GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Indiana, Wisconsin, Minnesota, Texas and New Mexico!

USAA

This *Musings* is just a heads up to those of you who are not aware of the situation with USAA. USAA is a large institution serving primarily military personnel (you see all of their ads on TV). They are also apparently one of the early developers of remote deposit capture software and hold numerous patents with respect to that software. USAA, through its law firm "Epicenter," has recently been sending letters to community banks indicating they would like community banks to pay for the use of their software through a licensing or other arrangement. These letters are not quite as extortionistic as the Americans with Disabilities letters that are coming from the Philadelphia law firms, but they can be unsettling as well.

If you get one of those letters, let us know. We can help. As a practical matter, most of the time the service provider (Jack Henry, FIS, or whoever it is) will hopefully indemnify the bank for any claims by USAA. This is just a heads up, particularly for your outside board members who may see this and be concerned.

ATTRACTING AND RETAINING KEY PERSONNEL

One of the more difficult issues in community banking today involves attracting key personnel, particularly senior leadership, and then retaining them once they get there. Numerous community bank boards are beginning to focus on this problem as a result of an emerging succession issue, a potential acquisition opportunity, or something similar. My general recommendation to the boards is to take a full look at the benefits, incentives, and golden

handcuffs offered to your senior personnel. It is very difficult to replace a CEO or a senior manager without spending a ton of money and a ton of time doing it. Better look to keep the good ones. As one director told me, "The poor will be with you always." It was the good ones he worried about. We are working on a number of these projects where we are evaluating senior management benefits and handcuffs. If we can assist, let me know.

MUTUALITY

I had the opportunity in the last couple of weeks to spend time with the board of a healthy, growing, proactive mutual. It was a good discussion that, as you might anticipate considering the organization has no shareholders, did not focus entirely on profitability and the like.

This board did a nice job of striking a good balance between the need to be profitable to continue to serve its members, community, and staff, as well as to keep the doors open for the regulators, and being able to serve the members, community, and staff because they do not have shareholders and are not operating the bank quarter-to-quarter. It was a nice balance and a nice job by the board.

The board also discussed the possibility of forming a holding company for their mutual. For those of you in stock bank holding companies, this basically operates the same way, where the holding company can leverage capital into the bank and repay it with non-taxable dividends. Most mutuals have not taken advantage of this opportunity, in my opinion, due to lack of knowledge. It is, however, a great tool for the mutual to avoid converting to stock and still retain its mutuality, while being able to raise capital for the subsidiary bank.

DISSENTERS' RIGHTS

In recent *Musings*, I mentioned a bank dissenter's case in which we were involved. That case was resolved in favor of the bank. In another case in which we are not involved, the Delaware Supreme Court, when appraising fair value for dissenters' rights purposes, determined that the dissenters in that case were entitled to less than what the bank was offering. The bank was offering $6.82 per share. The court concluded that the fair value was $6.38 per share. As noted in prior *Musings*, most dissenters do not realize that in connection with dissenters' litigation, they could get more money, less money, or the same amount of money the bank has offered for fair value. In this particular Delaware case, they got less. Justice prevails.

STOCK REPURCHASES

Those of you who have been *Musings* readers for some time know that I firmly believe one of the best allocations of capital for a community bank is to "buy itself." This is basically through the holding company repurchasing shares from shareholders willing to sell. I have been with the boards of a couple of privately-owned community banks lately whose stock, although it trades very little, is selling for less than book value. The strategic question for these banks is should they do anything to acquire the shares or just let the "thin market" do whatever it is going to do. My general recommendation is the board needs to get control of its stock, as well as the stock price. A repurchase plan at less than book value (or even above that for that matter) provides significant benefits to the non-selling shareholders. The stock is redeemed at less than book value, the ownership percentage for every shareholder goes up, earnings per share goes up, book value goes up, the company has created the illusion of liquidity, and if there is a dividend policy that pays out a certain percentage of earnings, the dividend to shareholders may go up as well. Who loses? Nobody. It is a productive allocation of capital.

I have also been with a number of boards who for lack of a better term are "hell bent" on acquisitions. This is to the exclusion of allocating capital for anything else, such as a stock repurchase plan, dividends, or even conversion to Subchapter S. The acquisition bias can creep in. Acquisitions, although we do a lot of them on both the buy and the sell side, have inherent risks that a share redemption does not. The board just needs to think about it and make a good strategic decision.

NEW SHERIFF IN TOWN

For those of you who are regulated at the federal level primarily by the FDIC (most of you), you probably are aware that you are going to have a new sheriff in town. The Trump administration is going to nominate James Clinger to be the outside director of the FDIC and take over the Chairmanship of the FDIC upon the expiration of Chairman Gruenberg's term. The interesting thing is that when Chairman Gruenberg came in, he was a strong consumer advocate. That resulted in an attitude at the FDIC that compliance, in addition to capital, was king. It will be interesting to see with the new chairman whether compliance is as difficult a topic as it was under Chairman Gruenberg. Times are changing, and I am optimistic things will be better.

AGGRESSIVE NEGOTIATIONS GONE WRONG

We have recently been assisting one of our community bank clients in pursuing a potential acquisition opportunity. This particular client was considering the acquisition of another community bank that was located in a complementary but not overlapping market. Our client is certainly the stronger of the two banks, with higher earnings, more equity, more assets, and better asset quality. The target institution has had a rough couple of years, but it is now beginning to come out of the woods and make just a little bit of money. They are also growing at a very rapid pace, which raises concerns about their future asset quality.

We completed a very detailed financial analysis of the transaction and essentially concluded that our client's shareholders should own about 67% of the combined organization and the other shareholders should own about 33% of the combined organization. We pursued the transaction on this basis by indicating to the target's principal shareholders our analysis and conclusions regarding the ownership split. They then took our information back to their experts and came back with their "counteroffer."

The target's counteroffer was very aggressive. They came back and said that our shareholders should own about 55% of the combined organization and their shareholders should own about 45% of the combined organization. When asked for their justification, they provided a contribution analysis that had very little to do with their current earnings, equity, and assets. Rather, it focused heavily on what they were going to accomplish over the next two to three years. Their stance was essentially that the organization is on its way to the top, and you ought to pay us today for what we will be able to achieve and bring to the combined organization three to four years from now.

Not surprisingly, the target's counteroffer did not fly well with our client. We certainly were not going to accept their position and pay them for something that they were not able to prove to be achievable. We also updated our analysis at some type of middle point, and it turned out that even if we were able to reach some middle ground between the two, the transaction would not be beneficial for our shareholders. With this in mind, our client simply thanked the potential target for the opportunity for the discussions, and each party will be moving ahead independently.

It is hard to bring these types of deals together. It is even harder when one of the parties has unrealistic expectations about their current value based on what they think they might be able to achieve in the future.

POST-CLOSING PROBLEMS

We recently encountered an interesting situation for a client that made an acquisition last year. To sum up the problem, the target institution in the acquisition transaction, whose corporate existence was terminated following closing, had incorrectly charged certain fees and incorrectly calculated the APR on a number of loans purchased by our client. Our client discovered these errors following the closing of the transaction. We took a very close look at all aspects of this situation, including the specific provisions of the contract that allowed for recovery under this type of situation. We were all "geared up" for the fight, which proved ultimately to never happen.

Instead of there being some long, drawn out fight, the principals of the two organizations settled this in a very professional manner. The president of our client essentially called the president of the seller, who was a very significant shareholder, and explained the situation. The selling shareholder understood completely and reimbursed our client for the out-of-pocket expenses it incurred in reimbursing customers for the problem. This solution reminded me of the types of individuals we get to work with in community banking on a day in and day out basis. I was so glad to see an amicable and efficient resolution.

THE FEDERAL RESERVE'S UNUSUAL REQUEST

I recently received a telephone call from a client that we assisted in acquiring a failed bank in the not too distant past. Our client indicated to me that he received what he thought to be an unusual request from the Federal Reserve. The request was essentially for a copy of all documentation from the failed bank. The request was not accompanied by any type of subpoena or other legal justification. The attorney at the Federal Reserve was simply wondering whether the bank would provide the requested information.

Our advice to the client was not to provide the information to the Federal Reserve. We were not encouraging the client to be hostile to the Fed. Instead, we encouraged the client to simply follow the rule of law. If the Federal Reserve needed the failed bank documentation, which the FDIC also has in its possession, the Federal Reserve could either get it from the FDIC or could subpoena it from the bank. In either one of those cases, the Federal Reserve would be able to get the information pursuant to a legitimate avenue. Our major concern was that if the client complied with the Federal Reserve's request, they would be part of the "fishing expedition" the Federal Reserve may be on against the failed bank directors and officers. We do not believe that is a good position for our client.

ACQUISITION INTEREST

Over the past couple of weeks we have begun the marketing process for a smaller, but extremely profitable, community bank in the upper Midwest. As we always do when we are engaging in a broad base marketing effort, we have contacted a number of potential acquirers regarding this acquisition opportunity. The thing that has struck me about this particular marketing process is the very strong interest that the potential acquirers have shown. Almost every potential acquirer we have contacted has indicated a strong interest in making acquisitions.

This is further evidence to me that many community banks are seriously thinking about the mergers and acquisitions game in today's environment. Obviously, only one of these community banks will ultimately end up being the acquirer in this transaction. However, it is evidence that there are many out there thinking about putting themselves in that position.

CONCLUSION

We hope all *Musings* readers have a fun and safe 4th of July. Life has been interesting from our perspectives as we travel around the country on a regular basis. Other than hurricanes/tropical storms, tornados/straight-line winds, and crazy people on airplanes trying to open the emergency exit doors, things have been pretty normal.

Have a great two weeks.

Jeff Gerrish *and* *Greyson Tuck*