GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Tennessee, Arkansas, Florida, Minnesota, Wisconsin, Iowa, Texas, and Arizona!

LIFT-OUT OF EMPLOYEES PART II

In the last *Musings* we led with an article about two bank employees who were being removed from office and fined by the Federal Reserve for various issues associated with their prior employer. We mentioned in that article that an employee lift-out is still a good strategy but you needed to be careful doing it. Subsequent to the delivery of *Musings*, we received numerous inquiries from *Musings* readers as to the facts of the case.

While you can appreciate the complexity associated with this matter, each of the two individuals, neither of whom apparently was under a non-compete or a non-solicitation, at one time worked for Central Bank & Trust, Lander, Wyoming, and subsequently became an employee of and obtained ownership in Farmers State Bank, Pine Bluffs, Wyoming. According to the Federal Reserve's Notice of Intent to Prohibit from Participation in the affairs of the bank, these two individuals allegedly - both before and after they left Central Bank - obtained confidential and proprietary information from Central Bank, such as Central Bank forms, specific information on customers and loan balances, terms of credit renewals, and the like, and contacted Central Bank customers regarding moving the loans over to Farmers State Bank. The goal, of course, was for these two employees to bring as many of Central Bank's loan customers to Farmers as possible once the individuals were permanent employees of Farmers State Bank.

The actions noted above resulted in Central Bank filing a claim against Farmers State Bank, its directors, and these two individuals in Montana state court. Central Bank prevailed in that claim and received a judgment of over $2 million against the two individuals and Farmers, which included reimbursement of over $150,000 of legal fees. The Federal Reserve, the primary regulator for Farmers, did not take too kindly to this, which has now resulted in the Federal Reserve seeking to remove these individuals and prohibit them from participating in the affairs of the bank.

As noted, this is not the garden variety "lift-out" situation (at least we hope it's not). In this case, the employees misappropriated confidential financial information from the employer they were departing to use for the sole benefit of the employer they were joining and of which they were becoming owners. Although this case is likely on the fringes, it is still sends a message that when lifting out employees from other employers, both the employees and the bank will need to be extraordinarily careful not to misappropriate any confidential information from that former employer.

If any *Musings* readers would like a copy of the Federal Reserve's Notice of Intent to Prohibit, please let us know.

DIRECTOR REPRESENTATION

We have been involved in a couple of situations recently where a question has come up as to who a director of a community bank or bank holding company actually represents. This is often in the context of which hat the director is wearing when he or she sits on the board of the bank and holding company and his or her family also controls the bank and holding company. It seems fairly obvious that the answer is the director represents all the shareholders. A director, in most situations, will wear numerous hats - a hat as the director of the bank or holding company representing all the shareholders, a hat as an individual shareholder representing themselves, and often a hat as representative of the family or a group of shareholders for whom the director is instrumental in obtaining stock.

To be an effective director, the director needs to understand the differences between the duties and responsibilities associated with each of those roles. The primary role of the director is to represent all the shareholders and do what is in the best interest of the shareholder base as a whole. This may involve voting as a director in favor of a certain action even though he or she may vote personal shares against the action when it is put before the shareholders for a vote. We do not see that scenario often, but we do occasionally see situations where a director believes that something is in the best interests of the institution and shareholders as a whole, yet his or her personal interests are not totally aligned with that institutional direction. That is perfectly ok, however, when the director votes as a member of the board of directors, that director represents all of the shareholders.

TUNING UP FOR ENFORCEMENT ACTIONS

We are beginning to see slight indications from the friendly federal regulators that they may be "tuning up" for increased future enforcement actions as the economy slows - particularly where a community bank has become "overconcentrated" in whatever the evil of the day is, be it commercial real estate or something else. As noted in today's lead article, the Federal Reserve is currently attempting to remove two bankers from the industry. We have also noted that one of the other friendly federal regulators leveled civil money penalties against a bank that has been under but unable to comply with a consent order for multiple years. We anticipate this is only a first step toward the regulatory agencies' renewed enthusiasm for enforcement actions as the economy changes or slows.

THE "MERGER OF EQUALS"

We recently read with interest a deal announcement for a deal in the Southeast that is being billed as a "merger of equals." In full disclosure, we are not involved in this transaction as legal counsel or financial advisor. This particular deal is an all-stock transaction that will provide the target shareholders slightly less than 8.6 million shares of the acquirer holding company's 14 million shares of common stock outstanding. This will leave the acquirer holding company shareholders owning about 62% of the company and the target shareholders owning about 38% of the company. As it relates to the board of directors, there will be 17 members on the acquirer holding company and bank boards when the transaction closes. Twelve board members will be the "acquirer's" board members, and five will be the "target's" board members.

Regardless of its billing, we do not view this as a merger of equals. We view this as a stock acquisition where the acquirer is using its common stock to purchase the target bank. There is certainly nothing wrong with that. We simply do not agree with the characterization of the deal as a merger of equals. Our belief is that this is an acquisition transaction and that trying to characterize it as a merger of equals is trying to paint it in a false light.

PURCHASE PRICE PROTECTION

Over the past month or so we have been involved in some transactions that, on the front end, did not involve purchase price protection for the buyer. In each of these instances, we were brought in to assist the buyer in the transaction, but we were brought into the mix after the Indication of Interest had already been negotiated and signed between the parties, which is later than we typically begin our involvement in a transaction. Luckily, these Indications of Interest are non-binding. Purchase price

protection is a critical part of a transaction for the purchaser and should not be left out of the Definitive Agreement, even if it was not included in the Indication of Interest.

Purchase price protection is essentially a way to protect the purchaser upon the occurrence of material adverse events. As an example, assume you have agreed to pay $33 million for a bank holding company with $20 million in equity. If the target holding company experiences adverse changes between the signing date of the agreement and closing such that the target's equity drops $3 million, then the purchase price should also be reduced $3 million (assuming a $3 million reduction was not anticipated and explicitly factored into the purchase price expressed in the Indication of Interest).

Most acquisition agreements are going to have a condition to closing that allows the buyer to terminate the agreement and walk away from the transaction in the event the seller experiences a material adverse event. However, this should not be the buyer's only source of protection. It is not good to put yourself in an "all or nothing" situation. It is much better to have purchase price protection that gives you options in the event of a material adverse event.

OH, HAPPY DAY

We recently received a telephone call from a long time client that could only properly be characterized as "an extremely happy camper." This particular holding company and bank were hit rather hard by the recession. They had all the usual suspects in terms of asset quality problems, earnings losses, excessive holding company debt, the requirement for additional capital, and the like. As you might suspect, this holding company and bank also had the joy of becoming closely acquainted with their friendly federal regulators through both formal and informal regulatory enforcement actions.

The President of the holding company and bank recently called us to let us know that their last regulatory enforcement action, which was a board resolution, was officially terminated. They are now back to an appropriate regulatory rating and are completely free of any type of formal or informal regulatory enforcement action.

This is great news for this holding company and bank. They were a little later than some in getting to this point, but that does not diminish the feeling. Many *Musings* readers can relate to the situation. Congratulations to this group of directors, officers, and employees in persevering through these problems! Better days are certainly upon them.

DIRECTOR EVALUATION FORMS

We have recently received a number of requests for copies of director evaluation forms. There are generally two approaches to director evaluations: self-evaluations and peer evaluations. The names are apt descriptions of the process. In a self-evaluation, a director evaluates his or her own effectiveness as a director. This self-evaluation is often combined with a "sit down" with the Chairman or lead outside director to see if he or she agrees with the individual director's self-assessment. In a peer evaluation, one director evaluates one of the other directors.

Director evaluations are an important part of corporate governance. They are very effective in keeping directors accountable and engaged. Some boards utilize only self-evaluations, other boards only peer evaluations, and some utilize both.

If you do not already utilize director evaluations, give consideration to the process. It is a fairly simple means of carrying out a key component of corporate governance. Please let us know if you would like copies of any of the director evaluation forms. We are happy to provide them.

KEEPING THE BANK INDEPENDENT

One of the issues we deal with very often is how do we keep our community bank independent in view of all the headwinds community banks are facing from technology and other issues. Our general answer is to deal with the internal sale triggers first. These may include lack of management succession, lack of board succession, lack of ongoing liquidity or a reasonable exit strategy for the shareholders, lack of cash flow off the stock, and the like. A fairly common trigger experienced by many community banks is simply the aging of the original investor group. While many in that group may not desire to sell the bank, when enough of them begin looking for liquidity, a sale of the bank is often inevitable. It is also important to look at the bank's management team and identify what could trigger the team's desire to sell the bank. It can get particularly complicated if ownership desires to remain independent but management desires to sell, so it is important to work toward aligning management's interest with the interests of the board and shareholders.

CHAIRMAN'S FORUM

We are pleased to report that we facilitated a very successful Chairman's Forum within the last two weeks. The Forum was held at the beautiful (and high service) Ritz-Carlton in Naples, Florida. The Forum - attended by 22 Chairmen, Vice Chairmen, Lead Directors - involved a day and a half of interesting discussion regarding issues involving the Chairman's duties and obligations,

responsibilities, and unique issues facing many of the banks present. We will report on some of the substance on this through the Chairman's Forum Newsletter, so please look for that.

CONCLUSION

Well, we are already at the end of January 2019. The ice, snow, frigid temperatures, and travel disruptions make it obvious that winter is here. In any event, we are well on the way to a busy year. We look forward to seeing many of you at upcoming community bank conventions.

Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*