GERRISH'S MUSINGS

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

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Dear Subscriber:

Greetings from California, Utah, Texas, Colorado, Georgia, and Florida!

DIRECTOR'S ACCESS TO RECORDS

We often have discussions with CEOs and board members about a shareholder's potential access to corporate records. Most community bank holding companies are chartered in their home state or in the state of Delaware. Most states, including Delaware, have very detailed statutes regarding a *shareholder's* access to records. The statutes generally require a shareholder to make an appropriate written request, to have a proper purpose, etc.

We recently ran into a situation, however, where a director had a dispute with the bank holding company. The issue was whether a *director* has limited access to records, such as a shareholder, or simply unfettered access to all corporate records.

At the end of December, an Illinois Appellate Court, when dealing with similar issues for a non-banking company, held that while a shareholder's right to access records is limited by statute in most states, a director's is not, and that corporate directors have "the presumptive right to inspect corporate books and records." To withhold the records, a bank or bank holding company would need to demonstrate that the director had an "improper purpose," instead of the director demonstrating that he or she had a proper purpose (as would be required of a shareholder). A fairly significant difference. If anyone would like a copy of a short article about this case or a copy of the case itself, please let us know.

SUBCHAPTER S CLARITY REGARDING TAX REFORM

As most *Musings* readers know (particularly those of you in a Subchapter S tax status), the Tax Bill signed by the President at the end of 2017 provided some interesting Subchapter S tax reform. One major issue involved the provisions allowing Subchapter S shareholders to take a 20% deduction on qualified business income. There has been a lot of "hubbub" about what this actually means. In the last couple of weeks, the Treasury Department has released its final Rule addressing these issues. Although it provides some clarity, it is still not crystal clear, particularly for those banks that deal in Wealth Management and Trust. If anybody would like any further information on this, please let us know.

THE SKY IS FALLING CONFERENCE

Many of you know this conference by a different name: AOBA (Acquire Or Be Acquired). In our firm, we believe that SIFC is a more reasonable name.

We have heard from a number of clients who attended the Conference this year who indicated that it really was a "sky is falling" conference with a huge push toward selling your bank. In fact, having read some of the conference literature we received from a couple of clients, it looks like "the only banks that have a chance of surviving are those north of $50 billion in total assets." Our recommendation is don't listen to everything you see and hear coming from folks who have an ax to grind or money to make in connection with the sale of your bank.

After that conference, an interesting article entitled "How Small Banks Can Win Deals" ran in the trade press. This article put forth an allegedly "new" strategy that came out of the conference. Here are the "new ideas" according to the article:

1. Small banks can win more deals by evaluating them differently.

2. Small companies can borrow more money under the Small Bank Holding Company Policy Statement now that it has been increased to $3 billion to make funding acquisitions easier.

3. More deals can be done by focusing on non-economic factors.

Apparently, one of the biggest takeaways is that "deal advisors" indicated private banks could be more competitive by pricing deals differently. Here is what they came up with - private banks should not be focused on tangible book value earn-back like a public bank, rather, private banks should instead focus on earnings accretion for an internal rate of return.

After reviewing this article and information from that particular conference, we have concluded that notwithstanding their focus on large banks, they have now "stumbled" on this great new revelation about smaller banks. Happily, these are ideas we have been touting for over 30 years.

THE ROUNDABOUT THEORY

We had the opportunity over the last couple weeks to be in a group of some really smart people. These are smart people as it relates particularly to the community banking industry. Representatives from Accounting, Technology, Legal, and other firms were present for this serious discussion of community bank issues.

One of the participants when discussing community bank strategy alternatives espoused the "roundabout theory." Think about what a roundabout does. It slows you down and forces you to look in each direction. If you make a misstep in a roundabout because you have slowed down, it could be a fender bender but with very little damage. Compare that to driving down a rural road at 70 miles an hour and trying to make a right turn or left turn. You misdirect on that and your car will likely roll over in the ditch. If you are lucky, you will be found five days later.

The roundabout theory sounded to us like a pretty responsible approach for community banks.

THE COMMUNITY BANK'S TEMPERATURE

As noted above, we were recently in a meeting with a bunch of very smart consultants and lawyers regarding community banking. One of the questions that was asked is, "What word best describes the community banking industry today?" In previous discussions with this group over the last couple of years, the word had generally been "optimism." The general consensus this time, and certainly our perspective, was that the industry is a bit "unsettled." This relates to not only national issues (i.e., Congress, the President, the trade issues, the volatile stock market, and the like) but also local issues such as deposit gathering and things that community banks have not needed to think about for a long period of time.

We do not view "unsettled" as being a bad thing, just a "thing." We suspect that things will settle as some of these macro issues settle down and as some of these community bankers who have never had to chase deposits or been involved with bad loans get some new experiences.

EVERYTHING IS NEGOTIABLE

As we have often noted in *Musings*, "everything is negotiable" in an acquisition transaction. This is everything from the tax treatment, to who pays data processing termination conversion fees, to who gets allocated the expense for change-in-control payments, and the like. While there are certain expected norms in this day and time, even the expected is negotiated.

If you have a deal that hits a dead end, see if you can approach the issue in a different way by negotiating some issues that often historically have been the set norms. We have recently had a couple of transactions like this that have helped move a stalemate back into a negotiated favorable result for both parties.

THE MEGA MERGER

The largest bank merger over the past ten years was announced last week. As I am sure each of you *Musings* readers know, BB&T and SunTrust have announced a "merger of equals" resulting in a bank in excess of $450 billion in assets. Over the past ten days or so, there have been numerous articles, White Papers, editorials, and other commentaries on the deal. There are multiple different facets of the transaction that could be analyzed, but those are far beyond the scope of *Musings*. For our purposes, there are really two points that we think very pertinent to community banking.

First, it appears clear from the public comments relative to the deal that BB&T has wanted to make this acquisition happen for a long time. Apparently, SunTrust's former executives were not on board. BB&T waited until there was a change in management and then figured out a way to make the deal work. This set of circumstances is fairly common in community banking. Deals of any size in the banking industry are not simple to put together. They often take longer than you would like and involve wait and compromise. If you are a community bank acquirer, keep this in mind. If you view yourself as an active acquirer, do not think that you will be able to go out and simply make it happen on your timeframe and under your circumstances. The same rings true for sellers. It is important to have a realistic expectation of the process and the timeframe that is necessary in bringing these deals together.

The second pertinent issue we see for community banks, particularly those in the Eastern half of the United States where BB&T and SunTrust have significant amount of market overlap, is to be ready to take advantage of market disruptions. When you have a mega merger like this, things are always going to change. BB&T and SunTrust have touted annual cost savings of about $1.6 billion. They have also talked about the closure of many branches and the consolidation of backroom operations. These cost saves are a polite way of saying they are going to fire people. The branch divestitures are going to present other opportunities. If you are in a market where BB&T and SunTrust each operate, we recommend that you begin thinking hard about how you might be able to take advantage of the disruption. There will be plenty of opportunities to do so.

THE IMPORTANCE OF PERSONNEL

We are currently assisting a community bank on the buy-side of a rather large acquisition. We recently had a discussion with bank leadership on both the financial and social issues relative to the transaction. It is interesting to us how different these two areas of discussion felt. We have always said that acquisitions are part art and part science, and this was a great example.

The financial discussion was very much along the scientific front. We were pragmatic in reviewing the numbers, reviewing returns, earnings per share growth, and the like. The personnel discussion was much more art, taking into account thoughts regarding how people would actually work together, whether key players would be happy, whether individuals would be willing to take on new roles, and the like. It was the opposite of scientific.

A successful community bank acquisition requires an acquirer to be good at both the financial and the social pieces of the transaction. If you miss on either of these two issues, it is very difficult to be so good at the other that you can make up for it. You obviously have to get the financials right, but you also have to get the human component right as well. We think this particular acquirer is doing a very good job of paying attention to both.

THE “NEW” CORPORATE STRATEGY

We recently facilitated a strategic planning session for a community bank that is undergoing quite a bit of change. This particular bank is about 20 or so years old, and since its inception has been heavily focused on asset growth. The bank recently underwent a change in top leadership and replaced the long-time Board Chair. During the planning session, these management transition changes were certainly a material part of the discussion. However, the biggest takeaway from the planning session was the change in basic business strategy.

As mentioned, this particular bank has always seen its primary business strategy as one of growth. This has allowed the bank to grow to a nice size. The problem is that it is not terribly profitable. It is not losing money by any means, but it is also not keeping up with peer. The board discussed this at length, and a new strategy was adopted. The board firmly decided that earnings would rule the day for the next three years. The board directed the management team that they did not care about asset growth at all, but wanted to see growth in the bottom line.

This was a very good discussion for this particular bank because it gives the new President perfect clarity in his charge. He is to lead the bank towards an increase in profits. In fact, the board went as far as to adopt a strategy of looking to improve earnings by approximately $1 million over the next three years. This clear strategic direction for the President should serve him well, as it gives a great framework for decision making.

STOCK APPRECIATION RIGHTS

We recently had a discussion with a client that was interested in setting up a Stock Appreciation Rights Plan for its executive officers. If you are not familiar with the concept, a Stock Appreciation Rights Plan is essentially a cash bonus plan that incents the bank's executive officers (or any beneficiary of the program) based on the increase in value of the bank's stock. This particular board was not seeing the growth in the value of the common stock that they thought was appropriate for the shareholders. They thought a Stock Appreciation Rights Plan would squarely focus management's attention and align their interests with that goal.

Stock Appreciation Rights Plans are pretty simple. The program beneficiaries receive a Stock Appreciation Right Unit, which has a baseline equal to the value of the stock at the date of grant. The Unit typically cannot be exercised for five years, but it can be exercised at any time between years five and ten. During that period, if the beneficiary exercises the SAR Unit, he or she receives a cash payment in an amount equal to the difference between the fair market value on the date of exercise and the fair market value on the date of grant. Obviously, the more they can increase the value of the shares and grow the disparity between those two numbers, the higher the cash payment.

We expect the Stock Appreciation Rights Plan will work well for this particular client. It is certainly going to focus management's attention on growing the value of the common stock.

CONCLUSION

It is now February 15th, the day after Valentine's Day. We hope all of you appropriately took care of your Valentines. If not, some type of "groveling" might be helpful.

Stay warm, dry, and snow-free. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*