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# GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Wisconsin, Tennessee, and Florida!

## HAPPY NEW YEAR TO ALL!

We are happy to report that “*Musings* never sleeps.” We are pleased to publish *Musings* on New Year’s Eve. We wish all of you a wonderful and prosperous New Year. We thank all of you for your community bank’s business over 2019 and look forward to assisting you and your community bank in 2020 and beyond.

In the last couple of weeks we have gotten interesting comments from clients. One indicated he was surprised we were working on Christmas Eve. Our response was pretty succinct – “24/7/365. Any questions?” Another client asked if we took off the last two weeks of December in honor of the holidays. We thought that one was pretty rich since year-end is generally a very busy time for us. We take pride in the level of service we are able to offer our clients, and we simply want to express our appreciation to all of you for your business - and many of you for your friendship as well.

Also, thanks to you avid *Musings* readers who provide us comments on *Musings* content. Sometimes you are happy and think we are right on point. Sometimes you criticize us, which we always review and respond to. Please feel free to keep those comments coming.

## SHAREHOLDER PREEMPTIVE RIGHTS

We were recently discussing with a holding company board of directors the issue of shareholder preemptive rights. As you likely know, shareholder preemptive rights are a right of the shareholder to participate in an offering of company common stock in an amount equal to the

shareholder's pro rata portion of ownership. In other words, it is an anti-dilution protection for the shareholders that gives them the opportunity to purchase enough shares in any offering to maintain their relative ownership position.

The discussion was whether the holding company, which currently has shareholder preemptive rights, should retain them. When asked by the board for our opinion, our comment is that shareholder preemptive rights are great until you need to raise capital. Put another way, the reality of shareholder preemptive rights is that they are frustrating to the process of capital raising.

We do not call shareholder preemptive rights frustrating because we are fundamentally opposed to the concept. We are all for giving shareholders the opportunity to maintain their pro rata portion of ownership percentage. Our distaste for shareholder preemptive rights comes from the securities registration exemption issues. Our experience is that the requirement to offer shares to all shareholders - regardless of their state of residency, status as an Accredited Investor, or similar factors - makes meeting the available securities registration exemptions much more difficult, if not impossible.

In summary, we do not typically recommend that our clients look to implement shareholder preemptive rights. As we told this board, you can always choose to offer any shares sold in a capital offering to all existing shareholders. However, we think it is much better to have the option, rather than the requirement, due to the applicable securities issues.

## EQUITY OFFERINGS

2019 was a good environment for successful equity offerings by community bank holding companies. We anticipate 2020 will be the same. Our general recommendation when a community bank needs capital or a bank holding company needs cash is for the holding company, particularly those under \$3 billion, to leverage capital into the bank or cash into the holding company through debt. Once that opportunity is exhausted from either a lender standpoint or a regulatory standpoint, then our next recommendation is to use equity. As noted above, we generally do not recommend that the holding company maintain preemptive rights in its Articles on the general theory that when a community bank holding company is going to raise capital, it typically proceeds toward its existing shareholders first anyway.

We anticipate equity offerings priced fairly will continue to be successful in 2020. Keep in mind, anytime the holding company issues equity, a registration statement will need to be filed with the SEC (which most community bank holding companies do not want to do) or an exemption from

SEC registration must be utilized. Let us know if we can help make that assessment or help with your holding company's equity offering.

### TRANSACTION NEGOTIATIONS

We are currently in the process of negotiating a merger agreement where we are representing a community bank seller. One of our recent telephone calls with the lawyer on the other side of the deal was a discussion on various deal points to be incorporated into the merger agreement. In response to several of our negotiation positions, the other lawyer took the position that he did not want to do what we were asking "because it was not market for this type of transaction." After hearing that copout a number of different times, we politely pointed out the fallacies of this negotiating tactic.

First, arguing that the specific deal points in a transaction between two parties should be controlled by what other unrelated parties have previously done in the past does not make sense because those unrelated third parties are not involved in this transaction. Rather than looking to what other people have (supposedly) done, transaction negotiations and the specific deal points should incorporate what makes sense for the actual parties involved.

Second, on a more widescale basis, how can one know with any certainty what is or is not market or previous precedent on these particular deal points? We assume that anyone indicating what market is for these types of transactions is actually talking about their prior experience. We do not believe counterparties typically go back and review the 250 or so bank merger agreements from the year to determine what others are doing in similar deals.

If you are thinking about being a buyer or seller, keep in mind that the deal points should reflect what works for you and your counterparty. We do not buy into the idea that your decisions ought to be driven by what someone believes others have previously done in similar situations.

### TRANSACTION ISSUES

We view community bank acquisition transactions, on both the buy and sell side, as having two primary sets of issues: (1) financial issues and (2) social and cultural issues. We view both of these sets of issues as of significant importance to the transaction. Acquisitions that typically turn out to be "good acquisitions" are those where each of the financial and social and cultural issues are well aligned. Acquisitions that turn out not to be "good acquisitions" typically have a mismatch on one or both of these two subsets of issues.

We recently had a discussion with a potential acquirer on the importance of these two issues. Our comment was essentially that an acquisition needs to be strong in both of these areas. If one of the

areas is lacking, we recommend either walking away or proceeding with caution. If the financial issues or the social and cultural issues are out of whack, the parties, particularly the acquirer, are probably not doing themselves any favors. If any mistake is to be made, we believe it is easier to recover from a financial misstep than it is from a social and cultural misstep.

In summary, if you are thinking about a deal on either the buy or sell side, keep the importance of these two significant subsets of issues in mind. The ideal situation is to have strong financial metrics as well as a good match in the social and cultural issues.

## BRANCH ACQUISITIONS

Over the past couple weeks, we have had a couple different discussions regarding branch acquisition opportunities. In both instances, we are representing the potential buyer. What is interesting about both of these opportunities is the significant amount of cash that would be provided to the buyer at the time of closing. This is because a branch acquisition is structured as a purchase of assets and assumption of liabilities transaction. The acquiring bank typically assumes all of the branch deposit liabilities and needs assets (whether loans, securities, cash, or real property) to fill out the balance sheet. In both of these instances the seller does not want to give up loans or securities, so it will give up cash as the asset to balance out the transaction.

The crux of whether these types of deals makes sense, and what they are worth to the acquirer, depends upon how the cash can be deployed following closing. If the acquirer has strong loan demand and can put that into quality, high yielding loans, that is a much better and much more attractive alternative than of taking the pile of cash and investing it in Fed funds or some other low yielding assets.

## REPURCHASE PLANNING

We continue to receive numerous calls and emails from community bank holding companies around the country with respect to stock repurchases. Most of these community bank boards of directors are simply in a capital allocation analysis discussion as to whether capital should be allocated toward repurchases, toward increased dividends or distributions for balance sheet growth, or acquisition of other banks or businesses. In connection with the repurchase discussions, however, often the community bank holding company board of directors seeks our advice with respect to how to price the transaction. As many *Musings* readers know, we generally recommend against getting a valuation in a voluntary repurchase transaction for a number of reasons. We simply recommend running through the numbers, seeing where they fall, determining how aggressive the board wants to

be with respect to pricing, and making sure that a redemption at that price level benefits those shareholders who do not sell.

In this type of analysis, the range of redemption prices from which the community bank holding company board of directors can choose can be very wide. For example, it could be at book value or slightly less, to 1.3 or 1.4 times book value (i.e., wherever it tops out on an earnings per share dilution analysis). The board's job is to determine where it wants to set the purchase price, what type of precedent it wants to set by putting it there, and how it will be viewed in view of the historical actions of the board of directors as it relates to redeeming shares.

### TROUBLED BANKS

No, this *Musings* article is not to predict the next recession or downturn and get everybody concerned about troubled banks. It is simply to address the troubled banks that are out there. There are currently approximately 50 banks that are rated 4 or 5 (i.e., troubled institutions as formally designated by the regulators). That is down from approximately 850 during the Great Recession. We currently have the good fortune to work with approximately 20% of these banks having difficulties. If you compare your own strong community bank to a troubled bank, the issues are all the same with the exception, typically, of the regulatory overlay, lack of capital, and lack of earnings. Throw in some on balance sheet liquidity issues, and there you have the recipe for a troubled institution.

We often get asked by outside directors in troubled banks as to whether they should simply get off the board of the troubled bank or stay to work out the problem. Our uniform advice is to stay to work out the problem. We generally advise that from a director's standpoint, the liability is fixed for whatever occurred prior to their departure from the board, so it seems the better course is to stick around and try and fix the problems.

Generally, we focus our attention on two areas with respect to working with a troubled community bank. The first is dealing with the regulators and holding them at bay while we address the second issue, which is solving the problem (this typically means finding a buyer or an entity to inject capital). The capital issue may or may not involve "washing" the bank holding company through a bankruptcy reorganization. Typically in this type of discussion, all options are on the table.

## CONCLUSION

We again wish each of you and your families, communities, and banks a wonderful and prosperous New Year. We look forward to continuing to serve you in the New Year. See you in two weeks.

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