GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Illinois, Wisconsin, Minnesota, Georgia, Maine, and Kansas!

LIQUIDITY STRATEGIES

We recently had an interesting telephone discussion with a group of directors regarding stock liquidity strategies. This particular community bank is a very well-run bank that has good profitability and a nice capital cushion. The holding company also has what they consider to be an aging shareholder base. In light of this aging shareholder base, the directors recently made a decision to establish a holding company line of credit to be at the ready in the event one of their aging shareholders or his/her estate had a liquidity need.

The implemented holding company line of credit was put to use faster than expected. The holding company recently repurchased a fairly sizeable chunk of common stock. However, what is interesting is that this stock did not come from what the directors consider to be one of their aging shareholders. Instead, the request came from a somewhat unexpected source. Nonetheless, the company had the ability and infrastructure in place to be able to satisfy the request nearly immediately.

The bright side of this transaction is that the company was able to repurchase a nice chunk of bank holding company stock at a reasonable price, which was beneficial for all the non-selling shareholders. If there is a downside, it is the fact that much of the holding company line of credit has now been drawn, so if any of these shareholders they expect may need liquidity come forward there will have to be an alternate way to fund the repurchase. We are helping them through that piece through the establishment of a 401(k) ESOP. This will provide a ready, willing, and able purchaser for the company common stock in the event a shareholder comes calling.

Kudos to this company for being proactive in recognizing and addressing their liquidity needs. Their forward thinking put them in a great position to satisfactorily address the issue.

THE LENDING FUNCTION

Over the last couple of weeks, we have had numerous conversations with various community bank clients around the country about the appropriate level of director involvement with the lending function. For several of our clients, the directors' only involvement is to set the policies, procedures, and risk tolerances. For others, the directors meet weekly as the Loan Committee to approve virtually every loan other than a "nominal" - as defined by that bank - loan size. For all banks, the directors' involvement should at least be the former (i.e., set policies, procedures, and risk tolerances). A compromise for many community banks is to allow the directors to actually prior approve "bet the bank" loans. A "bet the bank" loan is however the community bank defines it, but is often a loan that approaches or is at the bank's in-house lending limit, which is often 10% or 20% below the legal lending limit. If your board has not discussed its involvement in the lending function, it would probably be a good idea to do so. Abdicating responsibility for the largest asset class in the bank (i.e., loans) is not a good alternative, but there are several compromises in between that still allow the board to exercise its fiduciary duty appropriately.

PROXY DISCLOSURES

One of the questions that often arises from discussions with community bank boards that we are representing in a sale transaction is what information must be disclosed in the proxy statement sent to shareholders to approve the transaction. It is somewhat interesting that there is no specific corporate state statute that lays out exactly what the proxy statement must disclose. Instead, the matter is more driven by case law where the most pertinent guidance comes from prior cases where courts have ruled proxy disclosures inadequate.

The short answer is that the proxy statement really serves two purposes. The first is to fully and accurately disclose all items a shareholder may consider to be material to the decision on how to vote on the transaction. This means the proxy statement should fully disclose the terms of the transaction, including a detailed discussion on the transaction consideration, the history of the transaction, the board's recommendation on the transaction, conditions to completion of the transaction and the like. It is also important that the proxy materials disclose any instance where the insiders may be receiving any benefit or may be treated differently than the other shareholders, such as Change in Control payments, consulting agreements, employment agreements, and the like. The second purpose of the proxy statement is to transmit the actual transaction agreement, since the state law is almost always going to require the shareholder be provided a copy of the transaction agreement.

If your community bank holding company is going through a transaction on the sale side, keep in mind the importance that the holding company's proxy statements fully and accurately disclose all material terms relative to the transaction. The failure to do so can give the shareholders reason to gripe and potentially challenge the transaction after the shareholder vote. Obviously that is a situation to avoid.

GOLDEN PARACHUTE PAYMENTS

As you may know, the federal banking regulations prohibit banks that are in a troubled condition (typically subject to a regulatory enforcement order or 4 or 5 rated) from making "golden parachute payments." What is a golden parachute payment? It is essentially any payment made to an executive officer or employee based on their retirement or based upon a Change in Control where the payment is made from the troubled institution. The regulations that prohibit troubled banks from making golden parachute payments are contained in Part 359 of the banking regulations. They are somewhat straightforward. However, we have had a couple instances lately where the regulators have gone above and beyond in claiming certain transaction payments to be golden parachute payments.

In one instance, the transaction called for certain of the selling directors to receive payments after signing consulting agreements. In another, the transaction called for a retiring employee's receipt of approximately 18 months of health insurance benefits. In each of these instances, the regulators claimed these payments to be golden parachute payments. We do not necessarily agree with this stance based on the language in Part 359, but the regulators have indicated their "internal guidance" deems these to be golden parachutes.

In one instance, we worked with the regulators and received approval to make the golden parachute. We are in the process on the other. It is noteworthy that the regulators have recently taken a pretty expansive view of what constitutes a golden parachute payment based on their "internal guidance." This is eerily reminiscent of the regulators taking certain stances based on "unwritten rules" or internal "guidance" a number of years ago.

MERGERS OF EQUALS

As many *Musings* readers know, we are pretty consistent in our approach that a true merger of equals does not exist. There have been some exceptions. Normally, a merger of equals would be characterized by two banks of similar size with similar financial characteristics coming together in common ownership, the board equally divided between the board members of the two banks, and a representative management team pulling the best resources from each of the two management teams. Still, somebody has to be in charge for even a true merger of equals.

Over the years, we have had many acquisition transactions presented to us as a merger of equals. Most are not and, frankly, do not even come close. If one bank has 40% of the resulting ownership, no management except a branch manager, and only 40% representation on the board, that is hard to characterize that as a merger of equals other than for publicity purposes. Also, as we mention in these pages often, even under the accounting requirements, one of the banks, even in a true merger of equals, must be designated as the acquiror.

Forget the merger of equals issue for a moment. The real issue in putting two like-size banks together is does it make financial sense and does it enhance shareholder value over the long term. If you can answer those questions "yes," then generally the other issues can be resolved.

AVAILABILITY OF CAPITAL

We generally run into issues regarding availability of capital in connection with acquisition transactions. If a community bank holding company wants to buy another community bank holding company for cash, then the question is how does the purchaser generate that cash and make sure the resulting entity is well-capitalized. For most of our community bank clients, particularly all those under $3 billion, that is simply an issue of what is the least expensive and most productive debt the holding company can obtain. Is it from a bankers' bank, from a correspondent bank, from a rich and smart director, or from another community bank? Debt capital is generally the number one alternative when a community bank holding company is looking to generate cash for an acquisition. Lots of debt capital alternatives are available. The good news is there is also a lot of debt capital available. If your community bank holding company is looking to finance an acquisition transaction, make sure you do it with the appropriate means to generate cash at your holding company. Keep in mind that if you are under $3 billion, that note or instrument you use at the holding company does not need to qualify as a capital instrument because any consolidated community bank under $3 billion is only tested for capital adequacy at the bank level, not the consolidated holding company level. Do not forget that issue - it could save you some money.

UNSOLICITED OFFERS ARE ALIVE AND WELL

As we have put in these pages many times, one difference with respect to this period of consolidation and prior periods is the number of unsolicited offers that are being presented to community banks. These offers are not hostile - simply unsolicited. We have written in these pages that many community banks have taken the position that they want an Unsolicited Offer Policy so the receipt of that offer does not have to disrupt their board meeting every time they get one. Some have not.

The bottom line, however, in connection with an unsolicited offer, is that if it is from a credible purchaser at a credible price, then the board needs to consider whether the holding company shareholders are better off taking what is being offered or better off holding the current holding company stock and allowing the bank and holding company remain independent. This generally focuses on a financial analysis of which way the shareholders would be better off. If the financial analysis is "close," then the board can consider some of the intangibles like the character of the acquiror, the acquiror's history in acquiring other banks, the number of employees to be terminated, the impact on the community and the customers, and the like. Before the board can get to the intangibles, however, the financials have to be a toss-up or pretty close to it.

ATTRACTING AND RETAINING KEY PERSONNEL

As we continue to work with community banks across the nation, we continue to understand the struggles of attracting and retaining key personnel, particularly for those community banks located primarily in rural areas. In order to address the issue, the board and senior management need to acknowledge that there is an issue with respect to either attracting or retaining key personnel or both. Once the acknowledgement comes, then comes the planning on how to address it in that particular market, particularly in view of the ownership of the bank. Does management need additional tools such as stock grants, restricted stock, stock options, employee stock ownership plans, KSOPs, and the like in order to attract? Does there need to be an adjustment in the board's position on cash compensation as it relates to peers? Is equity not possible because of the ownership structure of the company? These things need to be worked out.

GETTING TO KNOW THE BUYER

As most *Musings* readers know, we have been involved in dozens of acquisition transactions over the last couple of years. Most, but not all of those, have been for cash. If you are doing a cash acquisition transaction and you are a seller, how important is it that you get to know the buyer? By "get to know the buyer," we mean get to know the buyer's culture, the bank, the historical treatment in acquisition transactions, and the like.

Frankly, some sellers just take the position that cash is cash, we don't care who the buyer is as long as the check or wire clears, we are going to leave town anyway and put all this behind us. Others acknowledge their commitment to the community and want to fully understand the buyer and the buyer's position as it relates to that community. The approaches are clearly different. If your community bank holding company is selling for cash, you have no right to control the buyer post-transaction, but it would be nice for peace of mind and for legacy reasons to understand the buyer's approach with respect to keeping employees, customers, and the community happy to the same extent that your community bank did. Just a thought.

"CASHLESS EXERCISES" OF STOCK OPTIONS

The previous edition of *Musings* contained a brief article regarding stock options. In the article we mentioned the two general ways to exercise stock options, one of which was referred to as a "cashless exercise." We received a couple emails asking us to clarify and provide additional information on what we mean for a cashless exercise.

A cashless exercise is an exercise of a stock option that is accomplished without the option holder providing a cash payment to the bank holding company or other stock issuer. Cashless exercises generally occur in one of two ways. The first is for multiple options to be submitted in exchange for one share of stock. In this type of issuance the value of the options surrendered is equal to the exercise price of the option. For example, suppose an option holder has two options that have an exercise price of $10 per share where the fair market value of the stock is $20 per share. Each of the two options is $10 in the money and has a $10 strike price. Rather than paying $10 cash to exercise the option, the option holder could surrender one of the options with a value of $10 as consideration for exercise of the other.

The second way to complete a cashless exercise is similar to the first, only existing holding company or bank stock is used in lieu of options. In this type of exercise the option holder surrenders their existing stock as consideration to the company for the exercise of the option. Using the same numbers above, an option holder could surrender one share of common stock with a fair market value of $20 to exercise two $10 options.

There are a number of different ways that options can be exercised. Please let us know if you have any questions on how any of this might apply to your community bank or holding company.

CONCLUSION

We hope everyone had a great and patriotic 4th of July. We also hope that all of you and your banks survived Hurricane/Tropical Storm Barry and the resulting flooding. It appears hurricane season is upon us.

Stay safe. Have a great two weeks.

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