GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Wyoming, Idaho, Colorado, Illinois, Oklahoma, Kansas, and Pennsylvania!

BANK SALES

We have been involved in a significant number of bank sales over the last couple years, including during the pandemic. We continue to see announcements of banks, particularly banks under $200 million, selling or merging with larger banks. We often get asked why this is happening. Although there are many reasons, they generally involve just a couple of fundamentals. One is lack of management succession, and the other is lack of ownership transition or director succession. Each bank is different, but in order to remain independent, the board must be proactive and make sure it addresses the issues that need to be addressed to keep the bank independent. If the board determines strategically that it is time to sell the bank, for whatever the reason, then the board needs to make sure that it is obtaining the best price available in the best currency. If you need any help addressing these issues, please let us know.

IT'S A SELLER'S MARKET

We are currently working a number of different community bank M&A transactions on each of the buy and sell side. Based on our current and recent involvement in this area, we are firmly convinced it is a seller's market. What do we mean? We mean that right now is a great time to sell a community bank because there are many more acquirers looking for small bank charters than there are small bank charters that are actually for sale. Thinking back to our old economics lectures in college, we are reminded of the principal that price increases when demand is high and supply is low. This fundamental economic principal has been confirmed in a number of different deals we are currently working or have recently completed.

If you are an acquirer looking for a small bank charter, know that you are not alone. There are multiple community banks, FinTechs, and investor groups that are looking to make acquisitions of a small bank for one reason or another. Although we are staunchly in favor of independent community banks, if you are a small bank that is thinking about selling, know that now is a pretty good time. Most community banks have seen their asset quality and earnings hold, and the fundamental business is strong. That combined with a healthy demand for community bank acquisition targets makes today's smaller community bank environment properly characterized as a seller's market.

FORCED SHARE REPURCHASE TRANSACTIONS

We are currently working with a couple different community bank holding companies to assist in share repurchase transactions. The specifics of each of the repurchase transactions are a bit different, but the commonality is that each bank and holding company have "excess capital" that needs to be allocated towards the enhancement of shareholder value. In each of the circumstances, the Board has evaluated the various alternatives available to allocate the excess capital and has determined the repurchase of company shares to be the highest and best use of the funds. As we have relayed a number of times in *Musings* previously, share repurchase transactions are beneficial and provide a number of benefits, including an increase in ownership percentage for the remaining shareholders, increase in earnings per share, increase in return on equity, and increase in dividends (assuming the level of dividends paid remains steady and the number of shares outstanding is reduced).

There are generally two forms of stock repurchase transactions: voluntary transactions and forced share repurchases. As the name implies, voluntary transactions are where the shareholders are provided the option to sell shares back to the company. Forced transactions are a little different because, as the name implies, certain of the holding company shareholders will not have the option to keep their shares, assuming the appropriate shareholder approvals are received.

Forced share repurchase transactions can be structured in one of two ways, either as a cash-out merger transaction or a reverse stock split followed by a cash-out of fractional shares. The forced share repurchase transactions we are currently working to complete are structured as cash-out merger transactions. This is a transaction where a newly-formed merger corporation merges with and into the existing holding company with the existing holding company surviving the merger. In the merger, shares that meet certain requirements identified in the Agreement and Plan of Merger will continue to remain shares outstanding. Those shares that do not meet the specific criteria will not remain outstanding but are instead converted into the right to receive cash and are repurchased by the company. The factors that differentiate which shares survive are based on the board's discretion and generally include whether the shareholder has a banking relationship with the bank, the number of shares owned, the shareholder's state of residence, whether the shareholder has recently voted or returned a proxy for shareholder meetings, or similar factors that have a reasonable business basis.

There are a number of issues to consider in a forced share repurchase transaction. These include the requirement to pay shareholders the "fair value" for their shares, the political risk associated with forcing shareholders out, and other factors. If you have excess capital and are looking to allocate it to enhance shareholder value, a repurchase transaction (forced or voluntary) is an available alternative.

DISSENTERS' RIGHTS

As we have often addressed in *Musings*, anytime a corporate transaction occurs – a merger, reverse stock split, or something similar where the shareholders could be forced to take cash or some other consideration for their shares – the laws generally provide that the shareholders have dissenters' rights. This typically means a shareholder cannot stop the proposed transaction from moving forward (without getting enough votes to do so) but can argue that whatever the price paid per share for the merger or reverse stock split or other corporate action is not fair. The litigation is typically over the value of the stock in what is known as an "appraisal proceeding." In our experience, most shareholders do not have a sufficient number of shares to warrant pursuing a dissenters' rights/appraisal proceeding, and those who do assume that they will gain more than was offered by the company to begin with. A recent Delaware Supreme Court case that dealt with appraisal rights involved a situation where the company offered all shareholders in a merger transaction $55.85 per share, the dissenters had sought $84.65 per share, and the Court determined the fair value of the shares was $53.95 (i.e., less than what was originally offered to them in the merger transaction). We have found that most dissenters do not realize they could get more than what the company has offered, they could get the same, or they could get less. This is a dissenters' rights case where the Court determined that the fair value of the shares was less than the amount originally offered by the company.

NON-COMPETE AGREEMENTS

One of our clients recently asked us to assist in drafting a Non-Competition, Non-Solicitation, and Confidentiality Agreement for a newly-hired lender. This particular community bank is hiring a "franchise lender" in one of its key markets, and, as you might suspect, they are making an appreciable investment to do so. Of course, they want to protect that investment, so part of the deal is for this lender to sign a Non-Competition, Non-Solicitation, and Confidentiality Agreement.

Kudos to this bank for putting this important piece of protection in place. We believe these types of agreements are a key element in this type of hire. Unfortunately, we see too many situations where the hire is completed without this important element of protection. In our experience, if you do not get the agreement at the time you are making the hire, the chances of getting it thereafter are extremely low. These types of agreements really need to be the stick that accompanies some carrot at the time of hiring. In our client's recent instance, the carrot was a pretty sizeable sign-on bonus spread over a number of years with certain benchmarks that must be met for the employee to receive payment.

We recommend you give consideration to the implementation of Non-Competition, Non-Solicitation, and Confidentiality Agreements, particularly for your lending staff. We see this as an important element to protect the investment made in these individuals. We recommend you look to put them in place at the time of hiring because it is tough to get an after-the-fact agreement.

GEOGRAPHIC EXPANSION – A DIFFERENT APPROACH

Most of the banks for which we facilitate planning sessions discuss at some point in the session geographic expansion. This could be through loan production offices, brick and mortar branches, or acquisition of other banks or lines of business. A fundamental question in the area of geographic expansion is, does the bank need to expand its geography through additional brick and mortar physical locations or can it do so through technology? Most of the time that discussion circles back to the fact that community banks are relationship-based. Because of that, while there may not need to be brick and mortar on every corner, there probably needs to be enough for the customer base and enough human beings to create relationships.

As noted above, the typical expansion process for community banks, at least historically, has been to first obtain the franchise player in the market in which they wish to expand and then allow that player to come over with his or her book of business and continue to generate loans for the franchise player's new employer. At the time the franchise player's loan portfolio gets large enough to support a brick and mortar location with other personnel, then it is established. As such, the general historical approach had been franchise player, loan generation, profitability, then a brick and mortar branch.

We have recently facilitated planning sessions for several very high-performing banks. A number of these banks are taking a different approach on expansion. That approach is to take an individual from their existing home office location - someone who is currently a lender in that market who understands the bank's credit culture and the type of loans and loan underwriting that it enjoys -

and relocate that person, temporarily or otherwise, into the new market. The general reaction to that in many community banks is that that approach won't work because the person who is relocated into the new market does not know anyone in the new market. What if you took a different approach and sent that individual into the new market to begin to know individuals and take advantage of their spheres of influence? It is certainly a different approach but one we have seen be successful.

The point is to think about what is best for your bank when expanding geographically.

COMMUNITY BANK DIRECTOR ISSUES

As most *Musings* readers know, we visit regularly with community bank board members as well as executive management. The typical community bank board member is a business man or woman in the community with a stellar reputation, the ability to look forward, and with some type of special expertise which the bank needs.

Lately, we have been having some discussions with various boards about their fundamental duties as bank directors. From a 50,000 foot level, the board's primary duty is one of oversight. Also, as the regulators say, in connection with that oversight the board should be a "credible challenge" to the management group. The board's job also is to set strategic direction for the organization. The board's job is not to micromanage the bank. As we have said many times over the years, if your board of directors feels it must micromanage the bank, then it obviously does not have confidence in the bank's management and should find management it has confidence in.

We generally only see micromanagement in a couple of different situations. One is new banks. The initial board of directors of a new bank is very involved with the formation of the bank. Once the bank is formed, it is tough to get them to back off into their director role instead of their organizer role. The other micromanagement situation we typically see is in a troubled bank. Frankly, micromanagement is much more understandable in a troubled bank situation and appreciated (if not directed) by the regulators, particularly as it relates to the loan portfolio.

For a healthy bank, high or even medium performing, director micromanagement should not be an issue and should not be apparent. Although directors should "direct and not be led," they should also only operate with "noses in and fingers out." If your bank has a micromanagement issue, then please address it.

SMALL BANK REGULATORY AGGRESSION

Over the past six months or so, we have noted in a number of different *Musings* that we have recently sensed an increase in regulatory activism, particularly as it relates to smaller banks. The last couple weeks have confirmed our suspicions. Specifically, over the last couple weeks, we have been contacted by three different small banks that are seeking our assistance in responding to and ensuring compliance with newly-issued regulatory enforcement actions. Each of these three banks has less than $75 million in total assets and is facing some type of new regulatory enforcement action following a recent examination.

The primary impetus for each of these regulatory enforcement actions does not appear to be the regulators' concerns with the bank's asset quality. Instead, each of these regulatory enforcement actions has a heavier focus on board oversight, management, and operational concerns. In summary, the enforcement actions say (without specifically saying) that the bank's management and methods of operation are not acceptable in the regulators' eyes. This is notwithstanding each of these banks generally having appropriate levels of capital and earnings.

Unfortunately, the reality is that these regulatory enforcement actions will be difficult to comply with for each of these small banks for two particular reasons. First, these types of regulatory enforcement actions take a tremendous amount of the employees' time and focus, particularly the executive officers. For many of these small banks, this is a precious resource that is difficult to allocate to ensure compliance with these enforcement actions. Second, compliance with these types of regulatory enforcement actions is not cheap. There is typically an appreciable amount of expense involved in properly completing all of the necessary work in a timely manner to ensure compliance with the regulatory enforcement action.

As we have noted previously in *Musings*, we anticipate these types of enforcement actions will become more prevalent. Unfortunately for these three small banks, they are now going to have to spend a good amount of effort and expense in ensuring compliance with these newly-issued regulatory orders.

MERGERS AND ACQUISITIONS WORKSHOP

As noted above, the M&A environment for the community banks, smaller community banks in particular, is extremely active. Over the past several years, the three of us have conducted a Merger and Acquisition Workshop for community banks sponsored by the ICBA. This workshop is very practical and moves from the big picture of acquisitions and strategic issues to hands-on review of financial modeling, among other topics. The link to the registration for the workshop is ICBA Mergers & Acquisitions Workshop.

It will be conducted virtually this year, but we look forward to "seeing" many of you there.

CONCLUSION

It is the Ides of March. That means we are nearly at the end of the first quarter of 2021. Things appear to be getting better. Most of our community bank clients across the country are doing well. Most of the CEOs and directors have received or are in line to receive the vaccination against the virus. Stay safe and well.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- March 31, 2021 – Graduate School of Banking-Wisconsin Webinar – "Liquidity Strategies for Illiquid Community Bank Stocks" (Greyson E. Tuck) Registration link: Liquidity Strategies

