GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Louisiana, Ohio, Pennsylvania, Texas, Tennessee, and Virginia!

FINANCING CONTINGENCIES

Many community bank deals involve the need for one of the parties to obtain financing. These types of financing arrangements are prevalent in M&A transactions, share repurchase transactions, acquisitions of alternative lines of business, and the like. Any deal that requires one of the parties to have financing should have a financing contingency as part of the definitive transaction agreement. This contingency is essentially a condition to closing for the party that must obtain the financing.

We recently ran into an interesting situation with a deal involving a financing contingency. The seller in the transaction essentially asked that the financing contingency be removed from the definitive agreement. They thought it was a potential roadblock to the deal and thought it would be better from their perspective not to have the contingency.

Our response to the request was a polite no. We viewed the financing contingency as a very important part of the transaction. Why? Because if we did not receive the necessary financing, we would not have the cash or ability to close the transaction. As you might imagine, we thought that important enough to fight over. After stating our case, the other side agreed and dropped the issue.

If you are thinking about a transaction that involves financing, be sure to keep in mind the financing contingency in the agreement. It is an important part of the documentation.

FRIENDLY FEDERAL REGULATORS

As we have reported in Musings, recently we have noted a change in attitude from the friendly federal regulators when they come into your bank. It is not as much of a "gotcha" attitude as it is a little more collaborative attitude. We were recently visiting with a CEO of a mid-size community bank about his examination experience. When asked how the examination results came out, he indicated that he had received a CAMELS 2, but that it was a "shiny" CAMELS 2. We suppose that would be like getting a B+ on an A, B, C, D, F scale. A "shiny 2" – a new term we had not heard from the regulators before. Maybe they are getting more creative, but we seriously doubt it.

INCENTIVES FOR LENDERS

Lately we have received a number of questions regarding incentive plans for lenders, commercial lenders in particular. With the price of obtaining a commercial lender these days on the high end of the scale, many of our clients around the country are trying to structure compensation systems for those commercial lenders that involve a heavy dose of incentive compensation. While incentive compensation for any individual executive officer or otherwise makes sense, when designing it for a lender, particularly a commercial real estate lender, it needs to be carefully crafted (keep in mind, you will get what you incent). Certainly, a community bank does not want to design the compensation incentives simply to put loans on the books. There have to be other criteria associated with that other than just originating credit. If it is only for originating credit, we guarantee the quality of that credit will slip. Many of these types of incentives have a two or three year earnout, depending on the quality of the credit. Some try to utilize a "claw back" (good luck getting the money back once the lender has received it).

In any event, if you are crafting an incentive plan for lenders, do so carefully. Let us know if we can assist.

ESOP ANTI-ABUSE ISSUES

As many *Musings* readers know, we are of the opinion that an Employee Stock Ownership Plan in a Subchapter S is so good it should be illegal. Why, you might ask, do we view this as such an attractive setup? It is because the Employee Stock Ownership Plan receives both "tax equivalent" and "dividend equivalent" distributions, the same as all other shareholders, but the ESOP is a tax-free entity. This has the practical effect of allowing the corporation to shield an amount of corporate net income for federal tax purposes that is in proportion to the amount of stock owned by the ESOP. It also turns into a significant cash accumulator for the benefit of the bank's employees.

Since an ESOP in a Subchapter S is so good it should be illegal, Congress has chosen to impose some limitations. These are referred to as the ESOP anti-abuse rules. A full explanation of the rules is well beyond the scope of this *Musings*. In summary, the general rule is that disqualified persons (those that own 10% individually or 20% when aggregated with family members of the shares in the ESOP) cannot collectively own 50% or more of the Subchapter S corporation stock, including stock both within and outside of the ESOP, without experiencing significant penalties.

As we come up on year-end, many Subchapter S corporations are thinking about making their annual ESOP contribution. Keep the anti-abuse issues in mind. You or your third-party administrator need to make sure that the ESOP contribution will not cause a violation of the anti-abuse rules. There are a number of negative consequences if that happens.

Our firm has a comprehensive Memo to Clients and Friends that explains the ESOP anti-abuse rules in detail. Please let us know if you would like a copy. Please also let us know if you have any other questions concerning the anti-abuse rules. It is complicated, and certainly an area where you do not want to trip up.

CHANGE IN CONTROL FAMILY GROUPS

Several times over the past couple weeks we have encountered issues relative to the Change in Bank Control Act family grouping rules. As you likely know, the Change in Bank Control Act requires individual shareholders or "groups acting in concert" to obtain Federal Reserve approval before becoming a control shareholder. Generally speaking, an individual or group acting in concert becomes a control shareholder if they own or control more than 25% of the holding company or bank common stock, or own more than 10% and less than 25% and are the largest shareholder or group acting in concert.

Lately we have been reminded of the expansive definition of a "group acting in concert." The Change in Bank Control Act essentially provides that certain family members are presumed to be acting in concert. These family members include fathers, mothers, step-fathers, step-mothers, brothers, sisters, step-brothers, step-sisters, sons, daughters, grandparents, grandsons, granddaughters, in-laws, and more! Oh, it also includes any spouse of the foregoing!

The listing above is not a full listing of the family relationships that will be considered a family group. Please let us know if you would like to see the actual regulation, as we are happy to provide it. The important thing is to keep these issues in mind. The Federal Reserve's assumption that a family is acting in concert casts a very wide net as it relates to family members.

CHANGE IN CONTROL PART II

What happens if the matriarch or patriarch of a community bank holding company goes to the Great Beyond and leaves their stock in a Trust to be distributed to the adult children? Does that trigger a change-in-control? In some circumstances, possibly not. Under most circumstances, probably yes. As noted above, groups acting in concert and obtaining control where they did not previously have control requires prior approval of the Federal Reserve. Often in these decedent estate situations, the approval cannot be obtained prior (or the individuals do not know they are supposed to get it) and is a post-transfer approval. The Fed is generally very forgiving with respect to these types of violations of the Change in Bank Control Act. If you have had a large shareholder go to the Great Beyond, please consider the change-in-control aspects of the distribution of those shares.

INDICATIONS OF INTEREST

Over the past couple weeks, we have drafted numerous Indications of Interest for potential acquisition transactions. An Indication of Interest is a two to four-page document that summarizes the material terms of a proposed transaction. Most of the time these relate to actual proposed acquisitions. We have utilized Term Sheets for other types of transactions in the past. Term Sheets are utilized simply for the sake of convenience. They are put together to summarize the material terms of a transaction and are executed by each party to evidence a meeting of the minds relative to the material terms, such as pricing, type of consideration, due diligence requirements, treatment of certain fees and expenses, and similar issues.

In summary, Term Sheets are simply a convenient way to smoke out whether there is a meeting of the minds relative to the key terms of a deal between two parties. Please let us know if you would like to see a sample Term Sheet for an acquisition or other type of transaction. We are happy to provide one.

ACQUIRE YOURSELF OR ANOTHER BANK

We were recently with a high-performing, well-capitalized community bank in a growing market. The strategic discussion at the planning session involved whether the community bank and its holding company should be “proactive” in looking for acquisition targets. The discussion really boiled down to whether they should look to acquire another bank or other line of business or simply acquire their own shares through their bank holding company. These are the most basic capital allocation issues. This particular bank, being on the conservative side (probably why they are so high-performing), weighed the costs and benefits of an acquisition. From a benefits standpoint, it would provide the bank and holding company with an additional earnings stream, as well as some management succession. From a cost standpoint, it had all the risk associated with the credit culture of the other bank, the integration of cultures between the two banks, and simply the premium being paid for the transaction. Once the board weighed out the costs and benefits, it determined that the best use of the bank's capital at this stage in the bank's life was to redeem shares of the holding company and consolidate ownership further in the core group. For this group, certainly a wise choice.

AVAILABILITY OF CAPITAL

As we often harp on in *Musings*, a large part of the directors' obligation is to allocate financial capital (and managerial) to enhance the value for the shareholders. When considering financial capital, the board needs to consider not only excess capital at the bank, its current state of earnings, but also the availability of capital. The good news is, particularly for those of you who maintain holding companies, that both debt and equity capital is available. Debt capital for a bank holding company under $3 billion in consolidated assets simply allows the company to borrow money (from an institutional lender or a rich and smart director) at the holding company level, downstream that cash into the bank, and it appears as capital. From a capital adequacy test by the regulators, only the bank's capital is tested. Equity capital is also available. We have done a number of successful private placements for our community bank holding company clients across the nation in the last 12 months. It seems that there is a significant interest in purchasing community bank or bank holding company stock, particularly when the attributes of that stock (generally thought of as appreciation and dividends or distributions in Sub S) are positive.

When you are contemplating how to allocate your capital appropriately, do not forget to contemplate additional sources of capital, including debt and equity.

CONCLUSION

In the last edition of *Musings*, we wished all *Musings* readers a Happy Thanksgiving on the theory that *Musings* would not go out again until after Thanksgiving. Apparently, the staff had other ideas. Happy Thanksgiving again to all of you. We hope you have a wonderful at least day off and a good weekend!

See you in two weeks.

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