GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Minnesota, Wisconsin, Illinois, Ohio, Florida, Tennessee, and Mississippi!

DIRECTOR SUCCESSION

As the community bank director population ages, many boards are facing the issue of director succession. Historically, director succession for community banks has been a fairly informal process. The Chairman, the CEO, or both found good businesspeople in the community (mostly men), decided whether they could work with them on a board, and simply invited them to come onboard. In the current day and time with reputational issues and financial issues at risk, that informal process is certainly not a best practice. A best practice for bringing on board members is to vet them the same way you would vet a key senior executive officer for your bank. This would involve background checks, reputational analysis, and all other matters similar to adding a key executive to the team. Although for some community banks this may seem to be "overkill," certainly for most it should be appropriate. This is particularly true when we still exhibit in our community banks directorship for life. If you are going to bring somebody on that board for life or until mandatory retirement, then shouldn't we be pretty sure of what they are bringing to the table and what baggage, if any, they might have? Think about it.

SUBCHAPTER S

Although Subchapter S has been available for community banks since the late 1990's, over the last couple of months we have had occasion to visit with community banks that have not elected

Subchapter S and are currently contemplating whether it is the appropriate way to go for their respective banks in view of the potential future need to provide a stock instrument that is attractive enough for the next generation to continue to hold.

Keep in mind, in closely held banks, whether family or not, if the stock that gets transferred to the next generation has little cash flow, little appreciation, and no benefit, then the day the funeral is over will be the day that generation approaches the bank holding company looking for a buyer.

As we have often put in *Musings*, for virtually every community bank in the country, Subchapter S still is a beneficial tax structure. We are going to run the numbers on these two or three institutions we have been visiting with lately and see whether it works for their specific bank. If you are not a Subchapter S, consider it as a viable alternative.

THE HOLDING COMPANY INTEREST

The community bank holding company, for most community banks, is a shell corporation. It is formed for multiple reasons, including allowing the holding company to generate cash through borrowings and drop that cash down into the bank as a contribution to capital. If your community bank holding company on a consolidated basis is less than $3 billion, you can pretty much utilize leverage all day long as a means to supply capital to the subsidiary bank. The second major benefit for a bank holding company is to be able to redeem shares of shareholders desiring to sell. One of the tenets of enhancing shareholder value is providing community bank holding company shareholders with the ability to sell a share of stock, or lots of shares of stock, at a fair price at the time they want to.

For many of us, particularly with the "graying" of our shareholder base, the community bank holding company will be of critical importance with respect to estate issues for our major shareholders. For that reason, the holding company needs to at least be knowledgeable of, if not directly involved in, the major shareholders' estate plans. If a major shareholder's estate plan involves the likely significant payment of taxes - for example, if the shareholder's primary asset is the bank holding company - then the holding company needs to assess its financial ability to redeem shares to cover those tax payments. In other words, the board needs to be aware of the issues so it can keep powder dry if that is appropriate.

While some of us try and ignore estate issues on the theory that we are going to live forever, it is probably not the wisest choice.

M&A ACTIVITY

We had the opportunity the other day to visit with a good long-time client whose bank is in the $1 billion plus range. His comment was that the "M&A market has become extraordinarily active" for his bank. They have been approached by numerous banks in the $200 million to $300 million range looking for a place to land. The interesting thing about these transactions is, unlike a normal situation - where a community bank is selling to a non-public, non-traded, illiquid, larger holding company, and the transaction is for cash - these transactions are likely to be part-stock/part-cash. It says a lot about the buyer's standing, reputation, and financial position for a community bank seller to sell out and receive part-stock. Most community bank sellers historically have not been willing to trade an illiquid stock they control (i.e., their own bank or holding company) for an illiquid stock they do not control (i.e., a buyer). We will see what happens.

DIRECTOR ENGAGEMENT

We have had numerous contacts, emails, and calls over the last few months from a variety of community bank Chief Executive Officers complaining about the lack of engagement on the part of their directors. One recounted how his directors simply show up at meetings, bless everything he proposes, have their coffee and doughnuts, pick up their check, and leave. His comment to us involved helping him get his directors more engaged in the process. Our comment to this particular CEO was, "be careful what you wish for." It is good to have an engaged board; it is bad to have a micromanaging board. Our theory has always been "noses in, fingers out" as the role of the board of directors. The goal is to get the noses in by having them engaged in what is going on at the bank, but not involved in the micromanagement operational issues that belong to the CEO and his or her team. A bit of a fine line.

DIRECTOR BACKGROUND CHECKS

For banks and holding companies filing applications, for example to acquire another bank or for troubled banks, the regulators have a say in whether you can add directors to the board. We are currently assisting clients with a number of different applications pending before various federal and state regulators. A couple of these applications involve the introduction of new directors into an organization. Unless the proposed directors are "known to banking," which generally means they have been a bank director within the past five years, the regulators conduct an extensive personal background check on the potential director as part of the regulatory review process.

A couple recent instances have reinforced the extent of the extensive background check process. The amount of information the background check reveals is amazing. It also reinforces the importance of properly completing the Interagency Biographical and Financial Report, which is the report the proposed directors fill out as part of the process. As we generally advise our clients, it is better to disclose being a murderer than to fail to disclose receiving a speeding ticket.

If you find yourself in a position where a proposed director is required to go through a background check, be sure they fully understand the process. It is very important they appreciate the extent of the review and required disclosure on the front-end. Any items that come up in the background check that are not disclosed in the Interagency Biographical and Financial Report significantly slow the process.

ACQUISITION ACCOUNTING ISSUES

We are currently assisting a client in the pursuit of the acquisition of a troubled bank. The plan for this acquisition is to acquire the target holding company and bank and merge the target holding company out of existence but keep the target bank a separately chartered institution. Notwithstanding this transaction structure, the acquisition still must be accounted for under the Acquisition Accounting rules. This requires all of the target's assets and liabilities to be recorded at their fair value as of the date of acquisition. It also requires the target bank's allowance to be eliminated completely, since the fair value marks include the anticipated losses associated with those loans.

Acquisition Accounting all works well in theory. In practice, we have a number of complaints against it. We are going to add to our list the calculation of Tier 2 Capital for regulatory capital purposes. As you likely know, Tier 2 Capital is essentially Tier 1 Capital plus the allowance for loan losses. After Acquisition Accounting, the allowance for loan losses goes away because the loss inherent in the loans is incorporated into the fair value marks. Unfortunately, the regulatory agencies do not take this into account in calculating Tier 2 Capital. This means Tier 1 Capital and Total Capital are essentially equal to each other under this scenario. This results in a Total Risk-Based Capital Ratio that, in our opinion, is not accurately reflective of the true capital position compared to the risk embedded in the balance sheet.

SHAREHOLDER ACCESS TO RECORDS

We are currently assisting a bank holding company in addressing what is somewhat of an unusual shareholder information request. In this particular circumstance, the shareholder owns a small block of shares but has decided, for whatever reason, they would like to obtain their own valuation of the shares. The shareholder had their valuation expert send what was a rather lengthy information request list. It included a number of different requests relative to the holding company, the bank, salary schedules, depreciation schedules, etc. We have seen a number of different valuation request lists, and this was certainly one of the longer ones we have seen.

The client asked our advice on how to address the request. Our recommendation was not to provide any of the requested information. We take this position for a couple reasons. First, each state has specific laws that address a shareholder's access to corporate records. In most states the shareholder must state the purpose for which they are requesting records and then the state law provides the specific records that must be disclosed. We think it best to follow state law in the provision of corporate records to shareholders. Second, this shareholder is an owner of a bank holding company, not a bank. None of the bank records, many of which were requested, are subject to disclosure because the individual is not a shareholder in the bank. Third, and most importantly, we view all of this as completely unnecessary. We have completed numerous valuations of banks and bank holding companies, and all of the information that is needed to complete the valuation is available in the holding company FR Y-6 and FR Y-9 as well as the Bank Call Report. It is just a matter of knowing your way around those documents to understand how the information is presented.

If you ever receive what you believe to be a suspect records, documentation, or disclosure request from a shareholder, keep these issues in mind. We certainly are not advocating you get adverse to a shareholder. However, we also do not recommend that you unnecessarily disclose documentation where there is no real benefit to your community bank or holding company.

HOLDING COMPANY ASSETS

We are currently assisting a bank holding company in preparing to market their bank for sale. One of the issues that has come up, which is not all that usual in these types of transactions, is the holding company's ownership of assets other than the bank stock. Most of the time these are fairly normal assets, such as investments in other entities, bad loans that have been taken out of the bank, or something similar. However, there are other times when they get a little more unusual, such as out of state vacation properties, boats, ATVs, airplanes, or similar items. Under these circumstances, the question always comes up as to what should be done with these assets as part of the process. Our advice is always the same: sell them outside of the transaction. We think this for a couple reasons. First, community bank acquirers are not typically looking for these types of assets, and most often require them to be sold as part of the process anyways. Second, if they do remain in the holding company, they almost never receive the same value that they would receive as being sold outside of the transaction. For these reasons, we think it is often better to simply clean up the holding company balance sheet and get any unusual assets out prior to the marketing process.

CONCLUSION

We hope all *Musings* readers enjoyed the long Memorial Day weekend last week. We look forward to visiting with many of you as we travel across the country on various projects. Don't forget about the upcoming Merger & Acquisition Workshop. We understand there are still a couple of slots left. To register, please follow the link below:

Mergers & Acquisitions Workshop

See you in two weeks.

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