

THE



Chairman's Forum

Opening the door to new ideas

NEWSLETTER

Gerrish Smith Tuck, Consultants and Attorneys

January 2020

Welcome to the year 2020! At the recent Community Bank Chairman's Forum that we hosted in Naples, Florida, we made that same proclamation and commented on how awkward it actually sounds to say that. But here we are! So, what are we going to do in this new year and new decade?

As we kick off the year for *The Chairman's Forum Newsletter*, we are going to revisit some of the key issues that were raised at the Community Bank Chairman's Forum a few weeks ago and try to cover some basic themes we are seeing. In particular, it seems that one overriding theme is a heightened recognition by Chairmen, Board members and senior management that, with the new year and the new decade, things are not going to be the same. Simply functioning in the status quo no longer seems to be an option for strategic growth and stockholder value. The real question, though, will be what strategies will your organization employ to continue to move the organization forward, perpetuate its long-term viability or otherwise create more stockholder value?

So, it is our hope that this initial edition of *The Chairman's Forum Newsletter* for the new year and new decade provides some insights into these matters and we hope many of you will continue to enjoy the newsletter throughout the year and send us any questions or comments you have that might be useful for your fellow Chairmen to read. We are looking forward to a wonderful 2020!

Happy Reading!

Jeffrey C. Gerrish

Philip K. Smith

Greyson E. Tuck

*Gerrish Smith Tuck
700 Colonial Road, Suite 200
Memphis, TN 38117
Phone (901) 767-0900
www.gerrish.com*

Copyright © 2020 – Philip K Smith

Any accounting, business or tax advice contained in this communication, including attachments and enclosures, is not intended as a thorough, in-depth analysis of specific issues, nor a substitute for a formal opinion, nor is it sufficient to avoid tax-related penalties. If desired, Gerrish Smith Tuck would be pleased to perform the requisite research and provide you with a detailed written analysis. Such an engagement may be the subject of a separate engagement letter that would define the scope and limits of the desired consultation services.



Opening the door to new ideas

THE

Chairman's Forum

NEWSLETTER

Gerrish Smith Tuck, Consultants and Attorneys

January 2020

Chairman's Summary

- ◆ Can our bank really remain independent?
- ◆ What steps ensure proper Board governance?
- ◆ Do I have to respond to every unsolicited offer?
- ◆ How do you handle a problem director?

Can Our Bank Really Remain Independent?

We were pleased to see that a number of attendees at the Community Bank Chairman's Forum were focused on finding strategies to maintain the organization's independence as opposed to trying to position the bank to sell. The discussion that Chairmen engaged in covered a host of topics with the discussion centered primarily on the idea that ensuring your independence is not necessarily about growing your asset size or engaging in an acquisition transaction, but trying to find ways to create improved performance for the benefit of stockholders. Key examples included ensuring that the organization is in the right structure with a bank holding company that is properly utilized, or a Subchapter S structure for more closely held organizations or perhaps developing an ESOP to provide greater employee incentives and a tool to attract and retain key employees.

The Chairmen also discussed the related concern of stockholder liquidity. In somewhat of a perhaps counterintuitive line of thinking, in order to ensure long-term independence, you have to provide stockholders a way to sell their shares.

Otherwise, stockholders may look for the first opportunity to sell to a third party when they knock on your door rather than having a viable alternative to sell their shares that has been created by the organization itself. In essence, creating liquidity is its own anti-takeover mechanism because it provides a viable acquisition alternative to selling stock to a third party. As part of that strategy, we continue to recommend organizations engage in stock repurchase transactions or at least offer stock repurchase transactions on a periodic basis to their stockholders. When community banks complain that they have very little trading in their stock and there really is not a market for their stock, we suggest the organization be its own market maker through appropriate stock repurchase planning.

A key focus of the discussion of maintaining independence was also centered on overall organizational efficiency, becoming more mindful of the efficiency ratio, but maintaining appropriate staffing to continue to drive the organization forward in terms of regulatory compliance, loan production and other critical areas. The issue is that, as community banks, we recognize that we must maintain appropriate staffing levels to provide the service that community banks are known for with relationship banking. In essence, then, the way to maintain our independence is to “earn” our independence by having a relatively low efficiency ratio and strong earnings per share performance, without sacrificing needed staffing levels.

A final component of independence that was discussed involved ensuring that you have an appropriate capital planning policy. That involves ensuring an appropriate dividend policy and procedure, maintaining appropriate levels of capital for future growth, but also ensuring that excessive levels of capital do not exist. Make sure that your Board discusses on a periodic basis what level of

capital is too little, but also what level of capital is too much and ensure that you have readily available sources of additional capital when needed.

What Steps Ensure Proper Board Governance?

The Community Bank Chairman's Forum spent quite a bit of time centered around basic governance functions. As relatively small financial institutions, most of us have a tendency to have the same agenda, same structure, same number of directors and even the same people as directors that we have always had. It is probably time to consider shaking things up a bit. For example, how much of your Board meetings are actually devoted to strategic initiatives rather than merely reviewing the financial statements from the last month? Consider updating your agenda, moving a strategic discussion to the beginning, using a Consent Agenda for summary items that can all be voted on and disposed of at one time and moving the more mundane issues of looking at reports and policies to the end of the meeting. It's time for our organizations to take a more prospective look at where the organization is going as part of your Board meetings rather than looking in the rearview mirror at what you have just done. As part of that more forward-looking initiative, we see organizations beginning to focus on technology, providing an updated Board of Directors and ensuring ongoing education for Board members. The bottom-line is that serving as a member of the Board of Directors is no longer merely an honor, but it requires affirmative action and education.

To improve our Board meetings, Chairmen should also focus on what might otherwise seem like trivial matters, but are of paramount importance. For example, consider how long the meetings are, whether directors are prepared when they show up for meetings, whether you will allow for remote participation in

Board meetings via videoconference or telephone conference, who keeps your minutes, what items are included in the minutes and similar factors. Appropriate corporate governance will not be the same for any two institutions. As Chairmen, your responsibility is to set the corporate direction, consider how you want meetings to function and to ensure that management is providing the necessary information to help you guide the meetings in the way you see fit. Don't allow Board meetings to merely devolve into management presentations where the Board sits quietly and listens to the information that is being fed them.

Do I Have to Respond to Every Unsolicited Offer?

There was a fair amount of discussion at the Community Bank Chairman's Forum regarding the current M&A markets. In particular, the question of how to respond to unsolicited offers was discussed at some length. For example, do you have to respond to all inquiries? The answer to that question often turns on whether you have received an actual offer. Have you merely had cocktail conversations with a director of another organization at your local club? Have you received a form letter from a third party out of state? Or have you actually received a formal written offer from a party that you know is validly interested in your organization, price quotations have been provided and other formalities? All of those can require different types of responses.

The key concern from most directors and Chairmen's standpoint is what level of response needs to be provided. The short answer is that if you have received a formal written offer that contains pricing and other structuring issues it requires your Board of Directors to conduct some type of analysis to determine whether there is a basis to accept or reject the offer. As lawyers, we can certainly demonstrate that the Board has liability for either accepting a bad offer or rejecting a good offer and there needs to be some basis that, in hindsight, the Board can

point to as to why it accepted or rejected a particular offer. That normally requires detailed financial analysis and a report of some sort by an outside third party such as our firm or others that the Board can use to “hang its hat on” as part of the support for what it did. The bottom-line is that even unsolicited offers must be taken seriously and there must be an appropriate process in place to exercise your fiduciary duties. We are attaching to this newsletter an article we wrote several years ago dealing with the various obligations that exist when receiving unsolicited offers.

How Do You Handle a Problem Director?

There were discussions at the Community Bank Chairman’s Forum regarding managing the situation with a difficult director. Interestingly, the issues of a problem director often revolve around a director who is a large stockholder and who wants to throw his or her power around in the Board meeting. It is a bit of an interesting dynamic because, within the boardroom, the director who owns a majority of the shares still only has one vote and can be outvoted by other directors. If that director then wants to exercise their dominant stockholder position to vote other directors off they can do so, but not at the time of a specific vote on a particular matter. The result is that we often find that a Chairman of the Board must deal with a problem director, directly and quickly. Allowing the problems to fester rarely makes them go away.

Part of difficulties can perhaps be overcome by setting director expectations on the front-end. Understanding that each director has one vote, all directors’ input is needed, valued and even required, and other similar factors. As Chairman, do not assume that the process going into the new year and the new decade has to remain the same. Outline new requirements, set guidelines and expectations including the possibility of having one-on-one meetings with each director to tell

them what the expectations are, the areas they need to improve upon and other factors. If you find that hard to do individually, consider implementing a formal director evaluation process so that all directors know how they are doing.

Meeting Adjourned

This year and decade can be the best ever. But as Chairmen and directors, we must set the overall corporate direction for the organization. We hope you continue to find valuable insights throughout the year in *The Chairman's Forum Newsletter* and we hope those of you who were unable to attend the Community Bank Chairman's Forum in Naples this year will consider doing so in January 2021. We are looking forward to seeing many of you in the coming months at various strategic planning sessions and at the ICBA Annual Convention. Please do not hesitate to stop us and talk to us because you never know when your story might find its way into *The Chairman's Forum Newsletter*!

Until next time,



Jeffrey C. Gerrish



Philip K. Smith



Greyson E. Tuck

*Gerrish Smith Tuck
700 Colonial Road, Suite 200
Memphis, TN 38117
Phone (901) 767-0900
www.gerrish.com*

HOW TO CONTACT US:

If you have questions or comments about the newsletter or would like to ask a follow-up question, please email Philip Smith at psmith@gerrish.com.

**Unsolicited Offers:
From Cocktail Conversation to Firm Offers
When Does an Affirmative Director Duty Arise**

**By Philip K. Smith
Gerrish Smith Tuck**

As the merger and acquisition environment continues to percolate with many institutions jumping at acquisition opportunities and with other institutions finding themselves as targets of increasingly aggressive buyers, it seemed appropriate to dust off an article that we published during the height of the last acquisition frenzy when we began to get a lot of questions about the board's duty when receiving overtures from another organization. Questions that often come up among institutions that are frequent targets of unsolicited offers are how to respond to an unsolicited offer and when the duty to take action or notify the stockholders arises. While sometimes the answer may be obvious, there are gray areas that may leave a director wondering, am I supposed to report that to the board or was that small talk?

This updated article provides current guidance on situations that can be considered mere "cocktail conversation" and which conversations require a director to report back to the full board. The following scenarios mirror situations that typically present themselves in real life and are designed to offer some guidance in making the decision of whether reporting is necessary.

The first and most common situation is where you or one of your fellow directors has some informal discussions with a representative of another institution. During your conversation, that individual makes a comment along the lines of: "We should consider putting our two banks together". In this situation, the board member really has no obligation to do anything with that information and it is merely what it is, an informal discussion like you might have at a cocktail party, bank conference, etc. There is really not even a duty to report that conversation back to the full board, though many directors would probably do so.

A trickier situation arises when an individual board member has a more substantive discussion with another bank representative, where the other individual says something like: "Our bank is looking for new markets for growth and our board thinks your bank and your community would be a good fit for us. We would like to talk to you and your board about a possible affiliation of our institutions and, if preliminary talks go well, we will even be happy to provide your bank with a formal written offer". With that type of more substantive discussion, the director who receives that information does have an obligation to report that discussion back to the full board. However, the board really has no affirmative duty to take additional steps unless and until there is additional contact by the bank who initiated the discussion.

Another problematic situation can arise when the bank president or the chairman of the board or an individual director receives a letter from another institution that is somewhat in the nature of a general solicitation. Assume the letter says something like the following: "ABC Regional Bank Holding Company is constantly seeking growth and expansion opportunities and has identified

your institution as a likely candidate for discussions of a possible affiliation. We look forward to discussing these opportunities with you. Please call us at your earliest convenience to arrange a time when we might discuss these matters in more detail”. The individual receiving that kind of general solicitation letter certainly has an obligation to bring it to the entire board of directors for the board to at least give preliminary consideration to it. However, because the letter is merely in the nature of a general solicitation that might have been sent to dozens of banks, the board really has no additional or affirmative obligation to take specific steps to contact the person sending the letter, to conduct any independent analysis and certainly has no additional obligation to report such information to the stockholders. In that situation, the board should note that it received the letter, note that the board gave preliminary discussion to it and, assuming the board has no current desire to sell the institution, the board may simply take no further action unless and until the other institution makes a more formalized offer.

On the other end of the spectrum, through preliminary discussions with bank officers or directors or simply on a totally “out of the blue” basis, your bank receives a more formalized letter that says something like the following: “ABC Bancorporation believes that an affiliation with your institution would produce mutually beneficial results for both entities. After reviewing publicly available financial information in conjunction with surveying relevant aspects of your banking market, the board of directors of ABC Bancorporation has authorized me to present to you the following offer for a proposed affiliation of our institutions. ABC Bancorporation will pay to stockholders of your bank cash equal to \$300 per share representing an acquisition price of 1.50 times June 30, 2019 book value and 14.5 times estimated annualized earnings for 2019 for your institution. The offer is subject to the execution of a definitive agreement and further due diligence”.

That type of letter obviously constitutes a formal written offer to your institution that requires the board to take certain specific steps. The board cannot simply consider it briefly at a board meeting, vote up or down and move on to other business. The receipt of that type of formalized offer imposes a fiduciary duty on the board of directors to analyze the offer to determine whether it is in the best interest of stockholders. That means the board will need to undertake a financial analysis of comparing the offer and its future impact to the likely future results of operations of your institution on a status quo basis. For our clients, we typically run the offer through our acquisition models along with running future growth scenarios for the institution to compare, on an apples to apples basis, whether stockholders of the target are better off accepting the offer from the other institution or maintaining their current stock ownership over the long-term.

However, even in taking those steps to analyze the offer and determine whether or not the board believes that offer is in the best interest of stockholders, the board does not have a duty to disclose the offer to stockholders at that point. In fact, the board could go through the complete financial and strategic analysis of whether to accept the offer and, if it ultimately decides to reject the offer, the stockholders really never need to know about it. For some of our clients that are frequent targets that may receive a handful of unsolicited offers throughout the year, the board has elected to have the president put in a typical letter to stockholders something to the effect of: “From time to time, the board of directors receives unsolicited offers from other institutions. To date, the board has not found any such offers to be in the best interests of stockholders and has not elected to pursue further discussions with those entities”.

For a non-public company, stockholders need not be informed until a formal definitive agreement is executed between the parties. In that situation, most banks will then send out a letter to their stockholders on the day the formal binding definitive agreement is executed indicating to stockholders that an agreement has been reached with the other institution and that in the coming weeks stockholders will be receiving information to consider and vote on the proposal, etc. By that time, the board should have fully analyzed the offer, fully negotiated an agreement with the potential acquiror and have a deal that is truly in the best interest of stockholders so that the response from stockholders is fairly positive.

It is time to be prudent again when considering offers, whether solicited or unsolicited. We hope this provides you some guidance.