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# GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Montana, Florida, Georgia, Wisconsin and Texas!

## THE ESOP

We are in the process of forming a number of ESOPs and 401(k) ESOPs for many banks. I have had a couple calls lately, however, from banks that have formed ESOPs many years ago and are wondering if they are still useful. For most banks, an ESOP, particularly in a Subchapter S, is so good it should be illegal. But if your ESOP is mature and has tapped out to the extent that it cannot buy anymore stock, then what do you do with it? You could allow the employees to continue to own the shares and let the ESOP serve as a cash cow and a wealth builder for the employees. You could freeze it so that no more funding occurs in the ESOP (if you do that, then you probably need to put another plan in place). Lastly, you could terminate it. Unfortunately, if you terminate it, then you give all the employees the right to ask for cash for their shares. That could be real expensive. As a result, most community banks do not plan on terminating their ESOPs. Many of them will freeze them and let them play out naturally as people retire.

## DE NOVO BANKS

We have had multiple calls in the last two weeks from technology guys – most of them out of San Francisco – that are looking for a de novo bank charter. Most of them do not have a clue what regulatory issues are involved. Once they hear what regulatory issues are involved, they really do not want to do anything further. They like to talk about it but do not want the heavy burden of having to actually comply with rules and regulations in order to get a bank

charter. A lot talk about how they will be tough competition for community banks. I am not so sure. They still have to get third-party funding to do what they are doing on the loan side. They cannot take deposits. They provide no relationships and no service. I am not sure that is a lot of competition.

### MANDATORY RETIREMENT

Recently I had the opportunity to be with a group of outside directors for a wide ranging discussion. One topic that was discussed was the entire issue of mandatory retirement. Interestingly, about a third of this group of 100 or so directors had mandatory retirement at their banks. Most of them indicated that they actually followed it (i.e., they did not make exceptions when somebody reached the age.) Mandatory retirement seems to be the prevalent practice. Still, in my opinion it is not a best practice. The best practice is for the chairman and the board to make the tough decisions when a director is no longer capable of serving effectively – no matter what age.

This same group also discussed the difficulty of attracting and retaining new directors in this day and time. I suppose it is easier for Wells Fargo to attract new directors, notwithstanding their problems, when they pay a quarter of a million dollars in directors' fees per director or so. In community banks, however, it is tough to get a director to serve on your board for the fee. It is much more likely you will get a director serving on the board because he or she still considers it an honor and a way to support the community. Congratulations to those of you who continue to serve for the betterment of your communities, notwithstanding the potential liability (which, in my opinion, is manageable).

### BLOWING UP THE SUB S

We have put literally dozens of banks in Subchapter S in the last 15 years. I never really had anyone that wanted to “blow up” a Subchapter S intentionally. We have, however, had many situations where a shareholder inadvertently blew up the Subchapter S (or came close) without trying. That can be “not a pretty picture.” If you are in a Subchapter S, you need to do a number of things to make sure no shareholder inadvertently terminates the Subchapter S election. First of all, your shareholders agreement should have provisions regarding appropriate transfers between shareholders in Subchapter S. Second, your articles of incorporation in your holding company should prohibit inappropriate transfers of Subchapter S stock. Third, you should receive annual certifications of Subchapter S shareholders that they have not done anything that

would improperly terminate the Subchapter S. Fourth, there should be an agreement that if they do improperly terminate the Subchapter S for everyone else, they pay the price. You might look at your Subchapter S documents and make sure that they are doing what they should.

### STOCKHOLDERS AGREEMENT

On a related note, I was recently with a bank that was a Subchapter S and a very closely-held one at that. I asked them about their stockholders agreement among the Subchapter S shareholders. Their response was they did not have one. I explained to them the perils of not having an agreement, which is primarily that any shareholder can “blow up” the Subchapter S for everybody else. They seemed to see the light on that one. We are going to have to try to get an effective, after the fact stockholders agreement addressing all of the issues to keep the Subchapter S in place. They do think their shareholders will cooperate. Unfortunately, it only takes one uncooperative to not get an agreement.

### LEVERAGED ESOP BUYOUTS

Over the last couple weeks we have been contacted by several different community bank holding companies to discuss the buyout of a majority or sole shareholder. The interesting thing about each of these discussions is that the client came to us with the idea that the purchaser was going to be either an existing or newly-formed employee stock ownership plan.

The sale of a company to an ESOP is much like the sale of the company to any other purchaser. However, there are some unique issues. The most common issue is where the cash will come from for the ESOP. Unless the ESOP has been in place for some time and is sitting on a pile of cash, this will mean leveraging the ESOP. It could also mean converting the ESOP to a “KSOP” and using a portion of the participants’ 401(k) balances to provide cash to purchase holding company stock.

Another interesting thing about the potential sale of a company to an ESOP is the “30% rollover rule” in a C corporation. Essentially this rule allows an existing shareholder to sell more than 30% of the company to an ESOP on a tax-deferred basis. The seller will avoid paying tax on the cash from the sale of more than 30% of the shares if that cash is rolled over into a new, qualifying investment in a short amount of time.

If you are thinking about how you are going to buyout a large shareholder, give consideration to the ESOP. It often makes a lot of sense as a purchaser.

## THE COMPLICATED MERGER TRANSACTION

As I have relayed a couple different times in *Musings*, we have been working on one of the most technically difficult merger transactions we have seen in a while. Although the size of the banks involved in the merger were small, the transaction involved a number of complicated issues. This particular transaction involved a merger of two bank holding companies, a merger of two banks, an ESOP becoming a bank holding company, a change in control authorization, and a conversion from a national bank to a state bank. The entirety of the transaction successfully closed Monday morning (from 35,000-feet, I might add). This is the culmination of about eight to nine months' worth of hard work for these boards and, in particular, the executive officers involved. Congratulations to each of them for "fighting the good fight" and getting their deal done. It was no easy task.

## SUBCHAPTER S SHAREHOLDER CERTIFICATIONS

Is your holding company taxed as an S corporation? If so, do your shareholders sign any type of annual shareholder certification relative to their stock ownership? This annual certification essentially indicates the shareholders continue to maintain ownership of the stock, have not attempted to transfer the ownership, have complied with the terms of the stockholders agreement and have otherwise not taken any action in an effort to terminate the S election. If you are an S corporation, consider requesting this type of certification from the shareholders as a best practice in corporate governance. It will help you flag any potential issues that you need to address relative to the stock ownership and ongoing S election. Please let us know if you have questions or would like us to assist in putting together a certification for you.

## EXECUTIVE OFFICER RETENTION

We recently received a call from a community bank that is very forward thinking in their executive officer retention. This particular bank has a bank president that they view as a "super star." This individual is under an employment agreement that terminates in a few months. It is expected that there are a couple banks that will make a run at trying to hire this individual because he is young and viewed as extremely talented in their market. Instead of being reactive, the board wanted to be proactive to ensure they put together an offer to this executive officer to make sure that they are able to keep him. They asked us to assist in putting the offer together.

Essentially what we are doing is designing a compensation package for this executive officer that we are going to present to him to ensure he stays with this bank and does not take his

talent elsewhere. The compensation is going to consist of a pretty healthy annual base compensation and a defined cash bonus program. Since the organization is closely-held and the shareholders are not willing to give up dilution, the program is going to include “synthetic equity” in the form of either stock appreciation rights or phantom stock and a deferred compensation program.

Kudos to this board for being proactive. They have said that losing this executive would certainly not kill their institution. However, they do like him and his talents and are doing what they can to make sure he continues to use his talents for their benefit.

### CONCLUSION

It is hard to believe we are closing in towards the end of the first quarter of 2017. Where does the time go? Spring appears to be trying to peek its head out in various parts of the country (although not all by any means). See you in two weeks.

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*and*

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