
• Some sellers need a nudge (not a push)
• Make personal contact early
Not Paying for Value

• If it adds value, it’s worth paying for
• Find the relevant cost savings
• Give the seller the small things they want

Not Taking “Measured” Risks

• You can’t eliminate all risk in the acquisition agreement
• Don’t become the regulator in the evaluation process
• Avoid immediate dilution
Not Considering Alternatives

- Is a branch better?
- Is a loan production office better?
- Why buy it if you can steal it?
- Buy your own bank?

Structuring Mistakes

- Not considering tax ramifications
- Using the wrong form of consideration
- Getting the board ahead of the numbers
- Not conducting adequate due diligence
Common Mistakes of Sellers

Not Having Something of Value to Sell

• Clean up problems
• Eliminate regulatory concerns
• Maximize earnings performance
Unrealistic Pricing Expectations

• We have a unique story to tell
  (no, you don’t)
• The bank down the street got more
  (so what?)
• That’s not what we were told when we bought the shares
  (we were wrong)

Not Selling on Your Own Terms

• Avoid the pushy buyer
• Not on regulators’ terms
• Not because an advisor told you to
• Ask for what you want
Structuring Mistakes

• Structuring a merger of equals
• Not understanding various consideration options for stock or cash
• Not considering the debt
• Trying to do it yourself

MOEs May Actually Exist!

• “If” … someone accepts loss of control
• “If” … loss of control produces greater shareholder return
• “If” … greater shareholder return outweighs ego
• “If” …
Buy, Sell
or Remain Independent

Acquire or
(Community Banks)
Be Acquired
Final Thoughts for Directors

• Buyers: Be realistic on cost savings and don’t assume bigger is more efficient!

• Sellers: Don’t let emotions override fiduciary obligations, but don’t give it away!

• Independents: You can survive, but don’t be naïve about the future!

Contact

Please contact us if we can be of service to you or your organization, or if you simply have further questions where we may be of assistance.

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Mergers and Acquisitions: You’re Doing It Wrong!
I. INTRODUCTION AND CURRENT ENVIRONMENT

In 1980, there were 14,870 independently chartered banks in the United States. At year-end 2018, there were approximately 5,430.

The Great Recession left community bankers to face a banking industry environment that is substantially different than it was ten years ago. Although interest rates continue to rise, the overall interest rate environment over the past number of years has been artificially low. This, in addition to an ever-growing list of regulations and new legislation, has caused community banks to go back to the basics in order to increase efficiency, reduce costs, and improve overall profitability. All the while, industry analysts and “experts” are constantly blowing smoke about how smaller institutions will be unable to survive independently and must seek out a merger acquisition to achieve economies of scale and compete in the “new normal.”

In light of all of these issues, more and more Boards of Directors of community banks, even those that desire for their bank to remain independent, are faced with tough acquisition choices. Has the Board and ownership had all the fun they can stand? Does older management without succession, an older stockholder base, a dying franchise or being behind the curve on technology dictate selling now? Does a younger and aggressive management, a younger or closely held stockholder base and expanding market dictate an acquisition in order? Should the community bank simply follow the philosophy that “If it ain’t broke, don’t fix it” and remain independent while enhancing stockholder value? Each of these strategic decisions requires a well thought out plan.

Any strategy—buy, sell, or independent—can be viable in the current environment if appropriate planning occurs. However, we often see key mistakes being made by all three types of organizations, those that want to buy, those that want to sell and those trying to stay independent. The following material should assist the Board in identifying the issues and common concerns as well as key mistakes to help you in making the decision to buy, sell or simply keep your stockholders happy and enhance stockholder value while being independent.
II. BUYING OR SELLING SECRETS

A. ESTABLISH YOUR BANK’S STRATEGY EARLY ON

It is important that a community bank have an acquisition strategy that it addresses and determines annually. However, before establishing that strategy, whether it is to buy, sell, or simply remain independent and enhance value, the Board must recognize the issues associated with each alternative. In doing so, it must balance the various stakeholders’ interest, including stockholders, directors, management, employees, depositors, and customers, as well as consider the market environment in which it is operating.

In addition, the Board must consider the management and capital with which it has to work. If embarking on an acquisition, how much can the institution pay and who will manage? If looking to sell, what does the institution have to offer?

1. Stakeholders’ Interest

It is incumbent upon the directors to consider each of the stakeholders’ interests. Clearly, the stockholders’ interests are of paramount importance. The stockholders’ desire for liquidity and increase in market value, combined with a change in the stage of life and general aging of the stockholder population, may drive the Board’s decision in one direction or the another.

In addition to the stockholders, however, the desires of top management, middle management, employees, the customer base and the community must be considered. As a practical matter, it is very difficult to have a successful sale without, at least, the acquiescence of senior management.

Even a sale which the stockholders support can be scuttled by senior management’s discussions with the potential purchaser with respect to the condition of the bank and the valuation of contingent liabilities. As a result, senior management and the other parties’ “needs” must be identified and met.

In addition, if ownership is fragmented, it is in the best interests of the Seller and Buyer to organize and consolidate the “control group” as early as possible. Any possibility of having factions develop among members of the control group should be eliminated, if feasible.

2. Market Environment

In connection with enhancing stockholder value without sale, the typical community bank is faced with a number of environmental forces, including aging of the stockholder base and lack of management succession, technology considerations, increased competition and regulatory concerns, all of which may drive the bank toward the strategy of buying additional institutions or branches to
enhance value or selling their own institution to enhance value. In addition to the regulatory burden currently imposed on banks, the inception of the new Consumer Financial Protection Bureau seems intent on increasing that burden significantly, as well as the costs associated with compliance.

3. **Capital**

The Board’s determination of its alternatives must include how best to allocate its capital. The Board of Directors must first determine how much capital is available. This includes not only the consolidated equity of the bank and the holding company, but also the leveraging ability of the holding company. Once that number is determined, how the capital pie is “sliced” must be considered. The new reality is that community banks will be required to maintain higher capital levels than they have historically. What used to be an over capitalized community bank, with 9% Tier 1 and 12% total risk based capital, will become the norm and practical regulatory minimums. Does the Board use a significant portion of its capital to repurchase its own stock or does the bank use the capital to offset losses? Does it use some of that capital to buy another bank or branch? Does it use the capital for natural growth? Does it dividend that capital to its stockholders? Or, does it exchange that capital for an equity interest in another institution through sale?

Particularly in light of Basel III, the new reality with regard to minimum capital means that, across the Board, community banks will suffer a lower return on equity and possibly lower pricing multiples. This reality could change in the not too distant future depending on the federal regulators’ capital rulemaking in response to the regulatory relief bill passed in 2018 (S. 2155, “Economic Growth, Regulatory Relief, and Consumer Protection Act”), which will grant community banks with assets of less than $10 billion the option to be exempt from the requirements of Basel III so long as they exceed a yet to be determined “community bank leverage ratio” (the ratio of tangible equity to average consolidated assets). In the meantime, however, the Board needs to make a conscious decision, particularly in an over capitalized community bank, as to whether to return some of that capital to its stockholders. The issue is not one of receiving “capital gains” treatment versus “ordinary income” treatment on that “extraordinary dividend” capital. The issue is getting some “value” for that excess capital through a dividend versus limited or no value through a sale which is priced based on the company’s earnings stream. That’s not to say tax considerations are irrelevant.

4. **Management**

Most transactions will result in existing management being retained by the acquiring institution (at least for some period of time). This is due to the fact that (a) most acquiring institutions do not have excess management, and (b) most Sellers will not be acquired if management is not assured of a position after the acquisition or otherwise financially compensated. Non-management owners should never forget that there is an inherent conflict of interest in allowing managers to negotiate with a potential purchaser when the management will be staying on after the sale. Obviously, management is then negotiating with its future boss.
5. **Consideration of Potential Acquirors**

If a community bank’s Board of Directors has made the decision to sell the company at some point in the future - no matter how distant - so that the question is not “if” to sell the company but “when,” the Board of Directors must consider which acquirors may be available at the time it finally decides to sell. A community Board should consciously identify its potential acquirors. It should then analyze, as best it can, what may occur with those acquirors. A potential acquiror that is interested in moving into the community where the community bank operates its franchise may do one of several things:

a. It may be acquired itself and thereby be eliminated as a player.

b. If it desires entrance in the market, it may use another entry vehicle, i.e. another institution or a *de novo* branch and be eliminated as a player.

c. It may simply lose interest and allocate its resources to another strategic direction and eliminate itself as a player.

Unfortunately, if “selling” is in the community bank’s current thought process, i.e. a strategy other than an adamant one for independence, sooner is probably better than later. “Sooner” will provide the maximum number of potential purchasers.

**B. CREATION OF THE PLAN**

Whether the Board of Directors’ decision is to buy, sell or remain independent and simply enhance value, it must plan for the ultimate outcome it desires.

1. **Implementing an Acquisition Strategy**

   a. **Needs of the Buyer:** Before finding a bank, bank holding company or thrift to buy, a Buyer must first define the kind of financial institution it desires and is, from a financial and management standpoint, able to buy. The Buyer must develop an acquisition strategy describing an overall plan and identifying acquisition candidates. Buyers must consider, in advance, the advantages that the Buyer wishes to obtain as a result of combining with the selling institution. These benefits generally fit within the following categories:

   (1) **Financial**

   * Earnings per share appreciation
   * Utilization of excess capital and increased return on equity
   * Increased market value and liquidity
   * Increasing regulatory burden offset by enhanced earning power and asset upgrades.

   (2) **Managerial or Operational**

   * Obtain new management expertise
* Additional systems and operational expertise
* Use of excess competent management

(3) Strategic

* Diversification
* New market entrance
* Growth potential
* Economies of scale and/or scope
* Enhanced image and reputation
* Elimination of competition
* Obtain additional technology expertise

b. **Formation of the Acquisition Team and Assignment of Responsibility**

(1) The Players: The Buyer and the Seller

The typical Buyer in this environment will probably be a small to mid-sized holding company desiring entry into the market to expand its franchise, or a community bank slightly larger than the target, looking to gain critical mass to cover the cost of doing business.

The typical Seller will be a community bank of any size in a good market with acceptable performance, and in all likelihood, with a Board that has “had all the fun it could stand”. From the Seller’s perspective, the decision to sell an institution will generally fall into one of four scenarios:

(a) The controlling stockholders make a decision to sell after a substantial period of consideration due to the pressures of personal financial factors, estate planning needs, age, technology, competitive factors, regulatory actions, exposure to directors’ liability and so forth.

(b) The institution is in trouble and needs additional capital and/or new management.

(c) The institution has no management succession and an older management and stockholder base.

(d) The Board is concerned about missing the upcoming “window.”

(2) The Players: Financial Consultants, Special Counsel and the Accountants

With the status of current regulations and the growing complexity of mergers and acquisitions, few institutions are capable of closing a successful deal without outside assistance. From a technical
standpoint, there is a greater need than ever before to secure the services of specialized financial consultants, legal counsel, and experienced auditors. The costs may be high, but it is a misguided chief executive who thinks he or she can economize by doing his or her own legal, accounting or even financial work in an acquisition transaction.

The primary goals of any outside advisor should be to close the deal and to protect his client’s interests. To achieve these objectives, the advisor(s) must have a number of attributes and qualifications, some of which differentiate him or her from many other professionals.

First and foremost, the advisor must have the requisite knowledge and experience in business combinations and reorganizations. This not only includes a solid understanding of the intricacies of acquisition contracts and regulatory issues, but more importantly, also a high degree of familiarity with the business and financial issues that arise in community bank acquisitions.

Second and equally important, it is essential that the advisor understands the tax implications of the acquisition and provides structuring advice early on in the negotiations.

Aside from the technical skills, the advisor(s) must seek to find solutions to problems which may arise rather than simply identifying them. Instead of finding reasons for “killing a deal,” which comes quite naturally to some, the talented advisor is oriented to “making the deal,” unless it would result in insufficient protection for his client.

The experienced advisor knows what must happen and when it should take place. Along with the principal parties, he must maintain the momentum for the deal. Experienced professionals will prepare and work from a transaction timetable, outlining the various tasks that must be accomplished, the person(s) responsible, and target dates.

An early decision which must be made is who will actually handle the negotiations. A general rule to follow when using outside “experts” for negotiations is as follows. If representing the Buyer, the experts should become involved early, but stay behind the scenes to avoid intimidating an unsophisticated Seller. If the experts are representing the Seller, they should become involved early in the negotiations and be visible to avoid a sophisticated Buyer trying to negotiate an unrealistic or unfair deal with an inexperienced Seller.

(3) Assignment of Responsibilities
Once the bank’s team and advisors are in place, it is critical to specifically assign responsibilities to each member of the team. It is helpful to have one coordinator for these tasks. That coordinator is often the outside counsel or financial consultant who has experience with transactions of this type.

The assignments of responsibilities should be formalized and documented so that significant matters are not overlooked in the excitement of the acquisition process.

(4) Preparation of Candidate List

Typically, Buyers find that the most difficult, frustrating and time-consuming step in buying another institution is finding an institution to buy - one that “fits”. This is especially true for the first-time Buyer who frequently underestimates the time and effort necessary to plan and locate viable acquisition candidates. Unfortunately, many such Buyers start a search for acquisition candidates without being fully prepared. The result is early disappointment with the whole idea. Following a well-constructed plan will assist a Buyer in pinpointing “buyable” Sellers and reduce unproductive time.

The Buyer needs to be aware that there is an inherent inclination toward acquisition. Well thought out and well planned acquisitions create value and minimize risks. Unplanned acquisitions maximize risks and limit future flexibility. Certain studies suggest that bank mergers do not guarantee major cost savings benefits. With planned acquisitions, many of the anticipated benefits will result. With unplanned or poorly planned acquisitions, they rarely do. In any event, as a Buyer, be careful valuing synergies.

2. Implementation of the Sale Strategy

Some institutions will simply decide it is the time to sell. This may be simply because, with the multi-year recession, the Board and ownership have had all the fun they can stand, or it may be due to an aging stockholder base, lack of management succession, technology issues, a troubled institution or a combination of several of these issues. Once the institution makes the decision to sell, the Board of Directors needs to be certain that it has in place a “process” designed to obtain the highest and best price for the bank stockholders in the best currency. Some institutions attempt to do this by having an appraisal conducted of their bank before they engage in negotiations. Unfortunately, an appraisal will not tell the Board what the bank is worth on the market. It will only indicate what other banks have sold for and what the bank may possibly be worth.

The only way for a Board of Directors to assure itself that it is obtaining the highest and best price in the best currency for its bank is to put the bank on the market on either a limited or extensive basis. Over the past several years, our firm has
marketed and sold a number of community banks on a turnkey basis. The process involves:

a. The identification of prospective purchasers.

b. The preparation of confidential evaluation material describing in detail the condition of the bank.

c. The distribution of that material, subject to a confidentiality agreement, to a list of potential acquirors as approved by the Board of Directors.

d. The submission by those potential acquirors of expressions of interest based on the material submitted to them and subject to due diligence indicating the price they would pay for the bank, the currency, i.e. stock, cash or a combination, the structure, i.e. branch or separate bank and any other relevant issues.

e. A review by the Board of Directors of the offers and a determination as to which, if any, of the bidders receive an opportunity to conduct on-site due diligence.

f. The negotiation of the transaction and legal services in connection with closing the transaction.

Once an offer or offers are selected by the Board, only then do the potential acquirors conduct a due diligence of the bank in order to reconfirm or increase their offer and eliminate the due diligence contingency.

Once the decision to sell has been made, the best way for the Board of Directors to assure itself that it has met its fiduciary duty and obtained the highest and best price for the bank is to market the institution. The second line of defense for the Board of Directors is the fact that the consummation of the acquisition will also be conditioned upon receipt of a fairness opinion shortly prior to the closing of the acquisition.

C. ANTI-TAKEOVER PLANNING AND DEALING WITH UNSOLICITED OFFERS

During the Great Recession, and continuing through the years immediately following it, unsolicited expressions of interest in community banks were fairly uncommon. Banks were failing in large numbers, and healthy institutions were hunkering down to weather the storm. In other words, acquisitions were not at the top of the list of strategic alternatives.

Today, however, the industry is in a different position. Overall profitability and safety and soundness have improved considerably from five to ten years ago. The banks that could not survive have either failed or merged out of existence. The community banks that weathered the storm are now, for the most part, focusing on long-term independence and how to improve profitability and operations in their communities. This means that as the economy continues to improve—and potential buyers’ stock becomes more valuable in the market—community banks and their holding companies are once again becoming the recipient of unsolicited offers.
Although such offers are unsolicited, that does not mean they are “hostile” by nature. Although our firm has handled one of the few community bank hostile tender offers to occur in recent memory (representing the target), today’s offers do not generally take the route of an “unsolicited tender offer” or “hostile offer.” These are simply more aggressive expressions of interest than the industry saw pre-recession. Many institutions recognize that they will only be able to carry out one, maybe two, acquisitions over a three to five year time horizon, depending on their size and capabilities. This means that potential acquirers are thinking strategically regarding whom they approach. They are identifying potential targets and pursuing the top candidate with an unsolicited offer. If that offer does not pan out, they will move down the list.

Regardless of the circumstances, these offers nevertheless cause the target bank or bank holding company a certain degree of trepidation. However, when a Board of Directors receives an unsolicited offer to acquire the institution, the Board’s primary job remains the same—to enhance value for the organization’s stockholders. For most, carrying out this responsibility while also maintaining a long-term goal of independence results in what we refer to as “anti-takeover planning.”

1. Avoiding Unwanted Attempts to Change Control

The implementation of a well thought out and strategically minded anti-takeover plan will give the community bank holding company greater mastery over its own destiny when presented with a potential unsolicited or hostile offer. The anti-takeover plan will not prevent the bank holding company from being sold if its Board of Directors believes it is in the best interest of the stockholders for such a transaction to take place. An appropriate anti-takeover plan will, however, present the Board with the luxury of time to consider an offer or shop the institution. The anti-takeover framework may also deter unwanted investors from initially seeking a control or ownership position in the institution altogether, especially if there exist provisions providing for specific defenses or required pricing considerations in the event a tender offer or other similar maneuver is commenced. At minimum, it will likely drive any potential acquirer into the boardroom instead of out to the individual stockholders directly.

The first step in anti-takeover planning is to have qualified counsel review the holding company’s charter and bylaws to determine what, if any, anti-takeover provisions already exist. Additional anti-takeover provisions should be added to the governing documents by amendment at the next regular annual stockholders meeting after full disclosure to stockholders. The purpose of this step is to ensure strategies for handling a takeover attempt are considered before the situation is confronted. Numerous courts have rendered significant opinions on anti-takeover and defensive strategies, and one of the main reasons for favorable court decisions upholding those defenses is the timing of their implementation. More specifically, corporations amending their charters and bylaws to include such protective provisions as part of advance planning have generally had their defenses upheld in court. On the other hand, in many cases, corporations with strategies implemented in response to a specific bid have had such provisions invalidated on the basis they were put in place only to protect existing management and were not in the best...
interests of stockholders. Bottom line: last minute, reactionary planning is usually ineffective.

For corporate purposes, most holding companies can utilize numerous types of “structural” anti-takeover techniques. Of the available alternatives, some are more commonly utilized than others.

One common alternative is for the holding company to amend its governing documents to require “supermajority” approval of certain acquisition transactions. Supermajority provisions typically require an approval vote in the range of two-thirds to 80% of the outstanding shares, but only if the Board of Directors does not recommend approval of the transaction. In order to amend the Company’s governing documents to require a supermajority, a percentage of shares equal to the supermajority requirement would need to vote in favor of the provision. In other words, if the Board adopted an 80% supermajority requirement, at least 80% of the outstanding shares would need to approve the provision.

The holding company could also work into its governing documents “non-financial considerations” for unsolicited offers—parameters for the Board of Directors to take into account when considering a potential acquisition transaction. Often times a deal that looks good by the numbers is not truly best for the organization and its stockholders for some cultural, social, or leadership reason, to name a few. By allowing the Board to consider non-financial factors of a transaction, the Board could build in protection against a hostile, but otherwise “attractive,” transaction. The Board would still be required to do what is in the best interest of the stockholders, but it would have a little bit more flexibility to do so on the basis of something other than the financials alone.

The holding company could further amend its Bylaws to provide for a staggered election of directors. State statutory schemes usually allow a company to stagger the Board into two or three groups. This would prevent a hostile party from taking over the Board of Directors in one fell swoop. The Board of Directors would have at least one, possibly two, years to mitigate the hostile party’s influence.

A fourth common strategy is for the holding company to amend its Articles of Incorporation to increase the number of authorized shares available for issuance. For example, if the holding company currently has the authority to issue 1,000,000 shares of stock, an amendment could increase the number of authorized shares to 10,000,000, adding an additional 9,000,000 shares of authorized but unissued stock. The purpose of this amendment would be to provide cushion in the event of a hostile takeover or a disgruntled stockholder vying for control. The Board would simply authorize the issuance of stock to friendly investors and/or current stockholders to effectively diminish the ownership and voting power of the hostile stockholder.

Again, these are some of the more common anti-takeover defenses, but there are more, such as the following:

- Limit stockholder written consent to approve certain actions
• Limit the size of Board
• Permit special Board meetings on “best efforts” notice basis
• Eliminate stockholder cumulative voting rights
• Allow director removal only “for cause”
• Limit stockholder ability to replace directors
• Eliminate stockholder preemptive rights
• Implement director qualification requirements
• Limit director affiliations with other institutions
• Require fair price provisions in potential takeover offers
• Require non-management director nominations to meet certain requirements
• Amend stockholder voting rights under certain circumstances
• Limit stockholder called special meetings

If you would like any additional information on any of these strategies, please let us know.

In addition to these structural anti-takeover techniques, there are certain general defensive strategies or “black book” procedures that should be followed by all companies. First, the Board and management should have list of key personnel, including special legal counsel, financial and public relations personnel, that can be accessed at any time remotely and includes information about how to locate and contact all those key individuals on short notice. It is also a good idea to review the stockholder list in order to identify key stockholders that might assist in solicitation efforts and be able to gauge stockholder loyalty.

Second, the company should identify a team of three or four directors and three to four senior managers to deal with any unsolicited offer on a daily basis. The Board should generally instruct all directors and personnel to decline comment to the press with respect to offers, but only individuals on the strategic team should be directly involved with the unsolicited offer.

Third, the company should monitor the daily trading of its stock. With today’s technology, all companies, regardless of reporting status, have the ability to monitor any significant transaction information and implement safe keeping practices for the company’s stockholder list.

Fourth, it is a good idea to establish a line of credit with a correspondent bank for a defensive stock repurchase program.

Fifth, consider entering into employment contracts with key officers at the holding company level that contain “Golden Parachute,” “Golden Handcuff,” or “Retention Bonus” provisions. Although such contracts must comply with IRS Code Section 409A, these contracts provide substantial monetary benefits to such officers if control changes involuntarily. The contracts may serve as a deterrent to “raiders” because of the cost they add to an acquisition. Most importantly, if structured properly, the contracts will help guarantee objective advice by management during a takeover attempt. Without such arrangements, management’s objectivity may be influenced by negotiating with a raider who could be their future boss.
With all of these considerations in mind, it is important to remember that a valid anti-takeover plan and a mission statement certifying that the bank desires to remain independent do not always prevent the institution from receiving an unsolicited acquisition offer. In order to understand how to deal with an unsolicited offer, a banker must understand the difference between an unsolicited offer and an “inquiry”. An inquiry is simply an overture by another institution asking whether the institution is for sale or would sell out for something in the neighborhood of X times book value or X times earnings. It is informal and can generally be dealt with informally. An unsolicited offer, on the other hand, is more formal and generally involves the receipt of a written offer by another institution for a merger or acquisition of the stock of the selling institution. As such, an unsolicited offer should be dealt with in a formal manner.

2. Dealing with Unsolicited Offers

Upon the receipt of an unsolicited offer from another institution, the first step that the banker should take is to consult with specialized merger and acquisition professionals and the bank’s Board of Directors. Many unsolicited offers contain very short fuses. It is generally not necessary to strictly comply with the deadline set forth in the offer, but it is advisable to have counsel consult with the offeror and let them know that the Board is currently considering its options.

In short, the Board of Directors has four basic options when faced with an unsolicited offer:

- Reject the offer.
- Accept the offer.
- Negotiate the offer.
- Shop around to see if there is a better offer.

Rejecting the offer out of hand is dangerous for both the individual who has actually received the offer and the Board of Directors. The offer may ultimately be rejected, but the rejection should be based upon a detailed financial and legal analysis of the inadequacy of the offer in view of the criteria considered by the Board of Directors. This would include relying on charter and bylaw provisions dealing with the analysis of offers as discussed above.

A Board of Directors’ acceptance of an “unsolicited first offer” constitutes a breach of fiduciary duty on its face. Many acquirers will generally make unsolicited offers based on public information regarding anticipated earnings-per-share impact on the larger holding company. If the holding company is interested in the franchise and interested in the bank, it will generally increase its offer through negotiation.

The third alternative is to negotiate the offer. Once a community bank begins to negotiate or consider the offer, the bank is clearly in play. It will be sold. Many Boards of Directors of banks desiring to remain independent have found that independence disappears once they decide to try and “negotiate” an unsolicited offer.
The fourth alternative is to see what other offers are available. In any event, when an unsolicited offer is received, the general advice is to test the waters once the bank is put into play and see what other offers are available. It is only through this mechanism that the Board can determine that it has received the highest and best price.

Because numerous issues beyond the scope of this brief outline are present when dealing with an unsolicited offer, each of these options must be considered in view of the Board’s extensive fiduciary duties to stockholders. The above options do, however, provide an outline of the Board’s options.

*If you would like any additional information regarding anti-takeover planning or dealing with unsolicited offers, please contact Gerrish Smith Tuck for additional materials.*

### D. CONTACT AND NEGOTIATION FOR COMMUNITY BANK ACQUISITIONS

1. **The Approach**

An acquisition by a regional holding company or another community bank may be one in a series of acquisitions for that institution. It is likely, however, that the sale by the Seller will be a sale by an inexperienced Seller and will be that Seller’s first and often last sale.

a. **Preliminary Approach through the CEO or Principal Stockholder.** Many different approaches are used by potential acquirors, be they bank holding companies or other community banks, toward target community institutions. In virtually every case, however, the approach will be to the chief executive officer of the Selling Bank or its principal stockholder. Often, the CEO or other high ranking officer of the acquiror will simply call the CEO of the target and ask if he would be willing to discuss the possibility of “affiliating” or associating with it. Inevitably, the potential acquiror’s representative will avoid the use of terms such as “acquisition”, “sale”, or “being acquired” and use the euphemisms of “affiliation,” “association” and “marriage” when talking about the acquisition.

b. **Getting Serious.** Although potential acquirors have made various approaches in the past with respect to acquisition of community institutions in particular, virtually all potential Buyers have now learned that in order to have any serious discussions with the community bank, the chief executive or chairman of the Board of the Buyer needs to engage directly in discussions with the chief executive of the Selling Bank or its principal stockholder. To be effective, this needs to happen very early in the exploratory stages.

Experience has shown that the Buyers that have tried to acquire banks by sending officers other than the CEO or chairman to conduct any serious discussions have generally not been as successful as those represented directly by one of them. Most community bankers understandably take the
position that when they are about to make the most important decision that they will ever make for their bank, they want to directly “eyeball” the CEO of the Buyer. Many understandably resent it if the bank holding company chairman or CEO does not give them at least some reasonable amount of attention.

c. **The Sales Pitch.** Buyers and Sellers have varying interests and reasons for wanting to engage in a transaction. Usually the acquiring institution, although it is technically a “Buyer,” must “sell” itself to the target. This is particularly true where stock of the Buyer is to be used as the currency for the transaction. The sales pitch varies with the perceived “needs” of the community bank which the Buyer intends to meet as a result of the acquisition. Many times, the needs of the Selling Bank will depend primarily upon the financial condition of the Seller. If the Selling Bank needs additional capital for growth or otherwise, the approach by the Buyer usually emphasizes that an affiliation with the Buyer will provide a source of additional capital so that the bank may continue to grow and serve its community.

If the Selling Bank is already well capitalized and satisfactorily performing, the approach usually involves an appeal to the stockholders of the community bank with respect to the liquidity of the stock of the Buyer and the lack of marketability and illiquidity of the community bank’s stock. The Buyer will also always emphasize the tax free nature of most transactions and the existing market for its stock.

In banks in which the chief executive officer is near retirement age and does not have a capable successor on board, the Buyer generally emphasizes its management depth and its ability to attract successor management who will have a career opportunity with a larger organization.

In summary, the Buyer will generally emphasize that it can bring to the table capital, management, liquidity for the investment, future earnings potential, appreciation, and career opportunities for employees. The specific needs of the Seller will determine which of these particular benefits will be emphasized.

2. **General Negotiation Considerations**

In all bank acquisitions, there are some advantages that inherently go to those who are selling and others that accrue to the Buyer. No matter which side you are on, two primary goals should be recognized: first, improve your bargaining position, and, second, understand the other side’s position.

a. **Stages of Negotiations:**

   (1) Preliminary negotiations leading up to determination of price and other social issues - usually represented by a letter of intent or term sheet.
b. **General Negotiation Suggestions for Both Parties:**

1. No premature negotiations - ignore deadlines. Make concessions late and always get something in return. The opposite is also true - take concessions and attempt to move on without giving up anything.

2. Plan and attempt to control all aspects of negotiations including place, time and mood. The Buyer usually has an advantage in this regard.

3. Throughout negotiations, be courteous but firm and attempt to lead the negotiations. Within the general rule that the “Buyer gets to draft”, try to have your professionals retain control over drafting and revisions of definitive documentation.

4. Use the “foot in the door” negotiating approach to get to higher levels of commitment. As the costs and expenses mount, a party will be more reluctant to terminate the deal since his institution will have to bear the expenses. (These expenses are usually a larger share of the Seller’s operating income.)

5. Consider using letters of intent or term sheets because they:

   - clear up any ambiguity or confusion over the terms of the deal,
   - cause a psychological “commitment,”
   - take the institution off the market and discourage other bidders, include confidentiality provisions, and
   - set forth the timing of the deal.

6. Keep communications open with stockholders. Make sure all parties in interest understand the delays associated with a bank acquisition.

7. Always be careful of unreasonable time demands. Is the acquisition so unique that the risk of speeding up the process is justified? Are there other bidders or alternatives for the other party? Where is the pressure coming from to expedite the transaction? How will the...
faster pace affect the acquisition? Are there “hidden agendas” existing with advisors? Is the potential reward commensurate with the risks?

(8) Be absolutely certain that you receive competent legal advice on exactly what public disclosures should be made regarding negotiations and the timing of such disclosures. Substantial liability can occur for misleading or late disclosures.

(9) Throughout negotiations, be certain everyone understands the importance of the “due diligence” examination since so often these examinations identify major problems. Try to make certain that by the time you get to the closing documents there are no more surprises.

(10) Always attempt to use a win/win strategy. It is almost impossible to make a totally unfair and overpowering deal “stick.” Regardless of the legal consequences, most people will not honor a contract if they realize they have been “taken.”

c. Specific Seller Negotiation Considerations

(1) The Seller should not reveal the reasons his group is interested in selling.

(2) A Seller should always show a limited desire to sell. This will have the effect of forcing the Buyer to sell itself rather than requiring the Seller to “sell” his institution.

(3) Consider using a representative for negotiations so that the representative can use the strategy of saying, “I can only make recommendations to my client. I cannot commit for him.”

(4) Due diligence examinations are integral parts of any acquisition. The Seller should usually try to force “due diligence” examinations before any definitive document is signed or as early as possible. This avoids premature press releases which can be embarrassing later. Also it removes the major contingency early. Termination of an acquisition, regardless of the reasons given in a press release, will nearly always damage the reputation of the Seller more than the Buyer. It will be automatically assumed that there is something wrong with the institution being sold.

(5) Remember the “foot in the door” negotiating approach used by many purchasers. A Seller should always realize that negotiations are never over until the cash or stock is received.
Bring up integration issues early in the negotiations if the post-acquisition operation of the bank is important to the Seller’s management and directors.

Don’t forget the social issues.

d. Specific Buyer’s Negotiation Considerations

Avoid discussion of price in the initial meetings. It is too sensitive a subject to raise until some personal rapport has been developed. In determining the pricing, always consider what incentive plans must be given to management.

Consider the “social issues” early on.

Make no proposal until you have arrived at a clear understanding of the Seller’s desires and expectations.

With a “cash” transaction, determine in the beginning the “financing” of the deal. Keep in mind that often a Buyer, a lender and the regulators must approve the deal from a cash flow and financial point of view.

If the Seller is unsophisticated enough to allow its existing senior management to negotiate, the Buyer should take advantage of the natural reluctance of management to negotiate “too hard” with its future boss.

It is always important that there is no uncertainty about who is speaking for the Buyer. Also, always make certain the person speaking for the Seller controls the Seller or has authority from the Seller.

Meetings of more than five or six people are less likely to be fruitful.

Be careful of valuing synergies. They rarely exist.

Identify all of the true costs of the acquisition, including the termination/deconversion fees associated with the target’s data processing contract, change-in-control payments to the target’s senior executives, etc. Such payments can be high, to say the least, and can have a significant impact on pricing. Identify them sooner rather than later.

Fair, honest, and straightforward negotiations will produce productive agreements. Any transaction that is “too good” for either side will generate ill will and run the risk of an aborted closing. In order for a transaction to work, it must be viewed as fair to both parties.
E. PRICE, CURRENCY, STRUCTURE, AND OTHER IMPORTANT ISSUES

1. Pricing and Currency Issues

If pricing of an acquisition transaction is not the most important issue, then it runs a very close second to whatever is. Granted, although “social issues” play a large role in acquisition transactions and have derailed many through the years, pricing and an understanding of pricing are critical.

a. **Stock or Cash as the Currency.** When considering an acquisition transaction as either Buyer or Seller, it is imperative to make a decision up front as to whether stock or cash will be the currency. The currency will generally be dictated by the desires of the selling company. If the Seller wants a tax free stock transaction, then a cash transaction will only be acceptable generally if it is “grossed up” for tax purposes, which will often make it prohibitively expensive. Particularly with the post-election “bump” many larger, regional bank’s stocks experienced, stock as currency has increased in attractiveness for many institutions. With that said, numerous questions arise which should be considered in connection with taking the stock of a holding company or other Buyer. Primary concerns should be as follows:

(i) The number of shares selling stockholders will receive in relation to the perceived value of the community bank’s stock. Is the price acceptable based on the market value of the holding company stock being received?

(ii) The investment quality of the holding company stock at that price. Is the holding company stock a good investment at that price and is it likely to increase in value or is it already overpriced and is more likely to drop?

(iii) The liquidity in the holding company stock to be received. Is the market thin or is there a ready market available for the stock? Although a number of holding company stocks are listed on an exchange and often there are many “market makers” through regional brokerage houses in these stocks, the true market for the stock may be extremely thin.

(iv) Who bears the market risk during the length of time that will transpire between the time an agreement in principle is reached and the time the stock is actually issued to the community bank stockholder so it can be sold?

(v) The taxable nature of the transaction. Will the stock be received in a tax free transaction so there will be no taxable event unless and until the community bank stockholders sell their new holding company stock?
b. **Determining Relative Value of Illiquid Shares.** When two community banks are combining for stock and neither bank has a “liquid” currency, then the acquiror and the target must determine the relative value of the two banks and their contribution to the resulting entity. In other words, the banks must determine how large a stake in the new combined company the target represents, which will dictate the value of a share of target stock in terms of stock of the acquiror. This determination is generally based on a “Contribution Analysis”.

To arrive at a relative value of the two institutions and their resulting share in the resulting institution, each bank’s relative contribution of earnings, assets, and equity to the combined resulting holding company should be considered. Because the contribution of a large earnings stream is generally more valuable than the contribution of equity, which is, in turn, more valuable than the contribution of assets, these three criteria should be weighted accordingly. By considering the relative value of each bank’s contribution to the combined entity, and by understanding which category, earnings, equity, assets, contributes more to the long-term value of the combined organization, the two combining banks can determine the relative values of the stock to each other.

c. **Pricing**

(i) **Realistic Pricing Expectations for the Current Environment**

Once upon a time, banks were consistently selling for two times book value. As it was not that long ago, it is logical that a potential target bank, whose business has not materially changed, could claim that the value of his bank has not changed either. The fact of the matter, however, is that community banks are operating in a vastly different economic environment, and are selling for lower multiples of book value. Prices are much improved and continue to rise, but they are still not up to pre-recession levels. Simply put, prices across the board have fallen, and healthy banks are selling for less than what they did ten years ago.

(ii) **Historical Pricing**

“Historical Pricing” is a method of pricing a bank deal by reference to similar deals. A bank will determine its own value by looking at prices paid for banks of similar size and profitability that serve similar markets. The fallacy of this reasoning is that a bank is “worth” only what a willing buyer will pay for it. Valuing a bank by reference to others is rarely, if ever, an effective way at arriving at an accurate value. That is why historical pricing is not considered to be an accurate indicator of a bank’s potential selling price. Historical pricing can be used to see if an offer is in the correct ballpark, but that is near the extent of its value.
(iii) Price Based on Earnings Stream

As noted, although pricing in bank acquisition transactions is often reported as a multiple of book value, bank acquisition transactions are always priced based on the target’s potential earnings stream and whether it will be accretive or dilutive after the acquisition to the potential acquiror. Whether or not the acquisition will be accretive or dilutive to the acquiror from an earnings per share standpoint is going to depend on the earnings stream that can be generated from the target post-acquisition. This means that cost savings obtained by the acquiror as a result of the acquisition, i.e. general personnel cuts, and revenue enhancements which will be obtained as a result of the target being part of the acquiror’s organization must be considered. Generally, when considering the resulting pro forma reflecting the post-acquisition earnings stream for purposes of pricing the acquisition, the target should be given a significant credit on the purchase price calculation toward cost savings to be obtained by the acquiror. The target generally gets no credit for revenue enhancements, which are items that the acquiror brings to the table, i.e. the ability to push more product that the acquiror already has through the distribution network of the target.

Because most transactions are initially “priced” before obtaining detailed nonpublic information about the target, the potential acquiror generally needs to determine an estimate of cost savings for purposes of running its own model. The general rule of thumb with respect to savings of noninterest expense of the target is as follows:

- Out of Market Acquisition: 15 to 20%
- Adjacent Market Acquisition: 20 to 30%
- In Market Acquisition: 25 to 40%

Once the pro forma earnings stream for the target after the acquisition by the acquiror has been determined, it is fairly easy to determine how many shares or dollars the acquiror could give to the target stockholders without diluting the earnings of its own stockholders. Most acquirors of community banks will not engage in transactions that are earnings per share dilutive, at least that are earnings per share dilutive for very long.

d. Critical Contract Considerations With Respect to Pricing a Stock-for-Stock Transaction

The single most important provision in the acquisition agreement relates to how the price is determined, i.e. at what time will the number of shares to be received by the community bank stockholders actually be determined. This is important since the value of the stock, particularly if a larger, public holding company is involved, typically fluctuates day to day in the market.

Competing interests between the Selling Bank and the Buyer are clearly present. The community bank’s interest is to structure the price so that the dollar value of the transaction is determined in the contract, but that the number of shares to be received by the community bank increases
proportionately as the market value of the holding company stock decreases up to the date of closing.

Conversely, the Buyer’s interest is to structure the transaction so that the value is fixed in the agreement and the number of shares or value of the transaction decreases as the price of the holding company stock increases in the market. These competing desires are usually resolved in one of several ways.

- A fixed exchange ratio that does not change no matter what the stock price is, i.e., a fixed number of shares to the Seller’s stockholders.

- An exchange ratio that fluctuates both up and down but has a collar and a cuff on it so that the amount of fluctuation in the exchange ratio is fixed. If there is a variation in the stock price that goes beyond the collar or cuff, the number of shares does not adjust any further.

Bank stock indices are also often being used as part of the pricing mechanism.

It is also important to obtain a “walk” provision which is utilized in the event the value of the Buyer’s stock drops below a specified dollar amount at a specified time or times. In that event, the Seller’s Board has the right to terminate the agreement without any obligation to proceed further.

As a practical matter, the “walk” provision is generally extremely effective from the Seller’s standpoint. In the unanticipated event that the stock of the Buyer falls below the “walk” price, the community bank always has the opportunity to renegotiate the exchange ratio and thereby retain its flexibility.

The key to the “walk” provision is to determine in advance at what date the holding company stock will be valued. Many acquisition agreements provide for an average value for a twenty-day trading period which ends five days prior to the effective date of the merger. Such a provision, however, may create unnecessary problems in implementation.

It is preferable to have a “walk” provision that has a twenty-day period run both from the date of approval by the stockholders of the Selling Bank and from the date of approval of the Buyer’s application by the Federal Reserve Board or other agency. Using these dates gives the community bank two shots at the “walk” provision. This also gives the advantage to the community bank so that if the federal regulatory approval, i.e. the “first walk date,” is obtained prior to the stockholders’ meeting, and the community bank determines to terminate the transaction, a proxy and prospectus need not be delivered and stockholder vote may never need to be taken.
2. Social Issues

Although pricing and pricing considerations are of paramount importance, many transactions stand or fall on social issues. As a result, oftentimes, particularly for a Seller, the negotiation of social issues first makes sense. If the social issues cannot be adequately addressed, then there is generally no need to move on to price discussions. Social issues include the following:

- Who is going to run the bank or company post acquisition?
- What will the company’s or bank’s name be?
- Who will sit on the Board of Directors?
- What will be the compensation of the directors and/or officers remaining?
- What will be the severance provisions for officers and employees who are terminated?
- Will the institution be turned into a branch or remain as an independent charter?
- Will employee benefits change?
- How much autonomy will the Board or advisory board and management have post acquisition?
- How much bureaucracy will be involved post acquisition?

Even an adequately priced acquisition may never close if the social issues cannot be addressed to the satisfaction of principal players. Address social issues early on.

3. Merger of Equals

It is not uncommon for community banks to consider a “merger of equals”. In other words, neither bank considers itself the target. In such situations, banks should be aware that under purchase accounting rules one bank must be designated as the acquiror when accounting for the transaction. Numerous issues are presented in what are purported to be mergers of equals. Often these are referred to as “unequal mergers of equals” not only because one institution must technically be the acquiror for accounting purposes, but generally one institution deems itself to be the acquiror. As many issues as can possibly be resolved ahead of time should be. Mergers of equals are difficult to consummate and integrate.

4. Intangible Considerations Associated with the Price and Autonomy

When a Selling Bank considers selling, major concerns on the chief executive’s mind are generally related to price of the acquisition and autonomy after the
acquisition. It is generally possible to satisfactorily quantify the price provisions and build in certain protections from market value fluctuations of the holding company stock. It is not as easy, however, to get a grasp on the issue of autonomy.

The community bank executive must understand, however, that while the acquiring holding company stresses the substantial autonomy that will be given to its subsidiaries, in reality, the autonomy dissolves rather quickly as more and more authority is assumed by the acquiring holding company’s main office.

It is generally true that within two or three years after the acquisition by a larger holding company, the chief executive officer of the community bank leaves and is replaced with someone chosen by the holding company. Although there are many reasons for this, the major one is that a CEO, accustomed to operating his or her own bank subject only to his Board of Directors, is simply unable or unwilling to adjust to having to respond to directions from so many people in so many areas in a larger holding company setting. For this reason, the CEO who is ready, willing and able to retire within a few years of the acquisition is in the best possible position to negotiate a good deal for his stockholders. He does not have to be so concerned about his own future at the holding company and can aggressively negotiate against the people who will be his future bosses if he stays with the bank after its acquisition.

In general, however, there is an inherent conflict between the desire for autonomy by the CEO and the best interest of the stockholders. In the usual case, the stockholders’ sole concern is getting the best price in the best currency. If it is not cash, it should be in a stock that is readily marketable and is expected to at least retain its value. The CEO must be careful that there is not a trade-off on price to obtain a better deal or more autonomy for the local Board and management at the expense of the consideration received by stockholders. Usually the stockholders are not concerned about autonomy - particularly if it is at their expense.

5. Dividends / Subchapter S Distributions

The payment of dividends or Sub S distributions must be considered in any acquisition transaction. Often, the community bank’s dividend payment history may provide significantly less cash flow than the dividends that will be received by the community bank stockholders after application of the exchange ratio in a stock-for-stock transaction. If this is the case, then acceleration of the closing of the transaction to ensure that the community bank stockholders are stockholders of record at the time of the dividend declaration by the acquiring company should be a priority. The worst possible case is that the community bank does not pay its dividend and misses the acquiring company’s dividend. This is generally avoided by providing that the community bank can continue to pay its regular dividend up until the date of closing and that the community bank will be entitled to its pro rata portion of its regular dividend shortly prior to closing if the community bank stockholders will have missed the record date of the acquiring company as a result of the timing of the closing. In other words, the community bank would get its own dividend or the acquiring company’s dividend, but not both.
The acquisition of Subchapter S institutions provides an additional consideration. Subchapter S organizations make (or at least should make) “tax equivalent” distributions to their stockholders for the purpose of covering the stockholders’ increased tax liability as a result of pass-through income. If a Subchapter S institution is acquired prior to making any tax equivalent distributions for the current tax year, then the target stockholders could be left with a tax liability from partial year income without any corresponding distribution.

Related, the potential for an extraordinary dividend must be considered. Since the replacement of the pooling of interest method of accounting, there are no adverse consequences to the payment of an extraordinary dividend. Indeed, in today’s environment, many community banks use the extraordinary dividend to reduce their capital account to approximately 8% immediately prior to closing. The payment of an extraordinary dividend in a cash transaction will often have no adverse impact as a result of the purchase price often being tied to “core” capital, rather than including excess capital in the calculation.

6. Due Diligence Review

No matter how large the Buyer or whether it is an SEC reporting company, before a Seller’s stockholders accept stock in an acquiring bank or holding company, a due diligence review of that bank or holding company should take place. This is similar to the due diligence review which the Buyer will conduct of the Seller prior to executing the definitive agreement. It is generally best to have disinterested and objective personnel conduct the due diligence review of the acquiror. Several difficulties are generally encountered in connection with this review, not the least of which often times is simply the sheer size of the Buyer whose condition is being evaluated and whose stock is being issued.

An additional and recurrent difficulty involved in the due diligence review is obtaining access to the Buyer’s regulatory examination reports. Although these reports are intended for the use of the Buyer’s company and bank only, it is virtually impossible to justify recommending to the Seller’s Board of Directors and its stockholders that they sell to the Buyer in a stock-for-stock transaction if the due diligence team is denied the right to review the regulatory reports to determine if there are any material considerations that would affect the decision to sell.

It is generally most efficient for the Selling Bank to retain outside experts to either completely conduct the due diligence examination or at least assist and direct the examination with the assistance of key people from the Seller. Individuals who are experienced in doing this type of work will quickly know the areas to focus on, the information necessary to obtain, and can generally facilitate a rapid due diligence review that is of minimum disruption to the Buyer and maximum benefit to the Seller. Most of the experienced and sophisticated Buyers are used to having these reviews performed in their offices and generally they will be cooperative with respect to the process.

Even in a cash deal, prudent Sellers will conduct due diligence on the acquiror to verify that the company has or has access to the cash to execute the deal, and can
obtain regulatory approval. In addition, conducting due diligence on a Seller can uncover problems at the front end that would later derail the deal. Spending valuable time and untold thousands of dollars pursuing a deal with no chance of success is an immense waste of time and resources. Due diligence can uncover a host of “under the radar” issues that are imminently important, even to a Seller in a cash deal.

7. Fairness Opinion

Another issue that is extremely important to the Selling Bank is that the definitive agreement contain, as a condition to closing, the rendering of a fairness opinion. The fairness opinion is an opinion from a financial advisor that the transaction, as structured, is fair to the stockholders of the Seller from a financial point of view. The fairness opinion will help to protect the directors from later stockholder complaints with respect to the fairness of the transaction or that the directors did not do their job. The fairness opinion should be updated and delivered to the Seller bank as a condition of the Seller bank’s obligation to close the transaction.

Conditioning the closing on the receipt of an updated fairness opinion will also protect the Seller further by permitting it to terminate the transaction in the event of material adverse changes between the time the contract is signed and the closing, which precludes the delivery of the fairness opinion.

8. Structuring

A good number of acquisitions, whether large or small, are structured as tax free exchanges of stock. It is imperative that the Seller, its Board of Directors, and stockholders understand the tax ramifications of the transaction as well as the Buyer’s tax considerations in order to fully understand the Buyer’s position in the negotiations.

Any acquisition transaction will be a taxable transaction to the Seller’s stockholders unless it qualifies as a tax free transaction pursuant to the Internal Revenue Code. Although a detailed discussion of the structuring of the transaction and tax considerations is beyond the scope of this outline, it should be noted that often community banks are offered a tax free exchange of stock in the acquiring institution. This will be the result of either a phantom merger transaction or an exchange of shares under state “Plan of Exchange” laws. Under certain circumstance, a transaction can still be tax free for stockholders receiving stock of the Buyer, even though up to 50 percent of the consideration of the transaction is cash.

It is critical that the Seller use a firm that has counsel qualified to review the structure of the transaction. If a transaction is improperly structured, the result may be double taxation to selling stockholders.

It is anticipated that cash transactions will become much more frequent in the near future. From the Seller’s perspective, the obvious advantage to a cash deal involves a “bird in the hand”. Sellers who accept cash are subject to none of the risk
associated with taking an equity position in an acquiring bank and have received consideration for their shares that is totally liquid – a big advantage. On the other hand, Sellers for cash are not afforded the upside potential of holding an equity interest. They will not be entitled to dividends or any subsequent appreciation in the value of the acquiror. For better or for worse, Sellers in a cash deal are frequently totally divorced from the bank following the acquisition. In addition, the sale of a bank for cash will be a taxable transaction. The stockholders will be subject to income tax at capital gains rates to the extent their shares had appreciated in their hands.

There is also a unique structuring consideration when the target organization is a Subchapter S corporation. Acquisition transactions can either be structured as a sale of the target’s equity (stock) or a sale of the target’s assets. For tax purposes, an sale of the target’s equity results in a “carry over” basis. In other words, the target company’s assets have the same depreciable tax basis as they had pre-acquisition. A sale of assets, on the other hand, results in the acquired assets having a tax basis equal to each asset’s fair market value. This is called a “step up” in basis, meaning that the acquirer is able to re-depreciate the assets. While this represents a significant benefit to the acquirer, a sale of assets often results in an increased tax liability for the seller.

In transactions involving the sale of an S corporation, Internal Revenue Code Section 338(h)(10) allows the acquiror to treat the acquisition of S corporation equity as a purchase of S corporation assets, thus gaining the tax benefits noted above. Because this results in increased tax liability for the sellers, however, the stockholders of the seller have to consent to the 338(h)(10) election. Selling stockholders are unlikely to bestow a benefit on the acquiror while increasing their own taxes without being compensated in some way. Thus, this structural element is ripe for negotiation.

9. Documentation and Conditions to Closing

Every Buyer or Seller needs to be aware of the basic documentation in acquisition transactions as well as conditions to closing. The basic documentation often used includes:

- Term Sheet
- Definitive Agreement
- Proxy Statement and Prospectus
- Tax and Accounting Opinions
- Due Diligence Report on Buyer
- Fairness Opinion
- Miscellaneous Closing Documents

It is advisable to use some kind of term sheet in a merger or acquisition. A term sheet not only provides a moral commitment, but more importantly, it evidences that there has been a meeting of the minds with respect to the basic terms of the transaction. The definitive agreement is the “big agreement”. The definitive agreement generally runs from 40 to 60 pages and is full of legalese, including
significant representations and warranties as well as pricing provisions, covenants that must be obeyed by the selling institution from the time of the signing of the agreement until the closing, and conditions to closing. The conditions to closing generally include financing in a cash transaction, regulatory and stockholder approval in all transactions (since they are generally structured as mergers), the receipt of a fairness opinion and the fact that there has been no material adverse change from the date of the agreement to the date of closing in the target (in a cash transaction) or in either company (in a stock-for-stock transaction).

10. Dissenting Stockholders

Since virtually all transactions will be structured as mergers to enable the acquiror to acquire 100% of the target’s stock, the target’s stockholders will generally have dissenters’ rights. In a transaction structured as a merger, the vote of the target stockholders of either 2/3rds or 50%, depending on the applicable law, will require 100% of the stockholders of the target to tender their stock to the acquiror in exchange for either the cash or stock being offered unless such stockholders perfect their dissenters’ rights. The perfection of dissenters’ rights by a stockholder does not permit the stockholder to stop the transaction or keep his stock. It only entitles the stockholder to the fair value of his or her shares in cash. In very few transactions are dissenters’ rights actually exercised for the simple fact that in a stock-for-stock transaction with a listed security, the dissenters can generally sell the stock received and obtain their cash very quickly. In a cash transaction or a stock transaction for a less liquid security, most dissenters do not have a large enough position to make it economically feasible to exercise their rights and pursue the appraisal and other remedies available. Historically, most transactions were conditioned upon no dissent in excess of 10%. This was due to some requirements for pooling of interest accounting. Even with the disappearance of pooling of interests accounting, it is likely that most transactions will retain a 10% or less dissent limitation in order to give the Buyer some certainty as to the price that will be paid and the support of the stockholder base for the transaction.

It should be noted that by exercising its dissenters’ rights, a stockholder is committing to accepting the value of the shares as determined by a Court. This can be a gamble. If the Court determines that the stock is worth less than what is being offered by the acquiring bank, the stockholder receives less.

11. Aspects of Securities Law Issues

Although a thorough discussion of securities law issues is beyond the scope of this outline, virtually any acquisition, including a stock exchange by Selling Bank stockholders for a Buyer’s security, will need to be approved by the Selling Bank stockholders. This will require the preparation of a prospectus (for the issuance of the stock) and a proxy statement (to obtain the vote of the stockholders). There is often a temptation from the Selling Bank to allow the Buyer, particularly if it is a larger holding company, to totally handle the disclosure process for the prospectus-proxy statement. The Seller must remember that to the extent the document is a proxy statement for a special meeting of the Seller’s stockholders, it is also a securities disclosure statement of the Selling Bank and must contain all material and
proper disclosures about the Selling Bank. As a result, it is imperative that counsel, accountants, and management of the Selling Bank be actively involved in the disclosure process.

Of more practical importance than the preparation of the disclosure material to the Board of Directors and stockholders of a target company in a stock-for-stock acquisition is whether their stock will be restricted from immediate sale once received. As a practical matter, in most stock-for-stock acquisitions with larger holding companies that are listed on an Exchange, a condition of the transaction is that the stock be registered by appropriate filings with the Securities and Exchange Commission. Registered stock, once received by stockholders of the target company who are not “affiliates” (insiders) of the target, can be sold immediately. Affiliates of the target, defined as directors, executive officers or stockholders holding in excess of 5% of the target’s stock, are restricted from sale under the Securities and Exchange Commission Rules 144 and 145. Although these Rules are lengthy and complicated, as a practical matter, an affiliate receiving restricted shares in connection with an acquisition only can dispose of those shares under the following basic conditions:

- The sale must occur through a broker.

- The affiliate cannot sell more than 1% of the stock of the acquiring company in any three-month period (this is usually not a problem since typically, no stockholder in a community bank receives more than 1% of the acquiring company’s stock as part of the transaction).

- An affiliate is subject to a holding period of six months, during which, sale of the securities is disallowed.

F. DIRECTORS’ AND OFFICERS’ LIABILITY CONSIDERATIONS

Directors of a corporation (a bank and/or its holding company) are elected by stockholders and owe those stockholders the fiduciary responsibility to look out for the stockholders’ best interest. Directors fulfill this fiduciary responsibility by exercising to the best of their ability their duties of loyalty and care. A director’s duty of loyalty is fulfilled when that director makes a decision that is not in his or her own self-interest but rather in the best interest of all stockholders. A director’s duty of care is fulfilled by making sure that decisions reached are reasonably sound and that the director is well-informed in reaching those decisions. In traditional settings, courts will rarely second-guess a Board of Directors’ decision unless a complaining stockholder can clearly prove self-dealing on the part of the Board of Directors or that the Board of Directors behaved recklessly or in a willfully or grossly negligent manner. The burden is on a complaining stockholder to show that the Board did not act properly in fulfilling its fiduciary duties.

In sale transactions (sale of business, merger, combination, etc.), Boards of Directors are subject to “enhanced scrutiny” in reaching important decisions regarding the sale of the business. Boards of Directors must be able to demonstrate (1) the adequacy of their decision-making process, including documenting the information on which the Board relied
on reaching its decision, and (2) the reasonableness of the decision reached by the directors in light of the circumstances surrounding the decision. In a sale of business setting, the burden shifts to the directors to prove that they reasonably fulfilled their fiduciary duties. The following is a partial list of actions that would be appropriate for a Board of Directors to take in reviewing or in making a decision whether to merge and/or be acquired or accept a tender offer in most situations:

1. The Board should inquire as to how the transaction will be structured and how the price of the transaction has been determined.

2. The Board should be informed of all terms within the merger agreement, acquisition agreement or tender offer.

3. The Board should be given written documentation regarding the combination, including the merger agreement and its terms.

4. The Board should request and receive advice regarding the value of the company which is to be bought and/or sold.

5. The Board should obtain a fairness opinion in regard to the merger.

6. The Board should obtain and review all documents prepared in connection with the proposed merger, acquisition or tender offer.

7. The Board should seek out information about national, regional and local trends on pricing a merger or acquisition.

8. Finally, the Board members should be careful not to put their own interests above the interests of the stockholders. If directors’ deferred compensation or other agreements exist between the corporation, they must be negotiated but not serve as a block to a transaction that would otherwise be in the best interests of stockholders.

The whole concept of “enhanced scrutiny” has arisen from (and, for that matter, is still being developed) by a number of Delaware Supreme Court decisions relating to hostile and/or competitive acquisition transactions. A great amount of material has been written attempting to explain the impact of these Delaware Supreme Court decisions. Not everyone agrees on exactly what these decisions mean, and lawyers and Boards of Directors continue to grapple with exactly what Boards must do to survive the “enhanced scrutiny” that courts will place on Boards of Directors in a sale of business transaction. Despite the lack of absolutely clear guidance on what Boards must do to survive the test of enhanced scrutiny, a number of general rules are becoming apparent. These include the following:

1. In a sale of business transaction, the Board of Directors must assure itself that it has obtained the highest price reasonably available for the stockholders, but this does not necessarily mean that the Board of Directors must conduct an “auction” to obtain that price.
2. The Board of Directors is obligated to “auction” the business if there is a “change in control.” For example, if the selling stockholders will trade their shares of stock for shares of the acquiror and the acquiror has a dominant, control stockholder, then an auction is required to assure that the selling stockholders receive the highest price and the best type of consideration.

3. In the absence of a large control stockholder, an auction is not necessarily required if the selling stockholders receive stock of the acquiror and that stock is freely tradable on an established market.

4. If the stockholders are to receive cash in exchange for their shares, an auction may be required. At a minimum, the directors must determine that they have agreed to the best available transaction for stockholders. Directors may be able to rely on publicly available pricing data for comparable transactions in reaching this conclusion.

5. In any case, directors should obtain a fairness opinion from a qualified valuation expert as to the fairness of the transaction to stockholders from a financial point of view. Directors can use this fairness opinion as a major component in satisfying their duty of care to the stockholders and surviving the “enhanced scrutiny” that the courts will impose.

Boards of Directors involved in any type of sale process or sale evaluation must take extra steps to assure that they are fulfilling their enhanced fiduciary responsibilities to the stockholders. Using board committees, specialized counsel and consultants to help the Board structure the “process” of evaluating a sale is absolutely critical to fulfilling the Board’s responsibilities.
III. MARKETING YOUR BANK

What do you do when you finally decide that it is time to sell your bank? Maybe you are tired of the hassles with the regulators. Maybe you are ready to retire. Maybe you have no management succession. Maybe your stockholders have become diversified through estate and gift distributions. For whatever reason, what do you do when you finally determine that it is an appropriate time to sell?

There are three basic alternative methods to go about selling your bank.

1. Deal with one other party as an interested prospective purchaser,

2. Select one or two potential purchasers, or

3. Market the bank widely to solicit offers and then select among the offers.

A. UNSOLICITED OFFERS OR DEALING WITH ONLY ONE OFFEROR

When you decide to sell your bank, your goal should be to obtain the best price in the best currency available. That currency may be cash or the stock of another institution. Some institutions are sold after being approached, unsolicited, by one potential acquiror who gives some kind of an “ultimatum” with respect to its offer and the community institution then sells for fear of “losing the deal”.

Some of the larger holding companies who are very active in the acquisition game are famous for this technique. Representatives of the holding company come to your bank, meet with your board of directors, put a letter of intent on the table with what appears to be a reasonably good or high offer and give you five days to respond.

Not only is this unfair to your board of directors, but it is also unfair to your stockholders since it clearly does not give the board time to conduct an appropriate analysis of the purchase or other alternatives. In these types of situations, we uniformly request additional time from the potential acquiror or refuse the offer due to the inability to analyze it in the time provided. In none of the transactions in which we have been involved has that offer ever “gone away”. The single acquiror in that case is attempting to intimidate the board or give them the fear that if they do not accept the offer, there may never be another one as good. That is rarely the case.

B. DEALING WITH SELECTED ACQUIRORS

Some institutions, particularly when the Board knows that they want to engage in a stock-for-stock exchange for tax reasons, will pick out only one or two potential acquirors who have listed securities and whose operating philosophy is compatible with theirs. These institutions will then begin to negotiate with each of those acquirors in an attempt (a) to get to know them better and (b) to understand the currency, i.e., the stock, that they are offering.
As noted elsewhere in this material, all listed securities are not the same. The key is whether the security provides liquidity and is likely to increase in value over the holding period rather than decrease. The target institution in this case negotiates with the two acquirors and decides between the two which acquiror will be the winning suitor.

C. Marketing the Institution

Do either of the above alternatives assure the target institution of receiving the best price in the best currency? The simple answer is no. That is not to say that offers obtained either through one-on-one negotiations or negotiations with selected but multiple acquirors cannot be supported by a fairness opinion as being fair to the stockholders. But “fair” to the stockholders may encompass a wide range of prices. The only way a community institution can determine the highest and best price in the best currency for their institution is to market it broadly. This is not a concept that comes from great revelation. This is a concept that comes from the fact that the sale of any item which would have broad appeal is more likely to occur at a higher price when more individuals have knowledge of the opportunity to purchase it. Some community institutions are adverse to putting their institutions “on the market” for a lot of reasons, most clearly with perceived public relations issues. If you own 100 percent of the stock of your institution or its holding company, this position does not present a problem. If the institution has stockholders in addition to you or your family, however, those stockholders are likely to want to receive the highest price and be less concerned about some of the perceived public relations issues associated with the marketing process.

This brings us to the third alternative, widely marketing the bank for sale. We have marketed a number of community banks. Almost without fail, each time, on behalf of the bank, we have received multiple bids and virtually assured the bank of receiving the highest and best price in the highest quality currency. Certain of these institutions sold for cash, certain sold for stock, and certain sold for a combination of the two. But each time, the board of directors of the bank had alternatives to consider.

Clearly, the marketing process protects the board of directors in that it will have received the highest price in the best currency based on what a number of willing purchasers would be willing to pay for the institution. The board has clearly done its job in this regard.

How many banks are sold through active marketing efforts? A great number. Although this type of a marketing and sale transaction may be distasteful to some, now at least 25% of the banks sold will have elected to take this route in order to assure that if the directors are also the principal owners, they obtain the highest price for themselves and if they are not, that they get the highest price in the best currency for their stockholders.

Are there any downsides to engaging in the marketing process? The only caution is that before entering into the marketing process, it is important that the board determines that it is time to sell the institution. Once entering the marketing process, the institution will become “in play” and will likely sell. It is difficult to put an institution on the market more than once and have any credibility with potential acquirors. Although the marketing process has been designed so that neither the selling bank nor the purchasing bank has to go through a great deal of time or expense until the purchase price is struck, the acquirors still do not like to
deal with institutions that they do not think are truly on the market. Make sure the board is ready to go ahead with a sale of the institution, assuming the price is reasonable, before it is put on the market.
IV. ACQUISITION ACCOUNTING UNDER ASC 805, BUSINESS COMBINATIONS

Prior to 2002, Accounting for bank transactions used the pooling of interests method. This was a fairly simple method where the acquiror basically combined the balance sheets for the two institutions and went on their way.

In 2002, the pooling of interests method was replaced by the Purchase Method of accounting. That method was used until the end of 2008, when it was replaced by the “Acquisition Method” beginning in January 2009. The Acquisition Method and the Purchase Method are very similar, with some minor differences.

The first step in acquisition accounting is determining the acquiror. Each and every bank transaction (even a “combination” between two mutuals) must have an identified acquiror and an identified target.

After the acquiror has been identified, the second step is determining the acquisition date. This is typically the day the Articles of Merger are filed, or the date specified in the Articles of Merger as the transaction effective date. This date is important because everything in the transaction is tied to the acquisition date.

The third step in accounting for a bank transaction is valuing each of the target’s assets and liabilities. ASC 805, Business Combinations, the accounting pronouncement that implemented the Acquisition Method of accounting, requires that the target’s assets and liabilities be transferred to the acquiror at their “fair value” on the acquisition date.

One of the difficulties in accounting for a bank merger is determining the fair value of the assets acquired as of the date of the transaction. Certainly cash is not hard, but this task can be difficult when acquiring securities or, more importantly, loans.

The fair value of loans is not necessarily what the target bank paid to acquire the loan or the face value or ledger balance of the amount outstanding. Instead, the loan’s fair value is determined by an accountant following the transaction, and is dependent on a number of factors, including, but not limited to:

- Interest rate of the loan;
- Term of the loan;
- Loan type;
- Collateral;
- Borrower credit ratings;
- Adjusted vs. fixed rate; and
- Premium/discount on interest rate variances.
The rules for purchase accounting allow some homogeneous loan pools to be valued on an aggregate basis. However, ASC 805 requires the more complicated commercial loans to be individually valued. This will certainly drive up acquisition costs because it will require more professional labor.

After the initial valuation of the loans, the bank is required to record, adjust and track the “difference” between the face value and fair value of each loan or loan pool. These periodic adjustments result in income or expense based on the initial valuation, and whether the loans were valued at less or more than the outstanding balance at the time of the acquisition.

Generally, a bank’s liabilities are easier to value. The fair value of a deposit liability is generally thought to be the amount owed on the account. There may be some variation for other liabilities, but for the most part, the liabilities are what they are as presented on the balance sheet.

Once an acquiror has determined the fair value for a target’s assets and liabilities, it can determine the equity and whether any goodwill will be recognized. The equity in a bank transaction is the net difference between the fair value of the assets and the fair value of the liabilities. For example, where the fair value of the target’s assets is determined to be $88 million and the fair value of the liabilities is determined to be $80 million, the equity would be $8 million, the difference between the two.

Once the amount of equity has been identified, the next step is valuing the purchase consideration. According to ASC 805, there are two separate components to total consideration. These include (1) the fair value of the consideration offered on the date of purchase (cash, acquiror stock or something else) plus (2) the fair value of any non-controlling interest the acquiror may hold in the acquiree (for example, if a bank holding company owned 25% of a bank and bought the other 75%, the fair value of the 25% ownership would be included in the purchase price). ASC 805 requires that the consideration be valued as of the acquisition date.

The requirement that the consideration be valued as of the acquisition date is a departure from the old accounting rules. Formerly, acquirors could choose a “convenience date” somewhere close to the date of acquisition or could use an average of some time period close to the acquisition to value the consideration. This was especially helpful when stock was used as consideration. ASC 805 did away with such “convenience accounting” and now requires that the stock consideration (or other consideration) be valued as of the date of closing.

After establishing the target’s equity and the value of the consideration, the final step in the acquisition accounting method is to determine whether the transaction results in negative goodwill or goodwill. A transaction results in negative goodwill if the purchase consideration is less than the equity. The negative goodwill is equal to the difference between the two. For example, an acquiror would recognize $500,000 in negative goodwill if they completed a purchase of a target with $9 million in equity for $8.5 million. ASC 805 requires the negative goodwill to be recognized as income immediately.
As a practical note, if a bank determines that a transaction will result in negative goodwill, ASC 805 requires that the bank go back and reestablish fair values for the assets and liabilities before the negative goodwill is recognized as income. This requirement serves as a “double check” to make sure the assets and liabilities have been valued properly.

Most transactions will typically not result in negative goodwill. Instead, it is more likely that the purchase price will exceed the target’s equity. In this situation, the excess of the purchase price over the equity (which is referred to as the “purchase premium”) will be split between two intangibles: a core deposit intangible and goodwill.

The core deposit intangible represents the amount a bank may be willing to pay for the opportunity to acquire core deposits. This asset is amortized over the useful life of the asset for book purposes (generally seven to 10 years), and is amortized over a 15-year period for tax purposes.

The amount of goodwill an acquirer must recognize is equal to the purchase price premium minus the amount allocated to the core deposit intangible. Goodwill is not amortized, but is rather tested periodically for impairment.

It is impossible to determine exactly what amount of a purchase premium is attributed to the core deposit intangible and what amount will be attributed to goodwill using some mathematical formula. Instead, the accounting firm handling the transaction will perform a core deposit intangible study to determine the value of the intangible. These values are generally based on the cost to acquire the deposits, as well as the income that may be attributable to them.
With the Great Recession behind us, those community banks that remain must continue to seek out new growth, new products and services, and new profitability. For some institutions, that requires seeking out acquisition targets or marketing the bank for sale. For others, that requires actively and intentionally operating to ensure long-term independence.

Regardless of your community bank’s acquisition strategy, it is imperative that your Board of Directors plan appropriately and focus its efforts on its fundamental obligation, which is to appropriately enhance the value for the stockholders. We hope this material helps you avoid common mistakes from those that are otherwise doing it wrong!
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Gerrish’s Musings

Gerrish’s Musings is designed for CEOs and board members of community banks. Gerrish’s Musings reflects our firm’s insights and experiences as we travel weekly visiting with community bank clients from coast to coast. The newsletter is delivered by e-mail twice a month to subscribers.

This is a free publication.

The Chairman’s Forum Newsletter

The Chairman’s Forum Newsletter is designed specifically for Chairmen of the Board. The newsletter is the response to the overwhelming success of the Chairman’s Forum Conference hosted by Jeff Gerrish and Philip Smith twice yearly. The newsletter is published electronically each month governing topics unique to the changing role of the Chairman of the Board.

This is a free publication.

Please feel free to contact us at (901) 767-0900 if you require any further information or assistance. This form may be faxed to Gerrish Smith Tuck at (901) 684-2339, e-mailed to gst@gerrish.com or mailed to the mailing address listed on this form.
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.


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
All board members should be involved in strategic planning and strategic thinking. However, it is not uncommon for directors to see that as management’s job or someone else’s job. Therefore, it may often fall to the Chairman of the Board to be the primary strategic thinker for the organization, to raise alternative points of view and to focus the board and management to think in new and different ways.

In this month’s edition of The Chairman’s Forum Newsletter, we take a look at some scenarios that bring about the strategic thinking of the Chairman and raise some new or different concepts for you to consider and decide whether those could be beneficial for your organization. As Chairman, don’t be afraid to challenge conventional wisdom or to challenge the way your board has always thought about things. Even if that leads to a discussion reaffirming the way things are done, that is better than simply being in a rut of doing them because you always have. We hope the materials in this newsletter will allow you to think about things in some unique ways.

Happy Reading!

Jeffrey C. Gerrish
Philip K. Smith
Greyson E. Tuck
Chairman’s Summary

♦ A shocking “new” revelation.
♦ How do you balance older versus younger directors?
♦ Do you prefer chess or checkers?
♦ What if directors did not own stock?
♦ How much capital is appropriate?

A Shocking “New” Revelation

There is a large national conference held every year that recently concluded that we know many of you may have attended. Among other things, the conference purports to enlighten community banks on the current M&A market and various developments. A recent news article was describing somewhat of a “new revelation” articulated at the acquire or be acquired conference (often designated AOBA) which indicated, shockingly, that small banks can win more deals by evaluating them differently. The article went on to talk about how small banks should focus on the earnings performance of a target and not tangible book value. The article also went on to talk about the Small Bank Holding Company Policy Statement change and how regulators don’t look at a holding company’s consolidated leverage ratio and the ability to use debt to fund acquisitions. Additionally, the importance of social issues for small bank deals was touted.
All of these areas are very well known to community banks and are issues our firm has been espousing for 30 years. It’s nice to finally see these big bank conferences stumble into what they think are new areas of focus for smaller banks, especially when the conference often seems primarily geared not toward maintaining independence, but on ways that small banks can sell themselves or ways that big banks can buy smaller banks. Perhaps rather than being labeled AOBA, it should more appropriately be labeled SOBS (sell or be sold). As one of our clients who attended the conference told us, “There sure was a lot of ‘gloom and doom’ for small banks and while it wasn’t all bad, you certainly had to sift through the bias against small banks to find anything relevant”. As Chairman, think strategically on your own. Don’t listen to the large investment banking firms who, for example, would purport to give a small Midwestern bank their strategic options. Those options normally lead to only one result, a sale. As Chairman, keep your directors focused on the bigger picture, you can and will survive and thrive!

**How Do You Balance Differences in Directors?**

How different are your directors? In particular, how different are they age-wise, technology-wise or in other facets? Do you find that makes your job of managing them a bit more difficult? We recently encountered a situation that pointed this out where a board was trying to decide, in light of some of the bad weather we have been seeing across the country, whether to cancel or postpone a board meeting scheduled for the next day because of the likelihood of snow, difficult travel, etc. First, a director responded that it was really going to be difficult to know and that everyone would just have to “wait and see what the morning brings”. Alternatively, one of the younger
directors responded that he was looking at the weather app on his smart phone and could tell that the snow would stop by 3:00 a.m., the temperatures would warm to substantially above freezing by 7:00 a.m. and, therefore, the roads would be clear by 8:30 a.m. So, everyone would easily be able to make it in and he looked forward to the meeting. A bit of an old school versus new school approach. When the morning rolled around, the older director sent a follow up indicating that he had walked out to the end of his drive and the newspaper had been delivered. So, therefore, the roads must be fairly passable and he was probably going to make it to the meeting. Again, one of the younger directors, intentionally kind of poking fun in a good natured way at the older director, commented that he didn’t know that newspapers actually still came in a paper format and were actually still delivered to your house. He mentioned that he thought the newspaper was only available in an on-line electronic version. He jokingly asked the director if he also was still having milk delivered to his front door.

What this humorous situation points out is probably reflective of many of your organizations as well. Community banks often have Boards of Directors that span generations, there are deep divides on the desire and ability for technological uses and other key differences. Your job as Chairman is to strike an appropriate balance between those and while it may point out the need not to have a board filled with entirely old people, it also points out the fallacy of kicking all the old board members off, because we wonder what the younger director would do when the snow and ice cause power outages that cut off Internet access! There’s probably a benefit to all forms of information and all types of directors!
Do You Prefer Chess or Checkers?

Let us give you an interesting question to think about as Chairman that can be applied to a number of different situations. Is your bank playing chess or is your bank playing checkers? Arguably, they are both games of strategy and require strategic moves, anticipating what your opponent is going to be doing and looking for opportunities to make big moves and big plays when possible. But what is the primary distinction between the two games? The answer is in the moves that the various pieces can make. In checkers, each piece is restricted to making the exact same moves as every other piece. All the pieces look alike and act alike. However, in chess, there are multiple different types of pieces, each of which has its own unique moves. Therefore, there are a wider array of strategies needed for chess, more complication in the moves, but also the ability to move multiple pieces around the board, take advantage of multiple situations, etc. In checkers, it’s pretty straightforward and plotting one or two moves at a time.

Compare that to your organization, for example, as it relates to technology. Is your bank structure more like a checkers match, somewhat older, antiquated and you look across at your competition and, rather than the competition playing with the same pieces that can do the same moves as you, they have the latest technology, more infrastructure and are moving pieces at a much greater pace in different positions around the board. That can also be applied to how we look at products and services, how we look at our branches and even how we look at our Boards of Directors. Are our boards composed of checker pieces, all of which look alike and make the same moves, or are our boards composed of chess pieces that look different, act different, have different moves and, as a result, bring to the table a much
more dynamic playing experience or, in your case, a much more active and engaged board? Perhaps a silly analogy, but think about that in terms of the benefits that it can bring. You don’t want to continue to operate a checkers bank in a chess environment!

**What if Directors Did Not Own Stock?**

We often hear, and our firm has even touted, that it is beneficial for directors to have “skin in the game”. By this, we typically mean that they should have some vested interest in the form of stock ownership. However, some recent circumstances where we have been involved present an opportunity to challenge that way of thinking. Certainly, some or all directors should generally have stock ownership, but we are seeing some cases where, because the board is aging and because they are fairly significant stockholders, they are unwilling to take the entrepreneurial and strategic steps necessary to modernize their organization, move it forward and face the coming challenges. That is primarily because they are comfortable with the amount of growth (no matter how small it is), they are used to the steady dividend and, at this point in the organizations’ and their personal life cycles, they don’t want to do anything too risky. We are seeing some of those banks fail to take advantage of growth opportunities where they exist.

So, ask yourself, could there be a benefit to having directors on your board who are not stockholders or at least not major stockholders? Would they think a little more entrepreneurial? Would they be more likely to take calculated risks? Even if your directors all own stock, which is very typical, perhaps as Chairmen, you should begin leading discussions on key areas by
asking “What would you do or how would you decide this question if you didn’t own any stock at all”? A little outside the box thinking and looking at things from a different perspective may help open up new avenues for new initiatives.

**How Much Capital is Appropriate?**

This is another question that came out of our Chairman’s Forum conference in Naples in January. The general question was how much capital is the right amount of capital to have. Of course, there is no one size fits all answer to this and our general comment is that you need enough to keep the regulators happy based on your organization’s risk profile, but not so much that it is an impediment to stockholder value. These days, most community banks are finding that that range is probably somewhere in the 8% to 11% range.

Normally, the Chairman and the board are attuned to the ideas of making sure they have enough capital. But occasionally the Chairman may be required to challenge the board on whether or not the organization has “excess” capital. Certainly, we want enough capital to support safety and soundness and to be ready for any loan losses, but does having a tier 1 leverage ratio in the teens return true value to stockholders? If you are going to sell the bank, would a buyer pay you a premium for that excess capital? The answer to those questions is that neither one is generally true. So, consider what level of capital is appropriate for your organization, but avoid the temptation of stockpiling capital just to see how high you can stack it. Continue to increase and enhance stockholder value by deploying capital to smart uses.
Meeting Adjourned

The cold is still lingering in most of the country, but we hope in our home state of Tennessee we can at least provide a little warmth for those of you who will be attending the ICBA’s Annual Convention in Nashville. Please take the opportunity to come speak to us individually and attend our sessions. We would love to speak with you and to hear your comments on our newsletters. Also, be on the lookout for next month’s edition where we hope to be able to make some exciting announcements about future Chairman’s Forum conferences.

Until next time,

Jeffrey C. Gerrish  Philip K. Smith  Greyson E. Tuck

HOW TO CONTACT US:
If you have questions or comments about the newsletter or would like to ask a follow-up question, please email Philip Smith at psmith@gerrish.com.
GERRISH SMITH TUCK
NEWSLETTER

PLEASE SEND YOUR EMAIL ADDRESS TO:
vwilt@gerrish.com

If you would like to be added to our database of clients and friends who receive this publication free of charge, please contact us or leave your business card with the speaker.
Community Bank Acquisition Due Diligence

The community bank mergers and acquisitions market is currently very active. While this has been the case for the past few years, the industry as a whole is in a much different place today than it was five years ago. During and coming out of the recession, much of the industry's consolidation was born out of necessity—i.e., survival—and many of the "traditional" reasons for mergers and acquisitions, such as lack of succession or a price too good to refuse, were not predominant factors driving deals. In today's environment, an increasing number of community banks that are looking to get into the game are there, at least in general, because they believe an acquisition transaction is a good strategic move for the long term benefit of the shareholders. This shift in motivation has not only impacted the tenor of the negotiation process, but it has had a positive impact on overall preparedness for a transaction, particularly as it relates to due diligence.

The due diligence component of an acquisition is an irreplaceable factor in the overall success of the transaction. From the buyer's perspective, conducting a proper due diligence review will, at a minimum, either confirm the legitimacy of a safe and sound target or allow a buyer to avoid what would otherwise be a very unwelcome surprise after closing. When a target limps out of the recession and comes to the negotiation table bleeding, it is clear—at least it should be clear—to the acquirer that there is a problem in need of addressing. For the most part, though, today's banks are healthier, more profitable, and more compliant. This only underscores the importance of taking time to confirm the shape of the target.

From the seller's perspective, if the transaction is funded entirely with cash, the seller's due diligence is limited essentially to whether the buyer can receive regulatory approval of the acquisition and fund the cash consideration at closing. If the seller is accepting the buyer's stock as all or a portion of the total consideration, however, the seller is practically in the same position as the buyer. In that situation, the seller is, in essence, using their company to acquire stock in the purchaser, so it is prudent for the seller to complete a thorough due diligence review of the buyer prior to making the investment.

In light of what is at stake, the due diligence review should always take place prior to entering into the acquisition agreement. Although there are often "outs" that allow either party to walk away from a transaction after the agreement is signed, there are often monetary penalties imposed on the party that walks away, not to mention the wasted time and emotional energy. It is in everyone's best interest, then, to coordinate and prepare for each aspect of due diligence as soon as possible. In this respect, there are essentially three major components of a thorough due diligence review that need to be taken into account by the buyer, each with multiple "sub-components" of importance. (As noted,
due diligence is of significance to sellers as well, but this article will focus on the perspective of the buyer.)

I. Asset Quality Review

The first major component, and the one given the most focus in recent memory, is asset quality. The asset quality review is similar to a safety and soundness examination in that the acquirer should thoroughly review the quality of each of the target's primary classes of assets. For most community bank acquirers, the majority of effort will focus on the target's loan portfolio, credit culture, and investment securities portfolio. Loans and investment securities, of course, typically represent the vast majority of assets in most community banks, and our firm has seen too many deals fall apart because of differing credit cultures. However, the value and investment quality of the other assets should not be taken for granted, and the scope of review should depend on the makeup of the specific target.

To properly complete the asset quality review, an acquirer needs to involve the right people. For example, to thoroughly review the target's loan files, the acquirer should, at a minimum, use its loan officers, outside professional assistance, or both. Due to confidentiality and the sheer volume of documents, this review is typically done on-site, which requires the buyer to ensure all of the necessary individuals are present and have access to the necessary documents. While this requires an increased level of coordination, having the right individuals involved affords the buyer three benefits:

1. The acquirer gains a first-hand understanding of the target's credit culture, underwriting standards, documentation standards, and similar aspects of credit administration;

2. The acquiring loan officers familiarize themselves with the target's credits and fully understand the combined credit portfolio following the acquisition; and

3. Specific credit or documentation deficiencies are noted, considered, and possibly resolved prior to entering into the definitive agreement.

The acquirer's review of the target's investment portfolio is similar to its loan review. The acquirer identifies the appropriate individuals, and those individuals review the target's investment portfolio so the acquirer thoroughly understands the types of investments held in the portfolio and the associated risks, particularly interest rate and credit risk. The most notable difference is that the investment portfolio review is often much easier to conduct off-site. An off-site review may also be appropriate for other sub-categories of assets, but the overall process should be similar in form and function to the loan portfolio review.

Which individuals are appropriate for a specific area of review is a matter of discretion, but it is certainly better to over prepare than under prepare. As previously noted, some asset quality reviews are completed solely by the acquirer's loan officers. Others involve outside professionals, such as consultants or external loan review providers. The involvement of outsiders will depend on the size of the loan portfolio, the cost, and other similar factors, which means it is a best practice to begin communicating and coordinating the due diligence process as soon as possible.

II. Regulatory Compliance Review

The second major component of an appropriate due diligence review is a thorough review of the target's regulatory compliance. It should be no surprise that compliance has been a "hot button" issue since the recession. A compliance violation can result in a quick and heavy hammer on the institution, and resolving a compliance issue can be a long road. Under no
circumstances does an acquirer want to purchase an unidentified compliance nightmare, so the importance of this review cannot be overstated.

In regard to personnel, a compliance review is most often completed by the acquirer's compliance officer or internal or external auditor. The form or process of this review is similar to an asset quality review, though it is most often conducted off-site, at least initially. It is typically only if the off-site review of policies, SARs, board minutes, and the like reveal any issues or matters of question that a team may be sent on-site for a more detailed review. However, in most situations, requesting provision of additional documentation or information is sufficient. Again, what is appropriate should be determined in light of the specific target and specific matter at hand.

It should go without saying that this portion of the due diligence review is intended to identify any and all areas of deficiency or risk related to regulatory compliance. This, of course, results in an extensive list of areas to be reviewed, so prioritization based on the environment and specific target is critical. The "hot topics" in today's environment relate to Unfair, Deceptive or Abusive Acts or Practices, BSA/AML, Fair Lending, Truth in Lending, RESPA, and similar regulations. The important aspect of a regulatory compliance review is to identify areas of potential liability in the target's operations, any prior regulatory criticisms, and any material weaknesses that must be corrected in order to ensure the acquirer does not have any surprise regulatory compliance issues following closing.

III. Legal Review

The third important component of a thorough due diligence review is the legal review, which analyzes the legal risks associated with the target's governance and operations. Typically, the legal due diligence is completed by the acquirer's outside or in-house counsel and is intended to fully understand the target's corporate structure, potential corporate liabilities, and corporate operating policies and procedures. This is generally accomplished by interviewing the target's senior executive officers, outside counsel, and external auditors and performing a detailed review of corporate documentation. Examples of documents that should be reviewed in this area are the target's governing documents, such as the Articles of Incorporation and Bylaws, Board Minutes for the prior two years, shareholder proxy materials and meeting minutes for the past two years, statements from counsel regarding any recently completed, pending, or forthcoming litigation, and any documents associated with recent merger transactions or stock offerings.

Of the three areas discussed in this article, the legal review is the most ambiguous on the front end. Whereas asset quality and compliance are issues commonly critiqued in the banking world, it is much less common for an outside party to conduct a detailed review of the target's governing documents and shareholder materials. Often, the potential issues that arise in this review are ones that the buyer may not know to look for because they frankly have very little to do with the target's operations. That does not, however, mitigate their significance.

As an example, our firm recently conducted a due diligence review in which the number of target shares issued and outstanding exceeded the number of shares issued and outstanding by Philip Smith and Greyson Tuck of Gerrish Smith Tuck, in coordination with the Independent Community Bankers of America, are producing a DVD series for director training that discusses relevant issues such as strategic planning, corporate governance, and compliance. For additional information about the forthcoming series, please contact Carolyn Martin at cmartin@gerrish.com.
authorized by the target's governing documents. While we were able to resolve the issue with the appropriate board resolutions and amendments, this could have been a significant problem if it had gone unnoticed. For one, the target attested to the validity of all issued and outstanding shares as a representation and warranty in the definitive agreement. Failure to remedy the error would have, at a minimum, resulted in a technical breach of the representation and warranty, and it could have ultimately invalidated the transaction on the basis that shareholder approval was ineffective since some of the shares were not validly issued.

An appropriate due diligence review includes an asset quality, regulatory compliance, and legal review. If your community bank finds itself in a situation where due diligence of another party is appropriate, be certain not to omit any of these important components or fail to have the appropriate individuals participate in the review. Doing so significantly increases the chances of unwelcome surprises at some point in the future.

Our firm has an extensive due diligence checklist that serves as a guide to the various aspects of review in an appropriate due diligence process. Please feel free to contact us if you would like a copy of this due diligence checklist or would otherwise like further information regarding the due diligence process.

Compensation Strategies for the Board and Management

Compensation planning for management and other employees is best described as a high-wire balancing act. Directors' obligations to enhance shareholder value, maximize profits, minimize expenses, and manage risks may often appear to be in conflict with establishing fair compensation that motivates the highest level of performance. Management is in a fishbowl in establishing compensation and benefits. Transparency has to be balanced with strategy.

Although setting compensation ranges for various levels of rank and file employees is essentially an exercise in information gathering and establishing job titles and job descriptions, determining the appropriate level of compensation often involves performance-related factors that extend beyond titles and responsibilities. As part of overall compensation, some, but not all, financial institutions have written bonus plans that establish incentives for all employees, including executives, in hopes of improving performance.

If properly balanced, the compensation plan will include short-term, mid-term, and long-term incentives. (Incentive ranges can be defined in various ways, but a benefit that can be achieved and received in a three- to five-year period is a good mid-range term.) Generally, mid-range and long-term incentives can be divided into two categories: equity-based compensation and non-equity based compensation.

Equity-based compensation includes stock bonuses, stock options, employee stock purchase plans, and restricted stock, all of which involve the potential issuance of stock, as well as stock appreciation rights plans and phantom stock plans, which are based on the stock's fair market value growth and usually do not involve the actual issuance of stock. The most popular...
types of incentive plans are the Incentive Stock Option Plans, Employee Stock Purchase Plans, and Employee Stock Ownership Plans ("ESOPs"). Each of these plans is authorized under the Internal Revenue Code and can provide substantial tax benefits.

Of all incentive plans that provide for the issuance or purchase of employer stock, however, one of the most motivating and most frequently used by financial institutions is the ESOP. ESOPs are qualified retirement plans that are primarily invested in employer stock and may provide a benefit that is greater than is available under other retirement plans. Many institutions also form ESOP hybrids, such as the 401(k) ESOP ("KSOP") and the Subchapter S ESOP or KSOP, as a means of raising bank capital. KSOPs allow 401(k) employer contributions and employee deferrals to be used to purchase employer stock, and the ESOP or KSOP that holds Subchapter S stock has the unique advantage of being the only qualified retirement plan authorized as a Subchapter S shareholder that is not required to pay income tax on its share of annual income. Because of this, the employee plan accounts can accumulate a sizable amount of Subchapter S distributions not available to other plans.

Each of the above mentioned equity plans usually requires the issuance of additional stock, which will result in dilution of stock ownership and could result in dilution of book value depending on the price at which the stock is issued. Perceived ownership dilution can be overcome if the proceeds from the issuance of new stock are productive. If the employer wishes to avoid ownership dilution altogether, the stock appreciation plan and the phantom stock plan offer alternatives that are measured by the growth of stock value rather than requiring the actual issuance of stock.

The other general type of mid-range and long-term incentives is a non-equity incentive plan, which includes deferred compensation plans, supplemental executive retirement plans, or other plans designed to enhance retirement benefits, in addition to Social Security and retirement plan payments. These plans provide for potential annual increases in account balances and can be easily linked to vesting schedules and performance goals. Additionally, these plans usually provide benefits in case of disability, death, and change in control, as well as retirement. As statistics are becoming available, Americans are not adequately providing for their retirement. For this reason, employees of all ages, but especially employees within 10 to 20 years of retirement, are becoming more and more interested in these long-range plans.

When structuring any type of incentive bonus plan, the
Compensation Committee and the Board should be familiar with the bank regulatory agencies' Joint Guidance on Sound Incentive Compensation Policies, which instructs that incentive compensation should not be based on financial benchmarks alone because this encourages unnecessary risk-taking. Rather, incentive bonuses should be based on other performance factors, such as obtaining new business, specific expansion of banking products and services, customer relations, customer retention, and personal goals, in addition to financial performance.

A final part of compensation packages is a life insurance plan, which is usually a part of a group health insurance plan. For executives, Split Dollar Insurance Plans are often used to provide insurance proceeds to beneficiaries, as well as repaying the employer for premiums. Bank-Owned Life Insurance (“BOLI”) is also used by a majority of banks to repay the banks for all types of benefit payments, as well as being a balance sheet asset, offsetting accruing liability for benefit plans.

When assessing the appropriate compensation package for your organization, please be aware that most benefit plans cannot be considered without reviewing whether the plan must comply with Internal Revenue Code §409A requirements, which are presumed to be applicable unless there is a specific exemption in the legislation. For this reason, among others, financial institutions should always consult with accountants, attorneys, and appraisers to make decisions and implement strategic compensation planning. This planning will provide excellent payback for shareholders, directors and executives, and other employees, so it is imperative that all of the details are addressed appropriately on the front-end.

Our firms have conducted numerous compensation and benefit studies, structured compensation packages, and established ESOPs, KSOPs, and other compensation plans for banks of all sizes across the nation. We would be happy to assist your organization also. Please let us know how we can help.

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**THE CHAIRMAN’S FORUM NEWSLETTER AND GERRISH’S MUSINGS**

The Chairman’s Forum Newsletter and Gerrish’s Musings are complimentary email newsletters prepared and distributed by Gerrish Smith Tuck. The Chairman’s Forum Newsletter, distributed monthly, is exclusively designed for community bank Chairmen, Vice Chairmen, and senior directors. Gerrish’s Musings, distributed bi-monthly, contains practical commentary for community bank directors and officers based on Jeff Gerrish’s, Philip Smith’s, and Greyson Tuck’s experiences with community banks around the nation.

If you would like to receive either of these complimentary newsletters, please contact Valerie Wilt at (901) 684-2310 or vwilt@gerrish.com.

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**GERRISH SMITH TUCK AFFILIATED RESOURCES**

Over the last 30 plus years of exclusively helping community banks across the nation, we have developed relationships with various service providers who we believe provide the best services in their particular niche. This includes bank branch location specialists, IPO managers, securities transfer agents, loan review specialists, auditors, technology specialists, executive placement firms, and the like.

If you need any of these services, or others, and are not sure who to call, please let me know and we will provide some recommendations.

Jeff Gerrish
gerrish@gerrish.com
Gerrish Smith Tuck has created numerous Memos to Clients and Friends on various topics (available free of charge). Set forth below are sample Memos to Clients and Friends:

**Acquisitions**
- Responding to Unsolicited Offers
- Treatment of Transaction Expenses

**Employee Benefit Issues**
- Incentive Compensation Plans
- Taking a Fresh Look at ESOPs
- Key Employment Contract Provisions Utilized by Community Banks

**Raising and Allocating Capital**
- Raising Capital Without Registering with the SEC
- Stock Repurchase Plans
- The Continuing Benefits of a Community Bank Holding Company

**Regulatory**
- Qualified Mortgage Rule
- Civil Money Penalty Process
- Community Bank Leverage Ratio Capital Plan

**Subchapter S**
- Subchapter S Taxation Under the 2017 Tax Bill
- Use of S Corporations by Financial Institutions
- Eligible Subchapter S Shareholders

**Miscellaneous**
- Loan Production Offices
- Efficient Conduct of Board Meetings
- Enterprise Risk Management
- Legal Entity Identifiers
- Types of Incentive Compensation Plans

Gerrish Smith Tuck, in connection with various speaking engagements around the country, has created high quality “handout” booklets. The publications below are available for a nominal charge:

**Asking the Right M&A Questions**
**Looking Beyond the Past: A New Direction for Community Banks**
**Director Duties: Creating Value for the Organization**
**Corporate Governance**
**Directors’ Responsibilities in Mergers & Acquisitions: Responding to the Unsolicited Offer**
**How to Improve the Value of Your Bank**
**What’s Next – Back to Basics and Back to the Future**
**Enhancing Shareholder Value – With or Without Sale**
**Mastering Merger & Acquisitions for Today’s Community Bank**
**Reducing Costs and Promoting Growth through ESOPs**
**How to Improve the Value of Your Bank**
**Is a Holding Company in Your Bank’s Future?**
**New Truths About Directors, Shareholders and Regulators (Including Compliance)**
**The Community Bank Survival Guide: How to Survive and Thrive**
**The Pros and Cons of Converting to Subchapter S**
**Strategic Planning: Don’t Make Me Do It!**
**Understanding the Director’s Role**

If you are interested in any of these memos or publications, please call or email Valerie Wilt at (901) 684-2310 or vwilt@gerrish.com.

Please visit our website at: www.gerrish.com
Areas of Service

Gerrish Smith Tuck, LLC, Consultants and Gerrish Smith Tuck, PC, Attorneys are committed to the delivery of the highest quality, timely and most effective consulting and legal services exclusively to community financial institutions in the following areas:

**FINANCIAL ADVISORY/CONSULTING SERVICES**

- Acquisition Pricing and Financial Analysis
- Fairness Opinions
- Capital Planning
- Subchapter S Financial Modeling
- Directors’ Liability
- Mergers and Acquisitions Transaction Structure
- Executive Compensation
- Employee Benefits
- Bank/Stock Valuation Analysis
- Estate Planning
- Strategic Planning
- New Bank Formations
- Tax Planning
- Going Private
- Stock Repurchase Analysis
- Branch Profitability Analysis
- Expert Witness

**LEGAL SERVICES**

- Mergers and Acquisitions
- ESOPs and KSOPs
- Dealing with the Regulators
- Going Private
- Director and Officer Liability
- Private Securities Placements
- Fair Lending
- Subchapter S Formations
- Executive Compensation
- Holding Company Formations
- Federal and State Taxation
- New Bank Formations
- Corporate Contract Review
- General Corporate & Securities
- Regulatory Enforcement Actions
- Probate
- Employee Benefits
- Estate Planning for Executives

Custom Director Programs & Presentations

In addition to facilitating numerous strategic planning retreats and proprietary director and officer training sessions, Gerrish Smith Tuck also has recently provided speakers for the following trade associations on a wide variety of topics:

- Alabama Bankers Association
- American Bankers Association
- Arkansas Community Bankers
- Arizona Bankers Association
- Bank Holding Company Association
- California Bankers Association
- Community Bankers Association of Georgia
- Community Bankers Association of Illinois
- Community Bankers of Iowa
- Community Bankers of West Virginia
- Independent Bankers of Colorado
- Independent Community Bankers of America
- Independent Community Banks of North Dakota
- Independent Community Banks of South Dakota
- Indiana Bankers Association
- Iowa Independent Bankers
- Maine Bankers Association
- Michigan Association of Community Bankers
- Montana Independent Bankers
- Nebraska Independent Community Bankers
- Pennsylvania Association of Community Bankers
- Pennsylvania Bankers Association
- South Carolina Bankers Directors College
- Tennessee Bankers Association
- Virginia Association of Community Banks
- Washington Bankers Association
- Western Bankers Association

Please email us or visit our website at www.gerrish.com for a complete listing of upcoming conferences and seminars at which we will be speaking. Gerrish Smith Tuck is also available to facilitate strategic planning retreats and proprietary training designed for your Board of Directors.
Recent Transactions

Peoples Bancorp
Bank Holding Company for
PeoplesBank
Rock Valley, Iowa
has acquired
Pinnacle Bancorp Inc.
Bank Holding Company for
PinnacleBank
Twin Bridges, Montana
Gerrish Smith Tuck, Consultants and Attorneys, served as financial and legal advisors to Peoples Bancorp and Peoples Bank

Eagle Bancorp Montana, Inc.
Bank Holding Company for
OpportunityBank
Helena, Montana
has acquired
TwinCo, Inc.
Bank Holding Company for
Ruby Valley Bank
Twin Bridges, Montana
Gerrish Smith Tuck, Consultants and Attorneys, served as financial and legal advisors to TwinCo, Inc. and Ruby Valley Bank

First Holding Company of Cavalier, Inc.
Bank Holding Company for
UnitedValleyBank
Cavalier, North Dakota
has acquired
Mahmomen Bancshares, Inc.
Bank Holding Company for
FirstNationalBank
Mahmomen, Minnesota
Gerrish Smith Tuck, Consultants and Attorneys, served as financial and legal advisors to Mahmomen Bancshares, Inc. and First National Bank of Mahmomen.

To discuss your institution’s bank acquisition transaction opportunities, please contact Jeff Gerrish at jgerrish@gerrish.com, Philip Smith at psmith@gerrish.com, or Greyson Tuck at gtuck@gerrish.com.
To discuss your institution’s bank acquisition transaction opportunities, please contact Jeff Gerrish at jgerrish@gerrish.com, Philip Smith at psmith@gerrish.com, or Greyson Tuck at gtuck@gerrish.com.
Recent Transactions

First State Bancshares of Dekalb County, Inc.
Bank Holding Company for

First Rainsville Bancshares, Inc.
Bank Holding Company for

Docking Bancshares, Inc.
Bank Holding Company for

Relianz Bancshares, Inc.
Bank Holding Company for

Community Financial Corp.
Bank Holding Company for

Olympic Bancorp, Inc.
Bank Holding Company for

To discuss your institution's bank acquisition transaction opportunities, please contact Jeff Gerrish at jgerrish@gerrish.com, Philip Smith at psmith@gerrish.com, or Greyson Tuck at gtuck@gerrish.com.
Recent Transactions

<table>
<thead>
<tr>
<th>Bank Holding Company</th>
<th>Bank Holding Company</th>
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<tr>
<td>Washington Savings Bank</td>
<td>Tioga Bank Holding Company</td>
<td>Sargent Bankshares, Inc.</td>
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<td>Effingham, Illinois</td>
<td>Tioga, North Dakota</td>
<td>Forman, North Dakota</td>
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<tr>
<td>First Federal MHC</td>
<td>Tioga Bank Holding Company</td>
<td>FNB Bankshares, Inc.</td>
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<td>Mutual Holding Company for</td>
<td>Tioga, North Dakota</td>
<td>Bank Holding Company for</td>
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<td>Mattoon, Illinois</td>
<td>Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Tioga Bank Holding Company and The Bank of Tioga.</td>
<td>Milnor, North Dakota</td>
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<tr>
<td>Security Financial Services Corporation</td>
<td>Bloomer Bancshares, Inc.</td>
<td>WSFS Financial Corporation</td>
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<td>Bank Holding Company for</td>
<td>Bloomer, Wisconsin</td>
<td>Bank Holding Company for</td>
</tr>
<tr>
<td>Fairfield, Iowa</td>
<td>Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Farmers Savings Bank.</td>
<td>Wilmington, Delaware</td>
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<td>has acquired</td>
<td>Bloomer, Wisconsin</td>
<td>has acquired</td>
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<tr>
<td>Keota, Iowa</td>
<td>Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Bloomer Bancshares, Inc. and Peoples State Bank of Bloomer.</td>
<td>First Wyoming Financial Corporation</td>
</tr>
<tr>
<td>Security Financial Services Corporation</td>
<td>First Wyoming Financial Corporation</td>
<td>Bank Holding Company for</td>
</tr>
<tr>
<td>Bank Holding Company for</td>
<td>The First National Bank of Wyoming</td>
<td>Bank Holding Company for</td>
</tr>
<tr>
<td>Durand, Wisconsin</td>
<td>Wyoming, Delaware</td>
<td>Bank Holding Company for</td>
</tr>
<tr>
<td>has acquired</td>
<td>Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to First Wyoming Financial Corporation and The First National Bank of Wyoming.</td>
<td>First Wyoming Financial Corporation</td>
</tr>
</tbody>
</table>

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Recent Transactions

Abby Bancorp, Inc.
Bank Holding Company for
Abbotsford, Wisconsin

has acquired

Fidelity Bancorp, Inc.
Bank Holding Company for
Medford, Wisconsin

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to AbbyBank.

Blackhawk Bancorporation, Inc.
Bank Holding Company for
Milan, Illinois

has acquired

First Port Byron Bancorp, Inc.
Bank Holding Company for
Port Byron, Illinois

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Port Byron Bancorp, Inc. and Port Byron State Bank.

TCB Mutual Holding Company
Mutual Holding Company for
Tomahawk, Wisconsin

has acquired

Merrill, Wisconsin

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to TCB Mutual Holding Company and Tomahawk Community Bank.

Sullivan BancShares, Inc.
Bank Holding Company for
Sullivan, Illinois

has acquired

Moultrie Bancorp, Inc.
Bank Holding Company for
Lovington, Illinois


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Gerrish Smith Tuck

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The Client’s Needs Come First