GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Florida, Tennessee, Pennsylvania, and Texas!

THE IMPACT OF THE CORONAVIRUS ON COMMUNITY BANKING

We contemplated designating this particular *Musings* as the "Coronavirus Musings," but for a lot of reasons we thought better of it. We will, as the pandemic progresses, let *Musings* readers know of our view of the impact of the Coronavirus on community banking. With the recent stock market meltdown, the universities, colleges, and other schools as a practical matter closing for the year, and even the closing of Disneyworld (maybe the end of life as we know it can't be far off), we at the beginning of this crisis are noticing a strong, appropriately conservative pullback by community banks. Community banks and their boards are conservative by nature. They are going to be prudent. We do not see that changing going forward.

Several of the articles in this *Musings* deal with issues associated with the Coronavirus. Several articles were prepared prior to the Coronavirus being given a pandemic designation and severely impacting the U.S.

As you may suspect, members of our consulting and law firms have numerous client/board/association meetings scheduled over the next month or two. We anticipate many of these will go on as scheduled. (We are still willing to come see you.) Some will not, however. As a result, we are offering the opportunity to our community bank clients to videoconference, audio conference, Zoom, or use some other technology mechanism to meet with the members of our firm. Although we fully understand that this means of communication is not nearly as effective as face-to-face, it may be an appropriate alternative in view of the health risk, particularly for older directors, in the next few weeks.

Also, if any of you care to share the immediate impact of the pandemic on your bank, we would appreciate hearing from you.

DEALING WITH THE REGULATORS DURING AND POST-CORONAVIRUS

You will note this article addresses the possibility of "post" Coronavirus. We firmly believe (and hope) that this will burn itself out. Although the fundamentals of the economy are still strong, we anticipate that the impact of the Coronavirus will certainly cause significant asset quality impact on community banks. Whether the community banks are lenders to the hospitality industry, such as hotels and restaurants, or heavy consumer lenders, to consumers who may have been without jobs for several weeks or months, we believe that the ultimate result of this will be an adverse impact on asset quality. We do not anticipate it will be the same as the "Black Swan" event when the real estate market crashed in 2008, but we think the impact still may be significant, particularly in parts of the country with high infection numbers.

The issue then is what to do with the regulators. We can tell you one thing not to do and that is to expect any type of "forbearance" from them. We were recently asked our thoughts with respect to what the current presidential administration could do to assist community banks through the threat provided by the Coronavirus. . Our response was that community banks will need statutory forbearance when asset quality deteriorates, not the good faith, lip service forbearance the regulators indicate often that they will provide. We mean "forbearance" in terms of lack of enforcement actions, lack of requiring banks to do things they cannot possibly do in this type of environment—like raise capital or correct asset quality problems quickly—and the like.

In view of the fact there will not likely be much of this type of forbearance, community banks need to understand their rights when dealing with the regulators. We have had 40 years of experience dealing with community banks and the regulators through various different downturns in the economy, including the Great Recession. If we can assist you in any way, please let me know. Also, if you would like some written material that explains the regulator's rights versus the bank's rights, please let us know that, and we will forward it on.

ACQUISITIONS AND THE VIRUS

As most *Musings* readers can imagine, the Coronavirus' impact on the bank merger and acquisition market has been dramatic. For any of those community bank stocks whose stock are listed on an exchange, their currency is now, as a practical matter, worth two-thirds or half of what it was. This effectively eliminates those banks as purchasers for now. We do not see the same impact on cash deals as such, except for the banks that have to raise cash to do the deal or utilize excess capital in part to get the transaction completed. We do see some pullback from those buyers who are concerned about reducing capital in view of the uncertain economic times or highly leveraging their company in the same economy. We anticipate M&A for 2020 will eventually be alive and well, but for the short-term it seems most of the potential players are viewing the activities in the M&A market from the sidelines.

RESTRUCTURING OWNERSHIP

We have worked with a number of community banks and holding companies around the country over the last six months in connection with the restructuring of their ownership. These are banks that have excess capital on their balance sheet or capital available that they can obtain. We have always taken the position that a community bank's or holding company's ownership composition a strategic decision that is the responsibility of the Board.

Generally, when restructuring ownership there are three alternatives. The first is that the bank or holding company can simply do a voluntary stock repurchase plan. This will allow those shareholders desiring to sell their shares to sell them back to the holding company, thereby reducing their position. The voluntary repurchase plan is the least effective means to restructure ownership because it is simply that—voluntary.

The second basic alternative for restructuring ownership is the reverse stock split. This is a transaction executed at the holding company level (or bank if there is no holding company) that, subject to shareholder approval, eliminates any shareholder holding shares below a certain number. The benefit of a reverse stock split is it clearly gets rid of the shareholders. They cannot hold onto their stock. All they can do is dissent from the transaction and argue about whether the price is fair. The problem with a reserve stock split is it is a "bright-line test" in that it eliminates <u>all</u> shareholders below a certain level.

The third alternative for restructuring ownership is a discriminatory merger. This is simply a merger transaction at the holding company level (or bank level if there is no holding company) where the terms of the merger determine who gets cashed out and who stays in. There is significant flexibility on the terms of the merger as long as the terms provide some business benefit to the organization. For example, shareholders that stay in may need to have a minimum number of shares, may need to live in the state where the bank does business, or may need to do business with the bank. Any discriminatory term can be utilized as long as there is some overall business purpose for it. The discriminatory merger is approved by a vote of the shares and is binding on everyone. Again, the shareholders who are coming out cannot generally stop the transaction. All they can do is argue about whether the price they are being paid is fair.

If your community bank is in a position (notwithstanding the economic turmoil now) where it has excess capital, this may be a good time to consider restructuring ownership. Both a reverse stock split and a discriminatory merger require a valuation of the shares at fair value under state law. This may be a good time to get that valuation and restructure ownership.

DIVIDEND DATES

A Subchapter S bank holding company recently contacted us to ask for our thoughts on their method of paying distributions. They specifically wanted to know our thoughts as to how they treated the split of distributions when shares were sold at some point other than a quarter or year-end. This company indicated they prorate the Subchapter S "tax equivalent" distribution based on the split of ownership in the period, paying the selling shareholder their portion of the dividend for the period and the purchasing shareholder their portion of the dividend.

Absent a written directive from each of the buyer and the seller to the contrary, we do not recommend treating Subchapter S tax equivalent distributions in this regard. We take this view because there is typically nothing in the Articles, Bylaws, or a Shareholder Agreement that provides for the proration of the dividend in this manner.

In corporate law, there are three important dates relative to the payment of dividends or distributions in a Subchapter S corporation. The declaration date is the date on which the board of directors declares the dividend. The payment date is the date on which payment is made. The ex-dividend date is the date on which the right to receive the dividend no longer attaches to the share. In other words, the close of business immediately before the ex-dividend date is the record date (if you will) for the corporate shareholders that are entitled to receipt of the distributions. Any shares traded on or after the ex-dividend date do not include the right to receive the dividend unless a written agreement between the shareholders to the contrary is executed.

This is important for a Subchapter S corporation to keep in mind, particularly if there is trading in the shares on any date other than a quarter or year-end. This is important because the tax laws provide that the K-1 to the selling shareholder allocate income through the date of sale. The situation that needs to be at least understood and accounted for is that of a selling shareholder having income allocated to them for the period of ownership but not receiving "tax equivalent" distributions to cover the tax on that period of ownership.

BOND VALUATIONS IN ACQUISITION TRANSACTIONS

The past couple weeks have seen significant fluctuations in the value of probably every financial instrument ever known to man. It is impossible and far beyond the scope of *Musings* to try and summarize everything that has happened. However, there are certain areas we feel worthy of note.

One of the issues that we have seen in a couple different circumstances over the past couple weeks is the treatment of unrealized gains or losses in a community bank bond portfolio in a merger or acquisition transaction. We have recently been involved in a number of different instances where buyers and sellers are thinking about the allocation of the volatility risk inherent in the portfolio. The central question is where the risk of change in the value of the bond portfolio ultimately falls.

The short answer to the issue of risk allocation is that you get what you negotiate. Generally speaking, there are one of three ways the risk of changes in the bond portfolio can be allocated. It can be allocated to the buyer, allocated to the seller, or split between the two.

There is no requirement for how the risk of fluctuations in the bond portfolio is allocated in an acquisition transaction. Instead, it is all about what is negotiated between the buyer and seller. Like any other negotiation, it is all part of the give and take to finally arrive at an agreement that works for all involved.

SHAREHOLDER AGREEMENTS

Over the past month or so we have had a couple different clients come to us and ask for assistance on their bank holding company Shareholder Agreements. There is no requirement that a bank holding company have a Shareholder Agreement. Frankly, most C corporations do not. Almost all S corporations do. If you are an S corporation and you do not have a Shareholder Agreement, our recommendation is that you have one in order to protect the S election.

One of the questions that often gets asked when we are assisting in the review of these Shareholder Agreements is what is required to be in the Agreement. The reality is that there really is only one requirement in a Shareholder Agreement, which is a required termination provision in order to satisfy an outdated Federal Reserve rule that allows the Agreement not to be considered a bank holding company for purposes of the Bank Holding Company Act. Beyond that, the parties are free to include whatever they would like.

A Shareholder Agreement typically serves three primary purposes. The first is to protect the S election. The second is to control the transfer of shares. (This is typically accomplished by the Shareholder Agreement providing for certain permitted transfers and right of first, second, and so on refusals that provide certain parties an option to purchase the shares should a shareholder desire to transfer shares in something other than a permitted transfer.) The third is to include all other provisions the shareholders want to include relative to the control of the company, share ownership, and the pricing for the holding company's right of first refusal.

If you have a Shareholder Agreement, make sure that the terms of the Agreement are still of practical benefit to you and your shareholder base. What we often find is that the needs and desires of shareholders today may be very different than they were a couple decades ago when the Shareholder Agreement came into effect.

STRATEGIC PLANNING "BIG IDEAS"

We recently had the opportunity to facilitate a strategic planning session for a very high performing community bank. This particular bank is a larger community bank that involves a good number of their bank employees in the strategic planning process. At this year's planning retreat we decided to do something a little different, and we concluded the planning retreat by dividing into smaller groups and developing and presenting "big ideas" for the holding company and bank.

The idea behind the big ideas was to develop something that the organization would be extremely proud to rollout to its community. The fun part was that there were no limitations or items that were off limits. Instead, the whole point of the exercise was to really think creatively about things that the company could do from a strategic perspective to introduce new products and services, deepen customer relationships, grow the business, and further support the community. We are not at liberty to divulge the big ideas that came out of the discussion. However, they were great! It might also be that some of these ideas gain some traction and are reformed to go from concept to reality. The overall belief of the group was that it was a very energizing and useful way to conclude the session.

Consider devoting some time to the development and discussion of "big ideas" at your next planning session. It may be that it spurs some line of thinking that ultimately turns into a big hit for your organization.

CONCLUSION

We hope all of you are working your way through these turbulent economic times caused by the current pandemic. We are confident that as community banks have historically worked through the turbulent times (Farm Crisis, Savings & Loan Crisis, Great Recession), we will work through these times as well.

Please be advised Gerrish Smith Tuck, Consultants and Attorneys will fully be in business. There has been no suspension of our services (we do have the benefit that all the professionals and staff have the capability of working remotely, and many of the professionals in our firm have worked remotely for years).

We hope all of you and your community banks and families stay healthy and well as we work through this current crisis.

See you in two weeks.

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