The

Chairman's Forum

Opening the door to new ideas

Newsletter

Gerrish Smith Tuck, Consultants and Attorneys

February 2018

In this month's edition of *The Chairman's Forum Newsletter*, we repeat some advice that we gave to a client recently who was dealing with issues surrounding the possibility of a hostile takeover. We look at what the definition of a hostile offer is, and how the Board's obligations play into that. We also consider how to manage the process where a minority group of stockholders may be trying to influence the majority. Is that something to be concerned about? We will look at the Chairman's role. We also mention a very common occurrence we see in community banks which is dealing with the transfer of stock upon death or inheritance and how the next generation may have different views than the previous generation and how the Chairman can plan for those succession needs with appropriate capital and organizational planning. Finally, we look at a growing trend of bringing in outside investors or outside Board members to your organization and the impact that can have on community banks. We hope you find all of this informative and, if you have questions about any of it, please do not hesitate to contact us.

Happy Reading!

Philip K. Smith and Jeffrey C. Gerrish

Gerrish Smith Tuck
700 Colonial Road, Suite 200
Memphis, TN 38117
Phone (901) 767-0900
www.gerrish.com

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Chairman's Summary

- What is a "hostile" offer?
- Can minority stockholders force a sale of the organization?
- Beware of inherited stock.
- Do you need outside investors and outside Board members?

What is a Hostile Offer?

Recently, a Board Chairman called asking a few questions regarding the nature of offers that his organization might receive and how the Board should respond in connection with sorting out exactly what these various scenarios mean. As a result, his questions presented some larger issues we think could be helpful for most Chairmen. Accordingly, please note some of these comments that we provided.

The question of what constitutes a hostile offer would seem obvious on its face, but there are some nuances of which to be aware. We would view a hostile takeover as any acquisition scenario that is not welcomed, approved or authorized by a majority of the Board or where it is otherwise viewed as unfavorable or unwelcomed by key and large stockholders or family groups. So, for example, a hostile takeover or a hostile offer could be one where a party tries to get a large block of stockholders in favor of the proposal even if a majority of the Board has turned it down or is not recommending the transaction to the stockholders. Similarly, if a third party could not get the largest stockholders or family groups to go along with a transaction, but decided to try an "end run" around the largest stockholders by trying to gather up enough votes to get the deal approved without going through typical protocol of the Board of Directors' approval and predominant stockholder backing, that might also be considered a hostile takeover. In short, if you don't like it, it's hostile.

Can Minority Stockholders Force a Sale of the Organization?

A sometimes interesting question is whether or not it would be possible for a group of minority stockholders to force a merger or a hostile takeover, for example, in the event of the death of the CEO, or for any other reason. As a practical matter, if the largest stockholder family owns more than 50% of the stock, the answer is no. Since the family controls a majority of the stock, if they want the bank to be sold, there is really nothing the minority stockholders can do. Similarly, if a family owning a majority of the stock chooses not to approve a sale, there is not much the minority stockholders can do to force a sale. There are some other nuances that would be involved in terms of what type of vote is actually required to approve a transaction based on your community bank holding company's Articles, Bylaws and state law, but the general rule of a majority vote controlling applies in most circumstances.

However, take an example where the family is by far the largest individual stockholder group and controls 49% of all of the shares. Assume that the next largest stockholder only owns 2% or 3% and the rest is widely held among other stockholders who do not own very many shares. You might view everyone who is not part of the family to be "minority" stockholders. However, if they were all to band together and vote for a sale of the bank, then (again considering what your Articles and Bylaws might provide as well as state law) their combined 51% ownership might be enough to force a sale of the organization notwithstanding that one family group which owns 49% and is running the bank does not want a sale to go through. Practically speaking, though, a buyer would rarely do a deal without the backing of a 49% family block.

The most common circumstance we see, though, is where a minority stockholder block, perhaps a family or others, that, for example, controls only 20%, attempts to influence the majority of the shares by threatening to put their block of stock on the market, transfer it to parties the majority does not want or like, or take other similar steps. Often that can have major repercussions so the minority block does have some power, though not ultimate power to force a sale of the entire organization. In those circumstances, it is best to deal directly with those stockholders because often all they are really wanting is liquidity for their shares. Thus, it might be best for the organization to simply try to provide them that liquidity rather than having the stock marketed to a third party.

Beware of Inherited Stock

One of the biggest concerns for community banks that we see is when the matriarch or patriarch of a family that owns a large amount of stock and has held it for a long time, begins to make transfers to children, siblings or other family members or to provide for their inheritance of the stock upon death. Often, that is done with the misguided idea that the rest of the family will want to continue to perpetuate the legacy of the family's ownership of the organization. However, we often find that is not the case and that the first question of the heirs upon receipt of the stock is "How much is this worth?". Therefore, it points out the need for appropriate strategic planning for family groups, appropriate estate planning as well as practical business planning on ownership succession in the institution in addition to Board and management succession.

Another big concern is always the capital planning aspects as they relate to stock ownership. Upon the death of a large stockholder, if family members want to liquidate the shares, is the organization prepared to do that? Does the organization have access to excess capital that can be utilized to purchase shares? Does the organization have access to third party lines of credit to help fund the repurchases? Can the organization utilize its holding company to acquire shares? If the organization has not gone through enough organizational planning to be able to fund that liquidity need, then the desire for liquidity by some of the stockholders or heirs of the family may often result in the organization seeking a third party to purchase some or all of the shares in order to prevent the family from seeking liquidity through a sale. In short, the lack of a clear strategic plan and ownership succession plan often can put the bank in play to be sold and there is a threat to the organization's independence. Therefore, as Chairmen, you need a good handle on the estate planning needs of your various large stockholders.

Do You Need Outside Investors and Outside Board Members?

We have run into a number of circumstances recently where a Chairman has been confronted with the notion of whether to accept investors and new capital from outside of their market area as well as considering the need for directors who are not local to the community. Is that a good idea or a bad idea? We believe there are some scenarios where those types of "outsiders" can be very beneficial to an organization for strategic purposes, for emergency purposes (for example, where you absolutely need the capital) or other reasons. However, in the overwhelming number of those scenarios for community banks, the out of territory directors or outside investors normally cause more harm than good.

In capital raising scenarios, there are a number of "activist" investors around the country who would be more than willing to buy the shares of your community bank, but whose long-term goal is not to see your local community thrive, but rather to see their own balance sheet increase. Therefore, capital planning through a public offering of stock must be carefully considered in order to avoid these types of activist investors. Often they wind up trying to obtain Board seats, influence the direction of the organization, push for a sale or take other steps from "afar" while you are trying to hammer out a daily existence in your community. Likewise, if you are going to add new Board members, do you need a "professional"

Board member who does not live in your community, but who happens to serve on the Board of another financial institution in another part of the country or another community? There may be some benefit to having some Board experience and expertise, but often times that may be outweighed by the benefit of having a local business person serving on your Board to provide local contacts, local business referral and local experience for your organization. Therefore, beware of the "expert" who has no desire to move to your community.

Meeting Adjourned

The Chairman's role is never done! We hope to see many of you at the ICBA Annual Convention in Las Vegas. If so, stop by and give us some more anecdotes for future *Chairman's Forum Newsletters*. Keep up the good work and we will see you soon.

Until next time,

Philip K. Smith and Jeffrey C. Gerrish

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700 Colonial Road, Suite 200
Memphis, TN 38117
Phone (901) 767-0900
www.gerrish.com

HOW TO CONTACT US:
If you have questions or comments about the newsletter or would like to ask a follow-up question, please email Philip Smith at psmith@gerrish.com.