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

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Dear Subscriber:

Greetings from Illinois, North Dakota, Indiana, Arizona, Colorado, and California!

$1 BILLION THRESHOLD

We have worked with a number of community banks over the last couple of months who have approached or recently exceeded the $1 billion in consolidated assets threshold. For many community banks (for whatever reason) this seems to be a target or a goal. For others, it is a threshold they do not care to cross.

The general argument in support of a community bank becoming $1 billion or more in assets is that there should be some realizable economies of scale at that size. The downside is the bank does pick up some additional regulatory obligations. If any *Musings* readers want a Memo to Clients & Friends with respect to regulatory obligations for crossing either the $500 million or $1 billion threshold, let us know, and we will send it on.

For our part, we view any threshold like that to be pretty much artificial. None of our clients, as a practical matter, worry about the $10 billion threshold, so $1 billion and $3 billion are the key issues. As most *Musings* readers know, once the community bank crosses the $3 billion threshold, it can no longer take advantage of the Small Bank Holding Company Policy Statement which allows the holding company to leverage significantly.

Crossing $500 million, $1 billion, or $3 billion in total assets should be a strategic issue, not simply a “goal.” When a community bank indicates their goal is to be $1 billion or $3 billion or something similar, our usual question is “Why?” What benefit does the company, the bank, and the shareholders derive from crossing this particular threshold? If the Board of Directors can answer that question with a positive, then fine; it is a great goal. If they can't, then they need to move on to something else.

COMPLIANCE, COMPLIANCE, COMPLIANCE

For most community banks in the current environment, financial performance is great. For certain, many of the community banks we have worked with recently are considered to be in the super-high performing category. Most of those banks have a great handle on asset quality. They may be heavily focused on commercial real estate, but they feel they have the risk managed well.

Interestingly, the boards of directors of these super-high performing banks are not worried about the "other shoe" dropping as it relates to asset quality or financial performance. The "other shoe" they are worried about - the one that can stop a great financial performer in its tracks faster than anything else - is a compliance problem. Compliance problems - allegations of fair lending and unfair, deceptive, and abusive practices in particular - put the community bank in the penalty box for a long period of time. Those acquisitions the board had their eye on? Forget it. The establishment of a new brick and mortar branch? Forget it. In fact, forget anything that requires regulatory approval or non-objection.

The boards of directors who are appropriately focusing on the future are making sure compliance is in order. While financial performance is great, compliance needs to continue to be great as well. Consider that for your own community bank.

HOLDING COMPANY STOCK REDEMPTIONS

Over the last year, we have assisted dozens of holding company boards of directors in designing and implementing holding company stock redemptions. As most *Musings* readers know, we believe that a stock redemption is a good allocation of capital. It benefits the shareholder who sells, and it benefits the shareholder who does not sell (assuming it is priced correctly). Recently, we have been getting a number of questions about pricing for community bank holding company stock redemption. The bottom line: if you are a non-SEC reporting, non-public community bank, the board has wide latitude/discretion as to where they set the price. This is notwithstanding the fact that the bank may have had some type of "walk-in" repurchase program in the past in which the board had an established price for a period of years. The real issue with respect to pricing and establishing a community bank holding company stock repurchase plan is not defrauding the selling shareholders (i.e., giving them enough information to make an intelligent decision with respect to selling) and making sure it benefits the shareholders who do not sell. This is generally an earnings per share, return on equity, and cash flow test. Do not shy away from a redemption, formal or informal, of your holding company stock.

MID-TIER BANK SALES

Based on what is reported in the trade press, and our own in-office list of buyers and sellers, it appears in the last two quarters there have been a lot of what we refer to as "mid-tier" community banks that have determined it is time to sell or merge with another institution. We define a mid-tier community bank as one between $400 million and $750 million in total assets. We have served as financial advisor and/or legal advisor on a number of these transactions over the last six months. Just like smaller or even larger banks, mid-tier banks sell for a variety of reasons. Some do not feel they can keep up without getting some size to provide economies of scale. Some have liquidity issues. Some are still closely-held and need funds to provide liquidity for the family or to pay estate taxes. Whatever the cause, there have been a lot of mid-tier banks that have sold recently. As often happens with a board of directors, when you get to that mid-tier range you are looking to either be a buyer or, if you cannot be a buyer, a seller. We suggest that any mid-tier bank contemplating a significant strategic move consider all the alternatives. It is certainly feasible, possible, and profitable to remain independent if the board establishes an appropriate strategy to do so.

SHARE TRANSFERABILITY RESTRICTIONS

We are currently assisting a potential community bank seller consider and negotiate of an indication of interest in what is proposed as a 100% stock deal. The transaction calls for the acquirer bank holding company to issue shares to the target bank holding company shareholders at the effective time of the transaction. The indication of interest provides that the shares to be issued will be "restricted securities," which are securities issued pursuant to a securities registration exemption. Restricted securities include transferability restrictions, including a minimum one-year holding period.

The target's board of directors was not too terribly excited about signing up for a minimum one-year holding period for the shares received in the transaction. We are currently working with the buyer's counsel to evaluate the alternatives. We think it likely we will be able to work around these transferability restrictions by using a Regulation A+ offering, which allows for the issuance of shares without the transferability restrictions.

It is important to keep in mind and understand the transferability restrictions on restricted securities. Particularly if you are engaging in an acquisition transaction with stock as consideration, you want to make sure you do not run afoul of the applicable securities laws that impose the minimum holding period. Also, keep in mind that these same transferability restrictions applicable to restricted securities also apply to "control securities," which are securities held by a director, executive officer, or principal shareholder. If any of your shareholders own restricted or control securities and are looking to sell the stock, we suggest you have the transaction reviewed in order to make sure the transfer of the shares does not violate any of the rules applicable to the transfer of restricted or controlled securities. Please let us know if you would like more information concerning the exact requirements to be met.

THE QUICK AGREEMENT

We are often asked how long an M&A transaction will take. This is a loaded question with really no standard answer. Each deal seems to take on a life of its own. We have some general thoughts regarding timing, but it is not uncommon at all for a transaction to deviate from the general course of action.

This past couple weeks, we have assisted in what we would classify as a lightning speed transaction. The steps of the process were fairly typical. A potential acquirer presented an indication of interest, which was considered, negotiated, and then approved by the target's board. The interesting thing about the indication of interest was it said the transaction agreement needed to be signed essentially two weeks later. There is typically a four to six week timeframe between signing the indication of interest and signing the actual agreement. This is because agreements take time to review, disclosure schedules have to be put together, and the like.

In this particular deal, what normally takes four to six weeks was completed in one. There were a number of different individuals that gave an extraordinary effort in bringing it together, and the agreement was signed eight days after it was presented. We do not expect the rest of the transaction will move forward quite as quickly, but this particular piece went forward with lightning speed.

CONTRIBUTION ANALYSIS FACTORS

We recently received a call from a client that is considering engaging in a stock-for-stock swap with another community bank. Both of these community banks are closely held, and neither has any market liquidity at all. The lack of market liquidity means we cannot look at the trading prices of each stock to figure out the appropriate exchange ratio in the transaction.

In this type of situation, we determine the relative value of each stock using a contribution analysis. This analysis determines the appropriate share ownership split by looking at what each holding company and bank contribute to the combined organization. The "textbook" contribution analysis evaluates each organization's contribution to the combined organization's earnings, equity, and total assets. Earnings are generally weighted at 50%, equity at 40%, and assets at 10% based on their relative value.

In a contribution analysis, it is not uncommon for each of the organizations to make arguments that they provide additional benefit to the combined organization in addition to earnings, equity, and assets. Some of the usual suspects that are negotiated include management and director expertise, alternative lines of business that will provide the opportunity for revenue enhancements, SBA or similar lending programs that will provide additional non-interest income, and the like. These are all very valid points to argue and should be considered in addition to the contribution analysis.

A contribution analysis is always the starting point in determining the relative value of two thinly traded stocks in a stock-for-stock transaction. However, it is not uncommon at all for one or both of the parties to argue that it does not tell the whole story. These other issues are taken into consideration because, in the end, it is like all other deals - you get what you can negotiate.

THE BOARD DECIDES THE TERMS

We are currently assisting a client in a private placement of common stock. In this particular transaction, the community bank holding company is looking to sell up to $5 million of common stock to accredited investors. The board has asked us about the viability of a number of different terms and conditions relative to the offering. For example, we were asked whether the offering could require existing shareholders to purchase a minimum of 100 shares but non-existing shareholders to purchase a minimum of 10,000 shares to require a material investment. We were also asked whether they could accept subscription agreements from existing shareholders first, followed by subscription agreements from non-existing shareholders. Our answer to all of these questions was yes. All of these are permissible options because the offering is the company’s offering. They have full control over the terms and conditions of the offering. It is simply a matter of decision making and disclosure. As long as the decision does not discriminate based on some protected factor, the company can do anything it wants as long as the private placement memorandum appropriately discloses the board’s selected terms.

BIDDING ON BANKS

In 2019 we have assisted numerous community banks in finding buyers for their organization. Although as most *Musings* readers know, we are stridently in favor of independent community banks, when a board does decide to sell, we always like to make sure they go through an appropriate process. In most cases, we serve as both the financial advisor and the legal advisor on the sale side of a transaction. In connection with these transactions, we are always amazed when Expressions of Interest are received how widely the prices can vary. It is not unusual to get a bid range for a bank that spans, for example, from $15 million to $30 million as a purchase price. You almost wonder if it is the same bank these potential purchasers are bidding on. This is not necessarily a new phenomenon. There are a lot of issues to which you can attribute the wide range of pricing in Expressions of Interest by various potential purchasers. Some banks can afford to pay a higher price, some try to "steal the target," some mistakenly think the target is desperate, etc. We never mind seeing a wide range of bids, as long as we have multiple bids. It does show how interesting the process can be and how your bank may be super valuable to one potential purchaser and not nearly as valuable to another.

CONCLUSION

Here we are at approximately the two-thirds mark of the summer. Schools in a lot of places will be starting in the next couple of weeks. When vacations die down and everybody is back to work for the third and fourth quarters, we look forward to seeing many of you at your banks.

Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*