GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Iowa, Illinois, Wisconsin, South Dakota, and Florida!

THE IDEAL DIRECTOR

I was recently with a healthy, well-performing community bank. This organization had several directors who were of the older variety. During the director succession discussion, several of them agreed to get off the board within a reasonable period of time. This led the board to discussing the possibility of adding a couple of directors and characteristics of the ideal director for their bank.

I have had many conversations like this over the last several months. Usually the ideal director is someone who has technology experience or commercial experience or something that the bank needs. High on this board of director's list for the ideal director was honesty and integrity and understanding of the board's fiduciary responsibilities.

I thought it was good that the board identified that as an important characteristic because it certainly is.

THE SUBCHAPTER S SHAREHOLDER AGREEMENTS

We have been contacted by numerous Subchapter S clients lately to ask us to look at their Shareholders Agreement. Many of them are contemplating reducing the tax distribution to their shareholders in view of the reduction in the Tax Cuts and Jobs Act which provides an effective maximum tax rate for Subchapter S owners on the pass-through income of approximately 29.6%. Many of the Shareholders Agreements we have reviewed require the holding company to distribute to its Subchapter S shareholders at the maximum federal individual tax rate. The problem is, technically, the highest individual federal tax rate is 37%, although with the reduction of pass-through income by 20%, it is an effective tax rate of 29.6%. Does this require some communication with the shareholders or an amendment to the Shareholders Agreement? It probably requires both. If you have not looked at your Shareholders Agreement lately you might look at it as it relates to the tax distribution amount. Of course the bank could continue to distribute at 43% as they were doing previously, and it will just put more after-tax cash in the hands of the holding company's larger Subchapter S shareholders. The alternative is to reduce the tax distribution and retain more earnings and capital in the bank.

THE ACQUISITION TARGET

I was with a board of directors of a community bank the other day discussing acquisition issues. The question for this bank is "do we want to participate as a buyer in the ongoing consolidation of the industry?" The general consensus of the board was that they did. They also wanted to be proactive in looking for a target bank to purchase. Being a proactive purchaser is not an unusual strategy for a community bank in this day and time. The issue is how you select the target. I asked this board of directors what they were looking for in a target bank. We talked about size, characteristics, and the like. In short, the consensus was we want a bank "just like us." The "just like us" really dealt with culture more than it did business lines. They are going to need to do significant research to find such a fit. It will be interesting to see what happens.

WELLS FARGO AGAIN

Within the last couple of weeks, the Federal Reserve Bank has come at Wells Fargo with an enforcement action and a consent cease and desist order. It deals with all the usual stuff at Wells Fargo that has been going on for a fair amount of time now.

The unusual thing about this particular order, at least according to the trade press, is it restricted Wells Fargo's asset size to its asset size at year-end 2017. For those of you who don't know, Wells Fargo's asset size at year-end 2017 was $1.95 trillion. The trade press made a huge deal about how unusual it is to restrict a bank's asset size. My reaction was "not really." Virtually every Prompt Corrective Action Order issued to a community bank during the recession by any of the regulators contained an asset size restriction that limited growth, limited acceptance of broker deposits, and limited virtually everything else the community bank did. Not that unusual. It is unusual for a "too big to fail" bank to have any types of restrictions like that.

LOOKING FOR CAPITAL

I was recently with a board that was looking for capital. I gave them my general advice, which is look at debt capital first and equity second. With debt capital, they began talking about subordinated debt, which would bear an interest rate of 7% or 8%. I suggested that the board consider either a bank stock loan or debt directly issued to the directors, as either one of those would be at a lesser price.

They were not aware that directors could loan money to the holding company directly, other than some type of a public debt offering scenario. The discussion saved the bank holding company about 300 basis points in interest on a significant chunk of change.

The board and I also discussed how they could also purchase equity in the privately held holding company very easily without some type of big registration of the securities. As long as the securities are being sold around the board table, the disclosures are minimal and all directors are considered accredited investors for securities law purposes, i.e. rich and smart (whether they actually are or not). I anticipate the board will do that as well.

REGULATORY RELIEF

Regulatory relief is talked about a lot. While we have seen some movement in Congress lately with respect to regulatory relief (at least in a couple of specific areas), we have not seen much from a regulation and statute standpoint.

What we have seen is regulatory relief in the form of a change in attitude, particularly by the field examiners. We were recently visiting with a banker who indicated that his relationship with his primary federal regulator went from good to horrible during the recession and is coming back to be halfway decent. We both have noticed a significant change in the field examiners' attitudes. I suspect this will last as long as the economy is on the rise. In other words, don't get lulled into complacency that these friendly federal regulators are actually "friendly."

THE BRANCH ACQUISITION OPPORTUNITY

We recently received a call from a community banker that was approached by another community banker looking to sell a couple of his bank branches. This seller has been experiencing capital and profitability issues and is looking to shrink the bank in order to improve capital ratios and profitability. The seller, who did not have any professional representation, essentially pitched an opportunity for the sale of two branches that totaled about $90 million in deposits (keep in mind, the last time we checked, deposits are liabilities that have to be paid by anybody who assumes them). When our client approached us to discuss this opportunity, one of our first questions was what assets the seller was going to give up in order to balance out the assets purchased and the liabilities assumed. Our client had not been provided this information, so we contacted the seller to ask whether they intended to provide cash, securities, or loans in the transaction. The seller was completely unaware of what we were talking about. The seller said that we would have the opportunity to assume the deposits and pick up the customer relationships. We then explained to the seller the structure of a branch transaction and that the purchaser has to receive assets that fill out the balance sheet in the transaction. After some discussion, the seller realized it would make no sense at all for the purchasing bank to assume the liabilities but not receive any corresponding assets. After giving this some consideration, the seller decided selling the branches was not a valid strategy. Although it would reduce the size of the bank, the earnings that would be given up on the assets were simply more than they could stomach.

If you are thinking about doing any type of branch acquisition, make sure you understand the unique purchase of assets and assumption of liabilities structure. In branch acquisitions, the seller is going to provide assets to the buyer to balance the assets purchased and liabilities assumed.

M&A FRUSTRATION

We are currently marketing a troubled bank for sale. This particular troubled bank has a large OREO portfolio and a pretty hefty amount of loan problems. They are essentially treading water from a profitability standpoint, but capital levels are not close to what they need to be for the bank to continue as an independent entity.

Through the marketing process we have contacted a number of potential acquirers. About three weeks ago one of the potential acquirers sent an Indication of Interest that was frankly a much better offer than we thought made sense. Regardless, we moved forward and brought the potential acquirer in for due diligence.

The first day of due diligence went fine. The second day was very frustrating. About halfway through the second day, one of the acquirer's representatives walked in and essentially said the level of problem assets, which were fully disclosed prior to due diligence, was more than they could handle. They then thanked the bank for the hospitality and left.

This was frustrating. Unfortunately, there is nothing we can do about it. The Indication of Interest was, as all documents like this go, non-binding and subject to due diligence. Until an actual contract is signed, neither party is legally bound to the deal. Either party is free to walk away well into the process. I guess a silver lining here is that we did not spend more time or money drafting contracts with this potential acquirer. We have been through that frustration before as well, and I would prefer to avoid it in the future.

MORE ON SUBCHAPTER S

Over the past couple months we have reiterated in *Musings* that our belief is that Subchapter S continues to make sense for community banks after the Tax Cuts and Jobs Act of 2017. Several of our clients have asked us to actually put the pen to the paper and "run the numbers" by using their actual financial information and comparing the taxation of the company as a C corporation to the taxation as an S corporation. We have now done so for a number of different clients under a number of different scenarios. Based on each of these projections, we continue to see Subchapter S as the most beneficial tax structure. It is the most efficient way to get money from gross income into the hands of the shareholders. Even if a company is not paying a high "dividend equivalent" distribution, the Subchapter S still makes sense because of the significant increase in tax basis the Subchapter S shareholders receive.

Please let us know if you have any questions on S corporation taxation after the new Tax Act or would like us to run a similar financial analysis for you. It is important that you fully understand the S corporation and why that taxation continues to be superior to that of a C corporation.

CHANGE IN CONTROL AGREEMENTS

We are currently working with a board of directors that is contemplating Change in Control Agreements in conjunction with marketing their holding company and bank for sale. The board is somewhat wrestling with what I consider to be the typical questions that come up when considering these types of agreements. This board is trying to figure out who should receive Change in Control Agreements, how much those agreements should pay, and the terms and conditions under which the payments should be made. The interesting thing about these types of Change in Control Agreements is that there are no "right" answers. There is no standard or set amount that should be paid, and there is not a list of employees that should receive them. Instead, the board's responsibility is to look at its own organization and balance the interest of keeping key individuals in place to actually get the bank sold against being fair to the shareholders. As to cost, it is important to make the Change in Control payment enough to actually keep employees in place, but you do not want the payment to be so much that shareholders have a gripe that you have overpaid employees to the detriment of the shareholders. In terms of who should receive the Change in Control payment, those are generally paid to individuals that are material to the transaction and would give an acquirer the right to argue a material adverse effect if they left between the time of signing the contract and closing.

The issue of Change in Control payments in a sale transaction is not an easy one. It is just one of the many difficult decisions a board will wrestle with through this type of process.

CONCLUSION

We hope all of you remembered Valentines' Day yesterday. If not, we extend to you our sincerest condolences.

We anticipate the next *Musings* will be delivered the day before our firm's 30^{th} anniversary of March 1^{st}. We look forward to another 30 years and will further correspond with you about that in the near term.

Jeff Gerrish *and* *Greyson Tuck*