GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Wisconsin, Minnesota, Ohio, Iowa, and North Carolina!

STRATEGIC PLANNING

I have recently been asked by a couple different clients how often the bank should engage in some type of strategic planning and how often the board should follow up on the plan after the attending the facilitated retreat and approving the plan/report.

My general recommendation is that the board and senior management review the plan, along with the strategies and created action plans, in detail at least annually. The review itself need not be a full blown planning session unless things have changed fairly dramatically. It may not even involve a change in strategic direction. It may simply involve a confirmation that the direction set at the last full blown planning session is appropriate. Normally, if your planning session lasts a day, then the annual follow up can last a few hours. This also allows the board to adjust if circumstances have changed or if there is some reason to change the strategies within the plan period. While the plan should not be totally fluid, it should not be unchangeable either.

With respect to monitoring and providing accountability for the plan, I recommend the board at least quarterly review the action plans from the strategic plan. As many of you know, I strongly suggest that the board free up time during the board meetings (normally through the use of a consent agenda) to address strategic and risk issues. One of the strategic issues is the bank's progress on the execution on the strategic plan. This does not mean the board micromanages the operational and tactical piece, which it should never do. But it does mean that the board provides oversight resulting, hopefully, in accountability on the part of those who are executing on the plan. Again, I recommend this be done at least quarterly.

DO YOU REALLY NEED SUBORDINATED DEBT?

We had a number of inquiries lately from clients who are contemplating the issuance of subordinated debt. Subordinated debt is often the best choice, but there are several alternatives for funding a cash obligation of the holding company. Subordinated debt or any other funding could be used for any number of reasons. Often it is to fund part of the cash portion of an acquisition or redeem a large block of shareholders from an estate or something similar. Most of those clients are under the impression that they need the subordinated debt because they need some type of instrument that counts as capital at the holding company level. For community banks under $1 billion in consolidated assets, that is not accurate. Under the Small Bank Holding Company Policy Statement only the bank's capital is reviewed for capital adequacy purposes, not the consolidated capital. As a result of that, the "cash generator" for the holding company could be subordinated debt, bank stock debt, preferred stock, or anything that generates cash to the holding company that can be utilized by the company to either increase the bank's capital or pay out some third-party for something such as stock.

The advantage of subordinated debt is it is generally interest-only for a fixed number of years, usually five to ten, which certainly helps the holding company's cash flow. It is also pretty simple to do. In most cases, it does not involve a lengthy legal document. The disadvantage of subordinated debt is the rate, which can be anywhere from 6% to 8%. When you compare that to the typical bank stock loan, which would be somewhere in the neighborhood of prime (3.50% to 4.0%), then subordinated debt is significantly more expensive. It does reduce the holding company's cash flow obligations at least in the short term since it is interest-only, but it may be an expensive way to accomplish that.

Depending on your strategy, subordinated debt may be the right way. On the other hand, just plain debt or a bank stock loan may be the right way to meet the funding needs of the company. Consider the alternatives.

LINE UP YOUR PROFESSIONALS EARLY

Recently, I had an interesting telephone conference with a banker I have known for a long time. He wanted to talk to me about whether our consulting/financial advisory and law firms could assist him in the event that anyone ever made an unsolicited run at his bank.

I asked him why he was concerned about this. His response was that he wanted to make sure he had trust worthy professionals that knew what they were doing lined up in advance in case he ever just needed to pull the trigger. He said he had been inundated by some of the bigger investment banking houses on the financial advisory side, but realized that based on the size of his bank, if he engaged one of them, he would get some low-level clerk out of New York assisting him. He wanted more than that. On the legal side, he indicated that in his environment (i.e., the nearest big city) there are a couple of lawyers that have some banking knowledge, but no one that has significant expertise, particularly in acquisitions, capital raising, and the like. He was pleased we would fit the bill on both.

Other than being shameless self-promotion, I think it is probably a pretty good idea to do what this particular CEO is doing – line up at least a relationship with professionals who are knowledgeable that you can trust before you need them. This is particularly helpful in an acquisition environment where unsolicited offers often have unrealistic and short triggers.

SUBCHAPTER S ISSUES

I was recently with the board of directors of a bank that is contemplating Subchapter S. Their biggest hang up was the fact that their best customer of the bank who over the years had maintained several million dollars in deposit accounts and borrowed a fair amount of money was an ineligible Subchapter S shareholder. He was only a 3% shareholder, so it was not like he was a control shareholder, but the board was nevertheless concerned about doing anything that would upset this particular customer. The customer was the corporation, and the corporation owned stock in the holding company. Because this was an ineligible shareholder, their shares would be eliminated for cash in connection with the Subchapter S reorganization. The board's concern about forcing this customer to sell the stock involved a very lively discussion.

What about the other side of this? Should the bank not take an appropriate strategic action because they are concerned about a 3% shareholder? The general thought of the board was it is more than a 3% shareholder; it is the best customer in the bank. Interesting situation. Not yet resolved. I will keep you posted.

CUMULATIVE VOTING

Tis the season for annual meetings. A number of our clients still have cumulative voting in their holding company charters. Cumulative voting, for the most part, is kind of a "blast from the past." Cumulative voting was initially designed to allow a majority shareholder to at least get representation on the board through cumulating all of their votes onto one or two directors. For the most part, we generally recommend the elimination of cumulative voting in our holding companies on the theory that it really gives the minority too much control. You might look at your articles of incorporation of your holding company to determine whether there is cumulative voting. If so, you may want to evaluate at the next annual meeting whether an amendment should be offered that would eliminate cumulative voting.

A similar issue involves preemptive rights. Preemptive rights are simply the ability of any shareholder to purchase a pro rata portion of any stock that is offered by the holding company. Generally we recommend deletion of preemptive rights. They slow down any stock offering when often, if stock is offered to all of the shareholders, uninterested shareholders simply do not subscribe. In other words, it provides an unnecessary step. Likewise, if the board is going to offer shares, the first place they would typically go would be to the shareholders. Forcing them to do so, however, can be a real stumbling block on an offering. Some more closely-held companies will not go along with this suggestion to delete preemptive rights because there is a trust factor that everybody wants to make sure they have the opportunity to at least maintain their position if they can afford to do so.

BANK HOLDING COMPANY DISSOLUTION

I recently read with interest a brief article in one of the banking publications that a rather large regional bank is dissolving its bank holding company. The transaction is structured such that the holding company will be merged with and into the subsidiary bank, with the subsidiary bank surviving the merger. This will cause the current bank holding company shareholders to become shareholders of a state-chartered bank whose primary regulator is the FDIC. More importantly, this will remove the Federal Reserve from having any regulatory authority over this particular organization.

This corporate transaction intrigued me because it is very unusual for a bank to make a decision to dissolve its holding company. The multitude of benefits offered by the holding company greatly outweigh any regulatory issues, even for the smallest of banks. The fact that a multi-billion dollar bank would do this is surprising. With that in mind, I did a little investigation to see if there was any publicly stated reason for the dissolution. The document filed by the company with the SEC indicates the company believes the reorganization will "further improve the combined entity's efficiency by eliminating redundant corporate infrastructure and activities as well as the associated supervision and oversight from the FRB…"

Regardless of what is stated in their 8-K, my guess is that this particular bank holding company was simply fed up with the Federal Reserve, for whatever reason. My guess is that the board decided to terminate the holding company in order to get out from under the regulation of the Fed. If I am correct, the relationship with the Fed must have been very bad for the organization to believe losing the benefits of the bank holding company was a better alternative than maintaining that regulator.

UNUSUAL MERGER REQUEST

I recently ran across what I believe to be a first of a kind request, at least as far as I have seen. We are currently assisting a community bank that is merging with another community bank. Our client is the target and will be merged out of existence. We are going through the process of providing termination notices for certain of our contracts. Two of the vendors to which we provided termination notices requested a copy of the regulatory approval of the transaction before they would terminate the contract and provide the final termination payments. So far as I can recall, I have never had this request before. The service providers have indicated this approval is necessary because they have a lot of banks that are "fishing around" for termination fees without actually having solid deals. With that in mind, they have said they are providing termination fees only for transactions that have received regulatory approval. I hope these are isolated events, and not the new norm, for some of these third-party service providers.

TRUST SHAREHOLDERS

Over the last couple of weeks I have been very involved with two separate applications before the Federal Reserve that include complex trust shareholders. Each of these trusts have significant assets, and the bank holding company stock owned by the trusts represents only a portion of those assets. In this type of situation, the Federal Reserve has very complex rules on the terms that must be incorporated into the trusts so the trusts are not considered a company for purposes of the Bank Holding Company Act. Without getting into the complexities of these rules, it is sufficient to say my recommendation is if you have a trust that is going to own more than 5% of a bank or bank holding company, you are well-served to have the holding company stock as the sole asset in the trust. The best bet is for a standalone trust to be created solely for the ownership of the bank's stock because it makes things much easier with the Fed.

CONCLUSION

Tax day is coinciding with the Easter weekend this year. I know all of you will do your duty and pay your taxes. Have a great Easter weekend with family and friends as well. See you in two weeks.

Jeff Gerrish *and* *Greyson Tuck*