

The



Chairman's Forum

Opening the door to new ideas

Newsletter

Gerrish Smith Tuck, Consultants and Attorneys

May 2018

In this month's issue of *The Chairman's Forum Newsletter*, we tackle some issues that have arisen lately surrounding the idea of repurchasing stock from existing stockholders who need or want liquidity. We are finding that there are pitfalls that some organizations are overlooking in what otherwise appears to be a straightforward transaction. Consider, for example, if you simply buy 10 shares of stock from an out of state stockholder who wants to sell. Can you turn around and immediately resell those shares to a director or to another individual that you know wants to buy shares?

We also take a look at strategic planning and how, as Chairman of the Board, you go about deciding which parties you want to have attend. Should it be only the directors, the management team only, some combination of both? We also address an interesting dilemma of whether your Board should be comprised of members who are very active and engaged in their communities, sit on other boards, have lots of family obligations, etc., or whether that could hinder their ability to govern. Rather, should you look for candidates who are retired or older? We look at both sides of the issue.

We hope you find some useful information in this month's edition. Please let us know how we can help.

Happy Reading!

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Chairman's Summary

- ◆ Involve the Board and management in strategic planning.
- ◆ Repurchasing stock is best accomplished by the holding company.
- ◆ Don't buy and then resell shares.
- ◆ Directors need to be engaged, are they?

Strategic Planning: Whose Role Is It?

As you might suspect, our calendars are filling up for strategic planning between now and the end of the year for banks of all sizes across the country. In doing so, it is always interesting to us how similarly situated financial institutions can take the exact opposite approaches toward strategic planning. What is perhaps even more surprising is that both structures can be strategically successfully.

One of the key ways in which planning can be structured that varies greatly from bank to bank is simply in the parties who are invited to attend strategic planning. We have many clients who position strategic planning as solely the function of the Board of Directors of the holding company. Those banks have the directors meet, outline strategies for the coming short-term

and long-term, and then the results are presented to the management team at the bank level to implement. On the other hand, we have other clients who view strategic planning as the role of bank management. They have bank management meet to outline strategic plans for the coming term (although arguably these are often business plans as opposed to strategic plans) and, once the management team is all on Board with the strategies that are developed, they are then presented to the Board of Directors merely for ratification (and hopefully with no other questions asked in many cases).

Still others, as you would guess, combine elements of both the holding company and the bank as well as Board members and management. So, as Chairman, what should you do and what structure should you recommend for planning? Generally, if we are engaged to help a bank with strategic planning for the first time, we will often try to work within the structure they already have set up without necessarily making dramatic changes unless we are asked to do so. However, what we believe is the best practice for strategic planning is to involve both the Board of Directors as well as, at least, your senior executive management. In addition, if your Board composition is different at the holding company level versus the bank level, we believe it is appropriate to have the Board members of each entity represented.

We believe the primary fiduciary obligation for strategic planning rests with directors, but it should not be done in a vacuum and should involve a collaborative process with senior executive management. However, in bringing both parties in, it is important to distinguish between the roles of “strategic” planning and “business” planning. By this, we mean that strategic planning should be focused on big picture organizational

themes. For example: do we need to pursue growth through expansion into new markets; should we be looking for other organizations to buy or to position our organization to sell; should we be considering Subchapter S as an opportunity; how is our capital position and do we need more capital or do we need to use our existing capital better. Then, those types of strategic issues can be further refined to business decisions and business actions by the management team to develop the specific tactical steps and directions to take to accomplish the overall strategic initiatives. Often, an organization may even split those two functions into two separate meetings with one meeting being to establish the strategic themes and a separate meeting (perhaps only with management) to develop the tactical plans to implement the strategies that have been developed. So, do what works best for your own organization, but consider involving both the Board and management at some level so that each can fulfill their unique duties and responsibilities related to planning.

Should You Allow Directors to Buy Shares From Other Stockholders?

Interestingly, we have recently had a similar question posed to us by institutions in different parts of the country relating to the question of how to handle the purchase of shares that may become available from stockholders who have a need or desire to sell the shares. In particular, in both of the recent circumstances, the organization was wanting to know if it was permissible for some or all of the members of the Board of Directors to acquire the shares from a stockholder who had asked the organization to find a buyer for the shares.

Most community banks do, indeed, try to create liquidity for their stockholders when needed or wanted. Unfortunately, though, many may go about it the wrong way. In our opinion, what is often typical (and wrong) is that the bank president typically keeps two lists, one for potential buyers of shares and one for potential sellers. If someone calls wanting to sell their shares, then the president goes through the list, tries to help the selling stockholder find a decent buyer, may help them figure out the price per share and otherwise helps facilitate the transaction. Don't do that! That makes your president an unlicensed securities broker.

Additionally, while there may be nothing legally, ethically or morally wrong with presenting any stock purchase opportunity to the Board members and then allowing one or more of them to acquire the shares and thereby create liquidity for the stockholder, doing so also puts the organization in a difficult situation of answering the question of why all stockholders were not provided the opportunity to increase their ownership percentage by acquiring more shares. In addition, are these directors privy to some inside information that makes them willing to buy the shares that other stockholders would not know about? Also, how has the price been set? Do these directors have inside knowledge that the shares are really worth more than what the stockholder wants for them and, if so, does that create some kind of fiduciary concerns? You can see where all of these issues become difficult in practice, or in hindsight when a disgruntled stockholder believes they were treated unfairly or not given full information.

Therefore, we believe that in all situations, where you have the ability to do so, acquiring shares from other stockholders should be given as a first priority to the holding company. If the holding company becomes the buyer

of those shares, then the shares, when reacquired, simply revert to authorized but unissued shares, and the total number of outstanding shares declines. The result is normally that earnings per share, return on equity and dividends per share are all improved as a result of the transaction. Likewise, if the shares are acquired at less than book value, book value per share will be benefitted. Perhaps most importantly, every single stockholder's ownership percentage will go up without them spending any of their own money and it avoids any argument that the directors were simply trying to line their pockets.

For a large block purchase, keep in mind that the holding company can also go back and borrow money to fund the acquisition and the debt is simply serviced with dividend payments from the bank to the holding company. So, we recommend avoiding the fiduciary concerns with repurchasing shares by insiders and, instead, allow the holding company to be the purchaser of "first resort". If you have questions about that process, let us know.

Why Repurchase Shares if You are Just Going to Resell Them?

Another question that boils out of these scenarios involving stock repurchases is one where the organization feels like they need to continue to have the same number of shares outstanding without any reduction. These organizations often may agree to have the holding company buy back shares from a stockholder, but then there is the desire to immediately turn around and sell those shares under some theory that capital needs to remain at the same level or they need to have the same number of stockholders

outstanding or similar arguments. We don't necessarily agree that those concerns are valid, but if they happen to be valid arguments for one reason or another, it would still be better for the organization to simply put the seller in touch with the likely buyer and have them negotiate terms themselves in order to avoid two common mistakes that can otherwise be made as described below.

The first mistake is acquiring shares from a stockholder and then immediately reselling them without giving consideration to whether preemptive rights exist which would require you to offer the shares to all other existing stockholders and give stockholders the right to subscribe for their proportionate ownership interests in those shares. Many times, if it is a small block of stock that has been repurchased, preemptive rights would wind up being time consuming and difficult because many stockholders would not even have the opportunity to subscribe for one whole share. So, beware of that technical requirement.

The second mistake is having your holding company resell those shares without giving consideration to the Federal and state securities law issues that exist. Before a company can sell corporate shares, the shares either have to be registered or an exemption from registration must be available. In almost all circumstances there are exemptions that are available, but, in order to utilize those exemptions, the company may have to provide certain disclosures to a stockholder who is purchasing the stock. Keep in mind you are asking them to make an investment decision and of course there are disclosures that are typically required. Again, as stated above, though, many of those concerns can be eliminated by having the holding company purchase the shares rather than having new investors who

want to become stockholders buying them after the holding company has acquired the shares.

Directors Need to be Engaged, Are They?

Whenever we are asked about the idea of having term limits or mandatory retirement for bank directors, we generally respond by indicating that simply drawing a line in the sand at some arbitrary date or at some arbitrary age does not make a lot of sense. Rather, we advocate that directors need to be those individuals who are active and engaged with what is going on at the organization, in their communities, etc., and that may not be totally dependent upon age or the length of time they have served. However, consider that large banks and smaller banks may look at directors in a totally different fashion. Recently, for example, we read an article asking the question of whether big bank directors are too distracted to govern. The article went on to point out that the directors of some of the biggest banks in the U.S. often sit on multiple boards, hold full-time executive positions, have multiple outside commitments, and, as a result, they might be expected to limit the time and attention that they devote to bank governance and, therefore, are too distracted to govern. The article pointed out that busy directors are more likely to miss meetings, hold committee meetings less frequently, are less likely to challenge management and are perhaps less likely to pick up on excessive risk taking by management or see other problems.

At the community bank level, it is interesting that we often argue the opposite. We often may think that an individual who has retired, sold their business or is older may not be an appropriate director because they do not

do anything other than serve as a bank director. We complain that they are not actively involved in the community as much as they should be, they no longer are in tune with changing technology and business strategies, they seem to want to serve on a lot of bank committees just to fill their time, etc. So, as Chairmen, maybe we should consider these criticisms of big bank directors who are perhaps too busy to devote substantial time to the bank and realize that a retired individual might be just the type of candidate we need on the Board (regardless of their age) to be actively involved in administering the governance of the organization. It is probably easy to go way overboard in one direction or the other. The Chairman needs to strike a good balance with all directors. The easiest way to do this is to simply establish a set list of director expectations that must be met and to require all directors to meet those obligations for being renominated to serve for the following term. Having a measuring stick of a set list of expectations, or conducting periodic director evaluations along with subjective evaluation of an individual director's value to the organization can all go a long way toward improving the composition and engagement of your Board.

Meeting Adjourned

Keep these unique issues in mind when fulfilling your role as Chairman. Also, do not forget about the Community Bank M&A Workshop we are hosting in St. Paul, Minnesota on June 11 and 12. There are still a few spots remaining. You may also consult our website at any time for a list of upcoming conferences and seminars where we are speaking.

Please let us know if you have questions on any of these matters and keep fighting the good fight.

Until next time,



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