GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Texas, Colorado, Indiana, New Mexico, Minnesota, and Alabama!

SHAREHOLDER DISTRIBUTIONS

As many *Musings* readers know, our firm's mantra is that the fundamental duty of a community bank director and officer is to enhance shareholder value. We have previously provided the "checklist" for enhancing shareholder value many times. As a reminder, one of the items included on the enhancing shareholder value checklist is dividends or "dividend equivalent" distributions. The question has come up recently whether a community bank holding company is absolutely required to pay dividends. Specifically, that issue has been raised in the context of a disgruntled shareholder arguing that a corporation's lack of a dividend rises to the level of minority shareholder oppression.

Notwithstanding the fact that dividends are on the "checklist" for enhancing shareholder value, there is absolutely no legal requirement that a community bank holding company pay dividends. The Board needs to look no further than a typical state corporate statute, which says a Board of Directors may (not shall) declare a dividend.

The central issue is not one of whether a dividend is paid. Instead, it is one of appropriate allocation of capital. As noted in the last *Musings*, capital should be allocated to its highest and best use. In this particular instance, the Board has given significant thought, discussion, and consideration to the allocation of capital, and it has determined the shareholder base is best served by allocating capital to retained earnings to support growth. This has resulted in significant growth in the corporation's earnings over the years, and the Board expects it will continue to do the same for the future. The Board in this case has more than fulfilled its fiduciary duty because it has adequately considered all of the alternatives and made a fully informed decision.

COMPLIANCE VERSUS LENDING

Often when we are in community banks, particularly the larger ones that have Compliance and Risk Management Officers, we at some point end up discussing the same topic - "is the bank 'overcomplying'?" This is really a question of whether the bank is paying too much attention to compliance and risk management instead of lending and serving its customers. Different community banks approach this in different ways. Many try to have a "balance" between the two. We were recently with a community bank who simply indicated that their community bank has a "culture of compliance." This is not the first community bank that we have been with that professes a "culture of compliance." Leadership of this particular bank indicated they will never knowingly do anything other than comply completely with their understanding of the law and risk management issues. This bank is a high-performer, so notwithstanding the culture of compliance, they apparently have worked a pretty good balance between compliance and lending.

OTHER LINES OF BUSINESS

It seems every community bank is striving to increase noninterest income and diversify the community bank's revenue stream. We were recently with a super high-performing community bank for a planning session. This particular institution had a good strong core banking business but also had another line of business that contributed nearly 50% of the annual profit to the consolidated organization.

This particular community bank developed this other line of business many years ago through acquisition. It has provided great diversification to the earning stream and a great boost to profitability. Do not hesitate to evaluate other lines of business as a way to boost your noninterest income, particularly if you can acquire good people with the line of business.

OREO VALUE

We are currently assisting a Board in evaluating the potential sale of their community bank holding company and/or community bank. This particular community bank has a number of different parcels of OREO. The interesting thing about this situation is that the bank has written down the value of many of these parcels of OREO to almost nothing. There is a multi-million dollar difference between the book value of the OREO and the fair market value of the properties.

One of the issues in evaluating this potential transaction is what to do with the OREO. The bank asked our thoughts as to whether the OREO should remain with the bank, be transferred to the holding company or to the shareholders (this is a small shareholder group), or sold to a third party. We are currently evaluating each of these three alternatives, but our initial impression is that allowing the OREO to remain with the bank may very well be the worst of the three alternatives.

Community bank acquirers typically do not like to buy other bank's problems (or other real estate). Most acquirers will heavily discount these problem assets in pricing the transaction. This is to compensate the acquirer for the time, effort, and expense associated with resolving these problem assets. As an example, when our firm is "running the numbers" on a bank with these types of problem assets, we typically apply a 33% to 50% discount to fair market value.

We are working with the Board to further investigate all of the alternatives. As previously noted, our expectation is that keeping the problem assets with the bank will likely produce the worst outcome for the shareholders. Based on our experience, one of the two other alternatives will likely produce a better solution.

RISKY BUSINESS

We were recently with a good size community bank that was involved in what some may consider a "risky" business. No, it wasn't banking the marijuana business, although we have a few clients who are engaging in or exploring that. This was a money services business. It is an intense risk assessment issue, BSA in particular. The question for any community bank is, of course, whether the risk is manageable and whether the bank is capable of assessing, monitoring, and managing it? If the answer is "yes," then forge ahead. If not, then run quickly in the other direction.

LETTERS OF TRANSMITTAL

We recently assisted a community bank in the sale of their holding company and bank. Shortly before the closing, the buyer's attorney provided to us the proposed Letter of Transmittal. As the name implies, a Letter of Transmittal is essentially a document the selling stockholders provide to the purchaser to transmit ownership of the shares being sold to the purchaser. Letters of Transmittal are used in whole bank acquisitions as well as in privately negotiated transactions between buyers and sellers. They are very similar to Stock Powers, although a Letter of Transmittal typically includes more extensive representations and warranties from the selling shareholder.

This particular Letter of Transmittal included a number of representations, warranties, and other covenants of the transferring shareholder. One of the included covenants was a release of any and all claims the shareholder may have against the selling company. In other words, the purchaser wanted every one of the shareholders to release any claim they might have as a shareholder, since the purchaser was "stepping into the shoes" of the seller as it relates to these claims.

When we saw the proposed release, we cried foul. It is not because we were trying to preserve some claim one of the shareholders may have against the seller, which is our client. Instead, we cried foul because the Agreement and Plan of Merger was completely void of any language that might suggest the shareholders were required to release any claim they may have as a condition of the transaction. We got back with the purchaser's attorney and told them we would not agree to this provision in the Letter of Transmittal because the terms of the transaction did not require the selling shareholders to release any claims they may have. To their credit, the seller's attorney very easily let the issue go, and the release language came out.

In a privately negotiated transaction where a bank holding company is repurchasing its own shares from a shareholder, it is absolutely appropriate to include a release of all claims. However, in this type of transaction, it was not. Thankfully the end result was right.

SHEARING THE CUSTOMERS

As many *Musings* readers know, the secret formula for making money in community banking is Revenue minus Expenses equals Profit. The easiest way to figure out what to do to improve profitability is to break down the income statement into a discussion of additional revenue generation techniques and expense reductions.

We were visiting with one community bank about improving profitability and revenue generation techniques and hit upon the issue of fees. This bank was not a heavy fee charger. They were not a big fee waiver either. They simply did not charge a lot of fees, and the fees they did charge were below market. They seemed to think that gave them a competitive advantage. (We are not so sure about that one.)

With respect to the lending function, they did not charge any fees at all. They said they would rather get it on rate because they thought the customer understood that. As one of the loan officers said, "You can shear the lamb multiple times, but you can only skin it once." We took that to mean that if you gouge your customers, they will not be back. On the other hand, if you collect a little additional on the rate or even on the fees, then they will not mind the shearing because it is not as painful or cuts as deep.

REGULATORY APPROVALS

As most *Musings* readers know, for any significant transaction in the community bank world, regulatory approval is required. It is generally required by your primary federal regulator as well as the State if you are a state-chartered bank.

We ran into an unusual situation recently where the Federal Reserve "waived off" any requirement for approval in this particular situation, but the State required an application. It was not any big deal, we just thought it was pretty unusual. Normally, the States defer to the Feds, but not this time. We dutifully filed the application on behalf of the client with the State, who apparently looked at it, decided they really did not need it or any further information, and approved it on the spot.

Just keep in mind, if you are making any type of transactional move in your community bank - such as branching or otherwise - you need to contact both your friendly federal regulator and state regulators. They may have different rules and concerns.

ICBA LEAD FWD SUMMIT

We are fortunate to, once again, be involved in the ICBA LEAD FWD Summit. For those of you that do not know, this is essentially the ICBA Annual Convention geared towards younger bankers. This year the convention is being held in New Orleans. We are quite certain the young folks will have no problem finding a good time there.

Two of our partners are speaking at the convention. Greyson Tuck is presenting a "LEAD FWD Talk," similar to a TED Talk, about the continued relevance of community banking. This rapid-fire session will provide Greyson's top five suggestions for community banks remaining the preferred financial services provider in their communities in the future, particularly as it relates to younger customers. Doc Bodine will be presenting a discussion on preparing your bank for the next possible economic recession and the associated compliance, safety and soundness, and other "fun" issues. Please let us know if you would like copies of any of the handout materials relative to either of these presentations. We are happy to provide them. For those of you *Musings* readers that might be present, Greyson and Doc would love to see you.

CONCLUSION

Hard to believe we are at mid-September. Schools are in full swing. Fall is in the air in the northern parts of the country. We look forward to seeing many of you during the fourth quarter planning season. Stay safe and have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*