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# GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Wisconsin, Tennessee, Arizona, Colorado, New Mexico, Kansas, and Texas!

## THE NOT-SO-INDEPENDENT DIRECTOR

We recently reviewed a Delaware Court case in which the corporate directors had been sued by a shareholder (i.e., a derivative action where the shareholder sues the Board and Corporation on behalf of the Corporation). Normally, the shareholder plaintiff in such an action is required to prove that a demand on the board of directors to sue itself would be “futile.” In this case, the plaintiff failed to make the demand because it took the position that such a demand would be futile because there were not enough independent directors to make a legitimate determination as to whether a suit against the director should be brought. This particular case focused, in part, on what constitutes an independent director.

Think about this in your own community bank and bank holding company. Are those directors that you designated as “independent” outside directors really independent? In this case, the director at issue was a former Chief Financial Officer of the company. He had been retired from employment long enough to otherwise be determined independent, but he had close personal and family ties to the Chief Executive Officer who, as a practical matter, had been his mentor while he was at the company.

The lower court held that this particular former CFO was an independent director. The Supreme Court of Delaware determined that because of the family, cultural, and friendship ties to the CEO, this particular director was not independent. The moral of the story is before you consider a director independent, it is important to look at the holistic relationship of that particular director with

the Chief Executive Officer and perhaps, even other directors on the board of directors. An interesting issue. If anybody would like a copy of the case, please let us know.

### DISSENTERS' RIGHTS

As most *Musings* readers know, anytime your community bank holding company engages in a corporate merger transaction, such as to form a Subchapter S, to acquire another bank, or to conduct a reverse stock split or a discriminatory merger, all shareholders of the effected company have dissenters' rights. This is a right not to stop the transaction but simply to complain about the price they are being paid for their shares in connection with the merger. Of course, most dissenters believe they are being underpaid. Dissenters' rights litigation becomes a "swearing of the experts," each expert being loyal to his or her retainer.

What most dissenters do not realize is, in connection with a dissenters' rights suit, they could receive more per share than the company has offered, they could receive the same amount per share the company has offered, or they could receive less per share than the company has offered. We recently reviewed a situation (not involving a bank) where the dissenters received less than the company was offering in connection with the merger transaction. In that case the dissenters sought an appraisal of their shares. They got it, and the Court determined it was less than what the company was offering.

Although we do not see too many dissenters' rights cases in connection with bank and bank holding company transactions for a variety of reasons (most of the dissenters do not have enough financial interest to pursue it), the dissenters do need to understand that it is not always a win for them. They could get more, they could get the same, or they could get less than the company is offering.

### BUY SIDE PROFESSIONAL ASSISTANCE

We recently received a call from a client that was inquiring into our ability to provide financial advisory assistance in helping them to locate and complete a community bank acquisition. This community bank has previously adopted an active acquisition strategy and has been looking for acquisition targets for a number of years. This bank has been using another financial advisor to assist them in the hunt. They were disenchanted by the other financial advisor's work for a couple different reasons. One of the reasons was they felt like the financial advisor kept pushing them to make an acquisition even though it really was not what they were looking for and did not make a lot of strategic sense for them. We (somewhat sheepishly) asked how the financial advisor was being paid. Not to our surprise at all, it was indicated that the financial advisor would receive a success fee if a deal closed but would receive nothing unless there was an actual transaction.

If your community bank has adopted an acquisition strategy, give some consideration to how your “buy-side” financial advisors are being compensated. There are a couple of different ways to compensate buy side advisors. The typical one is the payment of a large “success fee” on the closing of an actual purchase. The other is our preferred method, which is payment by the hour for the work actually performed. We think this makes for much more of an “honest broker” that does not push to get a deal closed just to receive a paycheck. The obvious upside to the success fee is not having to pay unless a deal is actually closed. The downside is that this provides all the incentive in the world for the financial advisor to push to close a deal, regardless of whether it really makes sense for the acquirer.

### ESOP/KSOP LOANS

Many *Musings* readers maintain ESOPs or KSOPs in their bank. As most of you know, “ESOP” stands for Employee Stock Ownership Plan. A KSOP is a 401(k) Plan with ESOP features. Both of these work extremely well in community banks to provide employees with an ownership interest in the bank and “skin in the game.” As we have noted often in *Musings*, an ESOP or a KSOP is so good in a Subchapter S “it should be illegal” (but it’s not).

Many ESOPs and KSOPs are leveraged (i.e., they borrow money to buy stock of the holding company either from an individual shareholder or from the company itself). With a leveraged ESOP or KSOP, a question that regularly comes up is what funds can be used to service an ESOP or KSOP loan. The general rule per the IRS is that the regulations allow the following to be used for debt service:

- Employer contributions, and earnings thereon, while the loan is in effect, and
- Dividends or Sub S distributions on shares purchased with the loan proceeds either held in suspense or allocated to the participants.

Those are the only sources of repayment for ESOP/KSOP loans. If any *Musings* readers need any further information on ESOPs or KSOPs, please let us know.

### EXECUTIVE BENEFITS

We recently received a call from a client that was looking for what they coined as “different” executive compensation arrangements. This particular community bank holding company is a Subchapter S corporation that has historically used stock options as the sole source of equity compensation to the bank’s executives. Its stock price has experienced some pretty significant fluctuation in value over the years, and many of the stock options proved not to have any value. They were simply looking for other alternatives that might make sense for the organization.

There is a vast array of different equity compensation alternatives available to directors, executives and employees. The list includes phantom stock, stock appreciation rights, restricted stock, stock grants, ESOPs, KSOPs and other alternatives. Rather than recreate the wheel for this client, we provided them one of our Clients & Friends Memos that addresses each of the various available alternatives. This memo essentially summarizes the available alternatives and gives practical considerations to what the company and Board need to be thinking about if they are considering compensating directors, executive officers or employees with them. Please let us know if you would like a copy of the Clients & Friends Memo. We are happy to provide it.

### STOCK TRANSFERS

Over the past month or so we have received a number of different client inquiries regarding the transfer of stock. The questions have ranged from whether shares can be owned as tenants by the entirety, which is essentially joint ownership for married spouses, to the documentation needed to transfer ownership of a deceased shareholder in a Subchapter S corporation. The main two issues in evaluating stock transfer needs are determining whether the intended recipient is legally entitled to transfer of the shares and whether the corporate governing documents or Shareholders Agreements, if applicable, allow such a transfer.

The first issue of whether the intended recipient is legally entitled to the shares is typically answered based on the facts and circumstances and a review of the pertinent documentation. If it is a sale transaction between two living shareholders, there should be some sort of Purchase and Sale Agreement or, at a minimum, a Written Stock Power signed by the seller transferring the ownership of the shares. If the transferring shareholder is deceased, depending on how the stock is titled, the necessary documentation may include a will and appropriate accompanying testamentary documents. The documents need to clearly establish the intent between a transferor and a transferee as to the transfer of the shares.

The second issue relates to the qualification of the intended recipient as a shareholder in the corporation. In a C corporation, this is typically pretty easy. There generally are no restrictions on who may or may not own shares, keeping in mind Change in Bank Control Act and related issues. In an S corporation, it becomes more important. In that situation, it is important to make sure the transfer complies with the Stockholders Agreement and the intended recipient is a qualified Subchapter S stockholder such that the S election will be preserved.

Many community bank holding companies act as their own registrar and transfer agent. If you are transferring ownership of shares, keep these couple general issues in mind. It is important not to slip up and transfer shares in a manner that later turns out to be detrimental.

### DON'T "RELEASE THE BUTTON"

Over the past several months we have been involved in a couple of different transactions that have some very unusual circumstances. In each of these transactions there are multiple parties involved that have their own individual and competing interests. We have discussed the circumstances as being similar to a group of individuals all standing around in a circle and holding down a button. In any of the circumstances, any one of the individuals could have "released the button," which, continuing with the illustration, would have blown the transaction up. We view it as our job as advisors to create a set of circumstances where each of the individuals is individually better off by continuing to hold down the button rather than releasing the button and blowing the transaction up.

Some bank acquisitions are easier than others. Regardless of the perceived ease of the transaction, there are always challenges. In these transactions, it is important to identify these potential problem areas as best you can and then work to craft a set of circumstances where everyone is better off avoiding them. That gives you the maximum chances of a successful deal.

### THE VERY HIGH PERFORMING BANK

We recently had the opportunity to facilitate the annual planning session for an extraordinarily high-performing community bank. In fact, this community bank's historical goal had been to be in the top 25% of financial performers in its peer group. Last year they were in the top 15%, and their goal for the future is to be in the top 10%. The performance of this community bank, particularly at its size (north of \$1 billion), is truly something to behold.

One thing that set this bank apart is that a few years ago they set their vision for what they wanted to be, and they annually update that vision and strategy to execute to obtain the financial performance they were seeking. It has worked extraordinarily well. Part of that, in our opinion, is contributed to by the fact that they meet on an annual basis both as a board of directors and the senior management group to make sure that appropriate tweaks are made. Great bank, and a great group of individuals.

## CONCLUSION

For most of the country, at least the southern half, it is back to school time already. We hope everybody had a great summer and continues to do so through Labor Day. Keep an eye on those school kids when you are driving to work or otherwise.

See you in two weeks.

*Jeff Gerrish*

*Philip Smith*

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P.S. It may be warm now, but don't forget about the winter or the Chairman's Forum to be held January 16-17, 2020 at the Ritz-Carlton in Naples, Florida! Sign up now through the following link:

<https://barret.ws/programs/community-banking-chairmans-forum/>