

Community Banking Newsletter

VOL. 2008 NO. 1

TEN COMMANDMENTS FOR DEALING WITH THE REGULATORS IN AN UNCERTAIN ENVIRONMENT

Times have changed. The new frontier is safety and soundness. Be prepared! As a community bank, it is imperative to understand how to deal with the regulators in this current uncertain environment.

I. THE ENVIRONMENT HAS CHANGED.

The regulatory agencies, from the top personnel at the FDIC, the OCC and the Federal Reserve, are expressing concern about asset quality.

These warning signs, at the upper-most levels, filter down regularly to the examination staff who now view it as their mission to critically address these issues in community banks. When the regulators perceive problems, regulatory perception is reality.

II. PREPARE THE BOARD FOR THE CHANGING ENVIRONMENT.

It is very important in this changing environment to prepare your board of directors. This new

environment may be something new for them. Many of us who dealt with troubled banks extensively in the late 70's and early 80's understand, but your directors may not be aware that a new day is dawning. They need to be prepared that the examiners are going to be much tougher, challenging and more restrictive than they have been in recent memory. The preparation of the Board will eliminate Board surprise (although it should not eliminate concern). It may make the difference between the CEO retaining his or her position or being the casualty of a bad exam.

III. PERFORM A SELF ASSESSMENT (OR AN ASSESSMENT WITH PROFESSIONAL HELP).

The best course for a community bank in the current environment is to perform a realistic self assessment prior to an examination. This needs to be done in both the safety and soundness (asset quality primarily) and compliance areas. The bank's identification of its own problems is critical.

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GERRISH McCREARY SMITH
THE CLIENT'S NEEDS COME FIRST

MEMPHIS

700 Colonial Road, Suite 200
Memphis, TN 38117-5156
Tel: (901) 767-0900
Fax: (901) 684-2339

NASHVILLE

5214 Maryland Way, Suite 406
Brentwood, TN 37027-5071
Tel: (615) 251-0900
Fax: (615) 251-0975

IV. TREAT EXAMINATION PERSONNEL THE WAY YOU WOULD LIKE TO BE TREATED.

When the examiners come in the bank, it is not fruitful to create a hostile environment. The best rule is to follow the “Golden Rule” and treat the examiners the way you would like to be treated if you were in their shoes. They have a tough job. So do you. Personal respect and open communications are the watchwords for a successful, fair and impartial examination. The alternative approach, e.g. Keystone, West Virginia where the bank management attempted to intimidate and harass the examiners, may work for the short run but not for the long run.

V. NOTE YOUR DISAGREEMENT WITH THE EXAMINERS EARLY ON AND WITH SPECIFICITY.

Contrary to the belief of many community bankers, the examiners are human. They tend to forget. If the examiners extend a criticism and it goes un rebutted, then they assume that you agree with it. If you make a comment and you do not do so in writing, then it becomes lost in the shuffle or “it never occurred.” Any comments, criticisms, or disagreements you have with the examination or the examiners should be noted in writing early on and delivered to the examiner-in-charge. This eliminates any question of fading memories or recollections over the long term.

VI. UNDERSTAND THE REGULATORS’ OPTIONS WHEN DEALING WITH INSTITUTIONS WHICH THEY BELIEVE NEED CORRECTIVE ASSISTANCE.

The regulators have a myriad of options for dealing with institutions which they believe need a “corrective” program. These options range

from a board resolution to a memorandum of understanding to a formal agreement to a cease-and-desist order to a termination of insurance action. Potential civil money penalties for directors, officers, and others are also in the mix. It is important to understand the impact and enforceability of each of the regulators’ options. For example, a resolution or memorandum of understanding, if it is violated, cannot be enforced with civil penalties. A formal agreement and cease-and-desist order can be subject to civil penalties of hundreds of thousands of dollars a day. Under certain of the options, federal court enforcement is also available. It is important to understand what the regulators are proposing and the impact of the alternative.

VII. THE COMMUNITY BANK MUST UNDERSTAND ITS OPTIONS IN CONNECTION WITH DEALING WITH THE REGULATORS.

Just as it is necessary to understand the regulators’ options, it is also necessary to focus on the community bank’s options when dealing with the regulators. Fortunately, we still live in the United States of America where “due process” is available. Simply because the regulators propose an enforcement action does not mean that it becomes effective without the Board’s agreement. The Board can negotiate or litigate. Negotiations generally take place through a professional, but the Board needs to realize that it is not required to agree to whatever piece of paper the regulators put forth. In its most extreme form, this means that the bank is generally entitled to an administrative hearing before an administrative law judge and an impartial third party decision before any corrective action, particularly one enforceable with civil penalties or in federal court, can be imposed. Keep in mind, however, the regulators want to have their own way and will use intimidation of your Board to get it.

TEN COMMANDMENTS FOR DEALING WITH THE REGULATORS IN AN UNCERTAIN ENVIRONMENT (CONT.)

VIII. WORK WITH THE REGULATORS TOWARD A WIN/WIN RESULT.

The regulators' goal is not to destroy your institution. The regulators' goal is to get it back into regulatory compliance, with adequate capital and good management. The important thing is to correct the condition of the institution and to correct the perception in the regulators' eyes. Any negotiated settlement should be a win/win for everybody and a reduction of risks for the Board.

IX. REALIZE THAT THE EXAMINERS AND REGULATORY PERSONNEL ARE NOT NECESSARILY YOUR FRIENDS, BUT THEY ARE YOUR NEIGHBORS.

The regulators are not necessarily your friends. They have a job to do, which is to protect their reputations (and/or the insurance fund) and to make sure that banks operate within the guidelines set forth. Their job is not to help you. Their job is not to identify problems for your benefit. They do not like surprises. Their job is to do their own job. They are not your friends. They are your neighbors, however, meaning that you will have to live with them long beyond the last exam. Treat them accordingly.

X. REALIZE YOUR OWN LIMITATIONS.

Many community banks do not have a "corporate memory" that includes dealing with troubled situations. Obtain the necessary perspective on a troubled institution even if you have to go outside through consultants or other advisors to do it. It will provide comfort to the Board and expertise in solving the problems addressed by the regulators. Find professionals who under-

stand the lay of the land and the regulatory mindset.

Following these Ten Commandments for Dealing with the Regulators in an Uncertain Environment should assist your bank in a smooth transition through a difficult time.

If you would like more information, please request "Dealing with the Regulators in an Uncertain Environment" - a new 46-page Gerrish McCreary Smith handout which we will email on a complimentary basis.

Jeff Gerrish

Gerrish McCreary Smith

Established 1988

Our Mission

THE CLIENT'S NEEDS COME FIRST

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GERRISH'S MUSINGS

Gerrish's Musings is a twice-per-month subscription newsletter based on Jeff Gerrish's recent experiences with community banks around the nation. It is designed for bank directors and officers and is "choked full" of relevant, practical commentary to benefit community bank boards and officers.

Gerrish's Musings is available by email for your entire board for one nominal subscription price. For further information, please contact Linda Dandridge at (901) 684-2323 or ldandridge@gerrish.com.

RESOURCE MATERIALS

Gerrish McCreary Smith, Consultants and Attorneys, in connection with various speaking engagements around the country, have created high quality “handout” booklets. The titles for some of these publications are listed below.

Gerrish McCreary Smith Memos to Clients and Friends on the following topics (available free of charge):

- Administrative Law Hearing
- Attracting Core Deposits
- C Corp versus S Corp Comparison
- Civil Money Penalty Process
- Conversion of Credit Union to Mutual Savings Association
- Conversion of Credit Union to Stock Institution
- Conversion of Mutual Savings Association to Stock Institution
- Counting Shareholders for SEC Purposes
- Dealing with the Regulators in an Uncertain Environment
- Effecting Share Repurchases
- Electronic Board Book Programs
- FDIC Appeals Process
- Going Private by Reclassification of Stock
- Incentive Compensation Plans
- Requirements for an ESOP 1042 Transaction
- Responding to Unsolicited Offers
- Restricted Stock Plans
- SEC Executive Compensation Rule
- Section 409A
- Small Bank Holding Company Policy Statement
- Subchapter S Shareholder Consents
- Subchapter S Tax-Exempt Income
- Taxation of Stock Redemptions
- Ten Rules for Capital
- Treasury and Authorized but Unissued Shares

The following publications are available for a nominal charge:

- Controlling Your Destiny – Washington Bankers Association
- Corporate Governance: What is a Director to Do? Realities Post-Enron – American Bankers Association
- Directors Responsibilities in Mergers & Acquisitions: Responding to the Unsolicited Offer – The Assemblies for Bank Directors
- Directors' Liability – Arkansas Bankers Association
- Environment in 2020 – Community Bankers Association of Illinois

Practical Benefits and Uses of a Bank Holding Company – Western Independent Bankers

Is Your Strategic Planning a Waste of Time? – American Bankers Association

Managing Through the Current Regulatory Environment – Virginia Bankers Association

Mastering the Mundane: Excelling at the Unusual (includes discussion of general duties, mergers and acquisitions, stock redemptions, regulatory enforcement actions) – Independent Community Bankers of America

Matters of Importance to Community Banks (focusing on 10 specific issues for community banks) – Independent Community Bankers of America

Overview of the Role of the Community Bank Director – Community Bankers Association of Georgia

Stock Ownership of Community Banks – Independent Community Bankers of America

Strategic Planning Today – Independent Community Bankers of America

10 Issues of Critical Importance for Profitable Community Banking – West Virginia Association of Community Bankers

Ten Essentials for Community Bank Directors – Tennessee Bankers Association

The Primary Role of the Director: Enhancing Shareholder Value – Missouri Independent Bankers Association

Trust Preferred Securities – Independent Community Bankers of America

If you are interested in any of these publications, please call or email Linda Dandridge at (901) 684-2323 or ldandridge@gerrish.com.

SUB S STILL HOT

The reorganization of community banks into Subchapter S status remains a hot topic for 2008. However, many organizations still do not fully understand the process. You do not have to go out and voluntarily ask each stockholder to consent. A transaction can be structured to guarantee 100% consent. Also, did you know you can eliminate stockholders who live out-of-state or do not do business with your organization? For further information about how to properly structure a Subchapter S transaction for your organization, please contact Jeff Gerrish or Philip Smith (901-767-0900 or jgerrish@gerrish.com and psmith@gerrish.com).

Please visit our newly redesigned web site at: www.gerrish.com
We would appreciate your feedback.



SCHEDULE YOUR STRATEGIC PLANNING NOW!

Several members of Gerrish McCreary Smith facilitate strategic planning sessions for community banks. With the Fall planning season rapidly approaching, please call or email for a proposal and to secure a date for your Board's retreat.

GERRISH McCREARY SMITH AFFILIATED RESOURCES

Over the last 20 years or so of exclusively helping community banks across the nation, we have developed relationships with various service providers who we believe provide the best services in their particular niche. This includes branch location specialists, appraisers, fairness opinion providers, IPO managers, equipment lease sales, securities transfer agents, loan review, compliance review, auditors, bank technology specialists, executive placement and the like.

If you need any of these services and are not sure who to call, please let me know and we will provide some recommendations.

Jeff Gerrish

CHAIRMAN'S ALERT!

Because of the overwhelming success of the recent Chairman's Forum hosted by Jeff Gerrish and Philip Smith in conjunction with the ICBA and in response to the requests we have received from chairmen across the country requesting more specific information exclusively for chairmen, we are happy to announce a new subscription-based email newsletter exclusively for chairmen. To get on the initial subscription list or to request more information, please contact Philip Smith at psmith@gerrish.com.

Books Available

- The Bank Directors Bible: Commandments for Community Bank Directors, 3rd Edition – A compilation of “Ten Commandment” articles for bank directors and executive officers on topics ranging from strategic planning to mergers and acquisitions to troubled banks.
- Gerrish's Glossary for Bank Directors – A readable glossary. All relevant terms defined with a little bit of fun thrown in. A must for your bank directors.

To obtain information about purchasing either of these books, please contact Linda Dandridge at (901) 684-2323 or ldandridge@gerrish.com.

EDITORIAL STAFF

EDITORS IN CHIEF: Jeffrey C. Gerrish
Philip K. Smith

MANAGING EDITOR: Linda R. Dandridge

CONTRIBUTING EDITOR: Greyson E. Tuck

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Please address comments or questions regarding the newsletter to Jeffrey C. Gerrish, Gerrish McCreary Smith, PC, 700 Colonial Road, Suite 200, Memphis, TN 38117, or to our email address: gms@gerrish.com.

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COMMON MISTAKES OF BUYERS AND SELLERS IN AN ACQUISITION

Through the unique combination of our consulting firm and law firm, we have been fortunate to assist both buyers and sellers in the merger and acquisition process. From this unique perspective, we repeatedly see the same mistakes being made by both buyers and sellers. Set forth below is a summary of five of the most common mistakes made by buyers and sellers in the acquisition context. Contrary to the general consensus of the investment banking community, our firm believes there will be significant opportunities for community banks to acquire some of the smaller community banks in 2008. We trust this information will help you as you confront buy or sell decisions in 2008 and beyond.

Five Common Mistakes of Sellers

1. Pricing expectations beyond what the market will bear. Everybody thinks their bank is unique. Everybody also thinks their bank deserves the best premium ever paid “for a bank of our size with our uniqueness”. As a result, many boards expect to receive a price beyond what the market will bear. The result is often a board and management disappointed with the amount and type of offers received (if any). The key is to remember to have your expectations set appropriately according to current market conditions. You must take an objective view of your organization and engage in the process with a large dose of reality.

2. Not understanding how banks are valued. Purchasers do not buy capital, they buy future earnings potential. Too often, we see institutions that assume their worth is two times book value because trade journals they have seen show average pricing multiples of two times book value. Nothing could be further from the truth. Banks are priced according to their current earnings and prospects for future earnings, not their capital.

3. Structuring a merger of equals. There is no such thing as a merger of equals. A sale by any other name is still a sale. We try to encourage institutions that may be thinking about some type of general “affiliation” with an

other institution to realize that you are either a buyer or a seller. If a board of directors does not want to sell, but is willing to consider a merger of equals, we advise them that they really do not want to sell and they should apply their efforts elsewhere.

4. Timing. Achieving the best value for your organization may not always be a function of having the perfect organization to sell. Unless there are buyers, your perfect bank does not stand a chance. The goal is to time the market so that your bank has some “sizzle” to sell and someone willing to pay for it. Timing is about making sure your institution is in the optimum condition given market circumstances and the number of potential buyers. Your bank’s maximum value may come following a year in which earnings are fairly strong, there are a number of suitors and market conditions indicate the future may not present an equally viable acquisition window.

5. Not getting value from your professionals. Sometimes, institutions make the fatal mistake of assuming that, if they have received a few expressions of interest, they could save themselves a lot of time and money by simply negotiating on their own with the potential buyer. However, professionals should add value to the overall transaction, rather than taking from the value. As an example, through our financial advisory and consulting practices, we often will be paid, in addition to hourly fee work, a success fee for the additional value above a certain benchmark that we bring to the transaction. This provides an incentive to drive the value up. It is a win-win situation and you should make sure you similarly get value from your professionals.

If a scenario for a possible sale presents itself, please consider these cautionary issues and avoid making these mistakes.

Five Common Mistakes of Buyers

1. Getting the board ahead of the numbers. Too often, we see institutions get into a “buying frenzy” and start down the acquisition road without even knowing if they can afford it or if it is a good fit geographically, strategically or otherwise. The first step should be to conduct an in-depth financial analysis to determine the price they can afford to pay, how they would fund any acquisition and if the transaction makes sense in terms of adding to

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the buyer's bottom line earnings per share. Only when these variables are known should a bank begin to actively pursue an acquisition.

2. Failure to lock up key individuals. Too many buyers fail to appreciate the impact an acquisition has from a seller's standpoint. Key management personnel and even general staff in an organization are often critical to its ongoing efficiency. A buyer that fails to lock up senior management through employment contracts or otherwise may find the earnings stream it had hoped to purchase no longer exists because key producers have taken positions elsewhere.

3. Not conducting adequate due diligence. The key purpose in making an acquisition is (or should be) to add to the buyer's bottom line. Most sellers recognize that and try to make their organization as free as possible from "warts and wrinkles" during the acquisition process. However, it is incumbent upon buyers to thoroughly conduct a due diligence to make sure the target organization is as represented.

4. Using the wrong method of payment. From a buyer's standpoint, consideration needs to be given to whether a seller wants stock from a buyer, cash or some combination. In most community bank situations, the seller is only interested in cash from another community organization. From the buyer's standpoint, the buyer should consider the source of any cash that is going to be paid. Banks should consider all of their options in order to optimize their purchasing power.

5. Why buy it if you can steal it? Too often, buyers, particularly those in the same market, aggressively pursue an acquisition as a method of eliminating competition from entering the market. In some circumstances, that may be a valid option. However, if the acquisition does not truly fit within an organization's overall strategic plan, caution should be taken. The organization would be better off simply picking up or "stealing" all of the business of a new competitor in the market rather than paying a premium for it on the front end.

As you navigate the merger and acquisition environment, keep these common pitfalls in mind. If we can be of assistance in helping you along the way, please let us know and contact Jeff Gerrish or Philip Smith.

CUSTOM DIRECTOR PROGRAMS & PRESENTATIONS

In addition to facilitating numerous strategic planning retreats and proprietary director and officer training sessions, Gerrish McCreary Smith also has recently provided speakers for the following trade associations:

- Arkansas Community Bankers
- Bank Holding Companies Association
- California Independent Bankers
- Community Bankers Association of Alabama
- Community Bankers Association of Georgia
- Community Bankers Association of Illinois
- Community Bankers Association of Indiana
- Federal Home Loan Bank of Kansas City
- Federal Home Loan Bank of Seattle
- Independent Bankers of Colorado
- Independent Community Bankers of America
- Independent Community Banks of North Dakota
- Independent Community Banks of South Dakota
- Indiana Bankers Association
- Iowa Independent Bankers
- Louisiana Bankers Association
- Missouri Independent Bankers Association
- Montana Independent Bankers
- National Bankers Association
- Tennessee Bankers Association
- Texas Bankers Association
- Virginia Association of Community Banks
- Washington Bankers Association
- Washington Independent Community Bankers Association
- West Virginia Association of Community Bankers
- Western Independent Bankers

Topics include enhancing shareholder value with or without sale, corporate governance, strategic planning, mergers and acquisitions, employee benefits, mediation and other dispute resolutions, and similar topics.

Please email us or visit our website at www.gerrish.com for a complete listing of upcoming conferences and seminars at which we will be providing speakers. Gerrish McCreary Smith, Consultants and Attorneys, is also available to facilitate strategic planning retreats and proprietary director training designed for your board of directors.

Please contact Linda Dandridge for further information at ldandridge@gerrish.com or (901) 684-2323.

NEWSLETTER HIGHLIGHTS

- Ten Commandments for Dealing With the Regulators in an Uncertain Environment
- Sub S Still Hot
- Common Mistakes of Buyers and Sellers in an Acquisition

AREAS OF SERVICE

Gerrish McCreary Smith Consultants, LLC and Gerrish McCreary Smith, PC, Attorneys are committed to the delivery of the highest quality, timely and most effective consulting and legal services **exclusively to community financial institutions** in the following areas:

FINANCIAL ADVISORY/ CONSULTING SERVICES

Financial Modeling	Subchapter S	Executive Compensation
Acquisition	Financial Analysis	Employee Benefits
	Strategic Planning	Estate Planning
	Capital Planning	Mergers & Acquisitions
	Tax Planning	New Bank Formations
	S Corporations	Going Private

LEGAL SERVICES

Mergers and Acquisitions	Securities Offerings
New Bank Formations	Holding Company Formations
Dealing with Regulators	Director and Officer Liability
Regulatory Enforcement Actions	Fair Lending
Employee Benefits	Executive Compensation
ESOPs	Federal and State Taxation
Private Securities Placements	General Corporate & Securities
Estate Planning for Executives	Probate
S Corp Formations	Going Private

GERRISH McCREARY SMITH

Consultants and Attorneys

700 Colonial Road, Suite 200
Memphis, TN 38117

P. O. Box 242120
Memphis, TN 38124-2120

www.gerrish.com

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