GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Michigan, Pennsylvania, Florida, Tennessee, Ohio, Illinois and Missouri!

SALE OF STOCK

We are working with a number of community bank holding company clients currently that are trying to raise capital through the sale of stock. This is usually what the holding company board will decide to do when the holding company has used up all its leveraging ability through the use of debt.

The sale of stock by the bank holding company is not a big issue. As most of you know, anytime the holding company sells stock (any time!) the stock either needs to be sold pursuant to an SEC registration or pursuant to an exemption from SEC registration. For most community bank holding companies, stock will be sold pursuant to one of the various available exemptions from SEC registration. The sale of stock also needs to be accompanied by some type of disclosure. The depth of disclosure and the type of disclosure will depend on a number of things, including who the purchasers are and how far outside the board table the Board seeks to find purchasers. The further away from board members and senior officers, the greater the degree of disclosure.

If your community bank holding company needs capital and you have exhausted debt alternatives, then don't be overly concerned about selling stock to either existing shareholders or new shareholders. Just make sure you do it right.

PREPARING THE BANK

We have worked over the last several months with a number of community bank boards who are contemplating taking advantage of the currently higher prices for bank sales stemming from the change in Administration by finding a buyer for their banks and holding companies. We will assist these banks in both the marketing process and the legal process as a one-stop-shop. For most of them that have a fairly long runway to the sale, say three to six months or so, we will also help them prepare the bank for sale. This involves analyzing the existing contracts, negotiating some new contracts, cleaning up litigation, and taking care of other things you would think about to drive core sustainable earnings prior to the sale. This would also involve other critical issues related to the sale, such as identifying those employees who need to be "bribed" to stay through a sale (the use of retention bonuses). If you are contemplating a sale, give yourself enough time to make sure the bank is prepared for it. It is good to get the bank prepared so, from the eyes of an acquiror, it looks like an excellent target.

409A REVISITED - AGAIN

In connection with preparing some of our clients for sale, we have come across deferred compensation agreements that have been on the books or in the bank for a significant period of time. Most of these deferred compensation agreements do not comply with Internal Revenue Code Section 409A. This is a highly technical area, as we have addressed in prior *Musings*. If you have a deferred compensation agreement that has been around for a while, you might have us or somebody check to make sure it complies with 409A. I know we have mentioned this in *Musings* before, but it really creates a significant problem of potential penalties for the individual director or officer who might have a non-compliant 409A agreement. It means real money.

BANK ESOP VERSUS KSOP

We have worked with a number of banks lately that are contemplating establishing an employee stock ownership plan or a 401(k) employee stock ownership plan. For some of these banks there is confusion, at least at the beginning, as to what each of these different entities involves.

The fundamental decision for a board contemplating an ESOP or a KSOP is, "Is employee ownership a good thing?" If it says "yes," then an ESOP or a KSOP is often the best way to do that. Is there a cost associated with an ESOP or a KSOP? The answer is "of course." There is also a cost with giving your employees raises, raising director fees, or any other employee benefit or expense to the bank. The question is, "Is the cost worth the benefit?" An ESOP is simply an employee stock ownership plan wherein a trust is created to own stock for the benefit of all the employees in the bank. A 401(k) ESOP simply is an amendment to your existing 401(k) plan, which as a practical matter, allows the employees not only to invest in the current array of mutual funds or opportunities they have under the 401(k), but also, in appropriate circumstances, in holding company stock. It also allows the match that the company provides to be provided in holding company stock. That said, ESOPs and KSOPs are not solely an employee benefit; they are also tremendous financing tools to generate capital for the bank. If anybody needs any additional information, let us know.

KSOP #2

Is there a point when a KSOP or an ESOP might have too much ownership of the bank holding company? When the ESOP or KSOP is originally formed, too much ownership is really not an issue because it takes a fairly long while for the ESOP or KSOP to generate ownership (unless the trustees determine to leverage it highly). Down the road, though, is there ever a point where the ESOP or KSOP has too much ownership of holding company stock? My opinion is "not really." Once an ESOP or KSOP gets over 25% ownership of the holding company, then it must obtain prior approval of the Federal Reserve to become a bank holding company in its own right. This is not a big deal.

Practically, the only time the holding company board or trustees of the ESOP/KSOP may determine that it is getting too much ownership is if the emerging liability (i.e., the obligation to repurchase shares from retirees) grows beyond the capacity of the ESOP/KSOP or the holding company to handle. For the most part, an ESOP or a KSOP in a Subchapter S can generally become a cash accumulator and meet the needs of these redemptions more easily. Even when the ESOP or KSOP runs out of ability to meet the emerging liabilities or exhausts its leveraging ability, then the holding company generally steps up to the plate and makes the redemptions.

THE WALK-IN PROGRAM

We are working with a number of community banks across the country with respect to creating share liquidity for their shareholders through a "walk-in" repurchase program. The walk-in program is really a mechanism to create share liquidity where the holding company would otherwise have little, if any, market liquidity. A walk-in program is pretty simple and can be designed specific to each bank. It generally involves determining how much capital/cash the holding company is going to allocate to redeem shares on an annual or quarterly basis, what the share price is going to be, and who has the authority to make the purchases. If you do not have a walk-in program, it would probably be a good idea to set one up so you have some parameters that allow management to execute on the purchases when a shareholder approaches the holding company looking for a seller.

MORE ON BANK HOLDING COMPANIES

In the last edition of *Musings* we passed along some comments by the former Acting Comptroller of the Currency, Keith Noreika, addressing whether the bank holding company structure still makes sense. As you know, his answer was that generally the holding company structure did not make sense anymore. We relayed to you through *Musings* our strong disagreement with his position. At least as some vindication for our position, the Federal Reserve Bank of St. Louis agrees that the holding company structure still makes sense.

Julie Stackhouse, who is Executive Vice President and Officer-in-Charge of Supervision at the St. Louis Federal Reserve, recently published a blog entry entitled, "Are Bank Holding Company Structures Still Beneficial?" Her answer was in line with our answer. It was yes, the bank holding company structure still makes sense. Julie's blog entry summarizes all of the benefits of a bank holding company that we have previously relayed through *Musings* and points to those benefits as the reason for maintaining that corporate structure.

It is nice to see that some of the federal regulators out there are actually in tune with what is going on in the community bank sector of the industry and why a bank holding company continues to make sense. If you would like a copy of Julie's blog, please contact us.

DEAL PRICING

We were recently approached by a long-time client that asked us to assist them in evaluating a potential acquisition transaction. This potential transaction is the acquisition of a small bank in what the client defined as a steady, but not dynamic, market. The bank is about all the bank is ever going to be. This is not a growth market that presents some tremendous opportunity to enter into a new market and gain a bunch of new business opportunities. Instead, this is just a pretty good, little bank that has conservative loan underwriting and generally all of the market share it is ever going to have.

We ran the financial analysis for the transaction. We presented that analysis to the client and discussed the analysis with them in detail. One of my comments relative to the analysis was that the deal pricing for this type of transaction and the overall attractiveness of the deal was largely driven by cost saves. If the target bank does not present any growth opportunities and is generally doing about as well as it is going to do, the only meaningful way to generate any additional net income is through expense reductions. Obviously the more expense reductions you can get the more you can afford to pay. The assumptions relative to the expense reductions are critical because they are going to be a large driver in the ability to generate additional net income out of the target.

The second comment I made to the client was relative to the "pricing window." If you are not familiar with the concept, the pricing window is simply a range of appropriate acquisition values. On the low end is what we estimate to be the lowest amount the sellers would take in a sale transaction. On the high end is the highest amount the acquirer should pay based on the financial analysis and comparable transactions. The purchase price should always be somewhere within that window. The determining factor is how badly the acquirer wants it. If they want to make the acquisition very badly, the purchase price should be towards the higher end of the range. If they are looking at it more from a value perspective, the purchase price ought to be at the lower end of that range.

Deal pricing is certainly part art and part science. It is always a fun process to go through, and there are a multitude of factors to consider.

THE FINAL SHAREHOLDERS MEETING

I recently attended the final shareholders meeting for a family-run bank. This particular bank has been in the same family for a number of generations. Earlier this year, the family decided it was the right time to sell. The bank went through the marketing process, and we signed the contract a couple months ago. Last week the shareholders had the final shareholders meeting to approve the transaction. The business of the meeting went very quickly. What I thought interesting was that this shareholders meeting was similar to other final shareholders meetings I have been to. Once the actual business was completed, the shareholders had good discussion about the history of the bank and some of the many happenings over the years. It is a bittersweet moment for a family when they are selling the major family asset. Although the situations are often different, the emotions under this type of transaction are generally the same.

RETENTION BONUS AGREEMENTS

I have recently had a number of discussions with various clients around the country for various reasons regarding the payment of retention bonus or change in control agreements. As you likely know, these agreements are simply agreements that state the individual subject to the agreement will receive a retention bonus or change in control payment if the individual is employed by the bank on the date of a change in control of the holding company or bank. This is all pretty easy in concept. The area where the discussion almost always focuses is the amount of payment. We are often asked the question "How much should we pay the individual under these types of agreements?" The answer is always the same: "Whatever it takes to keep them here." (This, of course, is subject to Section 280G of the Internal Revenue Code, which limits such change in control payments to 2.99 times average five year compensation of the individual, unless of course you want to pay penalties.) We are not being flippant with that answer, just honest. There is no magic to a retention bonus or change in control agreement. What is important is that the agreement provide enough incentive for the individual to stay with the organization up to the time of a change in control.

CONCLUSION

This will be the last *Musings* before Christmas. Greyson and I wish all of you a Merry Christmas and a Happy New Year. Because *Musings* "never sleeps," we look forward to another *Musings* to wrap up the year on December 30th or so. Have a great holiday, a good two weeks, and get in some family time.

Jeff Gerrish *and* *Greyson Tuck*