
GERRISH'S MUSINGS

Jeffrey C. Gerrish
Greyson E. Tuck
Gerrish Smith Tuck
Attorneys/Consultants
700 Colonial Road, Suite 200, Memphis, TN 38117
◆ (901) 767-0900 ◆ Fax: (901) 684-2339
◆ Email: jgerrish@gerrish.com ◆ gtuck@gerrish.com ◆ www.gerrish.com

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Dear Subscriber:

Greetings from New York, Wisconsin, New Mexico, Ohio and Arkansas!

THE SUCCESSFUL TRUPS RESOLUTION

“Congratulations! The deal is officially closed!” These are the words of congratulations I recently sent to a client after closing a deal that we have been jointly working on for three and a half years.

In summary, this organization was hit very hard during the economic crisis. Their bank holding company was highly leveraged with a bank stock loan and two separate Trust Preferred issuances. At one point, the organization was bankrupt on paper because the holding company liabilities exceeded the bank’s capital. Thanks to the Small Bank Holding Company Policy Statement, the bank was never closed because the regulators were looking only at the bank’s capital ratios, not the consolidated capital ratios. The bank’s capital ratios were not low enough to fail the bank, although they were closer than the board would have liked.

About three and a half years ago we set out to remedy this problem. The holding company’s Trust Preferreds were both wrapped up in collateralized debt obligations and were in default. We had to spend a significant amount of time and effort tracking down the decision makers to settle the Trust Preferreds. Ultimately, we were able to do it, and we were able to reach option agreements with the Trust Preferred holders that allowed the holding company to repurchase the Trust Preferreds at about \$0.50 on the dollar. We then had to go to the Federal Reserve to get them to approve all this since the Fed still had their foot on this holding company’s throat.

We officially closed the transaction at the end of July. We settled about \$11 million worth of debt, including accrued but unpaid dividends, for about \$4.5 million. It was a day of great celebration for this holding company and bank because it essentially cleared up all of their problems and will now allow them to get completely back to the business of banking.

Congratulations to this client, who is a *Musings* reader! Three and a half years is a long time to bulldog a deal. It was great fun working them through it and being able to celebrate the successful ending with them.

DIVIDENDS AS AN ANNUITY

We are currently assisting a board that is considering a number of different capital allocation strategic alternatives. This bank is a profitable C corporation that currently pays a very strong dividend. At the beginning of the year the bank had about \$10 million in Trust Preferred Securities. At the end of the first quarter they paid about half of those off. The bank now has \$5 million in Trust Preferred Securities remaining, and the board is committed to paying those off on an accelerated schedule.

The interesting thing about this situation is the board's affinity for the payment of dividends. In discussing the alternatives with the board, we pointed out to them that they certainly have the earnings capacity to finish off these Trust Preferreds in about a year. Their comment was essentially that they view the holding company shareholders as the first creditor. They have paid a strong dividend for a number of years and are committed to continuing to pay the same level of dividend each year. The board's approach is to pay the shareholders first, retain earnings to support growth second, and then pay down any holding company debt third.

One of the central tenets of enhancing shareholder value is providing cash flow to the shareholders through dividends in a C Corporation, or distributions in an S Corporation. This board has certainly taken that to heart.

STOCK REPURCHASE PROGRAMS

We recently received a call from the management team of a bank that we had recently reorganized into a bank holding company structure. As with most holding company formations, the purpose for this one was to be able to leverage capital to support the growth of the bank and to provide an efficient avenue to repurchase common stock. The discussion involved stock repurchase programs and, specifically, how the Board should set the price and what they should pay.

Management's initial thought was that the board should essentially set a maximum price and then turn management loose on the shareholders who wanted to sell to cut the best deal they could, up to that maximum price. We advised the management group that that is not exactly our recommendation. We recommended that the board simply set the price that the holding company was willing to pay for the shares, which would then be relayed to every shareholder. Our concern with the other approach suggested by management is that it would penalize the shareholders that were not the best negotiators. For example, it would not be a good situation if a board set a ceiling of \$25 per share and the holding company repurchased 300 shares from one shareholder for \$20 per share on Tuesday and then turned around and purchased 300 shares from another shareholder for \$24 on Thursday as a result of the second shareholder being a better negotiator. Our recommendation is that the better alternative is simply to set a price the holding company is willing to pay and then provide that to all the shareholders. If they are willing to sell at that price, great. If not, they are free to go out and try to find somebody that will pay that price.

THE DIFFICULT NEGOTIATION / INEXPERIENCED BUYER

We are currently in the process of assisting one of our clients in the sale of their community bank to another community bank. The biggest difficulty in these negotiations is the buyer has never bought a bank before and their advisors are not bank specialists. Frankly, that has resulted in these negotiations that can only be classified as "difficult," to be charitable. The purchaser continues to make unreasonable requests/demands as it relates to the transaction. For example, their first proposal was to escrow approximately 40% of the purchase price for three years interest-free. That was never discussed in the initial Indication of Interest related to the transaction. When we refused this escrow setup, they came back with an alternative proposal that was worse. Instead of escrowing 40% of the purchase price, they wanted the shareholders to individually guarantee about 45% of the purchase price for a number of years post-closing. This guarantee was to serve as a source of recovery in the event the acquirer suffered any loss relative to the transaction. These are not the only areas where we have had major disagreement with the buyer.

The buyer's initial unreasonable demands have created a number of problems in the transaction. Obviously they are slowing the transaction down. More importantly, they are creating a tremendous amount of negative goodwill from the seller. Our client and the shareholders are getting very frustrated with the process and the significant difference between

the proposed transaction outlined in the Indication of Interest and the actual terms proposed in the Definitive Agreement. This negative goodwill will be harmful to the buyer if this deal comes to fruition and is closed.

We are doing our best to work through these issues. We have spent quite a bit of time educating the buyer and its counsel about the actual risks associated with the transaction and the best ways to mitigate those risks. We have also had to remind them that the transaction will not be risk-free. We will see if our efforts are successful. I will keep you updated as to whether we are actually able to bring this deal together.

“REVISED” BOARD EXPECTATIONS

The Board of Governors of the Federal Reserve recently published proposed Supervisory Guidance on the supervisory expectations for the board of directors of bank holding companies and state-member banks. The guidance is broken down into three separate areas. The first part includes proposed guidance addressing effective boards of institutions with total consolidated assets of \$50 billion or more (which I expect will become “best practices” for community bank boards). The second part is applicable to the board of directors of bank holding companies of all sizes. The third part contains proposed guidance related to the communication of supervisory findings.

The guidance applicable to institutions with more than \$50 billion in total assets distinguishes the board’s responsibilities from those of senior management. It specifically indicates that the hallmarks of an effective board are boards that:

1. Set clear, aligned, and consistent direction regarding the firm’s strategy and risk tolerance;
2. Actively manage information flow and board discussions;
3. Hold senior management accountable;
4. Support the independence and stature of independent risk management and internal audit; and
5. Maintain a capable board composition and governance structure.

The second part of the proposed guidance, which is applicable to all bank holding companies regardless of size, indicates the Federal Reserve is “conducting a comprehensive review of all existing supervisory expectations and regulatory requirements relating to boards of directors...” The guidance indicates the Federal Reserve is looking to revise or eliminate unnecessary, redundant, or outdated expectations to allow boards to focus more of their time and

resources on fulfilling their core responsibilities. The guidance distinguishes the responsibilities between the board and management and indicates that the board is primarily responsible for the oversight of management, with management being responsible for the organization's day-to-day activities.

The final part relates to the communication of supervisory findings in examination reports and the like. The Federal Reserve's existing guidance requires all Matters Requiring Immediate Attention ("MRIAs") and Matters Requiring Attention ("MRAs") to be presented to the board of directors so the board may ensure senior management devotes appropriate attention to addressing these matters. The proposed guidance would clarify the process and indicate that examiners and staff would direct most MRIAs and MRAs to senior management for corrective action. MRIAs or MRAs would only be directed to the board for corrective action when the board needs to address its corporate governance responsibilities or when senior management fails to take appropriate remedial action.

The Federal Reserve comment period is open for about the next month and a half. Please let us know if you would like a copy of the proposed Supervisory Guidance, or if you have any questions regarding the proposed changes.

A NOVEL CONCEPT: MENTORSHIP

I was recently with a very well-run mid-size community bank. We were talking about attracting and retaining key personnel as part of the strategic discussion. I found out at that time that the Bank has a very successful and well-developed mentorship program for young, up-and-coming future emerging leaders (most of them millennials). I have had a lot of community bank clients over the years that have talked about establishing some type of mentoring program, but not many, that I know of, that had. This bank was successful at doing it and had been doing it for a significant period of time. It is good to see.

Many of us remember when all the large banks had the mentoring/training programs. That is, of course, where the community banks would get their key personnel. Unfortunately, that does not happen too much anymore, so we typically need to train and grow our own. This bank was doing just that.

FAMILY BANKS

I recently had an opportunity to give an interview to one of the more prolific writers for the *American Banker*. For those of you who are unfamiliar with the *American Banker*, it is one of a couple of daily “scandal sheets” that most industry professionals read. Her article was on family-owned community banks. She was curious about things like how often the family members stay in the bank, how they get in the bank, what they do first, etc. I first told her every family bank is different, but there are some patterns that seem to be successful. The primary one is for the family member who wants to be in the bank to go get trained and mentored somewhere outside the bank. This generally gives the employees in the bank a much higher comfort level that the family member coming in actually knows what he or she is doing because they have been well-trained somewhere else. In this regard, it is not much different than any other family business where often the training for the family member who is going to take over occurs through another institution. Good idea.

CO-PRESIDENTS

I was recently with a bank that had just completed an acquisition transaction. We did not help them with the acquisition, but I was brought in afterwards to assist them with the strategic issues moving forward. One of the results of the acquisition was they had a situation where they had “Co-Presidents.” That’s right. When they put the two banks together, they took the President of each bank and made them Co-Presidents of the resulting bank.

Having been down this road with Co-Presidents or Co-CEOs before, I have seen it work very few times (though I do have some examples where it is has worked very well). I was concerned that they had structured the post-acquisition management in this fashion. My concern was justified. The Co-President situation simply did not work. The employees and senior staff did not know who was in charge. There was a failure to delineate duties between the two individuals. The bottom line is we are going to help them unscramble this egg a little bit to get this Co-President situation straightened out to a point where there is a workable resolution.

CONCLUSION

Mid-August is here. Many of the schools have started, and the kids are back hard at work. I hope everybody had a great summer. Watch for those school kids as you drive to work. See you in two weeks.

Jeff Gerrish

and

Greyson Tuck