GERRISH'S MUSINGS

Jeffrey C. Gerrish
Philip K. Smith
Greyson E. Tuck
Gerrish Smith Tuck
Attorneys/Consultants
700 Colonial Road, Suite 200, Memphis, TN 38117
♦ Phone: (901) 767-0900 ♦ Fax: (901) 684-2339 ♦
♦ Email: jgerrish@gerrish.com ♦ psmith@gerrish.com ♦ gtuck@gerrish.com ♦
Website: www.gerrish.com

June 28, 2019, Volume 395

Dear Subscriber:

Greetings from Missouri, Illinois, Tennessee, Kansas, Ohio, and Minnesota!

STOCK OPTIONS

Over the past couple weeks we have run into a number of different issues relative to Stock Options in acquisition transactions. The question that typically comes to the surface is how the Options are treated in an acquisition transaction. The short (and lawyerly) answer is that it depends.

There are two types of Stock Options: Incentive Stock Options and Non-Qualified Stock Options. They are the same in concept - they both allow the beneficiary of the Options to purchase shares at a stated price. The difference lies in the tax treatment. Incentive Stock Options are provided to employees and provide generally more advantageous tax treatment at the time of exercise than do Non-Qualified Stock Options.

The general question that comes up in acquisition transactions is what happens to the Option in the transaction. There are really two ways that they are treated. The first is a "cashless exercise." This is essentially a payment to the Option holder in an amount equal to the difference of the per share merger consideration in the transaction and the Option strike price. In other words, the Option holder receives an amount of cash equal to the amount the stock that is "in the money." The second alternative is to require exercise of the Option, followed by a cash-out of the Option at the time of the merger. This is a little less advantageous to the Option holder because it requires them to come out of pocket with the cash necessary to exercise the Option, if only for a little while.

If you are drafting a Stock Option Plan, our recommendation is to include provisions that allow for a cashless exercise. Even if those provisions are not in the Stock Option Plan, the Option recipient will still realize the benefit of the Option through the transaction.

UNUSUAL MARKETING

Marketing related issues always seem to be on the agenda for long-term planning sessions, particularly when there are strategic issues, such as changing the name of the bank, relocation of the world headquarters, or changing the tag line or "school colors." During a recent planning session, we were having discussions with a rural community bank about what their marketing efforts were. As with most community banks, they are in the process strategically of moving from purely traditional methods (i.e., radio, TV, newspaper, billboards, and the like) to much more digital-focused efforts. They did tell us that one of the biggest bangs they got for the buck, however, was on radio by sponsoring the reading of the obituaries in their local town. They apparently got significant positive feedback from their sponsorship of the obituary reading. We thought that was a little unusual but also fits in the category of "whatever works."

MARKETING PART 2

We shocked a potential client the other day when we were visiting and gave our business card with our cell phone number on it. We at Gerrish Smith Tuck have always prided ourselves on being available 24/7 for our clients. This means cell phone access and email access, anywhere, anytime. The only exception, of course, is when we are "up in the air" or on the phone. This particular banker had a little different philosophy on giving his cell phone number out to customers. He indicated that "the only bank customers who have my cell phone are those who borrow more than a million dollars from the bank." We thought that was a little bit unusual but probably also made some sense. Just a thought.

SUBORDINATED DEBENTURES

We recently received an email from a client that passed along the terms of a Subordinated Debenture for a rather large bank holding company. This particular subordinated note issuance was close to $100 million and had a less than 5% interest rate. Our client basically said if they could get the same terms of this type of debt they would be very interested. Our response was that although we agreed, based on our recent experience, we did not believe debt terms at this level could be replicated in a traditional community bank setting.

The subordinated debt issuances we have participated in over the last year or so are not anywhere near a 5% interest rate. They are closer to 7% to 8%. That is still not a bad rate for ten-year interest-only money, but it is not quite as good as some of the mega bank issuers are getting.

Also keep in mind that most community banks under $3 billion rarely have a need for subordinated debt at their holding company. Subordinated debt at the holding company counts as secondary capital, but since the holding company is not tested on a consolidated basis for capital (either primary or secondary), there is no need for a capital instrument at the holding company. The other drawback with subordinated debt is that it is more expensive than straight debt, which can generally be obtained at prime or so, and your community bank gets all the money "at once." Our question when we are typically approached by a client about issuing subordinated debt is, "why are you doing this, and what are you going to do with the money?"

TRANSACTION EXCLUSIVITY

We are currently running a marketing process for a smaller community bank. One of the potential acquirers recently called to ask about exclusivity. Their question was essentially how you buy the right to exclusivity in this type of auction process. We told him we thought the answer was pretty simple: a preemptive offer - i.e., cash, and lots of it.

We told the potential acquirer that exclusivity in this type of transaction was completely a board decision. Our comment was that the offer would have to be enough to entice the board that the benefits of providing exclusivity were worth the risk. We indicated this basically boiled down to the offered consideration (i.e., the amount of cash), the likelihood of the acquirer receiving regulatory approval and closing the transaction, and the risks associated with telling other potential acquirers the deal was off the table. We also told the potential acquirer that we would also expect some type of down payment (i.e., earnest money) at the time of signing the Indication of Interest, which would be applied to the purchase price if the deal ultimately closed or kept by the seller if the deal fell apart. In essence, they could purchase an option.

The potential acquirer said they were going to mull it over to see if they wanted to make what they considered a preemptive bid. It would be great for our client if they decide to do so.

CONFIDENTIALITY AGREEMENTS

For the most part, Confidentiality Agreements are pretty standard. They all typically include the same common provisions. However, like any other contract, they are subject to negotiation. We were reminded of this recently when providing a Confidentiality Agreement to a potential acquirer for a possible acquisition transaction.

The Confidentiality Agreement we use for acquisition transactions includes a restriction on the prospective purchaser soliciting the customers of the prospective seller. This is very logical because it protects against a prospective purchaser coming in and using the information they may gain through the evaluation process to the detriment of the prospective seller. Most of the time prospective purchasers do not have any problem with this. Recently, one prospective purchaser who is very growth oriented took slight exception to this, stating that they are targeting lots of folks in the area and do not want to run afoul of the issue. The prospective purchaser basically asked us to waive this prohibition. We were not willing to do so. We think if we are going to go out and open the books to a prospective purchaser, then it is appropriate to ask them not to use that information in going after the bank's customers.

CAPITAL

We have been with a couple of different banks over the last couple of weeks that are on opposite ends of the capital spectrum. Both are about the same size. One of the institutions had a capital ratio well into the teens. The other institution had a capital ratio in single digits. The bank with the high capital ratio of course determined that one of their capital allocation strategies would be to be proactive on acquisitions. The low capital ratio bank could not afford the same strategy. Theirs was one of organic growth. As many of you know, long-term planning basically involves the allocation of human and financial resources. If you have and can get financial resources, the alternatives available to your community bank from a strategic standpoint are significant. Keep in mind, that is not only capital you have on balance sheet, but capital you can get through holding company debt or equity offerings.

REGULATORY ISSUES

We have seen the regulatory landscape, for the most part, improve somewhat over the last couple years. In our opinion, this is due in large part to the fact that asset quality is good, the economy is humming, etc. Notwithstanding that, we do have isolated pockets of regulatory pressure on particular clients. Most of these are much more of a "one off" problem situation, either dealing with on balance sheet liquidity, asset quality, or compliance.

Keep in mind when dealing with the regulators, the bank does have significant rights. Our firm has never been afraid to push back against the regulators on behalf of our clients when we felt the regulators were acting inappropriately, taking the wrong legal position, or simply being bullies, or we thought our client needed the time to solve the problem that a pushback against the regulators can buy.

Next time you get regulatory pressure, don't forget you do have rights, even though they will somewhat insist that you don't.

CONCLUSION

We hope everyone has a great and relaxing 4th of July holiday. We hope each of you gets to spend time with family and friends. Be safe, particularly with little kids around fireworks.

Also, although we are in the warm summer months, when you think about next January and how cold it is going to be where you are, think about the Chairman's Forum, which is designed for Chairmen, Vice Chairmen, CEOs, and outside directors, and will be held January 16-17, 2020 at the Ritz-Carlton in Naples, Florida. Registration information will be available soon, so be sure and save the date!

Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*