GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Illinois, Iowa, Wisconsin, Minnesota, Florida, Tennessee, and Montana!

BOARD MEMBERS: GETTING THEM ON / GETTING THEM OFF

We have had numerous discussions with various community bank clients around the country over the last month or so with respect to adding new board members and eliminating existing board members ("eliminating" is probably too strong a word, but you get the idea). The real question is how do we get new board members on and get more seasoned board members off?

With respect to getting new ones on, it seems that every board is looking for someone with technology experience, plus whatever other skillset is needed on the board. Sometimes these other skillsets are legal, accounting, commercial real estate, residential real estate, and the like.

With respect to getting directors off of the board, this is an often discussed issue in *Musings*. There are various means of accomplishing it. Mandatory retirement is certainly an effective way, although probably not the best way. Some type of merit-based performance evaluation is the way to do it in the perfect world where none of us live.

We were recently contacted by a couple of clients who asked about term limits. Term limits would simply limit a director to a certain number of years per term. Not really much different than mandatory retirement. We are still seeing a fair amount of mandatory retirement banks but few to no term limit banks. If any *Musings* readers are using term limits for their directors, please let us know. We would be interested in discussing it further with you.

FAMILY-OWNED BANKS

As most *Musings* readers know, our consulting and law firms work with numerous family-owned/controlled banks around the nation. That is largely due to the fact that there are "a lot" of family-owned or controlled banks. We always advise the families that there are two clearly delineated issues in connection with family-owned banks. The first is the family dynamic. The second is the bank. Often, these need to be addressed separately. Generally, both can be worked through satisfactorily, but they need to be focused on separately to provide clarity on each.

UNSOLICITED OFFER POLICY

As we have mentioned often in *Musings*, unsolicited offers are becoming more prevalent these days. It is not that community bankers are getting more aggressive. It is simply a question of how do they best allocate their capital. If a community bank has a proactive acquisition strategy, then they are going to identify their primary target, engage in some courting, and make an unsolicited offer. We have witnessed numerous boards burn up a lot of time dealing with unsolicited offers in this environment. As we have recommended in prior *Musings*, an Unsolicited Offer Policy eliminates some of this "churning" time. An Unsolicited Offer Policy simply indicates that if the unsolicited offer is not from a credible purchaser (i.e., one that can close the transaction) and is not at a credible price (i.e., one that is above the "bar" set by the Board of Directors), then it can be dismissed out of hand.

The real test for an unsolicited offer is whether the shareholders of the community bank target are better off holding their existing holding company stock or what is being offered through the unsolicited offer.

DIRECTOR TRAINING

Over the past couple of weeks, we have received a number of inquiries as to whether our consulting and law firms provide director training services. These are not terribly unique requests, but it is interesting that we have received a flurry of these over the past couple weeks. Each of these requests has not been for any type of strategic planning session, but are instead more education focused. Some of the bankers that have provided these inquiries are thinking about board education as a whole while others are looking for specific education on board committees, mergers and acquisitions, allocating capital, and the like.

Director education is an important part of effective corporate governance. Most of the time this occurs through directors attending national or state association meetings, workshops, and the like. However, that is not always the case. There are other opportunities for director education, including personalized director education sessions. Whatever "delivery channel" you choose, keep in mind that director education is a very important aspect of appropriate corporate governance.

CHANGE IN CONTROL AGREEMENTS

We recently received a telephone call from a banker inquiring about change in control agreements. This particular banker runs a very profitable community bank. They have not adopted a strategy of selling the bank by any means. However, as the banker put it, he has clear eyes about what is going on in the industry and wants to be certain he is as prepared as he can be in the event someone makes an unsolicited run at them. This happened once previously, so there is a lot of wisdom in his thinking.

This particular banker first asked whether we thought change in control agreements made a bank more valuable. We told him we thought it was the earnings that really gave value to the organization. He then clarified his question by asking whether we thought change in control agreements were favorably viewed by acquirors. We told him that our general belief was yes, acquirors looked favorably on change in control agreements, provided they were priced right and "locked up" the correct people.

If you do not have change in control agreements in your bank, we suggest at least considering them. Regardless of your strategy as it relates to independence, they are a good tool in locking key individuals up in the event of any change in control. If you choose to sell the bank, or if someone makes a run at you through an unsolicited offer, the change in control agreement will serve to lock key people in place up to the time of closing. This significantly increases the chances of actually getting a deal done.

SHARE REPURCHASE PROGRAMS

We recently received a call from a long-time client that asked our thoughts on share repurchase programs. This is a smaller community bank that has an aging shareholder base. We gave him our general thought, which is that we believe share repurchase programs are one of the best ways a community bank holding company can enhance shareholder value. Share repurchases have a number of benefits, including providing liquidity for the stock for those shareholders that want it, an increase on return on equity, and an increase in ownership for the remaining shareholders.

After giving our initial thoughts on the share repurchase program, we talked a little bit more about specifics for this organization. They have some excess capital at this point, but not a lot. They also have an aging shareholder base that they expect may want some liquidity in the stock over the next five to ten years. They also felt like most of their shareholders were currently very happy with the investment, and they did not have any conviction that shareholders would actually participate in the share repurchase program.

After further discussing the circumstances, we thought a share repurchase program may not make the most sense at this point. It would provide liquidity, but it would also use their "dry powder" at a time when they may be better served keeping it. More importantly, they do not have conviction that if they do go out with a program that there will be any takers.

We are big proponents of stock repurchase programs. However, if you are thinking about one, be sure to take all of the various factors into account. There are some limited circumstances where they may not be the best alternative.

TRUST PREFERREDS ARE STILL AROUND

The last couple weeks have reminded us that Trust Preferred Securities are still alive and well. Most community banks that have Trust Preferreds outstanding are simply paying the interest as agreed. However, there are still a couple remnants from the recession that are creating issues for Trust Preferred issuers. We are helping a couple different issuers in resolving lingering problems on these holding company debts.

If you are a Trust Preferred issuer that is paying as agreed, do not put the Trust Preferreds completely out of mind. There are a couple things that we recommend you begin to think about relative to these debts. First, these Trust Preferred Securities are all tied to LIBOR, which is going to go away in a couple years. The general consensus is that LIBOR is going to be replaced by SOFR, but those issues are still in a state of flux. Second, keep in mind that all of these Trust Preferred Securities are 30-year, interest-only instruments. In the next ten to 15 years these instruments may come due. Some banks are beginning to think now about plans to address each of these issues.

We will provide more information on what Trust Preferred issuers need to be thinking about and doing as we get closer to and more clarity on the termination of LIBOR. We would not put this in the category of things to keep you up at night, but it is something you ought to be thinking about if you are a Trust Preferred issuer.

WHAT CONSTITUTES A GOOD OFFER?

We often get asked the question "What constitutes a good offer for my community bank?" The answer as you might imagine is, "it depends." It depends on a lot of things. What does your franchise look like, both geographically and financially? As most *Musings* readers know, acquisition transactions are basically priced off the earnings stream brought to the purchaser by the target. Other factors may be relevant as well. If the purchaser needs management succession and the target has it available, that is positive. If the purchaser has a 100% loan-to-deposit ratio and the target has a 40% loan-to deposit ratio, that would be a positive. A number of factors factor into the equation of how to determine the price.

With respect to the question of what is a good price for my bank, it really depends on what you are giving up in exchange for what you are getting. In other words, would you be better off holding your bank holding company stock or the cash or stock that is being offered by someone else? We generally approach this initially through financial analysis and then layer on the intangibles on top of that. It is both an art and a science, and it is far better than any "good instinct" or shot in the dark on the buy side.

ESTATE PLANNING FOR COMMUNITY BANKERS

With all the acquisition activity going on, many community bankers are coming into a lot of money. As they are trying to figure out what their taxes will be if they pass away and their bank sells, estate planning has really come to the forefront. We often provide that service for our community bank clients (at least their executives and directors), and have for many years, but it seems it is becoming more prevalent now. Although the federal tax laws require a fairly decent sized estate before it is subject to tax, there are still a significant number of issues that need to be addressed. In most planning sessions with a large shareholder, we generally ask the question (i.e., the elephant in the room): "What happens to your stock when you pass away?" Even though most of them anticipate they will live forever, we know that is not true. The real issue of what happens to the stock and how the estate tax can be addressed needs to be discussed. Do not shy away from some of these tough issues. Make sure the appropriate estate planning occurs.

CONCLUSION

It is *Musings'* good fortune to come out on April 15th, Tax Day. We hope all have remembered to file their taxes or at least file for an extension. Those of you who get a big refund, congratulations on making an unsecured interest-free loan to the United States Government. Those of you who are having to pay taxes, we are sorry about that.

See you in two weeks.

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