# GERRISH'S MUSINGS

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April 30, 2019, Volume 391

Dear Subscriber:

Greetings from Indiana, Illinois, Georgia, Florida, Arizona, Wisconsin, and New Mexico!

## RETENTION BONUSES

We are working on about a dozen community bank acquisition transactions that are at one stage or another. Generally, at an early stage, the issue of retention bonuses arises. These are payments made to employees at the time the transaction closes, provided they are on the job and have not been fired for cause. The purpose of retention bonuses is to keep key players in place pending the closing of the transaction. Once the transaction closes, then it is generally up to the buyer whether the employee continues employment. Because the time from the date of signing the Definitive Agreement until consummation of the acquisition transaction may be four to six months (or more, depending on the issues), it is important to keep the key players in place.

Our general recommendation for community banks that are selling is that they give consideration to the total amount of retention bonuses the board is willing to authorize. For example, if the board determines $1 million total in retention bonuses is appropriate, then the second decision is how to allocate that $1 million among those key players that need to be retained to bring the deal to closing. Retention bonuses are not always for the senior executives. They are instead for key individuals. For example, lending officers (i.e., those generating the revenue) are often given retention bonuses to keep them in place. The amount of the retention bonus needs to be enough to make sure the employee stays in place and no more. Also keep in mind that in most circumstances, retention bonuses are change-in-control payments that are limited by Section 280G of the Internal Revenue Code, which basically limits the bonus amount to three times the last five years' average compensation. If you are doing a deal, do not forget about retention or stay bonuses.

## AGENCY VETTING PROCEDURES

As most of you know, anytime that you start a new bank or have a change-in-control in an existing bank, you must receive prior approval from the appropriate friendly federal regulator with respect to the acquiring individual or starting entity's directors and officers. The process is generally kicked off by filing the Interagency Biographical and Financial Report (the proverbial IBFR), which is exactly what it sounds like. It is a filing all the agencies use containing a list of questions concerning work history, criminal convictions, and a detailed financial statement. Sometimes the applicant does not understand how thoroughly the agencies vet the IBFR. As a practical matter, they run it through all the lettered agencies, DEA, CIA, DOJ, etc. This means the problems an applicant may have had 50 years ago will likely show up in connection with the vetting of a federal banking agency transaction. We had one situation where the individual making the application had been cited for underage drinking when he was 16 years old. He thought the record had been expunged. It came out in connection with the research by the federal regulators. It is nice to know they are thorough. Frankly, they are probably too thorough.

## THE GERIATRIC DIRECTORS

Since the first of January, we have twice had the opportunity to significantly interact with a couple of geriatric directors. These are not just older directors; they are in fact directors in their 90s. Both of these gentlemen (at different banks) are in great shape physically and mentally. They are both sharp and still involved heavily in the bank. In fact, each of these gentlemen is sharper than some of the 50 year old directors we have had occasion to interact with at some community banks. As much as we rag on about older directors, director succession, and the like, these two gentlemen have certainly stood the test of time.

## LIBOR

As most of you know, LIBOR, the London Interbank Offered Rate, is going away in a couple of years. A lot of financial documents are tied to LIBOR plus some additional rate. For example, most of the trust preferreds of community banks are priced at the three month LIBOR plus 2.5% or something similar.

  

What happens when LIBOR goes away and there is nothing in the documentation that says there should be a substitute? The powers that be are coming up with a substitute rate (i.e., the Secured Overnight Financing Rate (SOFR)). If a document requires us to pay LIBOR plus a certain percentage and LIBOR goes away, can we make an argument that we simply pay the percentage (e.g., 2.5%)? There is going to be a lot of interesting discussion and litigation over LIBOR and its replacement. This is just a heads-up for you.

## A VOLUNTARY REPURCHASE PLAN

As most *Musings* readers know, the obligation of the Board and senior officers is to enhance the value for its shareholders. One tenant of enhancing the value for shareholders is to make sure there is liquidity for the stock. Since there is no market liquidity for the shares of most community bank holding companies, creating share liquidity often means the holding company engaging in a proactive voluntary repurchase program. In this regard, there is a lot of confusion for community banks with respect to setting the price. Many bankers think an appraisal is necessary to set the price, but that is not so. Remember, this is a voluntary repurchase plan. The holding company is not requiring any shareholder to sell. The shareholder can sell if he or she wants to, but there is no obligation to do so. The board is allowed to set the price at a point where it is beneficial to the remaining shareholders who do not sell. They cannot defraud the selling shareholder, so they have to tell that shareholder what stock trades have occurred, provide financial information, and all that, but a valuation is not necessary. This is different than a forced transaction like a reverse stock split or a cash-out merger. In a voluntary transaction, the board is in control and can set the price where it is beneficial to the remaining shareholders.

The problem with obtaining a valuation in a voluntary repurchase plan is that once you obtain it, you are pretty much stuck with it. Say the bank holding company goes out with a proactive voluntary repurchase plan, and one of the shareholders that your bank holding company has been wanting to get out is finally willing to sell but not at that price. They would be willing to sell at a price that is a few dollars higher. Now the board is in a position where it needs to distinguish why it is willing to pay an individual more than the appraisal price.

Skip the appraisal for a voluntary repurchase plan. Run the numbers (or let us do it) to give you some idea of what would make sense to pay, and then price it as aggressive as the board wants to be. Our firm likes to do valuations as much as the next (and get fees for them), but do not get one if you do not have to have one.

## POST-ACQUISITION

In a community bank acquisition, what changes post-acquisition? In some cases, we may find nothing. In others, we may find "a lot." Keep in mind that the buyer in any community bank acquisition is purchasing the earnings stream of that target. To the extent the buyer can improve the target's earnings stream, usually through cost savings, the buyer is going to be willing to pay more. Cost savings (i.e., noninterest expense savings) translate primarily into personnel savings. Typically, the back office would be cut out, technology would be consolidated, and the like. Generally, customer-facing employees, retail, lenders, and the like, are safe from an employment standpoint in an acquisition. What does happen, however, is that the buyer is going to put its cultural imprint on the seller. That may mean that even in the lending area there will be a different way of doing things. Not terribly unusual, just part of the process.

## FAMILY BANKS

There are a significant number of community banks that can best be described as "family banks." Characteristics of these family banks generally include S Corporation status, closely-held or majority-held by one family, and often the patriarch or matriarch is the Chairman of the Board after having served years as CEO. How do you keep these family banks independent? Two focuses. The first is on management succession (i.e., can we bring in a family member that will succeed to the CEO position). The second focus is on ownership transition. If a family bank can be successful at management succession and ownership transition, it will likely retain its independence long into the future. Many family community banks across the country have done just that. We are working with a number of others to help them remain independent and successfully traverse the management succession and ownership transition waters.

## THE SHAREHOLDER STRATEGY CONUNDRUM

We were recently involved in a lengthy meeting with a client to discuss the holding company's long-term strategy with regard to shareholder composition. This community bank holding company currently has around 500 shareholders. The composition of the shareholders is pretty typical for community banks. The shareholder base is aging, and it is expected that in the next ten years or so there will be a pretty significant number of shares that will be passed through inheritance. We discussed alternative shareholder strategies in order to establish a longer term plan and road map for dealing with these issues.

  

The two available and opposite strategies we generally discussed were 1) "going public" and significantly expanding the shareholder base, and 2) continue to take advantage of opportunities to contract the shareholder base, possibly even with a longer term eye on moving towards Subchapter S.

During the discussion, we took a pretty firm stance on our recommended strategy: pursue shareholder contraction and look for opportunities to repurchase shares as opposed to going public. Our belief is in order to get close to realizing the "benefits" (such as they are) of being a public company, you realistically need 3,500 to 4,000 shareholders. The opposite side of the spectrum is continuing to look to provide liquidity and repurchase shares, realizing all the benefits of the share repurchase transactions. We are firmly in the camp that community banks are better served by looking to repurchase their own stock as opposed to going public and becoming SEC reporting. We talked about all the different ways we could look to contract ownership, including the use of excess capital, bank holding company debt, ESOPs, KSOPs, and the like. There are many opportunities out there, and we believe each of these to be more beneficial to the shareholder group than is going public and becoming an SEC reporting company.

## SELLING THE SIZZLE

Over the past month or so, we have been assisting a community bank holding company in evaluating the potential acquisition of another community bank. This particular opportunity is not being peddled on a widespread basis. Instead, the seller contacted our client and basically said they are for sale and named their required sales price. Our client is interested in the deal, so they came to us to better understand whether that price made sense.

After analyzing how it is the seller calculated their proposed pricing, our comment to the client is that the seller was really trying to sell the sizzle. What we mean is that this particular seller was not selling what they had as much as they were selling a dream of what this particular community bank might become. We see this as being akin to trying to sell a "fixer upper" as though it has been fully refurbished and is move-in ready. The obvious problem with that strategy is that the hard work in getting it to top value is not done.

We do not begrudge a seller for trying to get top value for their asset. There is certainly nothing wrong with that. However, we have found that sellers starting with unrealistically high pricing expectations, whether genuine or not, typically get the deal started off on the wrong foot. Rather than getting a buyer excited about the opportunity to come, we found that it tends to make potential buyers more pessimistic and skeptical of what it is they are getting into. That is certainly not a good position to be in if you are looking to sell a bank.

  

## SHAREHOLDER AGREEMENT TERMINATION REQUIREMENTS

Over the past couple weeks, we have been reminded of a Federal Reserve policy that we believe is outdated and, in our opinion, makes about as much sense as trying to fly a lead balloon. This particular Federal Reserve policy essentially says that if your community bank holding company has a shareholder agreement or similar arrangement, then that agreement must terminate within 25 years or it will be considered a company for purposes of the Bank Holding Company Act. If you have such an agreement that does not terminate within 25 years, the Federal Reserve may very well chastise you for your failure to adhere to this policy. Essentially what you might get is a nasty letter from the Federal Reserve that says the agreement may be considered a company under the Bank Holding Company Act, and the agreement should be amended to terminate within 25 years.

We first ran across this issue a number of years ago. At that time, we pushed the Federal Reserve and asked them what would happen if the shareholders agreement was not amended to include the 25 year termination provision. We asked who would be considered the corporate entity of being the bank holding company, who would file the FR Y-9s and FR Y-6s, and the like. Of course, the Federal Reserve did not have a good answer. Instead, they basically told us that we needed to go along to get along.

We are griping here a little bit about the Federal Reserve because we think this policy is silly and of no use. However, the more important thing is that you think about this if you have a shareholders or similar agreement. If it does not have an automatic termination provision, you may want to think about putting that in. There are some other ways that the rule can also be satisfied, but the bottom line is you do not want to find yourself in a situation where the Federal Reserve cites a technical violation for this silly issue. Let us know if we can help.

## ACQUISTION SOCIAL ISSUES

The issues in a community bank acquisition can generally be separated into two general categories: social issues and financial issues. We have said a couple times previously that the financial issues are the easier of these two to get right. Based on financial modeling, return analysis, review of comparable transactions, and the like, an acquirer can reasonably project the financial returns associated with a transaction. The social issues in an acquisition are much more complex. We also believe that it is much easier to recover from a financial misstep (e.g. overpaying) in a transaction than it is to recover from a social misstep in a transaction.

What are the social issues that are important in an acquisition transaction? There are many, but they generally can boil down to people, culture, and strategy. Obviously, the people in an acquisition are important, since community banking is all about relationships. If you buy a bank and do not get any of the customer relationships that come with it, you really have not done yourself any favors at all. The cultural and strategy issues are also important. You might be surprised at some of the issues that cause dissatisfaction among customers and employees when two banks come together. Think casual Friday and lunch breaks.

If you are thinking of an M&A transaction, be sure to give as much consideration as possible to the social issues. It is certainly not unheard of for a deal that makes a lot of financial sense to be wrecked over trivial social issues.

## A PERSONAL NOTE

Our consulting and law firms lost a true friend last night at the passing of Chairman of the Board Jackie Stover of The Farmers & Merchants Bank, Dyer, Tennessee. God rest her soul. She will be greatly missed.

## CONCLUSION

May 1st is finally *almost* here. We generally thought from a travel standpoint that snow would be over, but not so. Hopefully the month of May will be a little milder in all parts of the country.

Please mark your calendars for June 18th and 19th. This is the Gerrish Smith Tuck/Independent Community Bankers of America Mergers & Acquisitions Workshop. It is a hands-on workshop for banks that are contemplating either buying or selling. If you would like to register, please click on the following link: Mergers & Acquisitions Workshop

Hope to see you there. Have a great two weeks.

*Jeff Gerrish* *Philip Smith* *Greyson Tuck*