

The



Chairman's Forum

Opening the door to new ideas

Newsletter

Gerrish Smith Tuck, Consultants and Attorneys

March 2017

It was great having the opportunity to see many of you at the ICBA National Convention in San Antonio and we appreciate the nice comments many of you gave us regarding the multiple presentations our firm gave during those sessions. Certainly, it is a time of renewed optimism within our industry, but along with that optimism comes the renewed focus on continuing education, exercising duties appropriately and continuing to move the organization forward in ways that create shareholder value yet promote safety and soundness.

In this month's edition of *The Chairman's Forum Newsletter*, we continue to look at a mixed bag of various issues and situations we have faced recently as well as issues from today's headlines. We hope you find this information useful as you continue to define your role as Chairman of the Board. If we can be of assistance, let us know.

Happy Reading!

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Chairman's Summary

- ◆ Fiduciary duties still matter.
- ◆ Consider alternatives to a typical branch.
- ◆ Ask the right strategic questions.
- ◆ Beware of certain “community bank” advice.

What is the Duty of Loyalty?

If you have been to any of our presentations, or if you know a little bit about the basic legal obligations of being a member of a Board of Directors, you have probably heard someone talk about fiduciary duties and, in particular, the duty of loyalty that directors owe to organizations. But what does that really mean, and how does it work in practice? Can a director technically be in violation of his or her duty of loyalty to the organization without really realizing it? In our opinion, the Chairman of the Board should have a good sense of what that duty really is, how it functions in the day to day interactions with the Board and what to do if the Chairman views someone as not upholding their fiduciary duty.

Consider this situation. A stockholder calls the bank President wanting to sell a small amount of shares. Following typical protocol, the President tells the stockholder that the organization, in one form or another, will likely acquire the shares, but he would like to have it considered formally at an upcoming Board meeting. At the meeting, the President explains that the organization has an opportunity to buy the shares and there is discussion that the holding company could buy the shares or the organization's Employee Stock Ownership Plan (ESOP) could buy the shares. It is agreed by all of the Board members that this would be a good opportunity for the ESOP to acquire the shares for the benefit of employees and the ESOP appraised value is, in fact, a value that the stockholder will accept. The only problem is one of the Board members speaks up and says that he would like to buy the shares personally and, since the ESOP can only pay the appraised value, he is going to offer the stockholder slightly more than the ESOP can pay.

Do you see a problem in this situation? It appears to us this would be a clear breach of the duty of loyalty where a director is using knowledge he has received as a Board member (the fact that there are even shares available) and "outbid" the ESOP for his own personal benefit and, therefore, to the detriment of the ESOP and the organization. Consider whether the Chairman should direct the director not to purchase the shares. Should the holding company then get in a bidding war with the director and try to outbid the director who has already outbid the ESOP? Again, it would seem the director would be working against the interests of the organization in that situation.

This really seems like a simple issue to us from a legal standpoint. If the organization has an opportunity to acquire shares, the director breaches his or her fiduciary duty by seeking to take advantage of a corporate opportunity for his or her own personal benefit by outbidding the organization. The director should probably be prohibited from acquiring the shares or removed from the Board for such a blatant violation if he attempts to move forward with the bid after being apprised of his fiduciary obligations. That probably then becomes the role of the Chairman. Sometimes the Chairman has to be the bad guy.

When is a Branch Not Really a Branch?

In a number of Board meetings we have been in recently, there has been talk by the group about expanding the operations of the organization and, in particular, trying to improve the loan to deposit ratio that has been relatively low during and coming out of the crisis as we look for more and better lending opportunities. Often, Boards of Directors will immediately default to the idea that there is a need to expand by putting a branch in a new area or a new market in order to increase the supply of loans. But, the reality may be that the organization does not need to establish a full-service branch, but rather would be just as well served by opening a loan production office (LPO). So, a branch is not really a branch when it does not accept deposits. As a result, a bank can much more simply open a loan production office with little to no regulatory approval since it does not qualify as a

branch. Since it will not be accepting deposits it is not legally a branch and, therefore, does not have to file a branch application.

We often see organizations use loan production offices as what might best be described as “test branches”. By this, the organization leases a storefront in a new area, hangs out a temporary sign that it is a loan production office of their bank and puts the franchise player on the ground making calls and trying to gin up loan business. The only catch is that the loans generated technically cannot be funded from the loan production office and must be funded from an actual branch location. If the operations become successful, then the organization can apply to have the location converted into a full-service branch that accepts deposits, funds loans and does all of the other typical branch functions, but, if the organization flounders, then it is pretty simple to cancel your short-term lease and pull out of the area without much downside. In that way, you have tested the waters of the area without committing to a full-service brick and mortar branch. So, consider the loan production office as a viable alternative to a branch. If you would like a copy of our Clients and Friends Memo on Loan Production Offices, please contact us.

Asking the Right Strategic Questions

As Chairman of the Board, are you ensuring that your organization is asking the right strategic questions? We are currently developing a new series of seminar presentations around this very topic because of the mistakes we see many organizations make in their strategic planning process. Too often, organizations get hung up on the “concept” of strategic

planning and, as a result, fail to do any true decision-making and strategic planning on real issues. For example, are you asking the strategic question “What is our value proposition?” If you are, is that more important than asking the question “How do we ensure liquidity for our stockholders?” It may sound nice to ask “What are the deliverables from this proposal?” when, in reality, what you should be asking is “Will a new branch location actually improve earnings per share for our stockholders?”

We encourage the Chairman to be the party that leads the charge toward common sense language and sound business and strategic decisions without getting hung up in the latest jargon of the day. In the end, the process of your strategic planning and the concept of planning itself is not nearly as important as the open discussion of true organizational concerns and making specific decisions.

Advice for “Community Banks”

Do you believe your organization is a true community bank? If so, do you seek out advice specific for community banks as opposed to all financial institutions in general? Typically, most of our clients would say yes they do, and we hope that is one of the reasons they often contact us because of our particularized and unique focus exclusively on community banks. However, we would like to issue a friendly warning to be cautious about the types of groups, organizations and associations purporting to offer advice for community banks. We would suggest that not all of these have community banks’ best interests in mind and perhaps do not truly recognize a real community bank when they see one. To use just one example, without

attempting to vilify any particular group or entity, we would suggest that you are looking at promotional materials and considering going to any type of community bank conference, community bank special education session on capital raising, mergers and acquisitions or other similar events, if the primary sponsors of those events tend to be large national law firms, investment banking groups out of New York City, Chicago or San Francisco, for example, and tend to focus on having a host of vendors present to sell you their latest goodies, that may not be an event that truly focuses on real community banks. Real community banks do not need to hear from investment bankers on Wall Street articulating the PE ratios of the largest banks on NASDAQ as a way of calculating future values for your bank. Nor do we need to hear the benefits of private equity money, mutual funds and other similar third party sources of capital and funding for our community banks when we have no need or desire to go public, take institutional money or pursue similar avenues. So, buyer beware on events for “community bankers” where the average size of the “community bank” attending may be several billion dollars.

Meeting Adjourned

It is safe to say we are fully into the new year now, so much so that it is not really “new” anymore. However, the strategies and decisions we see many of our clients making are new in the sense that we are seeing an uptick in merger and acquisition opportunities (both for buyers and sellers), new capital raising scenarios, enhanced and improved strategic planning and

various other positive steps for community banks. So, plan your future cautiously, but plan optimistically.

Also, if you are considering the M&A game on either side of the aisle, we would love to see you at the Community Bank M&A Conference in Chicago that our firm is hosting in conjunction with the Independent Community Bankers of America. It is scheduled for May 4 and 5. If you would like more information, please let us know or you may visit our website or the ICBA's website.

Until next time,



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