GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Utah, Alabama, Mississippi, Tennessee, and Florida!

PLANNING FOR THE FUTURE

We have spent a lot of "electronic ink" in *Musings* with respect to community banks planning for the future. This is primarily because we believe it is beneficial for them to do so. It is also an obligation of the board of directors of a community bank to establish the strategies for the bank moving forward. Many of our community banks prefer to engage in their strategic planning during the first quarter of the year when they can look at the entire runway for 2022, in this case, as well as the likely prospects for 2023. Others like to plan in the third or fourth quarter when they can look ahead for the next couple of years. Whatever timing is preferable for your community bank, the important point is that your organization, board, and senior management engage in planning for the future. As often quoted from Yogi Berra, "If you don't know where you're going, you might wind up someplace else." We would rather have our community bank clients across the nation know where they are going, at least based on the present set of facts, with the idea that they can make adjustments as the circumstances/facts change.

We facilitate dozens of strategic planning sessions for community banks annually across the nation. Please let us know if we can assist.

THE STRATEGIC PLAN

We were recently provided the opportunity to review a community bank's strategic plan. This bank essentially asked us to review their plan and provide our comments and observations. We took a look at the plan and were struck with two immediate thoughts. First, the plan was very well put together. It looked nice, had great graphics, was arranged in the appropriate order, and the like. Our second thought was that the "pros" of the plan ended there.

From a substantive perspective, we saw the plan as deficient. Although it set the 30,000 foot high level strategies (an obligation of the board), it did not establish as part of the plan any type of action plans as to how those strategies were going to be executed. It really did not do much in terms of setting forth actual items the holding company and bank were looking to accomplish. It did a nice job of outlining ideals, the benefits of community support, and the like. However, there were no "action items" that would allow for actual accountability as it relates to accomplishment of the strategic objectives.

Our recommendation is that, in addition to establishing strategies, the strategic plan be specific in establishing action items for completion. We like to see an action plan that includes the specific action item, the party responsible for completing the action item, and the required completion date. We believe this provides the best opportunity for accountability with respect to achievement of the strategies established by the plan.

MERGERS AND ACQUISITIONS FOR 2022

2021 was a very active year for community bank mergers and acquisitions. We closed a number of transactions at year-end and have a number of others in process. We anticipate 2022 will be an active year for community bank mergers and acquisitions as well. Not only are there a significant number of buyers with plenty of capital and debt capacity to do cash deals for community banks, there are also still a number of community banks struggling with the issue of independence. As we have indicated previously in *Musings*, most of the community banks that sell do so for the traditional reasons (i.e., lack of share liquidity, lack of management succession, and lack of an effective plan for ownership transition). We have, over the last several years, worked with multiple community banks on both how to stay independent, as well as how to prepare for a sale. Let us know if we can assist.

REGULATORY FINANCIAL PRO FORMAS

We are currently assisting a number of different clients in evaluating acquisition opportunities. One of the questions that often arises in these discussions is the regulatory requirement for bank capital on a pro forma basis post-acquisition closing. In other words, clients often ask what is the minimum Tier 1 Leverage Ratio the regulators will accept in considering and approving a merger application. This is often considered in conjunction with the amount of debt that will need to be borrowed to complete an acquisition.

Based on our experience, we believe it is likely the regulators, if asked the question, would provide a "verbose" answer (as usual) to the question of minimum capital. We anticipate it would be a short exposé on balancing the organization's asset quality and risk management practices against its business plans and current and anticipated capital needs. In reality (without the regulatory speak), we believe the answer is certainly no less than an 8%, and likely closer to 8.5%, leverage ratio.

Our recommendation to our clients has always been that we not file a merger application on their behalf that shows a less than 8% Tier 1 Leverage Ratio. We have been involved a couple of times on the "sell" side where the purchaser has provided an application that shows that the leverage ratio is less than 8%, although it recovers over a relatively short period of time. This situation inevitably invites further investigation, questioning, and skepticism from the regulators as to how additional capital support will be provided. This really is the regulators' not so indirect way of stating that they think additional capital is needed in order to approve the application. Most often in these instances the regulators will hold the application hostage in exchange for additional capital.

If your community bank holding company is considering a merger transaction, keep these issues in mind. We see an 8% Tier 1 Leverage Ratio as an absolute minimum for regulatory approval. Given the current environment, we see a more likely regulatory expectation of about 8.5%. If the pro formas are much below that, we anticipate you will get quite a few questions about your capital plan.

DISSENTER'S RIGHTS

We often get questions about dissenters' rights in acquisition transactions. A shareholder has a right to dissent from any community bank or bank holding company transaction that converts or may convert the shareholder's shares into the right to receive cash or other consideration. Dissenter's rights are a form of shareholder protection and allow for a shareholder to argue that the consideration it is receiving in a transaction, whether it be cash or stock, does not represent the "fair value" of the common stock that it currently owns. It is essentially the shareholder's argument that the value applied to the shares is too low and allows for litigation and an opportunity for the court to determine the fair value of the shares.

Our firm has been involved in a number of dissenter's rights disputes. In our experience, one of two usual circumstances lead to a dissent, and neither has to do with the actual fair value of the shares.

The first circumstance that is ripe for dissent is relationship based. This typically occurs where the majority of shareholders want to engage in some transaction that one or a group of minority shareholders does not agree with. The minority does not have the votes necessary to block the transaction. So, in their view, the next best thing is to dissent from the transaction and create as much consternation as possible.

The second circumstance that is ripe for dissent is a shareholder that sees dissenter's rights as an opportunity to extract a settlement from the company. In these dissents, the shareholder reasons that it has nothing to lose from the dissent and may create enough noise to extract a settlement that is more favorable than the offered consideration.

If you are considering a transaction that requires dissenter's rights, keep in mind these issues as you assess the probability of a dissent. These rights are statutorily provided, so there is nothing you can do to avoid them. If a shareholder does choose to dissent, we see it much more likely than not that the dissent will be settled. These rarely actually make it to a court hearing for a judge to determine the fair value of the stock due to the cost for the dissenter and the bank, as well as the fact that the court could determine what the dissenter has received under the transaction was fair, was too much, or was too little. In other words, the dissenter actually does have something to lose.

DIRECTOR AND OFFICER INDEMNIFICATION

We have recently spent quite a bit of time with director and officer indemnification issues for a variety of community banks in different situations. Over the past couple months, we have been working to negotiate a transaction agreement where the indemnification provisions have been a significant piece of the negotiation. If you are not familiar, indemnification is a corporation's obligation to either advance or reimburse expenses to a corporate director or executive officer that may become involved in litigation over their actions or duties as a director or executive officer. The general rule is that a corporation either advances or reimburses any expenses (including judgments) the director or officer may incur, as long as it is found that the director or officer acted in good faith with regard to the exercise of his or her duties.

The holding company and bank governing documents, most often referred to as Articles of Incorporation or a Charter, typically contain the provisions directly related to director and officer indemnification. Our general recommendation is that every community bank and bank holding company should provide director and officer indemnification to the extent allowed in the applicable statutes. This acts as a form of insurance for the directors and officers because it ensures they will not be personally liable for nuisance suits or claims when they have acted in an appropriate manner. In this circumstance, the corporation is responsible for bearing the cost of the nuisance claim, not the individual director. The company generally insures its obligation to reimburse the director through directors' and officers' liability insurance.

If your community bank has not done so, we recommend taking a look at the holding company's Articles of Incorporation or Charter and related state law to determine whether they have appropriate provisions related to director and officer indemnification. If your community bank is not offering it, our recommendation is that you give consideration to doing so. If your community bank does not provide director and officer indemnification, it puts the bank and holding company directors and officers at a disadvantage by potentially making them personally liable for nuisance suits and claims. We also think, as a practical matter, it is much more difficult to convince an individual to join as a director or officer if indemnification is not provided (assuming the individual understands corporate indemnification).

COVID IMPACT ON MEETINGS

As we have all experienced since March of 2020, the coronavirus (COVID-19) and its variants have significantly impacted community banks and their boards' ability/desire to meet in person. We have also noticed that banks in various parts of the country have different levels of COVID concerns, as do the state governments. Some states are completely open, as are the banks. Some states are shut down as each new variant comes along. Most of the banks follow suit.

We have found pretty much unequivocally that in-person meetings for any substantive issue (other than a regular board meeting) are far preferable to a video/Zoom meeting or a phone call. Since the beginning of the pandemic, we have been holding in-person meetings with our clients while observing appropriate social distancing and other COVID protocols. Thus far that has worked well.

We encourage your community bank to figure out what works best and is most effective for your group.

NO JAB, NO JOB

As many of you have read in the press, Citigroup has taken the position that if their employees do not get vaccinated by January 14th, they will be put on two weeks of unpaid leave. If they are not vaccinated by the end of the month, they will be terminated. Although there appear to be some exceptions, they do not appear to be broad-based. How about that for another stark difference between a big bank with 70,000 employees and a community bank with often a few hundred at most? We are not aware of any community bank that has taken the position "no jab, no job." Most have, in fact, taken the position that whether or not their employees get vaccinated is a personal decision of the employee. They do depend on their employees not to come in if they have any signs of the virus or are otherwise ill. We have not seen any heavy-handed tactics on the part of community banks, however. This does not surprise us since the community bank culture is one of collaboration and consideration, not domination and destruction.

Although we are all vaccinated as we travel around the country to our community bank clients, we certainly respect those who, for whatever reason, have chosen not to take the jab (or these days, the multiple jabs).

CONCLUSION

We hope each of you and your community banks had a great year-end and an excellent New Year's weekend. We are looking forward to an exciting and rewarding 2022. We hope to see many of you in person.

Stay safe. Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Meetings and Webinars:

- January 20, 2022 – Financial Education & Development Webinar (Philip Smith, presenter) Registration: [Understanding the Current M&A Market for Community Banks]

- February 27-March 3, 2022 – 2022 ICBA LIVE Annual Convention Registration: https://www.icba.org/

- Bank Director Current Issues Seminar
  - "What Every Bank Director Needs to Know" (Jeff Gerrish)
  - "The Board's Role in the Current M&A Environment" (Philip Smith)
- "For Sale? Strategies on Staying Independent" (Philip Smith)
- "Liquidity Strategies for Illiquid Community Bank Stocks" (Greyson Tuck)

