GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from South Carolina, Wisconsin, Tennessee, and Florida!

ELECTRONIC ANNUAL MEETINGS

Now that we are in the new year, there are a number of community bankers that are thinking about their forthcoming annual meetings. We have received numerous calls over the past couple weeks about annual meetings. The central questions are whether the annual meeting can be held electronically, and, if so, what are the specifics that must be followed to ensure all the business conducted at the electronic annual meeting is valid?

If you are thinking about an electronic annual meeting, give consideration to both the legal and practical issues. From a legal perspective, state law for the state in which your holding company is chartered, as well as your holding company Articles and Bylaws, should be reviewed to determine whether the meeting can be held electronically. Some states specifically allow for electronic meetings, some states permit them unless they are prohibited by the company's Articles or Bylaws, some states do not allow them unless specifically permitted by the company's Articles or Bylaws, and some state statutes are silent on the issue. We have also seen a couple states where there are Executive Orders placed down by the Governor that specifically allow electronic meetings for some specified period of time.

In addition to thinking about the legal issues of the annual meeting, the practical issues also have to be considered. Is the meeting going to be held via videoconference or conference call? Will everyone be placed on mute, or will the various shareholders be allowed to speak? Will there be a virtual happy

hour at the conclusion of the meeting for everyone to have a drink and discuss other important matters? (We are kidding on that one, kind of.)

The current circumstances are such that many organizations are staring down the possibility of an electronic annual meeting. If you are thinking about holding your meeting electronically, be sure to keep all of the applicable issues in mind. There are a number of both legal and practical issues of concern. Please let us know if there is any way we can help.

THE "SKIN IN THE GAME" REQUIREMENT

We are currently assisting a community bank in evaluating the potential acquisition of another community bank. The client asked that we first assist by "running the numbers" on the acquisition. In completing the financial analysis, our client asked us to evaluate the opportunity, make a determination as to the target bank's market value and, most importantly, determine how the acquisition could be funded. They said they would like to complete the acquisition, if possible, without having to raise any equity capital by selling additional shares of stock.

We went through and completed a detailed financial analysis of the acquisition opportunity. The potential acquirer does not have any "excess capital" of which to speak. We first ran the acquisition analysis to determine whether the acquisition could be fully funded with debt and allow the acquirer to continue to hold appropriate levels of capital while also meeting debt service requirements and paying shareholder dividends. The numbers worked. The problem is that would not pass regulatory muster.

The Small Bank Holding Company Policy Statement requires an acquirer to contribute at least 25% of an acquisition purchase price in existing equity. In other words, the applicable rules only allow up to 75% of the purchase price to be funded with debt. This rule makes the transaction more difficult for our client. Although the potential purchaser is profitable enough to very easily service the amount of debt that would be needed to completely fund the acquisition, the applicable regulations will not allow it. This means that if the deal goes forward our client will either have to utilize stock as part of the transaction consideration to the selling shareholders or have to sell enough stock to existing or new shareholders to fund at least 25% of the purchase price in cash.

PPP DOUBLE DIP

It appears the new PPP loan rules will now permit borrowers to take a "double dip" from a tax standpoint. Forgiveness of the PPP loan does not create taxable income for the borrower. That was the case under the first round of PPP and the second. The current, new round of PPP, however, allows deductibility of PPP expenses. So as a practical matter, your borrower gets the money, has the loan

forgiven, and generates no debt forgiveness income. The borrower then spends the money on expenses which are also tax deductible. Sounds like a double dip to us and good for the borrower.

TAXES, TAXES, TAXES

Now that the Congressional races have all concluded with the Democrats obtaining control of the Senate and maintaining control of the House, it is likely we will see legislation that impacts corporate and individual taxes. We are going to "go out on a limb" here and assume the impact on taxes will be an increase to the tax rate in the corporate world and on well-heeled individual bankers. Many *Musings* readers have been holding off on certain strategic issues (including converting to Subchapter S) until they had some drift of which way the tax rates were going. It appears to us they are going up. An increase in the corporate tax rate will only make Subchapter S look better. If anybody needs any information on Subchapter S, please let us know. We still believe it is the best way to enhance shareholder value and keep your bank independent as long as you want to.

FED UP

Over the past year, we worked on a number of acquisition transactions. Most of them went forward, but a couple of them simply stopped in their tracks. In one in particular, our firm represented the community bank buyer. In that case we found the community bank seller to be very difficult to work with. We are not sure if it was some deep seated "I really don't want to sell this bank". If it was, we respect that. Nonetheless, to drag a transaction along for several months, if that is the real concern, was kind of disingenuous.

In any event, finally the buyer got to a point where they were just simply fed up. This fit into the "life is too short" category.

The buyer concluded that if pre-transaction the parties were arguing over every single molehill and turning it into a mountain during the course of trying to pull the transaction together, what was it going to look like trying to get it to close and post-closing? Not a pretty picture. Our community bank buyer made a smart decision.

SUBCHAPTER S HOLDING COMPANY DEBT

If you read *Musings* with any consistency, you know we are big fans of community bank holding companies electing to be taxed as Subchapter S corporations. We also believe utilizing bank holding company debt is most often the best way to raise bank capital, should that be necessary. When tying

those two together, there is an important provision of the Internal Revenue Code that should not be forgotten. This is referred to as the Subchapter S Straight Debt Safe Harbor.

A community bank holding company that has elected to be taxed as an S corporation should be certain to structure any holding company debt to meet the requirements of the Subchapter S Straight Debt Safe Harbor to ensure the preservation of the S election. Any holding company debt that meets the Safe Harbor requirements will not be considered a second class of stock for purposes of the Subchapter S election. A second class of stock results in an automatic termination of the S election. The requirements of the Straight Debt Safe Harbor are:

1. The interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors,
2. There is no convertibility (directly or indirectly) into stock, and
3. The creditor is a specified qualified Subchapter S shareholder or a person that is actively and regularly engaged in the business of lending money.

If you are a community bank holding company that has elected to be taxed as an S corporation, keep the Subchapter S Straight Debt Safe Harbor in mind. You do not want to issue debt and unintentionally terminate your S election.

COMMUNITY BANK RECOGNITION

As most *Musings* readers are aware, the SBA opened up another round of PPP funding this week. This third round of funding is similar to the prior two, with one major exception. In this round of funding, all lenders are not provided the opportunity to loan the PPP funds at the same time. Instead, Congress established an order of priority, giving Community Financial Institutions first shot at making the loans, PPP-eligible lenders with $1 billion or less in assets second shot, and then all participating PPP lenders third.

We are pleased to see this order of priority as established by Congress. We believe that it is an appropriate recognition of community banks and their value and benefit to small businesses. The only place we take exception is the $1 billion threshold. Frankly, we see it as too low. We have a number of clients that have more than $1 billion in total assets that we consider to be great community banks that are strong allies and partners for small business.

SURPRISE, SURPRISE

We received an email from a community bank trade association executive the other day (who must have been relatively new) wondering if any members of our firm did keynote presentations,

workshops, webinars, or other presentations on community bank topics. We were actually pretty surprised at the request since, from our perspective, we were slightly concerned that we may have saturated the market with our "golden tones" and high-energy presentations. We responded, of course, that we did all those types of presentations. We then went back and researched and discovered we had provided multiple in-person presentations for trade associations (notwithstanding COVID-19), as well as dozens of webinars, seminars, and Zoom conferences. It just goes to show that not everyone understands what members of our consulting and law firms do for community banks and their trade associations, and likely not all of your potential customers understand what your banks offer. Sometimes you just have to continue to let them know.

CONCLUSION

We are off to the races in 2021. We concluded today another successful in-person Board Chair Forum in Naples, Florida in conjunction with the Barret School of Banking. Look for this event next January as well.

Stay warm and safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- January 26-29, 2021 – Independent Community Bankers of America – Credit Analyst Institute – Legal Issues Class (Cliston V. "Doc" Bodine, III) Registration link: Credit Analyst Institute
- February 2-3, 2021 – Mississippi Bankers Association (Zoom) – "Community Bank M&A Past the Pandemic" (Greyson Tuck) Registration link: M&A Seminar