GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Iowa, West Virginia, Nebraska, Wisconsin, Minnesota, and Florida!

DIRECTOR'S JOB

I was recently interviewed by a state banker's magazine with respect to "What is the director's real job in the rapidly changing community bank world." The interviewer kept addressing the issue as "How should directors be trained?" The more I thought about that, I really do not think directors should be trained, as such; they should be educated. Maybe that is a distinction without a difference, but I always thought of training as bringing someone along with a specific skillset so they can do a repetitive job without a lot of strategic thinking. Education is what community bank directors need. Education allows them to spot the issues, make the strategic decisions, and assess the risk associated with those decisions. More than a distinction without a difference in my mind.

BOND LOSSES IN M&A TRANSACTIONS

One item that has really turned into a hot topic in community bank M&A transactions over the last couple months is the treatment of unrealized gains or losses in the target's securities portfolio. As each of you likely know, community banks mark their available for sale securities portfolio to market on a quarterly basis. Generally speaking, the fair market value of the bond portfolio is the carrying value on the balance sheet. However, the applicable capital regulations do not require a community bank to recognize unrealized gains or losses in the securities portfolio until they are actually realized through sale of the security. This means that unrealized gains in the portfolio are deducted from equity and unrealized losses are added back to equity for regulatory capital purposes.

The regulator capital treatment for the target's securities portfolio is very clear. What is not so clear is how these unrealized gains, or in this market much more likely unrealized losses, are treated in the sale transaction. For those of you who are regular Musings readers, you will not be surprised to know that this is simply a matter of negotiation. There is no "right" way to treat the target's unrealized losses in an M&A transaction. It is a matter of negotiation between the parties. In some contracts, all of the risk for unrealized losses is on the seller. In others, it is all on the buyer. It is also possible to somewhat share in the risk, which is a resolution we reached on a contract negotiation this past week.

If you are thinking about buying or selling, keep in mind the treatment of your securities portfolio, particularly in this market. If you are a buyer, recognize that additional increases in interest rates will probably cause the value of the bond portfolio to drop. Also remember that acquisition accounting requires you to record the target's assets and liabilities at their fair value as of the date of acquisition, so the accounting rules essentially require you to recognize the unrealized gains or losses at the time of acquisition.

SYNTHETIC EQUITY

I was recently with a virtually 100% family-owned bank. Part of the discussion with the board involved how to attract and retain key personnel into the bank. The bank was going to be in the process over the next year or two in looking for some significant key officers. One of the management people who was also a board member indicated that the real gap in their compensation system involves the inability to offer any prospective senior employee any type of equity in the holding company.

For a closely-held bank, I have always found the desire of the control family to reduce its ownership position, whether it is 99% or 51%, is generally zero. As such, the board needs to work with the family and work around the control issues. If it is a situation where the holding company can redeem shares, thereby boosting the control position, then issue those redeemed shares or put them under options or restricted stock or something to senior employees so it puts the control ownership in the exact same position, then sometimes that is acceptable. More often than not, however, the only alternative is some kind of synthetic equity, either stock appreciation rights or phantom stock. Neither one of these are difficult to produce and have some of the very similar attributes to owning equity, even though they are actually simply cash bonus plans tied to the value of the stock. ESOPs and KSOPs, which would work in many banks to solve this problem in a good way for all employees, also have ownership dilution issues that are generally not looked upon favorably in the family-controlled institution.

DIRECTOR INDEPENDENCE

I recently had an interesting telephone conversation with a client to discuss director independence. The issue at hand was essentially what are the requirements for a director to be considered an independent director? This particular client was concerned about independence for a number of reasons, including Part 363 related to the Audit Committee requirements.

In summary, the rules for a director qualifying as an independent director are not absolute. There are some specific rules that do disqualify independence (i.e., an executive officer is never an independent director). However, there is quite a bit of gray area. It is really a facts and circumstances test. My advice to this client was to establish a framework for determining independence and then have the Board determine director independence on an annual or some other periodic basis. I like this approach because it gives the Board autonomy in its decision-making as opposed to being hamstrung by a set of hard and fast rules.

TRANSACTION EXCLUSIVITY

We have been assisting a troubled bank for some time in trying to find an acquiror. This is a little bit of a unique acquisition in that the bank is not looking for any sort of "sales price." Instead, we are looking for another bank that will come in to take this bank over and avoid the potential liability associated with a bank failure.

We have contacted numerous potential acquirors. There are a handful of acquirors that are showing some legitimate interest. This past week, we were working with several of these acquirors trying to continue moving the process along. When one of the acquirors came in and presented an Indication of Interest for the acquisition. This is exactly what we were hoping to receive. The one "issue" with the Indication is that it includes an exclusivity provision. In other words, if we are going to move forward with this acquiror, we have to stop our discussions with each of the other potential acquirors.

The Board asked our advice on what they ought to do, particularly as it relates to the exclusivity provision. My advice was to sign the Indication of Interest with the exclusivity. I told the Board that at some point we are going to have to get engaged to be married, which means that all of our other potential dates are going to be off the table. The Board agreed with this approach. The downside is that some of the potential acquirors may lose interest and we could find ourselves in a tough spot down the road if this deal does not work out. That is a risk the Board was willing to take, because the obvious upside is that we get the transaction we want with the acquiror that we want. In this situation, the risk was certainly worth the reward.

MORE ON AUDIT COMMITTEES

Speaking of Audit Committees, I recently had a client approach me with an interesting question. The client's question was essentially whether the Chairman of their Audit Committee, who is a long-time CPA and has extensive experience in financial reporting and audit matters, could continue as the Chairman of the Audit Committee notwithstanding his retirement from the Board of Directors. It seems odd that we could have a committee member who is not a Board member. We took a look into the situation by looking at the FDIC and applicable state rules, and it turns out that it is permissible. We had to jump through a couple hoops, such as putting the director under a Confidentiality Agreement and providing notice to the state banking department. However, the Audit Committee was able to retain his expertise as Chairman of the Audit Committee notwithstanding his retirement from the Board of Directors. This was a great result for this bank, because replacing the Chairman's expertise on the Audit Committee would have been a difficult task.

MERGERS AND ACQUISITIONS

Although we are staunch supporters of independent community banks, as you will note from our Newsletter and other publications, over the past four or so years our firm has averaged closing an acquisition on either the buy or sell side about once every 60 days. Because of that expertise, we have been conducting on an annual basis a merger and acquisition workshop sponsored by the Independent Community Bankers of America. This is really a hands-on, practical workshop that is perfect for outside directors, CEOs and CFOs, among others. The next one is going to be held at the beautiful historic St. Paul Hotel in St. Paul, Minnesota starting on the morning of June 11th and concluding about noon on June 12th. The workshop will be conducted by me, Greyson, and our partner, Philip Smith. The difference between this particular workshop and most of the M&A conferences you see is this is not dominated by big bank M&A proponents. This will give you the real world of how community bank deals are done. If you would like to sign up, please follow this link to do so:

https://myicba.icba.org/eweb/DynamicPage.aspx?webcode=EventInfo&Reg_evt_key=05d2f036-ff99-41ce-809c-72d9a9a70749&RegPath=EventRegFees&FreeEvent=0&Event=Seminar:

We would be delighted to see you there.

CONCLUSION

Four full months into 2018 - about a third of the way. It appears that most of those banks who have reported earnings and/or filed their Call Reports (which should be everybody) have had a pretty good quarter and have recovered from the ding of the deferred tax asset write-off occasioned by the new Tax Law. The second quarter should be very strong from a financial standpoint. This should allow all of us to take advantage of opportunities.

Hopefully the snow is gone. See you in two weeks.

Jeff Gerrish *and* *Greyson Tuck*