GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Indiana, Wisconsin, North Dakota, Texas, Arkansas, and Missouri!

ACQUISITION CONSIDERATIONS

We recently received a call from a long-time client that is interested in making an acquisition. This particular bank has informally discussed the potential acquisition opportunity with the majority shareholder of the potential seller. However, the discussions have not broached the subject of price, and our client, as the buyer, has not provided anything in writing up to this point. Thus far, the discussions have been much more along the lines of getting to know you than they have been actually trying to nail down the specifics of a transaction.

Our client is ready to move forward in bringing the specifics of the deal to light. Having never done this, they called and asked us our recommendation for the process. We recommended that they provide the potential seller an Indication of Interest that sets forth the material terms of the transaction. However, before doing so, we also recommended that they have another discussion with the majority owner, who is also inside the bank on a daily basis, to see if they have any specific requests relative to the transaction, such as employment agreements, director positions, and similar transaction issues. We think this is important for a couple reasons. First, it allows the buyer to know what the seller is hoping to get out of the transaction, and it gives the buyer the opportunity to put its best foot forward on the initial presentation of the Indication of Interest. Second, it avoids a situation where the buyer makes some type of Indication of Interest and then the seller comes back with a list of requests or worse "demands" from the transaction, putting the buyer in the position of having to trade purchase price or our other wants in the transaction against the seller's wants.

To ensure compliance with the requirements imposed by the U.S. Internal Revenue Service, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the U.S. Internal Revenue Code or (2) promoting, marketing or recommending to another party any transaction or tax-related matters addressed herein.

Overall, we think the best situation for the buyer is to try and get as much information as possible about what the selling shareholder may want to take out of the deal prior to submitting their initial Indication of Interest. We think this puts them in the best position to try and get a deal done in a way that makes sense for both parties.

NOT A BAD PROBLEM TO HAVE

We recently facilitated a strategic planning session for a community bank holding company that encountered what we see as not a bad problem to have. This particular holding company has a director that is reaching mandatory retirement prior to the next annual meeting. This director slot is going to be vacant, and one of the discussion items at the planning session was the nomination of a new individual to serve as director.

Prior to the planning session, this holding company had done a good amount of prep work in replacing this director. In fact, they had taken a list of candidates and narrowed them down to three, with the idea of selecting one. At the planning session, they discussed each of the candidates, who had been personally interviewed, and basically engaged in a discussion regarding the pros and cons of each. Although they were all well qualified, much of the discussion involved the fact that two of the potential directors were younger compared to the other, who is older but has prior experience as a bank director.

Much of the discussion in community banking today revolves around director and officer succession and the need to identify young talent. Although this holding company intended to nominate only one individual to the board, the discussion centered around the fact that these two younger nominees would provide some long-term director succession alternatives. In the end, the board made the decision to expand the size of the board and ask both of these younger individuals to join. The thought was that they had two great nominees on their hand and they did not want to unnecessarily limit themselves by sticking to some arbitrary number of directors or line of thinking. We thought it was a very good result.

THE PLAN WORKED

For the past six months or so we have been representing a community bank seller in a sale of their holding company and bank to another community bank. This transaction closed within the past couple weeks. The transaction itself was fairly straightforward. The most notable part of the transaction was how the seller's plan worked to perfection.

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As noted, we represented the community bank seller in this transaction. That community bank was hard hit during the "Great Recession." When these problems came along, the bank needed additional capital. A group of investors, led by one investor in particular, came in and recapitalized the bank, brought in new management and directors, and generally turned it around. Once the initial recovery was complete, the next step in the process was to grow the bank, which the group was able to do over the last eight years or so. As you might imagine, the investor group did all of this with the expectation of eventually selling the bank to monetize the return on investment.

The group's plan worked to perfection. Each of the investors earned a nice return on their investment. Just as importantly, they took this troubled community bank, fixed it, and then placed it into the hands of another strong, local community bank. We see this as a win-win for all involved.

NICER EXAMS/WONDERFUL EXPERIENCE - NOT SO FAST

In the last *Musings* we noted that we had had a couple of bankers who described their most recent examination as "wonderful." We commented that "wonderful" and "bank exam" did not really go very well together in the same sentence.

One avid *Musings* reader contacted us to let us know that in his part of the country the exams are not only not wonderful, they are still horrible. This particular *Musings* reader indicated that not only do the regional offices of the federal agencies not trust the examiners, they certainly do not trust the bankers. This is largely due in all likelihood to a significant failure in their region that was due to fraud. As usual, our friendly federal regulators are taking it out on the people who did not commit the fraud or have anything to do with it. That is certainly a different perspective than we heard two weeks ago.

CULTURE

How important is culture in an acquisition? First, what do we mean by "culture"? Culture is often a term bandied about but really means the essence of the bank. Normally, the culture of the acquiring bank is the culture that survives in the resulting combined organization. Culture is part of the due diligence of any target bank. We have had situations where when representing the buyer we have run the numbers and the number look great. The buyer goes in for due diligence and gets a feel for the cultures, on a general level but also often in the credit area specifically, are so far apart from each other that they could not possible be integrated, and the buyer walks away.

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Within that context, culture is absolutely critical for a bank acquisition. If the cultures are so different that individuals, frequently from the target, will depart, then the buyer will not receive the benefit of its bargain. Keep that in mind.

SUCCESSION PLANNING

We were recently with a "larger" community bank for strategic planning. We have assisted this bank in planning for a number of years and watched as they initiated their succession plans as it related to management extraordinarily successfully. This bank is high-performing, and the succession plan has come off very thoughtfully and basically without a hitch. The succession over the last five years has involved multiple "C" level executives as well as the CEO and Chairman. The reason this worked is that they planned far enough ahead to make sure they had the right people in the right slots. It is good to see successful transitions.

FRAUD

What is the deal with fraud against banks, particularly in the good times? We have often commented in *Musings* that during the recessionary times we saw very little insider abuse and fraud. Unfortunately, during the good times (that is where we are now for those of you who weren't aware of it) we have seen repeat fraud. Everything from tellers stealing money, to nominee loans, to falsification of documents for customers. Although it seems counterintuitive that you would have fraud during the good times, anecdotally it certainly has been the case. We are currently working on a number of matters where we are trying to collect money from the D&O carrier or the bonding company, depending on the type of activity. Hopefully we will be successful, but most of those companies make their money by "holding onto their money." We will keep you posted.

DISASTER PREPARATION

We were recently with a good size community bank that was very conscious, because of their geography, with disaster preparation. In fact, they had done various exercises to address various strategic one-off disaster issues such as a flood, fire, tornado, and the like. They referred to these as "tabletop" exercises. For each exercise, the CEO would give the individuals in the room the circumstance of the disaster. He would also tell them, or they would draw out of a hat, who was not accessible that day – i.e., the CFO was out, the IT guy was in Europe, or something similar.

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The general consensus was this really allowed the Bank to work through some of these issues without having to actually go through the disaster. Certainly an interesting concept in preparation for an unexpected event.

THE SMALL BANK HOLDING COMPANY POLICY STATEMENT

We recently received a question from a client regarding the Small Bank Holding Company Policy Statement. As most *Musings* readers know, the Small Bank Holding Company Policy Statement applies to bank holding companies maintaining less than $3 billion in consolidated assets. Operating under the Policy Statement provides such "small" bank holding companies significant advantages.

The question was essentially what is included in the calculation of debt in determining the holding company's debt-to-equity ratio. This is an important ratio because there are certain limitations on the payment of dividends when the debt-to-equity ratio exceeds 100%.

This particular bank holding company has somewhat of an unusual liability composition in the form of some unsecured obligations to former executives and officers that are payable over a five to ten year period. The question was whether these obligations should be included in calculating the debt-to-equity ratio.

In taking a look at the Small Bank Holding Company Policy Statement, we think the answer is yes. The Statement defines debt to include any borrowed funds and any securities issued by, or obligations of, the holding company that are the functional equivalent of borrowed funds. The "catch-all" language relative to the functional equivalent of borrowed funds leads us to believe that the Federal Reserve would likely include this holding company debt in calculating the debt-to-equity ratio.

If you are a small bank holding company, keep your holding company debt-to-equity ratio in mind. Also keep in mind that the Federal Reserve has this catch-all provision relative to what constitutes debt.

CONCLUSION

We are well into the fourth quarter of 2019. Hard to believe. The three of us are, as a practical matter, on the road "full time." We look forward to seeing many Musings readers as we tour around the country with our community bank clientele.

Enjoy the fall (except for those of you whom fall has skipped and who now have snow). See you in two weeks.

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