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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 Texas, Louisiana, Arkansas, Minnesota, Wisconsin, Missouri, and New York!

## THE CLOSED DEAL

In January of 2020, we represented a community bank client who was interested in selling their bank. This was not a terribly unusual situation. Community banks sell for what we often refer to as the “traditional” reasons. This includes lack of share liquidity, lack of management succession, death of the principal shareholders, and the like. This sale certainly fit in that category. The definitive transaction agreement (i.e., the long agreement) binding the parties was signed in January of 2020. As you will note, this was prior to any indication that there was COVID-19 or a pandemic in the offing. Once the pandemic hit in early to mid-March, this deal was put on pause. At that point there was some serious question as to whether the transaction would ever be consummated. We worked hard with both the buyer and the seller to see if there was some middle ground or a basis on which this transaction could be consummated. Fortunately, we found some by making an adjustment to, not the purchase price, but the purchase consideration. The deal had been initially structured as all-cash. The final resulting deal was mostly cash plus the transfer of a couple of assets that gave the buyer concern, particularly post-COVID.

The deal consummated in the last few weeks. We were glad for both parties that it did. It was a good purchase for the buyer and a good deal for the seller. It is also an indication that, notwithstanding the pandemic, bank acquisition transactions can still be consummated.

## WHAT DID WE LEARN FROM THE PANDEMIC?

Over the past few weeks we visited with numerous banks, large and small, about their response to the pandemic - more importantly, what they have learned from the pandemic and what practices, procedures, patterns, and products that might have been so positive that the bank will continue to pursue them post-pandemic.

It is probably safe to say that most of us have wished the pandemic had never occurred. There were some positive aspects of it, however, as we learned to work remotely, be more independent on technology, and the like. Our suggestion is that it is incumbent upon every bank to review its response to the pandemic and determine what changes, if any, resulting from the pandemic are good, survivable long-term strategies that will enhance the value for shareholders. This review should be part of every bank's strategic planning.

## THE GRAY SWAN EVENT

Many of us recall the "Great Recession" of 10 years ago as being referred to as a "Black Swan Event." A Black Swan Event is primarily defined as something that no one ever expected to occur. A rarity never occurring before. The Black Swan in 2008 and beyond was primarily the total collapse of the commercial real estate market, among other things.

We were recently visiting with the executive officer of a client when the CEO referred to the current pandemic as a "Gray Swan Event." A Gray Swan Event is obviously not a Black Swan Event. We inquired as to the difference. The reply was that a Gray Swan Event is something that has occurred previously but is never expected to occur again, as a practical matter. The reference was to the 1918 pandemic in the United States that cost several million lives.

We suppose whether it is a Gray Swan or a Black Swan doesn't much matter, but we anticipate we will do much better with this Gray Swan Event over the long term with regard to economic recovery. At least we hope so.

## TO ZOOM OR NOT TO ZOOM – THAT IS THE QUESTION

Since March of 2020, we have received multiple requests and participated in multiple Zoom, GoToMeeting, Webex, and similar video conferences with clients.

The question we often get asked is "how well does it work"? Our response generally is it works far better than no meeting. It works somewhat better than a phone call. It works best for single issue discussions. In other words, if the board wants to have a discussion about a single issue (i.e., a potential acquisition transaction, raising of capital, expanding geographically, obtaining a franchise player, and

the like), then a Zoom or similar meeting typically works fairly well. That is primarily because the issues are focused and the meetings are relatively short. We have found for strategic planning sessions requiring significant interaction, though that face-to-face presence is far and away the better choice.

### UNSOLICITED OFFER POLICIES

We have assisted a number of clients in drafting unsolicited offer policies, which are policies that set the framework for how the Board will respond in the event of the receipt of an unsolicited offer. Many of these policies incorporate a minimum price that must be met in order for the Board to even further consider the offer. This is intended to quickly and easily dispose of an unsolicited offer that is just some type of bottom feeder trying to pick up the bank on the cheap.

Unsolicited offer policies most often base the minimum price on recently announced comparable bank acquisition transactions. We often assist community bank holding companies by reviewing comparable deals over the past six or so months and identifying a minimum floor price based on these comparable deals. We recently had a discussion with a client on this issue, and our advice was to essentially do away with the comparable transaction analysis for now. We recommend this as appropriate because over the past six or so months there have been less than 20 deals announced, and the pricing on those deals, when it is made public, is all over the place. The short answer is that there is just not enough comparable transactions out there to make any reasonable argument that the comparable transactions form a reasonable basis for the value of the bank.

If you have an unsolicited offer policy, we recommend keeping these issues in mind. It is also important in the event you do not have an unsolicited offer policy but receive an unsolicited offer. We do not think that right now there is enough comparable transaction activity for the small number of announced deals to serve as the basis for value for a bank.

### LONG-TERM INDEPENDENCE IS NOT A QUARTERLY DECISION

We recently read with interest an article about credit unions buying banks that was published in a national banking publication. The frontpage summary of the article caught our eye, as it said the pace of credit unions buying banks in the second half of 2020 will come down to the central issue of whether community banks can generate strong enough profits in the second half of 2020 to justify their independence. Based on our reading of the article, we see the frontpage teaser as the print version of “clickbait.” The article never addressed community bank independence. The article was instead talking about how the pace of credit unions buying banks has slowed in the first half of 2020 and the reasons for

that. It was exactly what you would expect, citing concerns over asset quality and unknowns related to the pandemic and the like.

We have two central complaints with this article. First, the frontpage teaser's insinuation that community bank independence is determined quarter-by-quarter based on last quarter's profitability is just flat wrong. Community banks do not, and *certainly should not*, determine their independence based on their profitability over the past 90 days. Instead, community banks determine their independence based on their long-term strategic planning. The central issue is not one of quarterly profitability. The issue is whether the community bank has the ability over the long term to enhance shareholder value. If so, independence is absolutely an available strategic alternative. If not, a community bank's independence may be threatened, particularly if it cannot develop a strategy to enhance shareholder value.

The second complaint we have of the article is that it really is not an accurate reflection of the current community bank M&A environment. The article indicates that community bank mergers and acquisitions are "basically dead" and will not be coming back until maybe the second quarter or so of 2021. That is not our experience. As we have previously relayed in *Musings*, right now there is quite a bit of activity in community bank M&A. However, most of this is churning under the water, with deals coming together in a slower and more deliberate manner. This has slowed the pace of acquisition announcements, but saying that activity is dead is not accurate. Based on what we are seeing in our firm, there is strong interest in community bank M&A transactions.

### STOCK TRANSFER PROCEDURES

Stock-owned corporations represent the vast majority of community bank holding companies. One issue for consideration for stock-owned corporations is how they maintain and control their stock records. Most community bank holding companies act as their own registrar and stock transfer agent. Some outsource these activities to professional corporations that serve as third-party registrar and transfer agents. There is no requirement to do it one way or the other. It is simply a matter of preference.

We were recently approached by a community bank holding company that acts as its own registrar and transfer agent. Over the past couple months, they had been through a number of different shareholder transactions where they were not certain of the exact procedures to follow and documentation to require. They asked us to assist in drafting what are best described as standard procedures relative to their activities as registrar and transfer agent. We worked with this holding company and developed a set of written procedures that should be followed in the administration and oversight of their stock certificates, noncertificated shares and related stock records. For example, the

policies clearly set forth what is required in order for a transfer of shares when there is the death of an existing shareholder. Similar circumstances were covered as well. The holding company just wanted to make sure they knew exactly what they needed in terms of documentation and procedures in order to not mess up as the responsible party for their corporate recordkeeping.

We thought the holding company's request to be a very good one. Our experience is that community bank holding companies often fly by the seat of their pants as it relates to their registrar and transfer agent activities. We see a great deal of value in formalizing these procedures to protect against any mishaps in this important corporate governance function.

### “NEW” ACCREDITED INVESTORS

As most *Musings* readers know, when a community bank holding company looks to generate capital for its subsidiary bank, we generally suggest the first stop should be to look at additional borrowings at the holding company. If, however, a community bank holding company is looking to sell stock to raise capital, it is often structured as a Regulation D Rule 506 exempt offering. This type of offering allows a holding company to raise an unlimited amount of capital in a sale of equity to an unlimited number of “accredited investors” and no more than 35 “non-accredited investors.” Assuming a sale meets the exemption requirements, the stock can be sold without registering the offering with the Securities and Exchange Commission or any state equivalent.

Accredited investors are generally what we describe as “rich and smart” people. There are several different ways to qualify as an accredited investor. These are often referred to as the net worth or net income tests. The whole idea behind accredited investors is not to require a corporation go through the rigors of a public offering because accredited investors have the knowledge and experience to be able to fend for and protect themselves relative to the potential investment.

Over the past couple years, the SEC has given consideration to expanding the definition of an accredited investor. Within the past week, the SEC released their Final Rule in this regard. The Final Rule was only 166 pages, so it was some light, enjoyable reading! A complete summary of the Final Rule is well beyond the scope of *Musings*, but it is important to note that the Final Rule has expanded the definition of accredited investors. Accredited investors now include certain professionals that have certain certifications, primarily in the financial services and investments arenas. The changes to the Rules also expanded certain aspects of the net worth and net income tests.

All of this should be viewed as good news by community bank holding companies that may be looking to raise additional capital. These changes further increase opportunities to raise capital through the sale of stock, whether through Regulation D Rule 506 or otherwise, should that be desired. Please

let us know if you have any questions or would like to see a summary of the changes to the Rules. We are happy to provide one.

### PPP FRAUD

We continue to read articles and hear stories of PPP borrowers defrauding the government and getting caught. We would typically think that these would be larger loans. Even the SBA said that pretty much only loans over \$2 million would be audited. The most recent one, however, was a \$414,000 loan involving a North Carolina borrower. This borrower's scheme was not terribly creative. He falsified IRS payroll documents when submitting his application for a PPP loan of \$414,000. He was recently indicted.

We anticipate the bank felt that something was fishy in this regard even after they funded the loan. Although this is typically under the "size" threshold for investigation that we would normally expect to see, we would also likely expect more of these types of loan frauds to be discovered and prosecuted. Fortunately in this one, the individual still had nearly all of the \$414,000 in his bank account (no Lamborghini or condo at the beach), which the government froze.

### CONCLUSION

It is amazing how fast this crazy year of 2020 has gone so far. We are now at the end of August. The kids are back in some sort of school mode. We are heading toward the end of the third quarter, with the fourth quarter in sight. Labor Day Weekend is also upon us. Have a great time with friends and family.

See you in two weeks.

*Jeff Gerrish*

*Philip Smith*

*Greyson Tuck*