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# GERRISH'S MUSINGS

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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](mailto:jgerrish@gerrish.com) ◆ [psmith@gerrish.com](mailto:psmith@gerrish.com) ◆ [gtuck@gerrish.com](mailto:gtuck@gerrish.com) ◆

Website: [www.gerrish.com](http://www.gerrish.com)

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Dear Subscriber:

Greetings from California, Florida, Tennessee, Washington State, Alabama, and Iowa!

## THE INTERVENING EXAM

Although our firms strongly support independent community banks, we are also in the process of looking for purchasers for a number of our community bank clients who have decided that it is now time to take advantage of the pricing and multiple purchasers available in the community bank space. As a result, we are “peddling” several banks in various parts of the country. Some of those institutions have had or will have during the process what can best be described as an intervening examination by their friendly federal regulators. In connection with an “intervening” exam, the question always comes up, “Is this a good thing or a bad thing?”.

Our general thought process is it is a good thing. Although examination results are confidential (or not), the fact that an intervening examination occurs, either before or during due diligence, generally gives the buyer comfort that an independent set of eyes, particularly if they are the friendly federal regulators, will have evaluated this particular bank and picked up if there are any significant problems with the bank. The intervening examination basically gives the buyer comfort that its own due diligence has been adequate. Although the examination results are confidential according to the laws and regulations, we are not aware of any acquisition transaction in the country for which the examination results have not been produced in one way, shape, or form to the prospective purchaser. This is not necessarily “overtly” but often through a wink and a nod and other hand signals such as “we got a picket fence rating.”

In any event, if you are buying, an intervening exam is likely a good thing. If you are selling, it is also a good thing, for the most part.

### GENERATIONAL WEALTH TRANSFER

We have been doing a lot of reading and discussing with many community banks, particularly those who have Wealth Management lines of business, the tremendous generational wealth transfer that will occur over the next 20 plus years. Although we have collectively told our children that they do not need to worry about wealth transfer since we plan to spend it all, for the most part in the United States, significant wealth transfer will occur. From a community bank wealth management standpoint, we believe there are two issues that need to be addressed: 1) what is it those who will be transferring the wealth need to consider, and 2) what is it those who will be receiving the wealth need to consider, and how do they want the message delivered?

For many community banks, the establishment of a Wealth Management line of business or Trust Department is daunting due to the cost and long-term ramp-up involved. For those community banks that are fortunate enough to have begun this process long ago and are now profitable, the transfer of wealth provides an enormous opportunity. For one, there are not significant geographic limitations on where this business can be conducted (i.e., in state, out of state, nationwide, etc.). Second, it, like any other line of business (including your core banking business), is dependent upon those individuals on whom the client relies to provide advice. Because of that, we need to make sure those individuals are well-compensated, well-incented, and handcuffed to the organization to continue on, even when the downturn comes.

Interestingly, talking to a number of community bank that have significant Wealth Management arms, the assets under management over the last couple of years have grown significantly due to the notable increase in the stock market. That is one good way to improve profitability, but the best way is to continue to develop new clients and continue to move forward. We recently read a good article on the wealth transfer issues. If anybody wants a copy, please let us know.

### INDEPENDENT DIRECTOR

Among our community bank client base around the nation, the issue of independent directors often comes up. One specific issue is whether the directors your community bank would like to place on the Audit Committee or a separate (e.g. Acquisition) committee are truly independent. Although most *Musings* readers' bank holding companies are not listed on a national exchange, if your holding company was, then the independence question would be a bright line—either your director is

independent or the director is not. For most of the rest of us, Delaware law would apply as well as anything. In that situation, director independence is a fact and circumstances test that considers a variety of things, including whether there is a business relationship or the director is indebted to the interested party (which would compromise their ability to act impartially), as well as whether there is a close personal relationship, which might consist of co-investment in a large asset or large charitable contributions to the same entity. Also, whether those ties are “material” would be examined.

With respect to community banks, what difference does it make if a director is independent? Often, particularly in an acquisition context, we will recommend setting up an Acquisition Committee consisting primarily of independent directors. This is to make sure that the acquisition transaction is fair, particularly to minority shareholders, and does not favor the majority or control shareholders. The issue of independence also comes up, of course, in the Audit Committee, as well as other circumstances involving community banks.

We recently ran across a pretty good (readable) article on how to tell if your directors are independent. If any *Musings* readers would like a copy, please let us know, and we will forward it on.

### **BANK HOLDING COMPANY FORMATIONS**

We regularly get asked a couple of questions as it relates to community bank holding companies. The first, “Do I need a holding company?”, comes from community banks that do not have a holding company currently. The second one, which comes from community banks that do have a holding company, is, “Do I need to keep it even though some of the larger banks are getting rid of theirs?”

To the first question, our answer is “yes”. We are currently in the process of forming several bank holding companies for community banks in various parts of the country that do not have them. The bank holding company is still the best structure for a community bank in virtually all circumstances, particularly those banks that maintain total assets of less than \$3 billion (and thereby can take advantage of the Small Bank Holding Company Policy Statement of the Federal Reserve). The bank holding company is the fastest, cheapest, and easiest way to generate cash through leverage, to either inject capital into the bank, or to redeem shares without regulatory approval. The best time to form the bank holding company is when you do not need it. That way, the structure is in place so that at the time you do need it you can simply pull the trigger quickly with no regulatory delays or approval.

To the second question, our uniform answer is “no.” For all the same reasons we recommend forming a bank holding company, we also recommend keeping it. First of all, there have only been a few of the large banks that have terminated their holding companies. In our opinion, those banks did so because they were having difficulties with the Federal Reserve (the regulator of the bank holding

company), particularly getting acquisitions approved, and would just as soon get rid of that relationship. For most community banks, since the holding company is a shell and the Federal Reserve does not provide much “regulation or supervision,” the holding company still makes perfect sense. Keep it for when you need it. The burden of maintaining the holding company, either in cost or time, is minimal.

## ACQUISITION NEGOTIATIONS

Most community bank acquisitions follow a fairly typical process, which begins with the distribution of marketing materials and then moves to the submission of initial Indications of Interest, the approval of one or a small number of potential acquirers to complete due diligence, and then the submission of what is essentially the “highest and best” final offer from the potential acquirers. Following the submission of these final offers, it is typical that the seller selects the winning Indication of Interest and notifies the winning bidder.

One of the questions that often comes up is the negotiation of the Indication of Interest. It is common for the buyer and seller to negotiate the Indication of Interest prior to execution. Certainly the buyer and seller want to make sure that they are all in agreement as to the material terms of the transaction.

When negotiating an Indication of Interest, our recommendation is always to get all of the issues onto the table and out for discussion at the same time. This is preferable to essentially piecemealing the various issues because it allows both parties to understand the totality of all the issues in play, which is critical considering the negotiation is a give and take and tradeoff of certain issues and resolutions against others. We think this is a better alternative than raising an issue and settling it, only to have another issue raised thereafter, and so on.

If you are at a point where you are negotiating an Indication of Interest, we think it best to get all the issues out in the open at once. In our opinion, the chances of closing a transaction are higher when each of the parties recognizes all of the issues and works together to mutually agree upon them.

## TRANSACTION TIMING

We are currently assisting a couple different community banks in a potential sale transaction. The issue of transaction timing has come up in each of these potential transactions over the past couple weeks. As it relates to transaction timing, the issues are practical, such as trying to schedule the various steps of the potential transaction—e.g., due diligence—around scheduled examinations.

The issue of transaction timing is certainly not unique to these deals. Similar to many other things in life, there is no “ideal” time to sell a bank, at least from a practical perspective. If you are

thinking about selling, certainly it is important to sell at a strategically appropriate time—that is, when you have what an acquirer wants: earnings, good asset quality, no material litigation, low contract termination fees, and the like. From a practical timing perspective, there is no “best time” to sell a bank. There is always going to be something that gets in the way, such as an exam, audit, departure of executive officer, or something like that. The short answer is that you just have to do your best to work around these issues. We just do not see it as possible to identify a perfect time to sell a bank from a practical, day-to-day perspective.

### UNSOLICITED OFFERS

Over the past five or so years, unsolicited offers have become much more prevalent in the community banking industry. As the name implies, an unsolicited offer is simply an offer by a potential buyer that is presented to a potential seller without the potential seller actively pursuing or soliciting receipt of the offer. This is distinct from a hostile takeover, which is not prevalent in community banking.

Our experience is that unsolicited offers are more likely to fizzle out than they are to actually result in a completed transaction. However, just because an unsolicited offer does not result in a deal does not mean it has no value. One of the biggest upsides to an unsolicited offer that does not result in an immediate deal is the fact that the recipient of the unsolicited offer now knows for certain that the other party is serious about trying to make an acquisition work. That is beneficial, because if there is ever a time in the future when the seller decides they are ready to solicit offers, the party providing the unsolicited offer is typically at the top of the potential acquirers list.

### THE SECURE ACT

On January 1, 2020, the Setting Every Community Up for Retirement Enhancement Act of 2019, a/k/a the SECURE Act, took effect. As the name implies, the legislation included significant provisions aimed at increasing access to tax-advantaged retirement accounts. The SECURE Act included several changes related to the administration of Employee Stock Ownership Plans. These changes ease administrative burdens for Safe Harbor 401(k) Plans, extend certain adoption deadlines, allow plan access for longer term, part-time employees, and make other changes. A full description of the scope of these changes is beyond this brief *Musings*. However, our firm has drafted a summary of these changes as they relate to ESOPs. Please let us know if you would like a copy of this memo. We are happy to provide it.

## THE CHAIRMAN'S FORUM

A couple weeks ago we had the opportunity to spend a couple days facilitating the Community Bank Chairman's Forum at The Ritz Carlton in Naples, Florida. The venue was perfect, with sunny skies and highs in the mid-80s. However, that was not the highlight of the couple days.

The highlight of the Chairman's Forum was the actual discussion among the participants. If you are not familiar, the Chairman's Forum is an unstructured, facilitated discussion among community bank chairmen, directors, and executive officers on any topic they would like to discuss. The discussion was all things community banking, ranging from M&A issues and cybersecurity to dealing with dissident shareholders and unique strategies for share liquidity. We feel confident in saying it was a very practical, beneficial, and enjoyable discussion.

Events like the Chairman's Forum are beneficial for a number of reasons. Certainly, it is nice to reward your directors and officers with trips to great hotels with perfect weather. More importantly, there is great benefit to getting out of the bank and taking a little bit of a step back to discuss relevant topics with other community bankers from across the U.S., which provides different perspectives. Whether it is the Chairman's Forum, a state or national convention, or some other similar training opportunity, be mindful of trying to attend. They really are beneficial to the organization and all the related stakeholders.

## CONCLUSION

Where has January gone? It appears the first quarter of 2020 will continue at warp speed. We look forward to seeing many *Musings* readers at the upcoming state and national community bank conventions. See many of you soon.

*Jeff Gerrish*

*Philip Smith*

*Greyson Tuck*