GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Georgia, South Carolina, Tennessee, Kentucky, Texas, Arkansas, Minnesota, Wisconsin, and Missouri!

THE EXECUTIVE SESSION

I recently had the opportunity to facilitate a planning session for a very high-performing well-run community bank. As part of the session, we talked about some "corporate governance" issues, including the use of an executive session. This particular bank had not utilized executive sessions in the past except to discuss compensation or in connection with the Audit Committee. The "executive session" for this bank was determined to be a session without any of the management present, but with all inside directors present. That is not terribly unusual. What was unusual for this bank is they have decided to do it first, at the start of their meeting, instead of at the end. Part of that was because the executive session topics would be important. The other part was at the end of the meeting there was a social hour including senior management that they did not want to disrupt because it had been very positive for the bank and its culture.

You might think about flipping your executive session to the beginning, those of you that hold them.

THE SUGGESTION BOX

I was recently with a high-performing community bank that had in the past been working to address "communication" issues within the bank. As an aside, I do need to indicate that I have never been in a bank that didn't think they had some "communication issues."

The last time I was with this bank, the Board decided to establish a suggestion box of sorts. It was on the bank's intranet, but it allowed bank employees to make suggestions that were anonymous into the electronic suggestion box. I asked them how that was working. Apparently, it is working pretty well. They get five or six suggestions a month. Management then responds to the suggestions, to the extent they are not personal (i.e., Susie shouldn't wear such a short skirt, etc.). They plan to continue it because it has improved communication. Even though some of the suggestions might border on the absurd at times, at least the employees are getting heard.

DISSIDENT SHAREHOLDERS

We have received a number of calls and emails over the last month about dealing with dissident shareholders. These may not be large shareholders (although in some cases they are). They are simply shareholders who can best be described politely as a pain in the neck. Several of the community banks that we have assisted with these issues have determined to restructure their ownership in order to become more efficient and support the people who do business with the bank. Oh, by the way, the restructuring also eliminates the dissident shareholders.

As we have often put in *Musings*, the board's job is to enhance the value for the shareholders. Within that job description, the board does have some control over ownership composition. Many boards believe that they should enhance the value for the shareholders who enhance the value for the bank by doing business with it, living in the area, and supporting it in all respects. Why would a bank on the East Coast want to enhance the value for a shareholder on the West Coast who inherited his or her stock, has no interest in the bank, never attends meetings, and does not borrow money or deposit money? Because of that, a number of these banks are contemplating an ownership restructuring. As long as there is a legitimate business purpose for doing it, which there generally is, the ownership restructuring would typically be carried out through a cash merger transaction that defines the group of shareholders who are going to stay in, and cashes out the remaining shareholders at fair value. Generally, in a properly structured cash-out merger transaction, the shareholder cannot get a court to stop it; they can only fuss about the price through dissenters' rights. We will see if any of these go forward. We will keep you posted.

HIGH-PERFORMING BANKS

We have had the opportunity (and we really mean opportunity) to work with a number of what can only be described as high-performing banks throughout 2018. The great thing about a high-performing bank is that typically excess capital is present (notwithstanding an ROE in the 20%'s), the holding company typically has debt leveraging capacity, and the bank is poised to take advantage of opportunities. Those opportunities could involve the acquisition of another bank, the acquisition of another branch, the acquisition of their own shares, or even a line of business other than their core banking business. Financial performance in and of itself provides tremendous opportunities that other not so well-performing community banks cannot take advantage of.

NEW MARKETS

A number of banks we have worked with over the last several months have contemplated entering new markets. Some of them declined to enter new markets and simply used existing or additional technology to cover the market. Some of them still believe that brick and mortar branches in new markets is entirely appropriately, and in many cases it is. As noted in prior *Musings*, we have seen smaller, more redesigned branches in these new markets. The banks that have been successful in new markets are the ones that fully understand the market, already have business there, and can snag the franchise player in that market to lead the charge. Doing that, even though that branch will probably not make money for some period of time (unless it started as an LPO and the lender has generated significant loan activity), over the long term, that new market (assuming the bank picked the right one) should be a positive.

CORE PROCESSORS

We have often mentioned in *Musings* the issue of core processors in connection with acquisition transactions - how the termination fees and deconversion fees come right out of the shareholders' pockets, or worse, derail the transaction. Having visited with a lot of banks that are thinking about changing their core processor, we have anecdotally determined that no community banks in the country are happy with their existing core processors. We will not mention any of the core processors by name, but there are always the big three. We are not sure if the community bankers see the grass as appearing "greener" on the other side or if they are actually unhappy with what they have. Many community banks are unwilling to change core processors simply due to the cost of doing so. It seems like most of the CEOs and technology people are far from shy about sharing their lack of affection for their core processor. We do caution, however: if you are going to change your core processor, get professional help in doing that. We typically do not negotiate core processor contracts through our firms, but we do know some folks who specialize in that if you need a reference.

WE COMPLETELY DISAGREE

I recently had the pleasure of speaking at a state banking conference on community bank strategic planning. I was the last speaker of the day and caught the last 15 minutes or so of the presentation before mine. During this presentation, a community bank consultant was advising on directors' duties and risk mitigation techniques. This particular individual spent five to ten minutes talking about how the directors have no business approving loans except in very limited circumstances, such as policy exceptions or Reg O loans. The individual essentially said directors are not experts in credit and are taking on way too much risk by approving loans.

We completely disagree with this advice. We do not agree a director is well served to take a "hands off" approach to the loan portfolio. This is the largest asset and source of risk in the bank, and we do not believe that directors should turn complete control of the portfolio over to bank management.

Our advice has been, and continues to be, that community bank directors need to be involved in credit decisions. We do not think from a legal perspective or otherwise it is a good idea or appropriate for directors to completely abdicate responsibility in this regard. We do not think this provides any sort of protection for the director. Instead, we think this exposes directors to additional and unnecessary risk.

MORE ON DISAGREEMENTS

We are generally not disagreeable people, but apparently the past couple weeks have presented a couple opportunities for us to disagree with the opinion of others. We recently received an email from a client that is the president of a Subchapter S community bank. The Board of Directors of this bank and holding company approved the payment of a distribution back in September, which was to be paid in November. Following the declaration of the distribution, the bank realized that paying the distribution in November would cause an adverse tax consequence to the shareholders that could be avoided if the distribution were paid in January, 2019. This bank president first raised the issue with the bank regulators, who told the president that the distribution could not be "undone" and had to be paid. That is when the president called us. We researched the issue and told the president we were in disagreement with the regulators' position.

The declaration of a distribution to be paid at some point in the future is not a sacred distribution that cannot be undone. The declaration of a dividend does not create some sort of unconditional obligation to payment on the board. If subsequent information makes it such that the distribution is not beneficial, the distribution should be rescinded. That is what happened in this case. The Board simply passed a Board Resolution that rescinded the prior declaration of the distribution.

THE SHAREHOLDER DILEMMA

We recently had some interesting discussions with community bank shareholders regarding the future of their community bank. These particular shareholders are what we would describe as unwitting community bank shareholders from the same family. These individuals indicated they had no interest in owning a community bank that was over 800 miles away from their home. However, they happened into this investment by purchasing stock from the matriarch in order to provide cash flow for her living needs.

The interesting question that we discussed with these individuals related to the future of the bank. The question was essentially whether the shareholders should sell the bank since they were in control. We discussed these issues with the shareholders, but one piece of advice that we did give them was to consider how the sale might affect the matriarch. Yes, the matriarch had sold the shares to these individuals and was no longer a shareholder. However, this particular bank was started by the shareholders' father (the mother's deceased husband) and had been in the family a long time. Given her long-time interest and involvement in the bank, a sale of the bank would likely have a material effect on her. We suggested that should be taken into consideration in deciding the future strategy of the bank.

THE INAPPROPRIATE REGULATORY DEMAND

I recently had a telephone call with a regulator that I thought to be inappropriate. No, the call itself was not inappropriate, but I thought the regulator's position on a particular issue was.

In this instance we are assisting a client in purchasing another community bank. We have been in discussions with regulators concerning the transaction, but no formal regulatory application has been submitted. We are working on getting that together.

During my recent call with the regulators I was somewhat taken aback when the regulator directly told me the amount of capital that would be required for them to approve the transaction. The reason for my shock was twofold. First, the amount of capital that the regulators said they would require to approve the deal is obscene. It would result in this bank having about a 25% Tier 1 Leverage Ratio at the closing of the transaction. Second, the regulators had already made up their mind without seeing anything on paper. As noted, there has been no regulatory application or other documentation submitted to the regulators in the form of a business plan or financial projections.

I am all for the regulators providing guidance on these types of issues. However, this goes far beyond guidance. It is, in my opinion, a premature and unreasonable demand for capital. As you might expect, we are pushing back against the regulators on this issue. I will let you know what ultimately transpires.

CONCLUSION

It is October 31st - Halloween. There will lots of kids out this afternoon and evening. Enjoy but be careful.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*