GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Tennessee, Minnesota, Wisconsin, West Virginia, Florida, Louisiana, Alabama, and Pennsylvania!

UNSOLICITED OFFERS

We are currently in the process of providing assistance to a couple different clients that are addressing the receipt of unsolicited offers. Keep in mind that in community banking unsolicited offers are different than hostile takeovers. An unsolicited offer is essentially a bank approaching another bank with an offer to acquire where the recipient did not solicit the offer.

One of the questions that often arises for the recipient of an unsolicited offer relates to the analysis. The board often wants to know what it is they are supposed to be considering in light of their fiduciary duty to the shareholders. Our advice is that the analysis is essentially whether what is being offered by the unsolicited purchaser (i.e., cash, stock, or some mix) puts the potential selling shareholders in a better position than the alternative of continuing to hold onto the holding company stock and remaining independent. Regardless of a strategy related to independence, we believe there is some price point at which the board's fiduciary duty compels action on an unsolicited offer.

If your holding company happens to be the recipient of an unsolicited offer, the first step is to determine whether it is from a credible purchaser (i.e., can obtain approval of the transaction) and whether it is at a credible price level. If you answer both of those in the affirmative, then the board needs to keep its fiduciary duties in mind. Again, the central question the board must answer is whether the offered consideration puts the shareholders in a better financial position than the alternative of remaining independent. From there, there are a number of different strategic issues and approaches that need to be considered.

THE UNSOLICITED OFFER POSITION STATEMENT

In view of the recent increases in unsolicited offers, we recently had a board of directors ask us to assist them in drafting a written document to outline the board responsibilities, considerations, and individual member duties in the event of the receipt of an unsolicited offer. We originally began discussions on this document as a board policy. However, we chose to pivot away from a policy and instead created a board position statement on the receipt of an unsolicited offer.

The position statement is pretty straight forward. It identifies what is considered an unsolicited offer and differentiates the characteristics of what have been coined credible and noncredible unsolicited offers. It also differentiates between general and specific offers. The position statement also specifically addresses how the board will respond to the various types of other credible or noncredible general or specific offers.

We thought this policy statement a good approach in today's environment. It provides what we see as a good outline and framework for how to respond to an unsolicited offer, should one be received. If your board is thinking about how it might react in terms of the receipt of an unsolicited offer, this type of position statement may be a good strategic alternative for you.

REMAINING INDEPENDENT IN A CONSOLIDATING ENVIRONMENT

"Remaining independent in a consolidating environment" sounds like the title of a speech. In fact, it is. All of us have spoken on this issue at multiple locations. The real issue is what should the focus of a community bank board be if the goal is to remain independent? One significant issue is management succession. Another issue is board succession (which seems to be easier, frankly). The third issue, which is very important to remain independent, is ownership transition. We have had multiple engagements recently with community banks who have asked us to come in and assist in reviewing and advising with respect to ownership transition. This involves timing, transfer of power, agreements among owners, and the like. Failure to appropriately manage ownership transition is one of the more common triggers of a community bank sale.

THE LOSS LEADER

We have been in multiple planning sessions lately where the community bank has a small trust department. We always look at that from an economic standpoint and question why the bank maintains a small trust department when it is losing money and probably always will if they do not put some effort into growing it north of $100-$200 million in assets under management. As a way to get the conversation going, we often suggest that they sell the trust department off or give it away and stop the bleeding. We are often met with the response that the trust department is a "loss leader" for the bank. Most of the time, in our typical fashion, we just indicate that it is a "loss"—there is no leadership to it. We were recently with a bank that did not describe the trust or any of the other ancillary services as a loss leader, but in fact described the bank as the loss leader. The comment was made somewhat in jest, but the reality is this bank had numerous other lines of business and ancillary services such that the bank, once it had drawn in the customers, would serve as the feeder for these other ancillary services, all of which were highly profitable. The goal for most community banks is to grow noninterest income. This particular community bank has done far better than most.

REDUCING HOLDING COMPANY DEBT

We have been with a number of community banks lately that have significant holding company debt. A lot of this is a hang-over from the 2000's and generally presents itself as trust preferred securities. The interest rate on that debt, tied to LIBOR of course, is very low at this stage (even with LIBOR phasing out). Often, these holding companies have established some kind of a "sinking fund" to pay off that debt. As most of you will probably recall, trust preferred securities were issued significantly in the late 1990s and early 2000s and were 30-year interest-only obligations. Most still have another 10 or 15 years to run. Some of these banks who have maintained a significant sinking fund in cash at the holding company are wondering if now is the time to pay these off.

Our general advice is to look to the future and forecast what the bank and holding company capital allocation needs are going to be. If there do not appear to be any cash needs at the holding company, then there is no sense paying interest on money that the company doesn't need when it has cash on which it is earning virtually no interest that it could use to eliminate the overall consolidated expenses. If the company is going to need additional funding and would be required to go out and borrow at a much higher rate, then obviously it makes much more sense to keep the existing debt in place, use the cash, and only add additional debt as necessary. Based on that analysis, some of our clients around the country will pay that debt off sooner rather than later, and some will keep it on the books, pending an additional opportunity.

MANAGEMENT SUCCESSION

We have been in multiple community banks lately that are dealing with significant management succession issues. Management succession is always an issue, but in some of these banks where the CEO has a "7" in front of his or her age and no internal successor, management succession becomes a real issue. For most of them, it comes down to the question, do you replace the CEO, or do you simply make a determination that now is the time to sell the bank? Community banks go both ways. We have worked with many of them in the recent past who have determined that it is appropriate to replace the Chief Executive Officer and continue on with the bank serving its community and its shareholders. Others have determined that it is appropriate to sell the bank at the time the CEO is 18 months to two years from retirement (most buyers will want the face of the bank to stay on for a while) and not replace the CEO. Multiple factors go into that decision making, including the age of the Board, the age of the shareholders, and other typical triggers for a sale transaction. Our general preference is that community banks stay independent and find another CEO to replace the current CEO. We do advise boards, however, that even though they want someone exactly like the current CEO, cloning, thus far, is not legal in the U.S.

STOCKHOLDER AGREEMENTS

Over the past number of months we have assisted many community bank holding companies in reviewing and revising their Stockholders Agreement. In each of these situations, the central goal of the holding company is to establish control over and a framework for the sale and transfer of shares. In reality, most of these holding companies are using their Stockholders Agreement to act as protection for an S election and as a form of an anti-takeover defense.

One of the questions that has risen a couple different times in regards to review of these Stockholders Agreements is what provisions can and cannot be included. These primarily relate to restrictions on transfer and pricing. They involve questions regarding the ability to cap ownership by family groups at a certain percentage, questions as to how the value of shares will be determined and similar questions.

The short answer is that a Stockholders Agreement can contain any provisions to which the stockholders agree. Generally speaking, if a stockholder agrees to the Stockholders Agreement, then the stockholder will be bound by all of its terms. The key is drafting the Stockholders Agreement in such a way that all the stockholders will agree. Some community bank holding companies attempt to get the shareholders to agree voluntarily to the new Stockholders Agreement. Our general recommendation in order to assure the implementation of a new Stockholders Agreement is to use a cash-out merger transaction to require the stockholders to either agree to the terms of a new Stockholders Agreement or accept cash for their shares. This avoids the problems associated with some shares being subject to the terms of an old Stockholders Agreement and other shares being subject to the terms of the new Stockholders Agreement.

If your holding company is contemplating revising its Stockholders Agreement, keep in mind that pretty much anything is fair game, as long as it is not illegally discriminatory and the stockholders agree to it.

DEPOSIT PRICING

The issue of deposit pricing has come up a number of different times in recent strategic planning sessions. As we have relayed a number of times in *Musings*, most community banks are dealing with a significant excess of deposits and are trying to figure out how to deploy excess liquidity to protect net interest margin. One of the strategies that has been frequently discussed at planning sessions relates to deposit pricing, along with the related idea of "running off deposits" to reduce excess liquidity and interest expense.

Considering a strategy that lowers deposit prices in an attempt to run off deposits is sometimes met with resistance. It seems that it really goes against the community bankers' DNA to try and shrink the balance sheet. Where the discussion often runs is to customer goodwill. Many board members espouse a general belief that it is appropriate to pay up for deposits because the higher interest rate generates customer goodwill and is an overall better situation for the business.

Given what has happened to net interest margins recently, we have had a number of boards begin to question this stance. We cannot say we have had any boards outright reject the notion, but we see a number of boards that are at least taking a closer look and questioning whether the idea of paying up for deposits really generates any tangible benefits for the bank.

Given today's loan demand and excess liquidity, we recommend that community bank management give a hard look to the community bank's deposit pricing strategy. If the community bank is paying higher rates than its competitors, we see it as a best practice to specifically acknowledge the reason as to why it is you are doing so. If it is tied to the generation of customer goodwill, we think you would be well served to seriously consider whether or not the bank is receiving the perceived benefits.

CONCLUSION

We hope all of you had a wonderful Thanksgiving Day and weekend and had the opportunity to spend time with friends and family. Now that we are all back to work, it is time to push through the end of the fourth quarter. We look forward to seeing many of you at upcoming planning sessions and other events. Stay safe.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming:

- January 13-14, 2022 – Community Banking Board Chair Forum (Jeff Gerrish, Philip Smith, and Greyson Tuck) Registration: Board Chair Forum