GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from New Mexico, Minnesota, North Carolina, Florida and Tennessee!

THE BEDSIDE MANNER

As indicated in prior *Musings*, it is not unusual these days for our community bank clients to receive what amounts to an "unsolicited offer." Most of the time, however, they have some indication that it may be coming as a result of prior conversations or going to lunches, dinners, or the like with a potential suitor.

We have had at least three situations this year where our community bank clients became the target of an unsolicited offer "out of the blue." I have always thought when that occurs that the bedside manner of the potential buyer is just not very good. I understand the motivations of the buyer (i.e., they are looking for a place to allocate their capital, and they have decided that our client is the best target). They therefore do not want to waste their time dealing with community bank number two or number three. They want to go to number one and, as a result, make an unsolicited offer.

Frankly, this approach is pretty misguided. Each time that has happened, the board has had the initial recoil that they do not like the approach of the buyer and if that is the way they do business, they are going to have to factor that into something intangible that is associated with the offer. It is simply not a very good bedside manner no matter what the price.

If you are in the acquisition business and you are going to make an offer on a target, at least do some of the legwork and some of the courting before you just simply plunk down the offer on the desk of the CEO or the Chairman.

OUTSIDE DIRECTOR KNOWLEDGE LEVEL

I have had a lot of questions lately about how much the outside directors, in particular, are supposed to know. These are non-executive officer directors. These are simply the outside directors that come to committee meetings and board meetings once a month. What is their expected level of knowledge about what goes on in a community bank? My general response is that they need to know "enough" to spot the issues associated with whatever the current regulatory hot button is, whether it is compliance, acquisitions, governance, safety and soundness, or otherwise.

The outside directors are generally selected for their wisdom, their business acumen in the community, their integrity, and their reputation. They are not often selected for their community banking knowledge and ability. That is understood. The flipside of that, however, is that they need to get enough education to be able to identify the issues and ask the hard questions. It is a fine balance.

MERGER AND ACQUISITION AGREEMENTS

Every merger or acquisition transaction has what we in the business like to call the "definitive agreement" or "big agreement." The purpose of the definitive agreement is to give everyone a full understanding of the pricing of the transaction and what occurs, particularly at the target bank, between the time the deal is signed up and the time it closes, which these days can be anywhere from four to eight months. Unfortunately, some practitioners think a definitive agreement is designed to protect their client, whether on the buy side or the sell side, from any possible assumption of risk, known or unknown. That is really not the case. That is actually impossible. There is going to be some risk in the transaction that you have not accounted for either because you do not know about it or it has not been addressed.

One reason definitive agreements contain representations and warranties is to smoke out things that both sides need to know about the other side. That is generally pretty effective in mitigating risk, but it can quickly become overkill. One problem with the definitive agreement is once you get one you like, then you keep adding things to it, but you never seem to eliminate anything from it. If you are trying to protect your bank from every possible risk, then the definitive agreement will continue to get longer and more cumbersome. We just received one that was over 100 pages where our client is the seller. To be polite, that is a bit over the top.

REGULATORY RELIEF

"Are we seeing any regulatory relief yet due to the new Trump administration?" is a question I get asked often by community bankers, particularly outside directors. My response is "only anecdotally." As I mentioned in prior *Musings*, we had one meeting that we thought was going to be really bad with the regulators. It turned out not to be a big issue. We have had a couple other recent meetings that went better than we anticipated on some very difficult issues.

Some of the things that were hot buttons under the previous administration, such as Fair Lending, I anticipate will be deemphasized under the Trump administration, as was the case with the Bush administration. Other things, such as unfair or deceptive practices, I do not feel the same way about. I think those will continue to be hot buttons for the regulators.

The problem is once the regulators set the tone at the top, it takes a long time to get down to the field examiner who is still afraid to be second guessed. Time will tell, but we are beginning to see some indications that the regulators on the ground may be becoming a little bit more reasonable on some of their positions.

UNIQUE LINE OF BUSINESS

I was recently with a long-time client for a meeting with the board and management. For a long time this particular institution has engaged in a very unique and what others might view as risky line of business. I will not identify it because they are one of the few community banks in the country that engage in this particular line of business.

The bottomline of all of this was that the discussion with the board and management basically was "we know what we are doing in this line of business, we have assessed the risk appropriately, we have a culture of compliance, and there is no good reason we should not continue to organically grow this business." This is a good, strong institution, and they made the right decision.

My thought process is if you have a concentration in something, whether it is ordinary like commercial real estate or some other area, as long as you understand that concentration and how it works, and can manage it and deal with compliance issues associated with it, then why not pursue your niche and your expertise.

THE CAPITAL RAISING WEBINAR

I had the opportunity to conduct a webinar in the last couple weeks on capital raising for community banks. It dealt with many of the subjects that many of you deal with on a daily basis, such as holding company leverage, do we sell equity, do we do something different, what if I am a Sub S, and the like. I did create PowerPoints for that presentation and would be happy to share those with anyone who would like them.

SUBCHAPTER S EQUITY COMPENSATION

We were recently approached by the board of directors of a Subchapter S bank holding company that is looking for assistance in developing a long-term equity compensation plan for certain of the bank's executive officers. Based on some prior advice the board received, they were under the impression that the Subchapter S severely restricted the type of equity compensation they could provide. That is not correct. A Subchapter S bank holding company can provide the same type of long-term equity compensation as can be provided by a C corporation. The only limiting factor is that the equity compensation cannot constitute a second class of stock, which would terminate the S election.

We have assisted numerous Subchapter S bank holding companies in developing long-term equity compensation plans. We have put in place for S corporations stock options, stock appreciation rights plans, phantom stock, and similar equity-based compensation programs. These are all fair game for a Subchapter S, provided they are structured correctly and do not constitute a second class of stock.

SALE OF PERSONAL GOODWILL

We are currently assisting one of our community bank clients in acquiring a couple insurance agencies. One of the agencies that our client is acquiring is 100% owned by one individual. It is your typical "one-man shop" where the owner serves as the sole agent and is the individual with all of the business relationships in the organization. Acquisitions under these types of scenarios are often structured as asset sales, which was the case here. Our client purchased all of the insurance agency's assets necessary to run the business. Our client also purchased the sole shareholder's personal goodwill.

The sale of personal goodwill makes sense under a pretty specific set of circumstances. It did in this case. The advantage to the seller lies in the taxation. To put it plainly, a seller's sale of personal goodwill is taxed on a much more advantageous basis than is the sale of the assets from the company.

If you are thinking of buying a bank, insurance agency, trust or wealth management company, or any other business entity, give consideration to purchasing the shareholder's personal goodwill, if it has one or a small number of owners. It will not create tax advantages on the acquirer's side of the transaction. However, it creates some pretty impressive tax savings on the sale side of the transaction. If you are willing to agree to the set of circumstances for that structure, you can reduce the overall taxation in the transaction and use that as a negotiating point to lower the purchase price.

SUCCESSION PLANNING

I recently facilitated a strategic planning retreat for a well-run community bank. The board and executive officers were on top of their game as it relates to what I would consider to be most of the essential items. The bank is earning money, supports share liquidity through the holding company, and the like. The biggest challenge facing the organization that we spent quite a bit of time addressing is succession.

Like many other community banks, this bank is struggling with succession. They recognize the need for management succession, and are working hard on developing a formal and achievable plan to address the issue. The problem is that the board had not thought at all about director or shareholder succession. They had been so laser focused on management succession that they had not given any consideration to the other two.

In my opinion, community banks need effective management, director, and shareholder succession planning. The failure to properly plan for any of these is a threat to independence. My recommendation is to have discussions on each of these three separate succession issues at your next planning retreat. It really is essential to have a good emergency and "normal progression" succession plan for each of these areas of importance.

CONCLUSION

It is hard to believe it is now mid-July. Many of you are thinking about vacations with the kids and grandkids. Have a great time. Others of you might be pursuing academic endeavors at some of the many Graduate Schools of Banking around the country. Look for members of our firm teaching at virtually all of them.

Until next time.

Jeff Gerrish *and* *Greyson Tuck*

