GERRISH McCREARY SMITH

MERGERS AND ACQUISITIONS COMING TO A BANK NEAR YOU

Now is the time to prepare your Board of Directors for the coming opportunities/onslaught of mergers and acquisitions involving community banks. Notwithstanding the fact that the industry is in a deep "trough" right now with the end not nearly in sight, there will, at some point in the future, be a significant uptick in mergers and acquisitions. These will not only be transactions involving failed banks, but also acquisitions of healthy institutions who have simply had all the fun they can stand. The acquisitions will also involve the acquisitions of locations (in some cases, real estate only) and branches, which in all cases would generally mean deposits and some loans and other assets. The time to educate your Board with respect to M&A is now, not when the opportunity occurs.

The Board should focus on at least the following:

1. What is the Bank's strategic interest in doing an acquisition? In other words, why would the Bank and holding company do it? Does it fit with the Bank's strategic plan? What is the Bank's geographic reach? What benefit would the Bank receive from an acquisition, e.g. new markets, additional management, new products, additional distribution channels, and the like?

2. How does the Bank identify an acquisition opportunity? If the Board's strategy is to be proactive on acquisitions, that means management and its advisors must identify what the Bank is looking for, find it, court it, and cut the deal. If the Board is going to be reactive, then the Bank can wait for the call from the FDIC or the large bank with respect to the branch. The Board needs to make a determination whether it is going to be proactive or reactive, and then implement the plan.

3. How does the holding company pay for it? Is the Board willing to issue holding company stock? Would any seller take the holding company stock? Can the holding company add shareholders? Is the holding company a Subchapter S and at its shareholder limit? Does the holding company have a liquid or marketable stock? Can the holding company make a market in the stock? Can the holding company sell a seller on the sizzle of the stock going forward? Should the holding company pay cash? How is the holding company going to generate the cash to pay? Is the holding company over $500 million so that the Board must consider the consolidated capital rules? Can the holding company borrow the money somehow? Does the holding company have to sell equity to generate the cash even though the seller does not take equity? How much dilution of ownership are the holding company shareholders willing to suffer? Is the Board prepared to do a deal where the holding company may end up with a large, i.e. north of 25%, shareholder because the target bank is closely held? All of these questions need to be addressed and answered by the Board.

4. How does the holding company price an acquisition? Historically, until the recent downturn, acquisitions have been priced based on the earnings stream that the buyer receives from the seller post-acquisition.

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Because earnings have been deeply depressed, acquisitions are now being priced basically off hard equity. The reality is, the Board needs to understand that the shareholders of the buyer's holding company need to be better off after a deal than they were before. This generally means that the target institution eventually is going to bring more in earnings than the buying bank holding company gives up in connection with whatever it pays, i.e. stock or cash. In other words, will the earnings per share of the buyer be higher than they were before the deal, within some reasonable time horizon?

5. Is the Board prepared to acquire an institution that is slightly impaired? Slightly impaired is a polite word for "troubled." Does the Board have the appetite for the risk associated with a bank that is slightly impaired? These are not the brain-dead, life support, hospice unit banks, but they are, in fact, banks having asset quality problems, which, hopefully, are on a temporary basis. Does the Board have the appetite for that kind of risk, or will the Board only entertain a transaction where the risk is mitigated by the FDIC (in connection with a failed bank) or the bank is clean and non-troubled?

6. Does the Board understand due diligence concerns? The issue boils down to, how does the Board assess the risk in the target bank? If the target is receiving stock of the buyer, then the target is also going to want to do due diligence of the buying bank. The Board needs to be prepared for that to occur as well.

7. What about the social issues? If the Board really wants to move forward in mergers and acquisitions, is the Board willing to give up board seats? Is the Board willing to change the name of the bank? Would the Board be willing to relocate the holding company? Would the Board be willing to change the name of the holding company? And, oh, by the way, who is going to run the whole thing? Most transactions are derailed in the early stage by the social issues, not the financial issues.

8. If the Bank decides to acquire a branch, does the Board understand how that works? Does the Board know that the branch acquisition structure (a purchase and assumption transaction) limits the Bank's liability? Does the Board also understand that most sellers are now going to want the buying bank to take some loans along with the deposits assumed, simply because they do not have the cash (liquidity) to give to the buyer to offset the deposit liabilities assumed? Does the Board have the appetite for that kind of risk?

All of these issues, if the Board is planning on moving forward in acquisitions as the industry consolidates, need to be addressed. We have had lots of experience in the merger and acquisition arena, as both attorneys and consultants, on the financial/consulting, investment banking and legal pieces. Please let me know how we can assist.

Jeff Gerrish
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REGULATORY VICTORY

As many of you know from the trade press, FDIC, the regulator of the largest number of community banks, has moved away from the Cease and Desist Order as its formal enforcement action of choice toward the much more user-friendly "Consent Order." The former Cease and Desist Order, as those of you who keep track of such things know, contained some very obnoxious, publicly inflammatory boilerplate language, which had been present for over 25 years. As a result of the actions of our firm's Chairman of the Board, Jeff Gerrish, the FDIC reconsidered these matters and came out with the much more user-friendly Consent Order. We are pleased we have been able to serve the industry in this regard and publicly thank FDIC Chairman Bair for her personal involvement in causing this change.

LEADING A SCARED BOARD

Is your Board of Directors scared? Are they frightened of the regulators, scared of having their personal net worth jeopardized, concerned about personal and professional liability, worried about loan approvals made in the past with little or no thought to the consequences? If your Board is still in existence these days, the answer to one or more of those questions is probably "yes." This, then, calls for extraordinary leadership by the Chairman of the Board.

Our firm has had the opportunity to put together unique educational programs specifically for Chairmen of the Board, including the Community Bank Chairman's Forum, which is held twice each year in conjunction with the ICBA, and will be held this year in June in Coeur d'Alene, Idaho, and in November in Las Vegas, Nevada. At those sessions, one of the things we will be discussing is the emerging role of the Chairman in leading a scared Board. For more information about the Conference, visit our website at www.gerrish.com or the ICBA's website at www.icba.org.

The issue of the leadership of the Chairman in these difficult times is also highlighted in our firm's monthly electronic newsletter, The Chairman's Forum Newsletter. In the February edition, we spotlight this concern of the Chairman leading a scared Board. Some of the key issues discussed in that newsletter include:

- The Chairman needs to be the backbone of the Board, including standing up to the regulators, as appropriate.
- The Chairman needs to understand that throwing the President and CEO "under the bus" rarely is appropriate and almost never "curries" regulatory favor. Frankly, if you are going to get rid of the President, you might as well get rid of the entire Board.
- The Chairman must have a strategic vision for the organization.

To learn more about the Chairman's role, the Chairman's Forum, and The Chairman's Forum Newsletter, visit www.gerrish.com.

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REGULATORY ENFORCEMENT ACTIONS: THE TERMS ARE NOT SET IN STONE

In this environment of increased regulatory scrutiny, many banking institutions are being subjected to regulatory enforcement actions such as a Memorandum of Understanding ("MOU"), Consent Order, Cease and Desist Order, Formal Agreement or Written Agreement. The regulators generally present the enforcement action so as to make the bank believe that they are expected to sign the enforcement action as initially proposed. Unfortunately, many banks fall in line with this approach either because they (1) don't think they should oppose their regulator, (2) don't believe the regulator will agree to any more favorable terms or (3) believe they don't have a choice.

The regulators cannot put an enforcement action in place unless (1) the Board consents to the action on behalf of the bank, or (2) the regulator proves its case at an administrative hearing (similar to a civil trial). For this reason, the regulators are generally willing to negotiate on some of the terms of the enforcement action. In cases where the regulator will not negotiate, the Board has the right, on behalf of the bank, to refuse to consent to the action and argue at the administrative hearing that the enforcement action should not be put in place.

Take your time considering an enforcement action, understand your options, and make the decision that is in the bank's best interest. The Board must ensure that the terms of the enforcement action can be complied with, since formal enforcement actions can be enforced with civil money penalties or in federal court. Our firm has handled hundreds of enforcement actions over the years. Please let us know if we can assist.

Gerrish McCreary Smith
Established 1988
<u>Our Mission</u>
The Client's Needs Come First
www.gerrish.com

RESOURCE MATERIALS

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

- 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
- Enforcement Action Issues: The Administrative Law Hearing
- ESOP Tax-Free Rollover Requirements
- FDIC Appeals Process
- Going Private by Reclassification of Stock
- Incentive Compensation Plans
- Responding to Unsolicited Offers
- Restricted Stock Plans
- SEC Executive Compensation Rule
- Section 409A Deferred Compensation Issues
- 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

Gerrish McCreary Smith, Consultants and Attorneys, in connection with various speaking engagements around the country, have created high quality "handout" booklets. A list of certain of these publications is set forth below. These 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

Everything You Need to Know About Stockholders - Western Independent Bankers

Is a Holding Company in Your Bank's Future? - 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

The Pros and Cons of Converting to Subchapter S / Community Banks: The Right Stuff for the Future - Community Bankers of Wisconsin

The Role of the Chairman in a Changing Environment - American Bankers Association

Stock Ownership of Community Banks – Independent Community Bankers of America

Strategic Planning in a Difficult Environment - Florida Bankers Association

Strategic Planning Today – Independent Community Bankers of America

Surviving the Short Term and Excelling at the Long Term - 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

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

Please visit our website at: www.gerrish.com
We would appreciate your feedback.

CAPITAL IS KING

As community banks have endured the downturn, we have all been reminded that "capital is king." Capital becomes more king after the snowball effect, i.e. asset quality deterioration resulting in earnings elimination and capital reduction, takes place. Notwithstanding what is happening with the billion dollar plus banks, community banks are still having difficult times raising capital. Talk all you will about "private equity," it simply is not there for most community banks. As a result, most community banks will raise money through "friends, families, and their circle of influence." This generally results in a private placement of equity securities (of some type – common, preferred, convertible, etc.). We have had the opportunity to assist numerous community banks over the last year and a half in private placements of equity securities. Please contact us if we can help or you would like to explore this further.

Schedule Your Strategic Planning Now

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

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 "chocked full" of relevant, practical commentary to benefit community bank boards and officers.

Gerrish's Musings is available by email for your entire board and officer group for one nominal subscription price. For further information, please contact Linda Dandridge at (901) 684-2323 or ldandridge@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 dealing with the regulators and 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.

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ARE ESOPS STILL A GOOD DEAL?

ESOPs are still a great deal for community bank holding companies. For non-publicly traded bank holding companies, independent appraisals on bank holding company stock have generally been declining in value over the last two years. This is due to decreased financial performance of banks, as well as a general discount for financial institution stock (deservedly or undeservedly) because of the downturn in stock prices in the market. A number of banks have taken advantage of the lower price to establish Employee Stock Ownership Plans ("ESOPs") for their employees. Leveraged or nonleveraged ESOPs can now buy substantially more stock with ESOP funds than they could several years ago. This increased benefit for employees is an opportunity for growth of retirement account balances that traditionally would not have been available without the downturn.

ESOPs continue to offer substantial tax benefits to the holding company, as well as an opportunity to raise capital for bank holding companies with consolidated assets of less than $500 million when the capital markets are tight. The use of a 401(k) feature with an ESOP or converting 401(k) Plans to 401(k) ESOPs (or "KSOPs") have become an alternative that many banks are choosing. The legislative purpose of ESOPs is to promote employee ownership of employer stock, so there is protection for Trustees of ESOPs when funds that must be invested in diversified assets in other retirement plans are substantially invested in employer stock in ESOPs.

Providing employees with an incentive through an ESOP should help to increase the value of bank holding company stock, which will go a long way in this recovery period to enhance value for shareholders and to provide a significant employee benefit.

WE ARE GOING GREEN!

Send your email address to Linda Dandridge at ldandridge@gerrish.com.

SUB S STILL HOT

Subchapter S is certainly not new. It has been available to community banks for over 10 years. We continue to receive inquiries from banks who are contemplating Subchapter S. The usual comment from a bank that is contemplating Sub S at this stage of the game is, "Our bank holding company wants to do a Sub S, but we can't because one of our shareholders will not go along."

The polite answer on that is – wrong. If the holding company can, in most cases, receive a vote of 50% of the shares in favor of the Sub S, the holding company can convert to Sub S. If you have interest in Subchapter S and want to know how it works, please contact us and we will walk you through the process.

MANAGEMENT STUDY?

If you get stuck with a Consent Order, Written Agreement or some other enforcement action that requires a management study, please call us. Unfortunately, we have lots of experience.

GERRISH McCREARY SMITH AFFILIATED RESOURCES

Over the last 25 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 bank compliance experts, branch location specialists, stock appraisers, fairness opinion providers, IPO managers, securities transfer agents, loan 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
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CAVEAT EMPTOR!

"Let the buyer beware." That often quoted phrase has been said to be applicable in a number of situations. Community bank merger accounting can now be added to the list.

2009 brought the implementation of FASB 141R and the requirement that all bank acquisitions use the new Acquisition Method of accounting for bank mergers. As a result, bank acquirors are now required to value the assets acquired and liabilities assumed in a bank combination at their "fair value" as of the date of purchase. The difficulty for many bank acquirors will be determining the value of a target bank's most prominent assets – its loans – prior to the acquisition date.

The fair value of a loan acquired in a bank transaction is not determined by the amount of principal outstanding or what was paid to acquire the loan. Instead, the value is based on a number of factors, including the interest rate, loan term, type, collateral, and credit rating of the borrower. Each of these factors is considered independently, with there being no specific requirements on how each is weighted.

The new acquisition accounting rules allow some loans with similar characteristics to be pooled, and the loan pool valued on an aggregate basis. However, for larger and more complex loans, the loan must be valued on an individual basis. This adds uncertainty to the acquisition process, because the potential acquiror cannot determine with absolute confidence the fair value of the assets being purchased until the acquisition is complete. That value is important because it has a number of effects, including the amount of goodwill created as a result of the transaction.

Bank acquirors need to be familiar with the new accounting rules for valuing assets in a bank acquisition. These rules require a target bank's assets, including its loans, to be transferred to the acquiror at their fair value on the date of the acquisition. The problem is that fair value is not easily determined prior to the acquisition date, which could yield unexpected results.

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:

- American Bankers Association
- Arkansas Community Bankers
- California Independent Bankers
- Community Bankers Association of Alabama
- Community Bankers Association of Georgia
- Community Bankers Association of Illinois
- Community Bankers of West Virginia
- 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
- Michigan Association of Community Bankers
- Montana Independent Bankers
- Tennessee Bankers Association
- Virginia Association of Community Banks
- Washington Bankers Association
- Western Independent Bankers

Topics include maintaining shareholder value, mergers and acquisitions, dealing with the regulators in an uncertain environment, corporate governance, strategic planning, 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.

THE CHAIRMAN'S FORUM NEWSLETTER

The Chairman's Forum Newsletter is a monthly subscription email newsletter exclusively designed for Chairmen and available for a nominal charge. For information, contact Carolyn Martin at (901) 684-2326 or cmartin@gerrish.com.

Newsletter Highlights

- Mergers and Acquisitions Coming to a Bank Near You
- Regulatory Victories
- Leading a Scared Board
- Regulatory Enforcement Actions: The Terms Are Not Set In Stone
- Capital Is King
- Are ESOPs Still a Good Deal?
- Sub S Still Hot
- Caveat Emptor!

Areas of Service

Gerrish McCreary Smith, LLC, Consultants 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
Directors' Liability	Expert Witness

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

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