GERRISH'S MUSINGS

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June 30, 2020, Volume 419

Dear Subscriber:

Greetings from Georgia, Indiana, Illinois, Wisconsin, Tennessee, Florida, and Iowa!

REGULATORY SPECULATION

We have regularly speculated in *Musings* that the friendly federal regulators were playing good lip service to forbearance and other issues resulting from the pandemic. Our curiosity has always been whether the proof for examination purposes would be "in the pudding."

Last week the regulators jointly came out with "Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of COVID-19 Pandemic on Institutions." This is a Financial Institutions Letter that each of your banks should have received. We suggest you pay close attention to it. It does not sound much like "forbearance" to us. Although, according to the guidance, the friendly federal regulators will not blame you and your bank for not anticipating the pandemic as a risk – that's the good news - the friendly federal regulators will blame you for not appropriately responding to the risk, which is of course based on their opinion. If anybody did not get a copy of this Letter and would like it, please let us know. We are happy to forward it on.

TOO MUCH CAPITAL?

Can your community bank ever have too much capital? You wouldn't think so. We suppose it depends on your perspective. From a mathematics perspective, too much capital means a potentially abysmal return on equity. From a regulatory perspective, as we all know, FDIC stands for "Forever Demanding Increased Capital." From a banker's perspective, that capital needs to be deployed. From a director's perspective, capital needs to be deployed to enhance shareholder value. Can you ever have too much capital? Probably so.

We recently had the opportunity to work with a board of directors of a bank that literally had "too much" capital. The discussion primarily involved how to best deploy that capital to improve the lot of the shareholders and thereby improve the lot of the community and other stakeholders. For a bank that has too much capital, there are only so many shares you can repurchase and so many dividends you can pay. The deployment of capital in a bank that has an abundance really involves executing an appropriate acquisition strategy. Most of the community bank holding companies that are not public (and even some that are that don't have a liquid currency) will be engaging in cash acquisitions. Our recommendation to this particular client was to look at a cash acquisition to deploy excess capital effectively.

Many of you will think, particularly during the pandemic, excess capital is a nice problem to have. In reality, while it may not be a problem with the regulators, it can be a problem for your shareholders in terms of keeping your bank independent over the long term.

MICROMANAGEMENT

We received a couple of inquiries over the last month or two (mostly coming on the directors' helpline that our firm maintains for the ICBA) about a director's attempt to micromanage the bank. Interestingly, one of the calls came from a chairman of the board who was wondering how to reign in a couple of his directors who felt it was appropriate to micromanage the senior executives at the bank. The other came from a bank CEO.

We generally see micromanagement by the board in a couple different situations. When a new bank is being formed, the board is intimately involved in virtually everything that is going on. Once the bank is formed, they want to continue to be intimately involved in everything that is going on. This is somewhat understandable since, for the most part, they are generally fairly significant shareholders in the organization. The second circumstance in which we find micromanagement is in connection with a "troubled bank" situation. This type of micromanagement is generally encouraged by the friendly federal regulators under the guise of "increased board oversight." In the absence of either of those situations, there is no reason for a board or a board member to attempt to micromanage the executive team. The general rule is "noses in, fingers out." As we generally like to say, if the board feels the need to micromanage management, then that tells us that the board does not have confidence in the management. Instead of micromanaging it, they simply need to get new management they do have confidence in. Think about it. Your job as a director is to direct collectively as a board, not to manage.

FED IMPOSED CAPITAL RETENTION REQUIREMENTS

As you may have heard, the Federal Reserve has implemented what we consider to be some fairly stronghanded capital preservation requirements for the nation's largest banks. These capital preservation requirements are applicable to those bank holding companies with $100 billion or more in consolidated assets. In short, the requirements temporarily ban these bank holding companies from engaging in any share repurchase transactions. They also prohibit these bank holding companies from increasing their dividends from those paid for the second quarter of this year.

As noted, the Federal Reserve capital preservation requirements are applicable to only those bank holding companies with $100 billion or more in consolidated assets. Obviously, this excludes all community banks regardless of whatever metric you use to define community banks. However, we have concern that what are requirements for the nation's largest banks may trickle down to be "best practices" for all other bank holding companies.

Thus far our concern has not come to fruition. Over the past couple weeks we have had a couple different instances where we have provided notices of anticipated share redemptions for community bank holding companies, and the Fed has not imposed any type of restriction on the anticipated course of action. We hope this trend continues. We certainly do not see as necessary or appropriate the Federal Reserve applying these capital preservation requirements to the nation's community banks. Instead, the Fed should continue its course of allowing these institutions to understand their own asset quality, monitor their individual circumstances, and make their own business decisions on the allocation of capital towards share repurchases, dividends, growth, or any other allocation determined appropriate by the Board.

SUB S SHAREHOLDER DEATHS

Several times over the past couple weeks, we have encountered circumstances where a Subchapter S corporation has had a shareholder that has passed away. When a Subchapter S shareholder dies, there are a couple important things to keep in mind. First, the transfer of the stock owned by a deceased shareholder will be controlled by the individual's estate planning documents or applicable state law if they have died without a will. Often these documents will direct the shares to go to a surviving spouse, surviving children, trust, or other beneficiary. It is important for the community bank holding company to identify as quickly as possible to whom the shares are to be transferred.

Most bank holding companies that are taxed as S corporations have Shareholders Agreements that control the transfer of shares. If your bank holding company does have a Shareholders Agreement, it is important to ensure the intended transfer complies with the terms of the Shareholders Agreement. Given this is a contract between the holding company and the shareholder, it is important that all contractual formalities be followed.

Another very important element to keep in mind is that the estate of a deceased Sub S shareholder is a qualified Sub S shareholder only for two years. The Internal Revenue Code gives the estate and the company what it determines to be an appropriate amount of time to cause for the estate's transfer of the shares. If the estate continues to hold the shares at the two year mark, the estate likely needs to file documents with the IRS to be treated as either a Qualified Subchapter S Trust or an Electing Small Business Trust. This is necessary to preserve the S election. If the estate holds the shares past two years and takes no action, the S election is technically terminated, which the S corporation should look to avoid at all costs.

HOLDING COMPANY ACQUISITION DEBT

We have recently "run the numbers" on a couple different acquisition opportunities that involve fairly significant amounts of holding company debt. These transactions are all contemplated as 100% cash transactions. The potential acquirer does not have enough excess capital to fully fund 100% of the anticipated purchase price. Instead of going out and selling shares to raise the balance, the holding company anticipates borrowing funds at the holding company level to supplement existing cash (in the form of excess capital) and fund the purchase price.

One question that always comes up in this type of transaction is how much debt the bank holding company is allowed to take on to complete the transaction. There really are two answers, one technical and one practical.

The technical answer is that the Small Bank Holding Company Policy Statement limits acquisition debt to 75% of the purchase price. In other words, it requires a buyer to put in 25% hard equity, but allows a buyer to borrow the remaining 75% of the purchase price to fund the transaction. There are also debt-to-equity limitations at the holding company that need to be considered.

From a practical perspective, the real question is what is the Board's "squeal factor" as it relates to holding company debt. Some boards take the position of being "out of debt, out of danger" and do not have any interest in taking on any material amount of debt. Other boards obviously take a different view and are willing to borrow as much of the purchase price as is allowed. Frankly, most boards fall somewhere in between.

If your community bank holding company is contemplating an acquisition and funding the purchase price with debt, keep these two concerns in mind. Obviously the technical requirements of the law must be complied with. However, there are certainly practical limitations that must be considered as well. The important thing is that you conduct the appropriate financial analysis of a potential acquisition to understand and identify the appropriate level of debt to ensure compliance with the technical and practical concerns.

ACQUIRING AN INSOLVENT HOLDING COMPANY

We are assisting a couple different clients in pursuing the potential acquisition of an insolvent bank holding company (not one that has filed bankruptcy yet). What is an insolvent bank holding company? It is a bank holding company where the value of the assets are less than the holding company's liabilities, creating a negative equity position at the holding company.

In these types of transactions, the community bank holding company becomes insolvent due to a diminution in the equity of the underlying bank. This diminution in equity is preceded by the holding company going out and borrowing funds at the holding company level to use the cash for whatever intended purpose, typically either increasing bank capital to support growth, repurchasing shares, making an acquisition, or similar strategic purposes. Following the debt, the bank then experiences trouble, begins to lose money, and is restricted from paying dividends, which is the source of cash for the holding company to repay the debt. The losses decrease the bank's equity, but the holding company liabilities remain the same.

In evaluating the acquisition of an insolvent holding company, it is important to keep in mind what it is you are buying. The short answer is that the "purchase price premium" includes whatever additional losses remain embedded in the bank plus whatever amount is necessary to bring the holding company equity back to at least neutral. These financial realities often result in significant difficulty in making the numbers work for this type of acquisition.

SHARE LIQUIDITY

Musings often addresses the Board of Directors' obligation to enhance shareholder value through providing liquidity for the shares of the holding company. Liquidity is generally defined as the ability of a shareholder to sell a share of stock at a fair price at the time they want to. We have had numerous calls, emails, and Zoom conferences lately with community banks that are in the process of attempting to create a plan to create liquidity for their shareholders. We believe, in part, this is driven by the need for cash, and in part, by the uncertainty of the economy, as well as the aging of the shareholder base.

In general, we start these calls/Zoom meetings with a discussion of the board of directors' obligation to enhance shareholder value. Part of that is the obligation to create share liquidity. Often, the community bank holding company directors are very concerned about being "fair" to the selling shareholders in connection with a repurchase transaction. In connection with redeeming shares through the holding company, it is essential to be fair to the selling shareholders, but it is also essential to be fair to the non-selling shareholders. In other words, if the Board sets the price "too high" to be "uber" fair to the selling shareholders, are they then being "uber" unfair to the non-selling shareholders (shareholders who remain)? Both sides of the equation, the selling shareholders and non-selling shareholders, should be considered when pricing a share repurchase/redemption transaction. Make sure you keep that in mind.

CONCLUSION

To say this has been an interesting six months for community banking is an understatement. We are proud, however, to watch our community bank clients across the nation support their customer base and the communities, notwithstanding the impact of the pandemic. We are at the end of the second quarter. The 4th of July weekend is straight ahead. We hope everyone has a wonderful weekend with friends and family. Stay safe and healthy.

See you in two weeks.

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