GERRISH'S MUSINGS

Jeffrey C. Gerrish
Greyson E. Tuck
Gerrish Smith Tuck
Attorneys/Consultants
700 Colonial Road, Suite 200, Memphis, TN 38117
♦ (901) 767-0900 ♦ Fax: (901) 684-2339
♦ Email: jgerrish@gerrish.com ♦ gtuck@gerrish.com ♦ www.gerrish.com

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Dear Subscriber:

Greetings from Texas, Hawaii, Georgia, California, and Iowa!

280G LIMITS - CHANGE-IN-CONTROL

We have had a number of questions from clients lately, particularly as we continue in this consolidating environment, as to what limitations there are on payments to an employee triggered by a change-in-control. The primary limit is contained in Internal Revenue Code Section 280G. In a nutshell, Section 280G limits the employee, as a practical matter, to a maximum 2.99 times his or her average W2 annual compensation from the last five years.

The real question is what counts as a parachute payment? Some things count against the 280G limitation, such as post-change-in-control consulting agreements and retention bonuses, but some other things do not. You have to be cautious.

No one wants to violate the 280G limitation. Doing so makes the payments nondeductible to the bank and creates an excise tax penalty on the employee. If you need some help with 280G limitation issues, please let us know.

STOCK OPTIONS

We have received multiple inquiries and provided a significant amount of counsel to community banks who are trying to attract and retain key personnel. One "arrow in the quiver" of attracting and retaining key personnel is to provide some form of equity ownership. We have frequently addressed in *Musings* the benefit of ESOPs and KSOPs. We have recently been getting some inquiries about stock options. A number of our clients want to issue stock options, but frankly they would prefer to do so without shareholder approval. That can be done.

A stock option plan can be approved by the board of directors and granted by the board to director or officers of the bank. If the plan is not approved by shareholders and does not meet certain other IRS requirements, then the options are deemed "nonqualified stock options" and do not have the tax benefits associated with qualified stock options. The basic benefit of qualified stock options, which must be issued at fair market value at the time the option is granted and approved by the shareholders, is that upon exercise, the option holder does not pay any tax on the gain imbedded in the option at the time of exercise (but it is subject to the alternative minimum tax). In fact, if the option holder holds the stock acquired through the exercise of the option for a year and then sells it, they pay capital gains tax. With nonqualified options, the option must also be issued at fair market value at the time it was granted, but ordinary income tax is applied to the difference in the fair market value of the stock and exercise price of the option as soon as the option is exercised (assuming the option is non-transferrable). Bottom line, it can be done, but there are key differences to consider.

STOCKPILING CAPITAL

We have visited with a number of community banks lately who are, frankly, wrestling with the decision of whether now is the time to sell. Some of those boards think that even if they are looking to sell, they want to "stockpile" capital because they will get a bigger multiple. In other words, 1.5 times multiple on 12% capital would be a lot better than 1.5 times multiple on 8% capital. That is the theory. Unfortunately, it does not work that way. The purchaser is going to pay whatever they are going to pay based on the earnings stream that your bank brings that purchaser. It will then be converted to a multiple of book value, not the other way around. As a practical matter, typically what happens in any acquisition these days is that the purchaser allows (requires) the seller to dividend out or distribute its capital down to somewhere in the 8% to 9% range at the time of closing. You might as well give it out to your shareholders now, when they can spend it.

SUBORDINATED DEBENTURES

During the height of the recession, from about 2008 until 2012, most forms of bank stock debt were pretty much nonexistent. As things began to improve in the banking industry, that market thawed. Beginning in about 2013 and in the years that followed, there was a pretty good resurgence of lending to bank holding companies.

A community bank holding company essentially has four options in how it may structure holding company debt. These include a line of credit, a traditional bank stock term loan, an unsecured loan from a rich and smart director or other insider, or a subordinated debenture. As with any option, there are advantages and drawbacks to each.

We have recently assisted two community banks through a subordinated debenture issuance. One of the community banks is loaning money to another community bank pursuant to the subordinated debenture. The subordinated debenture is interest-only for a number of years and will then term out. The credit facility also includes a couple of other specific nuances that have been negotiated between the parties. The interesting thing is that these nuances do not technically fit the subordinated debenture within the framework of a Tier 2 capital instrument. However, for the issuing bank holding company, that really does not matter at all since the holding company typically has consolidated assets of well less than $1 billion (and can take advance of the Small Bank Holding Company Policy Statement) and does not plan on getting to that level any time in the near future.

If you are thinking about leveraging your bank holding company, be sure to understand each of the holding company debt options. Also be sure to keep in mind subordinated debentures. They were nonexistent during the height of the recession, but in the subsequent years have come back with pretty good frequency and are a viable option for the holding company depending on the rate being offered.

PIGS GET FAT…

We are certain that each of you has heard the adage that "pigs get fat and hogs get slaughtered." We have been involved in several potential acquisitions over the last couple weeks where this adage has fit particularly well. In one of these transactions we were representing the purchaser, and in the other we were representing the seller. In each situation the discussions were at a point where we considered each party to have a good deal. However, in each case the counterparty came back with additional demands that ultimately caused the deal to fall apart. The most interesting thing we found is that in both of these situations it was not the counter that caused the deal to fall apart. Instead, the counter extended the negotiation process and during that extension of time our clients became aware of new opportunities that were better business opportunities. In both cases we left the negotiations to take advantage of the better opportunities.

If you are involved in an acquisition transaction as either a buyer or seller, make sure you are not operating in a vacuum. There is certainly nothing wrong with negotiating an appropriate transaction. However, keep in mind that there are always things happening that are out of your control. If the process gets extended too long because you are trying to turn a good deal into a great deal, there is more opportunity for an intervening transaction to present itself.

LINGERING TRUPS DIFFICULTIES

Most *Musings* readers are familiar with Trust Preferred Securities that were issued by community bank holding companies, for the most part, prior to the beginning of the Great Recession. These debt securities are basically 30-year interest-only instruments that were very popular for capital raising from about 2002 until 2008. For those *Musings* readers that have been with us for the past five years or so, you also know we have been involved in several instances where we have assisted our clients in repurchasing Trust Preferred Securities that were well into the five-year deferral period or past the five-year time mark and in default. In each of these instances we were successful in repurchasing the Trust Preferreds at a significant discount to par.

Unfortunately, there are still some community banks that are dealing with lingering Trust Preferred issues. Over the past couple weeks, we have assisted a couple community banks in that boat. In one instance, the bank underlying the holding company is in a much improved position, but the Trust Preferred represents a threat to the bank's independence because the creditors are very quickly migrating from passive creditors to active creditors that are demanding the default of the Trust Preferred be cured. Due to the bank's health these creditors may turn even more active and try and take the bank over in what is essentially a foreclosure proceeding. In the other instance, the bank has not recovered from the recession, and the Trust Preferreds continue to weigh the organization down. If the Trust Preferreds were not an issue there would be some path to trying to save the bank. Unfortunately, the Trust Preferreds are an issue. Unless there is a significant concession on behalf of the Trust Preferred holder, it may be the proverbial straw that breaks the camel's back.

These lingering issues are evidence that not all community banks have fully recovered from the effects of the economic recession. We will keep you updated on these situations as we progress and let you know if we are able to resolve them in a way that saves these struggling community banks.

OPERATIONAL CHANGES

I was recently with a progressive community bank interested in growing at a fairly good clip for the next several years. We were discussing the changes that would be required in order to do that. One of the senior officers reported that a few years back they had a program aimed at a similar type thing entitled "Upgrading the Abacus." I thought that was a pretty good description of where some of us are and how we do need to upgrade.

THE INTRASTATE OFFERING EXEMPTION

Over the years many community bank holding companies have taken advantage of the SEC's intrastate offering exemption. This exemption exempts from federal securities registration any offering made by a company if the company (1) is chartered in the state where the shares are being sold; (2) operates substantially in that same state; and (3) sells only to residents of that state. For example, an Illinois state-chartered bank holding company that operates predominantly within the State of Illinois and sells stock solely to Illinois residents can take advantage of the intrastate offering exemption. The thinking behind the exemption is that any offering that meets those requirements should be controlled by the State of Illinois, not by the federal government.

The federal intrastate offering exemption was recently revised just a little bit. The rules were relaxed to better suit today's business environment. The first change is that it is no longer required for the company to be chartered in the state where the shares are sold. This change was made to allow for companies that were chartered in a state other than the home state (i.e., Delaware) but operate predominantly within the home state. The other change is that a transaction will now not fail the intrastate offering exemption test if securities are offered, but not sold, to residents of another state. In other words, if you are looking to meet the requirements of the intrastate offering exemption and you accidentally offer shares to a resident of another state, you have not failed to meet the requirements unless you actually sell shares to residents of another state.

This loosening of the rules is in line with what the SEC has been doing lately. They have certainly been looking to relax regulations to make it easier to raise capital. Let's hope the trend continues.

CONCLUSION

Thanks to all of you who have helped make our consulting and law firms successful over the last 30 years! As I indicated in the prior *Musings*, our firm's 30th anniversary is March 1, 2018. In honor of that, we are having an Open House at our offices in Memphis at 700 Colonial Road from 4:00 to 6:00 p.m. on Thursday, March 8th. All are invited. We know many of you are located far away from Memphis, Tennessee. If you are anywhere near Memphis, however, please come on by.

Jeff Gerrish *and* *Greyson Tuck*