GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Georgia, Wisconsin, Minnesota, Iowa and Illinois!

CONFIDENTIALITY…CONFIDENTIALITY…CONFIDENTIALITY

As *Musings'* readers know, in real estate, it is location…location…location. As a director or officer of a community bank, it is confidentiality…confidentiality…confidentiality.

I had a couple situations in the last few weeks where I have received pleading calls from CEOs that their directors were out "running their mouths" around town about things that occurred in the boardroom, a board meeting, or a loan committee meeting that should be kept confidential. These situations included information about customers who either were or were not granted an extension of credit, about long-term plans the bank has with respect to acquisition, and other issues that should remain confidential.

As directors and officers of community banks, there are three basic duties: the duty of care, the duty of loyalty, and the duty of confidentiality. Do not forget the duty of confidentiality. It is critical. A breach of the duty of confidentiality could not only adversely impact the bank's reputation, but it could also expose the bank to litigation.

INCREASED DIVIDENDS

I recently met with a board to do some capital planning. This bank is having a particularly good 2016. Their earnings are up significantly, and total assets have essentially remained flat. Given the bank's already strong capital ratios, the board has plenty of options in terms of capital allocation.

During the discussion, we considered all of the various ways this "excess capital" could be put to work. The discussion included growing the bank, acquiring another bank or a company that would provide additional non-interest income, repurchasing shares, and increasing dividends. This bank does not have significant growth prospects, and they do not see themselves as acquirors. Accordingly, the bulk of the discussion focused on increasing dividends or paying a special dividend.

The discussion on dividends focused largely on increasing the dividend as opposed to making a one-time special dividend. During the discussion, one of the directors made what I saw as a very valid point. This director essentially said the only risk associated with increasing the dividend based on their exceptionally good year, as opposed to paying a special dividend, was the possibility that the dividend could not be sustained in the future. The director's valid concern was shareholder perception in the event the increased dividend ever had to be lowered in the future. Although many community banks follow a "percentage of earnings" dividend strategy, these directors agreed that an "up and down" dividend strategy was not best for their organization. Instead, they opted for a dividend strategy that would provide sustainable increases in dividends going forward.

The establishment of a dividend strategy involves allocation of capital. I have never heard a shareholder of a community bank complain about an increase in dividends or sending a check back. However, once a dividend goes up, you will certainly hear from shareholders in the event it subsequently goes down.

THE UNSOLICITED OFFER

I have been working over the last year or so with a shareholder group of a high-performing community bank. When I began to work with this group over a year ago, relations among the shareholders were not good (that is an understatement). Unfortunately, relations among the members of the group have gotten progressively worse. It did not help that all of the shareholders are part of the same big, unhappy family. Each group had their lawyers, financial consultants, appraisers, valuation experts, and the like, which certainly contributed to the discord. As hard as it may be to believe, notwithstanding all of those issues, the group finally resolved its differences and has agreed to a plan under which they will move forward. It is about time.

DIRECTOR EVALUATIONS

I was recently working with a new CEO of a community bank. He was not new to the bank, but he had recently been promoted into the CEO position as a result of the former CEO's departure. The new CEO is concerned that his board (as trained by the former CEO) was simply a rubber stamp. He wanted a more active and engaged board. Of course, I cautioned him to "be careful what you wish for."

He wanted the board to fully understand their duties, responsibilities, and obligations as directors of a community bank. We provided him with a director's job description, list of expectations, and a couple separate board evaluation forms that our firm has on hand. This is going to form the basis for a subsequent discussion that I am going to facilitate with this board of directors.

In addition to getting the board to understand their duties, this new CEO's real wish list involves reconstituting the board. I told him based on my experience that will be more difficult because of some long-tenured (i.e., mature) board members. We will see what happens.

HOW DO YOU STAY INDEPENDENT?

I recently met with the board of directors of a community bank to discuss how to keep the bank independent in this consolidating environment.

After reviewing the situation and discussing it with them, my recommendation was not a complex one. It was simply to convert the bank to a Subchapter S. That will do two things. First, it will create a cash cow for this community bank's shareholders, which will keep them from looking for an alternative investment. Second, it will send the marketplace the message the bank is not for sale.

Of course, the action of converting to Subchapter S does not prevent the bank from receiving an unsolicited offer that may be at such a price that the board would have to consider it, but it certainly puts the bank in a better position to make an argument that the Subchapter S stock held by the shareholders is a better investment than whatever is being offered, cash or stock, by the buyer. It is likely this Subchapter S conversion will take place in 2017 and become effective January, 2018.

YOUR NET WORTH IS THE BANK

I was recently visiting with the CEO of a mid-sized community bank. Her concern was that she was approaching 60, owned virtually 100% of the holding company, which owned 100% of the bank, and her entire net worth was tied up in the bank. She has three children, two of which wanted to come in and work in the bank and one of which did not. The issue is how do we get the stock to the kids that want to work in the bank,d provide enough cash for estate taxes, and still keep a portion of the estate dedicated to the one sibling that does not want to work in the bank. The problem, of course, is compounded by the fact that the holding company stock is the primary asset of the estate. We are currently working through this on both the estate side and the bank side to try and come up with some type of reasonable resolution going forward. When you are talking about $25 million or so, it is not a small problem.

DATA BREACH

Two of our clients have had data breaches over the last few months. Let me rephrase that. They did not really have data breaches – their friendly federal regulator had a data breach that impacted the community banks' customers. In the most current situation, the friendly federal regulator does not even want to let the bank know which of their customers were impacted. The bank is stuck between a rock and a hard place of either waiting for the friendly federal regulator to get their act together or sending a notice to all their customers, the latter of which would do nothing but create reputational risk for the community bank. What do you suppose the friendly federal regulator would do if this situation was in reverse – that is, if the bank had caused a data breach that impacted the customers? I will give you a hint. They would drop on them like a ton of bricks.

This, in an odd sort of way, reminds me of the FDIC situation during the Recession when the insurer of the banks' deposits was technically insolvent but still had liquidity and stayed in business while the banks that were technically insolvent and still had liquidity were closed.

RANSOMWARE

Has your bank been hit with ransomware? Maybe a better question is "has your bank been hit with ransomware *yet*?"

If you are unfamiliar with ransomware, it is essentially cyber hijacking. A hacker in some remote location takes over control of the bank's computer system and then demands a ransom (typically paid in Bitcoins) to release control of the system back to you. I recently read with interest an article regarding ransomware, its prevalence in today's computer environment, and what many businesses are doing (including stocking Bitcoins) to prepare for a ransomware event.

In some of the recent planning sessions I have facilitated, we have had discussions on ransomware. It has not been extensive, but directors and officers are asking questions. That is important and appropriate given the circumstances. This is not an area where anyone can simply say, "this is technology, and I am not into it." These are very real threats that are increasing in prevalence, and we need to be thinking about how we will address them.

Please let us know if you would like a copy of the article or would like to otherwise discuss any of these technology concerns as it relates to your strategy and operations.

SHARE REPURCHASE PROGRAMS

We recently assisted a client in establishing a voluntary walk-in stock repurchase program. As part of the process, our firm completed a determination of the fair market value of the holding company common stock. We completed the "full blown" valuation that detailed all of the various valuation techniques we considered to determine the stock's fair market value. We also completed a lengthy report that explained in detail what we did.

We provided the valuation report to the board a couple of months ago. The board considered the report and then essentially asked whether it could set the repurchase price at a level that was about 10% to 15% higher than what we determined to be the fair market value. The difference of opinion (if you will) related to the perceived importance of the trading price for the company's common stock in very limited market trades.

Our response to the board was that they were free to set the share repurchase price for the repurchase program at any level determined to be appropriate. There are no set guidelines on the repurchase price, and the board is not required to follow our fair market value determination. We informed the board we thought there was a very small risk that a shareholder could sue them for corporate waste by paying more for the common stock than an expert (our firm) determined to be the fair market value. The board considered this risk and determined it was one it could live with. No problem by us.

PROGNOSTICATIONS ON M&A

I recently received a telephone call from a reporter asking me how Donald Trump's election would impact the community bank M&A market. My halfway joking response was to ask this reporter which position she would like me to advocate. The reality is that I think Donald Trump's election as President is a "knife that cuts both ways" as it relates to community bank M&A. One the one hand, the election has been kind to stock prices, particularly as it relates to bank stocks. There are many bank stocks that have enjoyed strong gains over the past three weeks. This obviously makes their currency more valuable in a stock transaction, making acquisitions easier. On the other hand, many banks, particularly community banks, expect regulatory relief as a result of the election. This could cause those sellers who are selling because they had "all the fun they can stand" to rethink their position. If there are prospects of regulatory relief, the motivation to sell may be significantly diminished.

Overall, I do not believe that one side of the argument will win out over the other. I think you will certainly see some increase in M&A, particularly from larger banks as their stock price improves. I also believe you will see many community banks that might have otherwise sold hang on to their independence if there are real prospects for regulatory relief.

CONCLUSION

I hope all of you had a wonderful Thanksgiving and were able to spend quality time with friends and family. And for those of you who are curious, no, we do not know nor can we get you adopted by the group that won the $400 million plus Powerball recently in Tennessee.

Have a great two weeks.

Jeff Gerrish *and* *Greyson Tuck*