GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Wisconsin, Minnesota, Kentucky, Illinois, and Florida!

NOT SO LOYAL DIRECTORS

I have been with several public companies lately (and a couple private ones) that had, as a result of an investment by a hedge fund (or some other type of fund) in their bank holding company, an issue with respect to the composition of their board of directors. All of these companies ultimately settled the issue with the investor by putting what is known in the business as a "constituency" director on the board. This is a director whose constituency is the investor who sponsored his or her directorship and forced the board to accept this outside director.

In each of these situations, the question comes up as to what type of information can be shared with the constituent director. Does the director get unfettered access to the books and records of the company as any other director? Can the director share the information that he or she obtains from the board and from board meetings with their constituency (i.e., the investor)? Can the board restrict or limit the information provided to this type of constituency director?

As you might imagine, this has come up multiple times over the last couple of years with investments in bank holding companies by independent third-parties. The Delaware Supreme Court in a number of decisions has weighed in on these issues. At least under the Delaware Statute, the general theory is that "a director that has a proper purpose has a virtually unfettered right to inspect the books and records of the company, at least equal to that of the remainder of the board."

There are some limitations, however, on what a constituency director can do or share. Some boards are putting constituency directors under confidentiality agreements indicating they will not share confidential information obtained from their board seat with their constituency.

This is an interesting situation, not only for public companies, but for private companies who may have what amounts to a dissident or a constituency director.

THE UNSOLICITED OFFER

We had a couple clients in the last month or so that have called because they received unsolicited offers for their banks. The initial issue when receiving an unsolicited offer is whether the board has to consider it. In connection with that discussion, the board needs to determine whether the offer is "credible" and is from a party who can get the transaction closed.

Once the board makes a determination the offer is credible and is capable of consummation, then the board has to determine whether what the shareholders are being offered put them in a better position than they would be if they continued to hold the bank holding company stock.

When we advise community banks that have received unsolicited offers, we help them decide whether the offer is credible and can be consummated, but more importantly, we help them decide under which circumstances the shareholders are better off. That decision-making process also involves consideration of other strategic alternatives, such as, for example, a determination of whether the bank, which is currently a C corporation, should convert to an S corporation to make their shareholders better off? Should they take the offer? Should they negotiate the offer for a higher price (almost always, yes)? Should they seek other parties? In other words, does this current offer put the bank in play?

All of these issues are critical in response to the unsolicited offer. And as I have mentioned in *Musings* many times, we are seeing far more unsolicited offers in the current merger cycle than we had in any of the past, which is primarily due to the fact that there are a lot of banks with excess capital looking to deploy it and acquisition of another bank is often a decent alternative.

SELLER'S EXPECTATIONS

One thing we are still seeing in the marketplace, which, frankly, surprises me a little bit, is unrealistic seller expectations about what their bank might be worth. What is a small, rural bank really worth? If you have a seller who thinks it is worth twice book value, then their expectations are way too high. If you have an overcapitalized bank seller that thinks it is worth book and a half, then that board's expectations are way too high. Sellers need to get their expectations realistic, and buyers need to stretch a little bit if they actually want to get some deals consummated.

THE TWO-STEP STRATEGIC ACQUISITION

I recently received a telephone call from a long-time client that is putting together what I would describe as a two-step strategic acquisition. This particular bank is currently considering a stock-for-stock merger with another similarly situated community bank. These two banks have joining, but not overlapping, markets. This is what I consider Phase 1 of the acquisition.

Phase 2 of the acquisition involves the acquisition of a third community bank. This time, the plan is for the acquisition to be a cash purchase, instead of a stock transaction. The Phase 2 acquisition will be of a community bank that has branches in what I would describe as very complimentary locations to the combined organization's location from the Phase 1 acquisition.

It is certainly not unusual to look at a two-step acquisition. The benefit for this transaction is that our client has been very strategic in identifying the players and, more importantly, how the two transactions will enhance shareholder value and create a franchise with size and a desirable market. As I told the client, the much tougher part is going to be actually executing the strategy. I will keep you updated.

SUBCHAPTER S DISSENTERS

As I mentioned in a *Musings* towards the beginning of the year, we completed a number of Subchapter S reorganizations around the country in 2015. In one of the Subchapter S reorganizations, we had two dissenters. These two dissenters were obviously working in conjunction with one another, although not very effectively. They each demanded different amounts of money as the "fair value" of the common stock.

Following their demand, we went through the required dissenters' rights process. This required the holding company to send each dissenter a letter providing them certain information related to the Company's determination of the fair value of the common stock. The dissenter statutes also are structured to encourage each party to make an attempt to settle the dissent. We made a good faith effort to settle the dissent by providing all of our information as to how the fair value of the stock was determined (which was an independent, professional stock valuation by a firm that does literally hundreds each year), and a reasonable settlement offer in light of the circumstances. During this process, we also asked the dissenters to provide any information they could provide to support their assertion that the fair value of the stock was something different.

The dissenters' response to our request for the information on how they determined fair value was essentially, "We will not tell you anything. We are fully prepared to tell it to the judge." They are going to have the opportunity. The holding company board rightly took the position that it was impossible to consider any position they might assert if they refused to provide any support for their assertion. We are heading for trial, where a judge will have the opportunity to hear each side's expert testimony (or at least our side's expert testimony) and make a determination as to the fair value of the common stock. It seems pretty obvious these dissenters had a much better chance at getting something from their dissent if they could provide any support for the asserted value of their common stock. Time will tell if they are able to produce any support for their asserted value. As an aside, most states provide that a dissenter can either get the amount offered, a greater amount, or a lesser amount as a result of the judge's ruling, and also that dissenters acting arbitrarily or vexatiously can get stuck with all of the court costs. These guys may be surprised.

THE ART/SCIENCE OF DEAL PRICING

As noted, we are currently assisting a couple different community banks in evaluating unsolicited offers. I was recently talking with one of the bankers that is wrestling with the issue of whether the deal makes sense for their shareholders. During our discussions, our client asked what was the minimum price they should be willing to consider for a sale of their bank. My response, which was admittedly a little tongue-in-cheek, was to ask the banker how bad he wanted to sell his bank.

The reality is, there is no "right" sales price in a transaction. As I explained to our client, in any deal, we can use the science of pricing deals to determine the bottom and top ends of a reasonable range of prices. Once the two outer limits are established, the art of pricing the deal comes in, and all of the various factors have to be considered in determining an appropriate purchase price. Obviously a buyer that is highly motivated to complete the transaction has more incentive to move towards the top end of the scale. Likewise, any seller that is highly motivated to sell has incentive to move towards the bottom end of the scale.

The reality is that in a community bank acquisition there is no "correct" purchase price. The science of pricing can lead to reasonable ranges, but within that range the actual price is totally dependent on all of the various soft factors that have to be considered.

MANAGEMENT SUCCESSION AS AN MRA

It is no secret that management succession is of significant importance to community banks in today's environment. If your strategic planning session does not include some time devoted to discussion on management and board succession, it should. I was recently reminded of this fact when I saw yet another report of examination that included the development of a management succession plan as a Matter Requiring Attention.

In your strategic planning session, you should give consideration to both emergency and long-term succession planning for at least the top three officers and the board of directors. On the emergency piece, the question that must be answered is how the day-to-day duties of a particular officer will be filled if that officer wins the lottery and buys an island in the Caribbean. On the long-term piece, the question is obviously who will succeed that individual on a permanent basis at the time of their retirement. The emergency succession piece is always in play. The long-term succession piece needs to be thought about at least five to seven years prior to the departure of a key individual.

I trust all of you *Musings*' readers are giving consideration to these important succession issues. If they happen to have slipped your mind, please put them on the list before the regulators do so for you.

CONCLUSION

Time flies. Here we are already at the end of the first quarter of 2016. I hope your banks and holding companies had a good first quarter. I also hope all of you had a great Easter and spring break. See you in two weeks.

Jeff Gerrish *and* *Greyson Tuck*