The Directors’ Dilemma: Do What You Should? Or, Do What You Can?

Presented by:
Philip K. Smith, President
Gerrish McCreary Smith, Consultants and Attorneys

Presented for the:
Arkansas Community Bankers
2016 Bank Management and Directors Conference
Little Rock, Arkansas
October 27, 2016
You can view or download Philip Smith’s materials for the Arkansas Community Bankers 2016 Bank Management and Directors Conference from our website at www.gerrish.com.

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PHILIP K. SMITH. Mr. Smith is the President and a member of the Board of Directors of the Memphis-based law firm of Gerrish McCreary Smith, PC, and its affiliated bank consulting firm, Gerrish McCreary Smith Consultants, LLC. Mr. Smith's legal and consulting practice places special emphasis on bank mergers and acquisitions, financial analysis, acquisition and ownership planning for boards of directors, strategic planning for boards of directors, regulatory matters, bank holding company formations and use, securities law concerns, new bank formations, S corporations, going private transactions, and other matters of importance to banks and financial institutions. He is a frequent speaker to boards of directors and a presenter at numerous banking seminars. He received his undergraduate business degree and Masters of Business Administration degree from the Fogelman School of Business and Economics at The University of Memphis and his law degree from the Cecil C. Humphreys School of Law at The University of Memphis. He is authoring a monthly electronic newsletter, *The Chairman’s Forum Newsletter*, which discusses key topics impacting financial institutions and, specifically, the role of the Chairman. Mr. Smith is a Summa Cum Laude graduate of the Barret School of Banking where he has been a member of the faculty. He has also served as a member of the faculty of the Pacific Coast Banking School, the Colorado Graduate School of Banking, the Southwestern Graduate School of Banking and the Wisconsin Graduate School of Banking.

Gerrish McCreary Smith Consultants, LLC and Gerrish McCreary Smith, PC, Attorneys offer consulting, financial advisory and legal services to community banks nationwide in the following areas: strategic planning; mergers and acquisitions, both financial analysis and legal services; dealing with the regulators, particularly involving troubled banks, memoranda of understanding, cease and desist orders, consent orders and compliance; structuring and formation of bank holding companies; capital planning; employee stock ownership plans, leveraged ESOPs, KSOPs and incentive compensation packages; directors and officers liability; new bank formations; S corporation formations; going private transactions; and public and private securities offerings. Gerrish McCreary Smith, PC, Attorneys has been ranked as high as third nationally by number of transactions in bank mergers and acquisitions.
Mergers & Acquisitions
Analysis of Business and Financial Issues
Target Identification and Potential Buyer Evaluation
Preparation and Negotiation of Definitive Agreements
Preparation of Regulatory Applications
Due Diligence Reviews
Tax Analysis
Securities Law Compliance
Leveraged Buyouts
Anti-Takeover Planning
Going Private Transactions
Financial Modeling and Analysis
Transaction Pricing Analysis
Fairness Opinions

Bank and Thrift Holding Company Formations
Structure and Formation
Ownership and Control Planning
New Product and Service Advice
Preparation of Regulatory Applications
Financial Modeling and Analysis

New Bank and Thrift Organizations
Organizational and Regulatory Advice
Business Plan Creation
Preparation of Financial Statement Projections
Preparation of the Interagency Charter and Federal Deposit Insurance Application
Private Placements and Public Stock Offerings
Development of Bank Policies

Financial Modeling and Analysis
Financial Statement Projections
Business and Strategic Plans
Ability to Pay Analysis
Net Present Value and Internal Rate of Return Analysis
Mergers and Acquisitions Analysis
Subchapter S Election Analysis

Bank Regulatory Guidance and Examination Preparation
Preparation of Regulatory Applications
Examination Planning and Preparation
Regulatory Compliance Matters
Charter Conversions

Subchapter S Conversions and Elections
Financial and Tax Analysis and Advice
Reorganization Analysis and Restructuring
Cash-Out Mergers
Stockholders Agreements
Financial Modeling and Analysis

Strategic Planning Retreats
Customized Director and Officer Retreats
Long-Term Business Planning
Assistance and Advice in Implementing Strategic Plans
Business and Strategic Plan Preparation and Analysis
Director Education

Capital Planning and Raising
Private Placements and Public Offerings of Securities
Bank Stock Loans
Capital Plans

Problem Banks and Thrifts Issues
Examiner Dispute Resolution
Negotiation of Memoranda of Understanding and Consent Orders
Negotiation and Litigation of Administrative Enforcement Actions
Defense of Directors in Failed Bank Litigation
Management Evaluations and Plans
Failed Institution Acquisitions
New Capital Raising and Capital Plans
Appeals of Material Supervisory Determinations

Executive Compensation and Employee Benefit Plans
Employee Stock Ownership Plans
401(k) Plans
Leveraged ESOP Transactions
Incentive Compensation and Stock Option Plans
Employment Agreements-Golden Parachutes
Profit Sharing and Pension Plans

General Corporate Matters
Corporate Governance Planning and Advice
Recapitalization and Reorganization Analysis and Implementation

Taxation
Tax Planning
Tax Controversy Negotiation and Advice

Estate Planning for Community Bank Executives
Wills, Trusts, and Other Estate Planning Documents
Estate Tax Savings Techniques
Probate

Other
Public Speaking Engagements for Banking Industry Groups (i.e., Conventions, Schools, Seminars, and Workshops)
Publisher of Books and Newsletters Regarding Banking and Financial Services Issues
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The Dilemma

• I want to buy another bank, OR
• I want to position my bank to sell
• I feel like I need to do something, BUT
• I don’t really want to do anything
• Do I do what I should? Or, should I do what I can? I have no idea what to do!
The Dilemma

Do what you should

Directors’ Legal Duties

• Duty of care: reasonably prudent bank or bank holding company director

• Duty of loyalty
  – Avoid conflict of interest
  – Avoid misappropriation of corporate opportunities
Directors’ Legal Duties

- Hire competent management: best insurance
- Establish appropriate policies and procedures
- Advise management: no micro management
- Develop business
- Respond to unsolicited offers
- Strategic planning
- Appropriate corporate governance

Directors’ Biggest Liability Risks

- Shareholders
- Regulators
- FDIC: Bank Closures

The Risk Is Manageable:
Business Judgment Rule – The Right To Be Wrong.
Our Real Job as Directors

• Direct and not be led
• Enhance shareholder value
• Beneficial result – good corporate citizenship

Primary Duty: Enhance Shareholder Value

• Earnings per share growth
• Return on Equity
• Liquidity for the stock
• Cash flow/appropriate dividend policy
• Maintain safety and soundness
The Dilemma

Do what you can

Nominating Committee

- All independent outside directors
- No directorship for life
- Establish a board evaluation system
- No automatic re-election
- Issues of mandatory retirement
Risk Committee

- No “all independent outside directors” requirement
  - At least one member with substantial risk management knowledge and expertise
- Identifies, assesses and manages institution’s risk exposure
- Required for bank holding companies with greater than $50 billion in assets ($10 billion if publicly traded)

Require Continuing Education for Directors

- Education budget
- Various education policy alternatives
- Regulatory requirement?
- Director job description or director expectations?
Corporate Governance Warning Signs

- Tough questions regarded as undesirable
- Corporate minutes are useless
- CEO shields Board from the management team
- Holding executive sessions

The M&A Dilemma
Not Being Proactive

- Target what you want and go after it
- Opportunistic may not be enough
- Some sellers need a nudge (not a push)
- Make personal contact early

Not Having Something of Value to Sell

- Clean up problems
- Eliminate regulatory concerns
- Maximize earnings performance
Five Common Mistakes of Remaining Independent

- Assuming it can be done passively
- Not focusing on core profitability
- Not planning board and management succession
- Not keeping up with changing regulations
- Not focusing on board issues
- Not creating value

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Board Level Issues

- Board meeting or bored meeting?!
- Active engagement and participation
- Don’t only look backwards
- Use of bank holding company board

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Move Ahead by Getting Back To Basics

- De-risk earnings stream
- Deconstructing the financial statements
- Pricing loans and deposits
- Source of non-interest income

Focus on Organizational Structure

- Branches?
- Products and services?
- Full-service? Or Targeted/Niche?
Should I Focus Solely on Earnings Growth?

• Of course, earnings drive value!

• But, however, maybe, I should…

Which Is More Important?

• An efficiency ratio below peer?
• A great work environment with happy employees?
• Happy shareholders?
• A thankful community?
The Dilemma of Ownership Structure?

- Very public - SEC
- Kinda, sorta public
- Private
- Very private – Sub S

The Answer!

Do all that you can!
And most of what you should!
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THE DIRECTORS’ DILEMMA
DO WHAT YOU SHOULD?
OR, DO WHAT YOU CAN?

Directors, as well as senior management, often face a dilemma in today’s environment. Do you do what you can or do you what you should?

I. THE DIRECTORS’ AND OFFICERS’ REAL JOB

Directors and senior management of financial institutions also have an obligation to enhance shareholder value and to plan for the long term. Hopefully, for most institutions, that means aggressively taking steps to ensure long-term independence and focusing on creating value within the organization. Every institution should at least consider the alternatives of remaining independent for the long term, acquiring another institution or possibly enhancing value through sale.

Today’s short-term operating environment for financial institutions, as noted, is still challenging. Therefore, it is imperative that as directors and officers of our community banks, we fully understand the short-term and long-term environmental issues as well as the drivers for long-term success. If our goal is to continue to serve our shareholders and communities, then long-term independence needs to be assured.

In many parts of the country, the short-term issues in the marketplace will continue to be difficult. As noted, regulatory issues, both safety and soundness and compliance, will continue to be paramount for community banks. The regulatory perception (perception is reality) will continue to drive a significant number of enforcement actions, both the compliance and safety and soundness, by the regulators. While the regulators (to give them the benefit of the doubt) may be well meaning with respect to their establishment of a “corrective program” for the bank, the reality is that the regulatory corrective program may not be consistent with the bank’s business plan for success, may not assist in the attraction and retention of key personnel, may create unintended liquidity events, and will divert significant financial and managerial resources to dealing with actions that will not sustain the profitability or the long-term franchise value for the institution.

To thrive over the long term, our banks must ensure that the shareholders are satisfied. Enhancing shareholder value continues to be of paramount concern. Four critical metrics to determine whether the Board is moving toward enhancing the value for the shareholders over the long term and fulfilling its obligation are set forth as follows:

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• Earnings per share growth - 8% to 10% a year. Notwithstanding all the discussion of book value among bankers every time a bank sells, earnings drive value. If the bank can grow its earnings per share by either growing net income or reducing the number of outstanding shares, that will contribute to the enhanced per share value of the organization.

• Return on equity – a range of 10% to 12%. For most community banks, this is merely a “target.”

• Liquidity for the shares. We hear often during board meetings about bank liquidity. As directors and officers, we also need to focus on liquidity for our shareholders, particularly as our shareholder base ages. Liquidity in this context is the ability of a shareholder to sell a share of stock at a fair price at the time they want.

• Appropriate cash flow. This means we must address the dividend policy associated with our shares. As the population ages, it is likely their demand for greater cash return on their investments will increase as well. We need to focus on an appropriate dividend policy.
The following material will briefly cover several specific strategies for enhancing shareholder value without buying or selling.

II. **Formation, Use and Capital Planning With the Bank Holding Company**

Approximately 80% of the community banks in the nation are in a bank holding company structure. All community banks, particularly those under $500 million in total assets, receive significant benefits from the bank holding company structure. It not only provides flexibility in repurchasing shares and in financing those purchases but it also provides flexibility in acquisitions, branch expansion, capital raising, new products and services and other means to enhance the value of the overall shareholders’ interest.

There are five key advantages of a holding company:

* Improved Capital Planning and Financial Flexibility
* Control and Ownership Planning
* New Products and Investment Opportunities
* Additional Geographic Expansion Techniques
* Enhanced Operational Flexibility

A Bank Holding Company ("BHC") is defined as any company which has control over any bank. In the broadest sense, any corporation or organization that "controls" a bank is a BHC. The Bank Holding Company Act of 1956 ("Act") prohibits any "company" from becoming a BHC without prior approval of the Federal Reserve Board ("FRB").

The Financial Holding Company ("FHC") is defined in GLBA as a BHC that meets the following requirements:

a. All of the depository institution subsidiaries of the BHC are well capitalized;

b. All of the depository institution subsidiaries of the BHC are well-managed; and

c. The BHC has filed the following with the Federal Reserve Board:

   (1) a declaration that the BHC elects to be an FHC in order to engage in activities and acquire shares in companies that were not permissible for a BHC prior to GLBA’s enactment; and

   (2) a certification that the BHC meets requirements (1) and (2) above.

Bank Holding Companies may borrow money with the debt treated as a liability at the holding company level; however, the funds can be "pushed down" to the bank as new equity capital for the bank. This "double leveraging" technique is most attractive for banks with assets under $500 million since the bank and the holding company's financial statements are not consolidated for capital purposes by the Federal Reserve. The technique is useful on a more limited basis for those institutions with assets above $500 million. Dividends from a bank to its holding company are non-taxable, thus the debt is serviced with "before tax"
dollars. The BHC and bank file consolidated tax returns, allowing interest on the holding company's debt to be used as a deduction against the bank's earnings.

Through use of the double leveraging technique by the BHC, individual shareholders are not required to provide additional cash to raise capital for the bank. In addition, their ownership percentages are not diluted by a necessary new stock offering to outside shareholders. For small banks, assumption by a BHC of acquisition debt by which the institution was acquired allows the debt to be paid with before tax dollars.

Funds provided by a BHC may be used in many ways, such as:

* Bank Acquisitions
* Non-bank Acquisitions or Activities
* Asset Growth Support
* Replacing Lost Capital
* Restructuring Investment and/or Loan Portfolios
* Providing Liquidity
* Financing Bank Premises or Other Capital Expenditures
* Stock Repurchase Plans
* A General Funding Source

There are also other miscellaneous advantages to a bank holding company in the capital and financial planning area which may be significant for many institutions, such as:

* **Alternative equity forms.** Since a holding company is simply a state chartered corporation, it can utilize virtually any type of equity structure. For example, it can use preferred stock as well as common stock. It can also use preferred stock with an adjustable rate dividend, or preferred stock convertible into common stock.

  A BHC may also use different classes of stock. For example, if an institution wishes to raise capital but is concerned about diluting the voting control of existing shareholders, a different class of common stock with no right to vote or a smaller percentage vote could be used.

* **Debt securities.** A holding company may also use various forms of debt. It can use long-term debentures and deduct the interest cost while pushing the money down into the bank as new equity capital. It can issue commercial paper. Short-term or long-term notes or "investment certificates" can be sold by the holding company to existing shareholders, bank customers or smaller banks, thus eliminating the need to pay a traditional lender a higher interest rate or pay an underwriter a fee for placing the securities. Debt securities with convertibility features allowing the debt to be converted into common stock may also be used. Care must be taken in structuring debt issuances to avoid possible consolidation of bank and bank holding company financial statements for capital adequacy purposes with banks less than $500 million in total assets.
A BHC can also take existing common stock held by individuals wanting a higher yield than they receive from current dividends and purchase those shares with debentures carrying a higher yield. The additional cost of this type of transaction to the bank may be very limited, since the additional money paid as interest is tax deductible as opposed to non-deductible dividends. Consequently, the IRS "pays" a major share of the cost of debentures while, with dividends, 100% of the cost is paid by the bank.

The key is flexibility. A holding company can issue equity and debt instruments quickly and efficiently. There is normally no need for approval from the primary bank regulators since the securities will be issued by the holding company. Normally, there is no need to get shareholder approval since most original holding company charters already authorize various types of securities. The institution is not limited by what type of capital structure a bank can have since the securities are issued at the holding company level.

Debt issued at the holding company level may be unsecured or secured by pledging the bank stock owned by the holding company. Consequently, a BHC will be able to provide a lender with collateral on a loan to the holding company, whereas, at the bank level, any debt would normally be unsecured and subordinated to the claims of all other credits. Finally, a bank holding company, in certain circumstances, will have more flexibility as to the maturity dates of various debt and equity instruments issued through the holding company.

The other benefits of the use of a holding company, including control and ownership planning, new products, investment opportunities, geographic expansion techniques, and enhanced operational flexibility will be addressed elsewhere in this material.
III. Creating Stock Liquidity

Uppermost in the minds of management, directors and shareholders of most financial institutions today are two fundamental questions:

- Who will control the institution in coming years?
- Can an institution remain independent and provide a market for those wishing to sell?

A. Going public? (Registering with the SEC?)

Liquidity for your shareholders is important. Liquidity must be planned for. “Liquidity” in this context means the ability of a shareholder of your institution to sell a share of stock at a fair price at the time he desires. Community banks often wrestle in the strategic planning process as to whether they should become “public companies”. The greatest tragedies are those community banks that with no thought or preparation inadvertently become public companies by finding themselves with greater than 2,000 shareholders as a result of “death and distribution” or simply sales of minority shares over which they have no control. Many community banks will find the consolidation of ownership is the best way to enhance value. Others will conclude that the expansion of ownership, the creation of liquidity and the generation of a market for their securities will best serve to enhance value over the long term. Whatever the result, however, the community bank, in order to be effective, must plan for it.

B. Stock Repurchase Plans

For the vast majority of financial institutions in the United States, there are very few acquisitions available, if any, which will improve earnings per share and return on equity more than the simple alternative of repurchasing the institution's own stock. Many institutions are currently realizing that the most efficient deployment of excess capital or leveraging ability is in connection with the repurchase of the institution's own stock. This is particularly true for community banks where such repurchases can generally be accomplished at reasonable prices.

The potential advantages of a stock repurchase or ownership restructuring program are numerous. Earnings per share and return on equity may be immediately increased with a stock repurchase or ownership restructuring program. The relative ownership positions of remaining shareholders will also improve. For shareholders wishing to sell, such plans provide a purchaser at a fair price. In addition, a repurchase program may also provide a "floor" for the institution's stock that works to enhance shareholder perceptions of bank stock value.

Some of the advantages and uses of stock repurchase and ownership restructuring plans are as follows:

* Increased Value. Earnings per share and return on equity may be immediately increased.
* **Market Communications.** Repurchase plans communicate that management is optimistic about the future and feels the stock is undervalued.

* **Takeover Attempts:** Keep stock in friendly hands.

* **Market Stabilization.** Stock repurchases stabilize the market and provide a minimum price for the stock.

* **Limit or Reduce Number of Shareholders.** Having 2,000 plus shareholders requires bank holding company compliance with federal securities laws including Sarbanes-Oxley. Institutions may use stock repurchases to take the bank holding company private or to keep the number of shareholders below 2,000.

* **Consolidate Ownership.** Some institutions wish to consolidate ownership around a long-term "core" group of shareholders.

* **Forced Sales.** Shareholders may be forced to place their stock on the market due to personal financial difficulties, estate taxes, etc.

* **Use of Excess Capital.** Many banks have excess capital, which can be used to support stock repurchases.

* **Interest Rates.** The cost of incurring debt to retire equity is relatively low because of moderate current interest rates and the tax deductibility of interest payments, which potentially lowers after-tax costs.

A repurchase by a bank holding company of its own shares at any reasonable price level has the following specific positive impacts on enhancing shareholder value.

* Shareholders who desire to sell receive cash and, thus, instant liquidity for their shares.

* The shareholders who do not sell become aware that the holding company has the ability to create a market and achieve "psychological" liquidity for their shares.

* A stock repurchase plan priced appropriately (and appropriately can mean at a fairly high level) will serve to enhance earnings per share for those shareholders who do not sell and therefore the overall value of the shares.

* A stock repurchase plan, by using excess capital, will increase return on equity for the remaining shareholders.

* Shareholders remaining after the repurchase will experience an increase in ownership percentage of the company without having expended any cash.
* If the company continues to pay cash dividends in the same "gross" amount to a smaller shareholder base, the remaining shareholders will receive an increase in cash flow.

A stock repurchase plan by a bank holding company is one of the few "win/win" strategic alternatives a community board that is not interested in selling in the near term can take.

(REMAINDER OF PAGE INTENTIONALLY LEFT BLANK)
### EXAMPLE OF STOCK REPURCHASE PROGRAM

A. Baseline - no repurchase  
B. Repurchase of 316,818 shares funded with $3,485,000 of capital  
C. Repurchase of 407,727 shares funded with $3,485,000 and $1,000,000 of debt  
D. Repurchase of 498,636 shares funded with $3,485,000 and $2,000,000 of debt

### Earnings Per Share (Accretion [+] / Dilution [-])

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.</td>
<td>$1.13</td>
<td>$.98</td>
<td>$.98</td>
<td>$.97</td>
<td>$.98</td>
</tr>
<tr>
<td>B.</td>
<td>$1.18 (+4%)</td>
<td>$1.04 (+6%)</td>
<td>$1.05 (+7%)</td>
<td>$1.04 (+7%)</td>
<td>$1.03 (+5%)</td>
</tr>
<tr>
<td>C.</td>
<td>$1.20 (+6%)</td>
<td>$1.05 (+7%)</td>
<td>$1.06 (+8%)</td>
<td>$1.05 (+8%)</td>
<td>$1.05 (+7%)</td>
</tr>
<tr>
<td>D.</td>
<td>$1.22 (+8%)</td>
<td>$1.06 (+8%)</td>
<td>$1.08 (+10%)</td>
<td>$1.07 (+10%)</td>
<td>$1.06 (+8%)</td>
</tr>
</tbody>
</table>

### Return on Equity (Accretion [+] / Dilution [-])

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.</td>
<td>19.3%</td>
<td>15.6%</td>
<td>14.4%</td>
<td>13.3%</td>
<td>12.6%</td>
</tr>
<tr>
<td>B.</td>
<td>22.1% (+15%)</td>
<td>17.6% (+13%)</td>
<td>16.3% (+13%)</td>
<td>14.9% (+12%)</td>
<td>13.8% (+10%)</td>
</tr>
<tr>
<td>C.</td>
<td>23.1% (+20%)</td>
<td>18.3% (+17%)</td>
<td>16.9% (+17%)</td>
<td>15.4% (+16%)</td>
<td>14.2% (+13%)</td>
</tr>
<tr>
<td>D.</td>
<td>24.3% (+26%)</td>
<td>19.0% (+22%)</td>
<td>17.5% (+22%)</td>
<td>15.9% (+20%)</td>
<td>14.6% (+16%)</td>
</tr>
</tbody>
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### Book Value Per Share (Accretion [+] / Dilution [-])

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<thead>
<tr>
<th></th>
<th>Year 1</th>
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<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.</td>
<td>$5.84</td>
<td>$6.33</td>
<td>$6.81</td>
<td>$7.28</td>
<td>$7.75</td>
</tr>
<tr>
<td>B.</td>
<td>$5.35 (-8%)</td>
<td>$5.89 (-7%)</td>
<td>$6.44 (-5%)</td>
<td>$6.97 (-4%)</td>
<td>$7.51 (-3%)</td>
</tr>
<tr>
<td>C.</td>
<td>$5.19 (-11%)</td>
<td>$5.74 (-9%)</td>
<td>$6.30 (-7%)</td>
<td>$6.85 (-6%)</td>
<td>$7.40 (-5%)</td>
</tr>
<tr>
<td>D.</td>
<td>$5.02 (-14%)</td>
<td>$5.58 (-12%)</td>
<td>$6.16 (-10%)</td>
<td>$6.73 (-8%)</td>
<td>$7.29 (-6%)</td>
</tr>
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EXAMPLE OF STOCK REPURCHASE PROGRAM
SUMMARY FINANCIAL DATA

EARNINGS PER SHARE

<table>
<thead>
<tr>
<th>Year</th>
<th>Baseline</th>
<th>Stock Repurchase Price Per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$148 per share 6,756 shares</td>
</tr>
<tr>
<td>1</td>
<td>$12.09</td>
<td>$13.09 (+8.3%)</td>
</tr>
<tr>
<td>2</td>
<td>$13.08</td>
<td>$14.42 (+10.2%)</td>
</tr>
<tr>
<td>3</td>
<td>$14.16</td>
<td>$15.82 (+11.7%)</td>
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<tr>
<td>4</td>
<td>$15.27</td>
<td>$17.31 (+13.4%)</td>
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<tr>
<td>5</td>
<td>$16.45</td>
<td>$18.88 (+14.8%)</td>
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RETURN ON EQUITY

<table>
<thead>
<tr>
<th>Year</th>
<th>Baseline</th>
<th>Stock Repurchase Price Per Share</th>
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<td>$148 per share 6,756 shares</td>
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<tr>
<td>1</td>
<td>8.3%</td>
<td>9.2% (+10.8%)</td>
</tr>
<tr>
<td>2</td>
<td>8.3%</td>
<td>9.2% (+10.8%)</td>
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<td>9.2% (+10.8%)</td>
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<td>4</td>
<td>8.3%</td>
<td>9.2% (+10.8%)</td>
</tr>
<tr>
<td>5</td>
<td>8.2%</td>
<td>9.2% (+12.2%)</td>
</tr>
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</table>

BOOK VALUE PER SHARE

<table>
<thead>
<tr>
<th>Year</th>
<th>Baseline</th>
<th>Stock Repurchase Price Per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$148 per share 6,756 shares</td>
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<tr>
<td>1</td>
<td>$145.51</td>
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<td>$187.49 (+2.9%)</td>
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<tr>
<td>5</td>
<td>$200.46</td>
<td>$205.35 (+2.4%)</td>
</tr>
</tbody>
</table>

(%) - % Accretion (+) or Dilution (-) from Baseline
IV. Considering Ownership Alternatives

Most boards of directors of banks and bank holding companies, both smaller and growing, do not realize that it is within their prerogative and, in fact, their duty, to determine as a long-term strategic decision, the most beneficial ownership for the company and its shareholders. The board has four basic alternatives in this regard.

1. Public company status,
2. Private company,
3. A very private company (Subchapter S)
4. Becoming a public company

Even if the bank holding company is a public company, the board of directors has the strategic decision to make as to whether to take that public company, which is SEC reporting, and make it into a private non-reporting company. The reality is that the board, through its recommendation and voting of its own stock, can, in fact, often control or direct the ownership of the bank or bank holding company and should make a long term strategic decision in this regard which are in the best interests of enhancing value for all shareholders.

A. Public Company Status

Under the SEC rules and regulations governing public companies, any bank or bank holding company that has in excess of 2,000 shareholders in any class of stock at year-end is a public company and if it is a bank holding company (a state chartered corporation), it must report to the SEC. If it is a bank (not a bank holding company), it must report as a reporting bank to the bank regulators. The reporting requirements for both the SEC and the bank regulators are substantially similar.

The question is "do you have over 2,000 shareholders". The regulations have numerous attribution rules where shareholders can be combined into one ownership. There are rules that provide that that stock held in street name is considered one shareholder per broker. Also, shareholders who received the stock through an employee compensation plan in an exempt transaction are no longer included in the shareholder count. For additional information, please request Gerrish McCreary Smith Memorandum to Clients and Friends on Counting Shareholders for SEC reporting purposes.

If the bank holding company becomes a public company, it should have been because of an affirmative decision by the board of directors of the bank holding company, not an inadvertent act out of the holding company's control where stock has been transferred. Later in this material, it will be addressed as to how to control ownership to avoid inadvertently becoming a public company. Some of the greatest "tragedies" we have seen in community banking in particular is a bank holding company that "eked" over the prior shareholder limit and became a public company when it really obtained no benefit from doing so and incurred significant expense. Even though the current 2,000 shareholders threshold is not as great a threat as the previous 500 shareholders threshold, a bank holding company should...
still take caution that it does not exceed the 2,000 shareholder mark. The reality of becoming a public company is that:

a. Disclosure is significantly increased by both the company and its directors. This includes stock ownership, compensation, meeting attendance and the like.

b. Particularly after Sarbanes-Oxley, as a practical matter, the liability exposure of directors of public companies has increased significantly.

c. The out-of-pocket expense associated with being a public company can run anywhere from $150,000 to $300,000 annually for even a small company.

d. The amount of time and effort put into reporting requirements and the soft costs of personnel is not insignificant.

e. If your public company is listed, it is subject to, in most cases, very little market liquidity and the ability of a single trade to move the market significantly.

Bank holding companies should not become public holding companies without an affirmative long-term strategic decision in that direction by the board of directors. Simply becoming a public company will not increase the marketability or market value of the stock and may, in fact, decrease it. This is simply due to the fact that for public companies, it is much more difficult to engage in repurchase plans and support the market price of their stock in the marketplace.

For most community banks, becoming a publicly reporting company will not serve to enhance the liquidity of their shares. Why, then, would a community bank want to become publicly reporting? The answer for many must lie primarily in the love and affection they have for their lawyers and accountants who they will make even wealthier than they are today.

Seriously, the expansion of ownership by many community banks is without adequate forethought. The community bank, to effectively create liquidity within the issue of "public versus private," must determine to "go all the way" if it is going to become a public company. "All the way" means significantly expanding the number of shareholders, willingly accepting institutional investors, courting the market makers and generally setting up an investor relations program as described below to generate liquidity and value in the shares.
In order to review the issue of enhancing value as a result of expanding ownership, the board needs to understand why community banks are primarily invisible to the markets. This is basically due to four principal factors:

- The company communicates only with current shareholders.
- Management is unaware they can influence the company’s share valuation.
- Little, if any, information about the company is made available to the outside.
- The company does not have an investor outreach program.

In order to generate meaningful market value and liquidity, the Director of NASDAQ Market Services suggests the following for a community bank.

- The institution needs to understand and help influence the valuation of its shares.
- The institution should market its stock just as it does its own products and services.
- The institution must differentiate its stock and position it among other investment opportunities.
- The institution must take the lead in convincing investors why the stock has investment appeal.
- The institution must focus its message and target its audience.
- The institution must reach out to the analyst community and obtain five or six analysts.
- The institution must be willing to target a mix of institutional and retail investors.

If an institution can accomplish the foregoing, then it has some hope of generating additional value through attention in the market.

In order to do this, however, the institution must have some kind of a formal investor relations plan. This plan, like the overall strategic plan, must have clear and defined objectives, specific marketing strategies, methods to implement the strategies, an idea of how much in the way of resources is going to be allocated to the plan, and a

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1 This information was obtained from Nasdaq Market Services
mechanism to measure the results of the plan. Typical goals for a community institution might be to increase share price, increase market valuation, improve trading liquidity, broaden analyst coverage, reconstitute the shareholder base, and decrease trading volatility. As a practical matter, most community institutions that are public simply need more coverage by the analysts. This simply means targeting analysts from regional brokerage firms and participating in conferences in order to tell the story of your institution.

If the board of directors determines to be a public company or already is a public company, then the issue of an investor relations/market liquidity and value planning must be on the strategic planning agenda. The board must recognize that if it is public, it can also influence the market value of its stock through an active investor relations program.

B. Maintain Private Company Status.

Most community banks and bank holding companies are private companies with less than 2,000 shareholders. It is imperative, if the board's long-term strategy is to maintain private company status, that it takes affirmative actions necessary to implement that strategy. This generally means keeping a close eye on the shareholder list and, if necessary, engaging in stock repurchases through the holding company in order to keep that shareholder list from getting over the 2,000 share mark. Many community bank holding companies will establish the long-term strategy of consolidation of ownership. From that comes the desire to reduce the outstanding number of shareholders through either repurchase of "walk ins" or affirmative repurchase plans.

C. The Move Toward a Very Private Company Status (Subchapter S).

Approximately one-third of the banks in existence are in Subchapter S status. Since the passage of the American Job Creation Act of 2004, Subchapter S now allows 100 shareholders (counting six generations of one family as one shareholder). All shareholders must still be Subchapter S eligible, execute the shareholders’ agreement, execute the IRS consent, and hold enough shares to be above the “cut line” to be part of the Subchapter S. In most states, any bank holding company that can obtain the vote of 50% of its shares can convert to a Subchapter S, through a “merger like” transaction.

There are at least three significant issues with respect to Subchapter S.

a. Does the conversion from a C corporation to a Sub S corporation make financial sense for the company in view of the number of shares that may need to be cashed out? In other words, can the company continue to execute on its business plan?

b. Politically, is the forced elimination of certain shareholders for cash (even though the price will be fair) a political risk the Board is willing to accept?
c. Will the shareholders remaining in the Subchapter S be better off from an after-tax cash flow standpoint over the long term than they would be in a Subchapter C?

Subchapter S is the greatest way to enhance shareholder value currently available to privately held community banks. In its simplest terms, the Sub S corporation eliminates corporate level tax on the bank and holding company such that all income is passed through without tax at the corporate level and for individual shareholders, it appears on their personal tax returns. This is similar to the tax treatment of a partnership. For most community banks and holding companies, the tax savings alone served to significantly enhance the value for their shareholders. The main caveat is to make sure the bank can provide cash flow through distributions (dividends) to the shareholders to pay the shareholders' personal tax liability. For additional information, please request Gerrish McCreary Smith materials regarding Subchapter S issues.

D. Converting a Public Company to a Private Company.

With the advent of Sarbanes-Oxley and its increased emphasis on corporate governance disclosure, rapid reporting, and certifications, many smaller community bank holding companies with public company status (greater than 2,000 shareholders) are contemplating returning to private company status. In order to take an SEC reporting holding company to a non-reporting holding company status, it must reduce its existing common shareholders to fewer than 1,200. Many community banks and holding companies automatically found themselves below this increased reregistration threshold as a result of the JOBS Act of 2012. For those banks and holding companies with more than 1,200 shareholders in a class, a shareholder reduction can be accomplished either through a cash-out merger that eliminates smaller shareholders for cash or a “reclassification” transaction that reclassifies the current common shares held by the smaller shareholders into other classes of common stock, which can have fewer than 2,000 shareholders. (As noted, under the SEC rule, there can be no more than 2,000 shareholders in any class of stock. Once the common class exceeds 2,000, it must be reduced to below 1,200 shareholders to go private.) Any time a bank considers a going-private transaction that either forces shareholders to take cash for their shares or forces shareholders into a separate class of stock, the bank must consider two major issues:

a. Can the bank politically afford to eliminate the shareholders or force them into a separate class of stock? In other words, will it so adversely affect the business relationships at the bank as to be an unwise business decision? This is a question only the board and management, after a thorough analysis of the existing shareholder relations, can answer. Our experience has been that generally, even with the elimination of 500 or 600 shareholders, there is rarely more than a handful of shareholders that, in reality, require personal attention by the board.
b. The second major issue is financial: if the transaction is going to involve a “cash-out”, can the company afford to eliminate the shareholders? Fortunately, many bank holding companies have some excess capital, some access to capital, or some borrowing ability that will allow them to finance the elimination of the shareholders through debt. If it is to be a cash-out transaction, it is important to run the numbers after determining that the political issues are manageable to see if the transaction is financially acceptable from a business standpoint. Normally, the freeze out of minority shareholders, which is tantamount to a redemption or a repurchase by the holding company, benefits significantly those shareholders who do not have to sell from an earnings per share accretion, return on equity accretion, and cash flow (dividend) accretion with respect to the stock.

If the transaction is to be structured as a stock reclassification where very few shareholders are to be eliminated, then the financial and political issues are significantly diminished.
V. Alternative Lines of Business

In order to assure income growth and de-risk the income stream, it is essential for the bank to focus on alternative lines of business. The most likely lines of business to be offered by community banks across the nation will be insurance, securities, trust, wealth management, and ultimately real estate brokerage, when it becomes available. The key factor, however, is to understand what the bank and/or its holding company can do and what fits with the market niche the bank plans to develop or what the existing customers want.

In 1999, the Gramm-Leach-Bliley Modernization Act (GLBA), which greatly expanded new product and investment opportunities for financial institutions, was enacted. As a result, a financial institution may choose from a variety of structures and entities in order to pursue new product and investment opportunities. These entities include:

* financial holding companies (FHC),
* traditional bank holding companies (BHC),
* bank financial subsidiaries (FS),
* bank operating subsidiaries (OS), and
* bank service corporations (BSC).

This material will focus on the use of the FHC and the BHC for product and service expansion.

Despite this variety of business structures and entities through which to pursue new product and investment opportunities, a financial institution's four basic goals in expanding its products and investment opportunities remain the same:

• An increase in earnings per share, not previously produced by the institution;
• Diversification of risk by decreasing reliance on traditional banking activities;
• Limitation of liability by the institution by using the holding company, its separate subsidiaries, or bank subsidiaries to provide new products and services; and
• Increased geographic range, since FHC and BHC are generally able to offer any permissible product or service in any geographic area.

A. Financial Holding Companies

The most flexible entity for a financial institution to use to engage in new types of financial activity is the financial holding company (FHC), which allows new activities to be conducted through a holding company affiliate regulated by the Federal Reserve Board. Congress authorized the FHC under provisions of GLBA that amended the Bank Holding Company Act. Consequently, the FHC is the primary entity through which a financial institution may engage in any type of
financial activity, including any type of insurance or securities activity, or become affiliated with any type of financial company. In addition, the FHC is the primary entity through which a non-banking financial institution (e.g. a securities or insurance company) may purchase a bank.

As noted earlier in this material, an FHC is simply a traditional BHC that satisfies, and continues to satisfy, certain regulatory requirements. A BHC that satisfies these new requirements may elect to become an FHC to engage in the broad range of financial activities permitted under GLBA. However, a BHC may elect not to become a FHC if it wants to only engage in the types of activities in which a BHC were permitted to engage in as of the day before GLBA’s enactment.

Financial Activities. An FHC may engage in any type of financial activity that was permissible for a BHC to engage in before the enactment of GLBA. In addition, an FHC may engage in virtually any type of financial activity. An FHC may even be authorized to engage in certain non-financial activities under limited circumstances. GLBA provides a detailed list of new activities that are permissible for an FHC. The most important of these activities include:

- All securities underwriting and dealing activities,
- All insurance underwriting and sales activities,
- Merchant banking and equity investment activities,
- Future (financial in nature) and incidental activities, and
- "Complementary" non-financial activities.

B. Traditional Bank Holding Companies

Permissible "Non-Banking" Activities. GLBA amended Section 4(c)(8) of the Bank Holding Company Act of 1956 (12 USC §1843(c)(8)) to permit BHCs to invest in shares of any company, the activities of which had been determined by the Board by regulation or order as of the day before GLBA's enactment, to be so clearly related to banking as to be a proper incident thereto, subject to such terms and conditions contained in the regulation or order unless modified by the Board. The Federal Reserve Board has compiled a list of permissible activities for BHCs in Regulation Y. Some of the non-bank banking activities listed under Regulation Y are:

- Acting as an insurance agent or broker for certain types of insurance (primarily credit related insurance),
- Underwriting credit insurance directly related to credit extended by the bank holding company or its subsidiaries,
- Making or acquiring loans, issuing letters of credit, and operating mortgage banking, finance, credit cards and factoring operations,
- Leasing personal and real property,
- Appraising real estate for a fee,
- Arranging real estate equity financing transactions for a fee,
- Providing data processing services,
- Selling money orders and travelers checks,
- Providing courier services,
- Underwriting and dealing in government obligations and money market instruments,
- Servicing loans,
- Providing management consulting advice to non-affiliated financial institutions,
- Operating various types of industrial banks,
- Acting as an investment or financial advisor,
- Acting as a futures commission merchant,
- Providing securities brokerage services,
- Investing in community welfare projects,
- Performing trust company services,
- Check guaranty services,
- Tax planning and tax preparation services, and
- Operating a collection agency and collection bureau.

In addition, a BHC may be permitted to engage in other activities not specifically enumerated in Regulation Y if the Federal Reserve Board finds that such proposed activities are "so closely related to banking . . . as to be a proper incident thereto." Recent developments in permissible activities include:

- Commodity trading advisory services,
- Consumer financial counseling,
• Armored car services,

• Future expansion of already permitted activities in the area of property appraisals and futures commission merchant advice, and

• Securities activities and products including limited underwriting.

Passive Investment Alternatives. There are investment possibilities at the BHC level which may not be available at the bank level. A BHC may own shares of any company as long as it owns no more than 5% of the outstanding voting shares. It may own a higher percentage of the equity than 5%, but that interest must be non-voting stock. The types of equity securities held by a bank are severely restricted as a result of amendments by the FDIC Improvement Act (FDICIA) to Section 24 of the Federal Deposit Insurance Act.

FDICIA severely limited bank investment activities to those permitted for national banks unless the activity (a) poses no significant risk to the deposit insurance fund and (b) the bank meets applicable capital standards. Only a few applications under this section of the Act have been approved. The safer and easier course, if funding is available, is to make the equity investment or engage in the activity at the holding company level.

There is no limit on the number of corporations in which a holding company may invest up to 5% of their voting stock. A financial institution may diversify the combined investment portfolio of a bank and BHC by using this power.

Stake Outs. Some financial institutions structure what is called a "stake out" to invest in banks or prohibited businesses. This is an alternative investment method not only for geographic expansion into prohibited areas, but also for expansion by a BHC into a prohibited industry. Specific guidelines adopted by the Federal Reserve Board limit and monitor this type of transaction. These guidelines were developed with the acquisition of equity interests by out-of-state companies prior to the advent of interstate banking.
VI. Attracting and Retaining Human Capital

A critical key for the directors is to make sure that the company can not only attract but retain quality and key employees. Generally, this means that corporate culture and employee compensation and benefits must be comparable to what an employee could obtain elsewhere.

Providing appropriate incentives for officers, directors and employees can often serve as a means whereby shareholder value is enhanced. It creates an incentive for individuals managing and operating the bank to insure that the bank operates profitably. It also gives those individuals a share in the increased profitability and productivity which they have created. Five major ownership incentives are used in a typical community bank and are fairly easy to implement. These include the employee stock ownership plan (ESOP), the incentive stock option plan (ISOP), stock appreciation rights plan (SAR), non-qualified stock option plans and restricted stock plans. Each of these is briefly addressed below.

A. ESOPs.

An ESOP is a means for a community bank to create liquidity as well as establish an employee benefit for the Bank's officers and employees. The definitions for Employee Stock Ownership Plans (ESOPs) include:

* qualified retirement plan and trust,
* defined contribution plan,
* stock bonus plan,
* deferred compensation fringe benefit plan, and
* a financing vehicle or strategy.

The basic rules of operation of an ESOP are identical to other qualified retirement plans, including stock bonus plans, profit sharing plans, or defined benefit pension plans. The ESOP must be operated for the exclusive benefit of employees and must not discriminate in favor of the highly compensated and others in the prohibited group including officers, directors and shareholders. The ESOP differs from other plans in that the primary investment of the ESOP must be employer stock.

The use of ESOPs for Subchapter S holding companies or banks, 401(k) ESOPs or leveraged ESOPs have additional operational requirements and offer additional benefits for employers and employees. For additional information, please request Gerrish McCreary Smith material entitled "Utilization of Employee Stock Ownership Plans."

B. Incentive Stock Option Plan (ISOP)

The ISOP is the term used for qualified stock options that do not result in a tax consequence when the option is granted or when it is exercised. (However, the amount that the fair market value of the stock exceeds the option price is a tax preference item used in the computation of the alternative minimum tax in the year the ISO is exercised.)
If the employee holds the stock for two years from the date the option is granted and one year after he receives the stock, the employee’s taxable gain on the sale of the stock will be entitled to capital gains treatment. If the stock is sold before these periods end, the employee has ordinary income. The employer will be entitled to a deduction only if the employee pays ordinary income on his gain. Under current tax laws, capital gains are preferable to ordinary income for many taxpayers; therefore ISOPs have become preferable to Non-qualified Stock Option Plans (which can result in ordinary income to the option holder).

Generally, establishing an ISOP requires that the written plan must be approved by the shareholders, options must be granted within 10 years after the plan is adopted, and options must be exercised by the employee within 10 years after the grant of the option. The option price must not be less than fair market value at the time it is granted (a good faith attempt to establish value must be shown). Additional requirements include:

- The option must be non-transferable except by death, and can be exercised only by the employee.

- The employee, at the time the option is granted, must not own more than 10% of the employer's stock. (This is waived if the option price is 110% of fair market value and requires exercise in 5 years.)

- An option can't be exercised if an earlier ISO granted to the employee is outstanding. (Earlier options can't be cancelled.)

- The value of the stock that can be exercised for the first time by an employee in any one year cannot exceed $100,000, based on the fair market value of the stock at the date of grant of the option.

- A special IRS ruling provides that employees may exercise ISO's with other non-qualified stock options of the corporation and not affect that $100,000 limit above. (Of course, the employee will be taxed on the non-qualified stock options.)

If all requirements are satisfied, incentive stock options are excluded from compliance with IRC Section 409A requirements for defined compensation type plans.
C. The Stock Appreciation Rights Plan (SAR)

Generally, a SAR Plan entitles an employee to the appreciation in value of the employer’s shares held in the employees account over a period of time. At the time of exercise, the employee will receive cash based on the increase in fair market value of the employer’s stock from the date the SAR is granted to the date the SAR is exercised.

The key factor is the valuation. Fair market value of one share of stock is usually the value relied on, but the method of establishing the value could be based on book value or otherwise and should be set forth in the SAR plan. In either case, employees' units typically increase in value by (1) appreciation in BHC stock, (2) dividends paid on BHC stock.

Employees receive no vote or ownership rights with units assigned. Employees can receive cash from BHC in exchange for their SAR unit value five years or later from the date the units are awarded or when an employee becomes disabled or dies, whichever comes earlier. The plan may provide that the employee has the option to cash-in his SAR rights after five years or that the employee is required to cash in after five years. If the employee has the option to cash in the SAR after five years and does not exercise the option, the account will continue to grow.

The tax consequences to the employee are:

1) The employee recognizes no taxable income at the time a unit is awarded to his account or as his account grows, and

2) At the time of payment of cash benefits to the employee, he recognizes ordinary income for tax purposes on the amounts received.

The tax consequences to Bank are:

1) Bank gets no deduction at the time the unit is awarded to the employee, and

2) At the time cash is paid to the employee, the Bank can deduct these payments provided the payments under the plan are reasonable enough to be considered ordinary and necessary business expenses.

There is no specific Internal Revenue Code provision authorizing the Stock Appreciation Rights Plan. There are a number of IRS private letter rulings and Revenue Rulings regarding SARs. SARs are excepted from the compliance requirements of IRC Section 409A for deferred compensation type plans if (a) the SAR payment is not greater than the excess of the fair market value of the stock (disregarding any lapse restrictions) on the date of exercise over the fair market value on the date of grant of a fixed number of shares at that time, and (b) the SAR may not include any feature that delays income inclusion beyond the exercise of the SAR.
D. Combination Incentive Stock Option Plan (ISOP) and Stock Appreciation Rights Plan (SAR)

A disadvantage of the ISOP is that in the year the employee exercises the option, he must do so with his own funds or borrowed funds unless the employer pays a bonus to the employee in that year.

For this reason, ISOPs and SARs are often used as a combination. The SAR is granted and timed so that the employee can cash in his SAR units in the same year that he will need cash to fund the purchase of stock pursuant to an ISOP. When this occurs, the employer will have a tax deduction in the amount paid for the SAR and the employee will have taxable ordinary income in this amount. Payment of the funds to the employer for the stock received by the exercise of the ISO will not result in a deduction for the employer or in income to the employee (unless there are alternative minimum tax considerations). From a cash flow standpoint, the employer may have paid out the same amount for the SAR that it will receive for the stock, so the transactions are a wash to the employer. That transaction would also be a wash to the employee from a cash flow standpoint, but the employee will receive new stock (with a basis of the cost of the stock) and will owe tax on the SAR amount.

The IRS has ruled that tandem ISOPs and SARs are permitted if:

(1) The SAR expires no later than the ISO.
(2) The SAR does not exceed 100% of the difference between the market price of the stock and exercise price of the ISO.
(3) The SAR has the same restrictions on transferability that are on the ISO.
(4) The SAR may be exercised only with the ISO.

The SAR can be exercised only when the market price of the stock exceeds the exercise price of the ISO.

E. Non-Qualified Stock Options

Non-qualified stock options are often granted to community bank directors at the same time ISOP's are established for officers and employees. If the non-qualified stock options have a value at the time they are granted, such options are taxable to the employee or director in the year the option is granted to them, unless the option is non-transferable. If it is non-transferable, no tax is due until the exercise of the option. A non-qualified stock option must have the fair market value of the stock at the time of grant as the exercise price and have no other provisions that delay the recognition of income when the operation is exercised, in order to avoid compliance with IRC Section 409A requirements for deferred compensation type plans. When the option is exercised, the employee or director will have taxable ordinary income on
the difference between fair market value of the stock at the time of the exercise and the option exercise price. The employer will have a deduction in the same amount.

The non-qualified stock option may contain any of the features required for an incentive stock option plan, but none of those are mandatory. The non-qualified stock option can be used in tandem with the Incentive Stock Option Plan (to exceed the $100,000 annual limit) and with the Stock Appreciation Rights Plan.

F. Restricted Stock

Restricted Stock Plans generally grant stock to executives with certain restrictions. The restrictions may be that certain financial goals must be met before the restrictions lapse or that the executive must continue to be employed for a certain number of years or both. If the conditions associated with the restrictions are not met, the stock is forfeited.

Restricted stock may have favorable tax benefits in that the executive is not required to recognize ordinary income for tax purposes when the restricted stock is issued. Assuming that the restriction constitutes a “substantial risk of forfeiture”, the executive will not be required to recognize income under IRC §83 until the restriction lapses. The executive will be taxed on the entire value of the stock when the restrictions lapse and the conditions are met, however, which could impose an extreme cash flow hardship if the executive does not want to sell his stock at that time.

If, instead, the executive makes an "§83(b) election" as authorized under the Internal Revenue Code, he would have to include in his income for the year of receipt the value of the stock on the date it is granted. The executive would then be able to defer recognition of the increase in the stock's value until the stock is sold, which might be 10 or 15 years later. Additionally, the amount deferred would be taxed at capital gains rates.

A Section 83(b) election is generally unattractive when the amount of taxable income immediately recognized (due to a high stock price) is very high. However, if the current price of the stock was low and substantial appreciation was anticipated, a Section 83(b) election would probably be advisable, since it would be made at a low present tax cost with a possibility of significant tax deferral. Also, the granting of the restricted stock could be spread over a period of years to lessen the tax effect of the 83(b) elections. Granting of the restricted stock can be linked to bonuses that help to pay the tax obligation imposed if the 83(b) election is made.

Another alternative would be for the company to sell the restricted stock to the executive for fair market value, so that a §83(b) election could be made at no current tax cost. The bank could loan to the employee part or all of the funds required to purchase the stock, subject to the limitations under Part 215 of the FDIC Regulations entitled "Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks" (Regulation O). The loan could be made...
repayable immediately, if the executive left the bank's employment. A part of the executive's bonus each year can be designated to retire the loan.

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<th>Questions and Answers Regarding Restricted Stock Plans</th>
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<td>Can employees receive capital gains tax treatment?</td>
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<td>Is employee taxed at grant?</td>
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<td>Is employee taxed at vesting?</td>
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<td>Can Alternative Minimum Tax apply?</td>
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<td>Does the employer get a deduction?</td>
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<td>Do the awards affect dilution and EPS calculations?</td>
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<td>Can employees delay exercise after vesting?</td>
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<td>How is value affected by volatility?</td>
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<td><strong>Can employees receive capital gains tax treatment?</strong></td>
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<td>Yes, any gain over price at date of grant is taxed as capital gain if an 83(b) election is made.</td>
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| **Is employee taxed at grant?** | **No, unless employee makes 83(b) election; otherwise, ordinary income tax paid when restrictions lapse.** | **No.** | **No.** |

| **Is employee taxed at vesting?** | **Yes, unless employee made an 83(b) election at grant.** | **No.** | **No.** |

| **Is employee taxed at exercise?** | **N/A** | **Yes.** | **No.** |

| **Can tax be deferred until sale?** | **Yes, if 83(b) election made at grant, capital gain can be deferred.** | **Yes, if requirements met.** | **No.** |

| **Can Alternative Minimum Tax apply?** | **No.** | **Yes, to spread on exercise if shares not sold in year of exercise.** | **No.** |

| **Does the employer get a deduction?** | **Yes, for amount recognized as regular income to employee.** | **Only for disqualifying dispositions for amounts taxed as ordinary income.** | **Yes, for amount recognized as regular income to employee.** |

| **Does the employee get dividends?** | **Can be attached to restricted shares before restrictions lapse.** | **Not until shares are actually purchased.** | **Not until shares are actually purchased.** |

| **Are there voting rights for employees?** | **Can be attached to restricted shares before restrictions lapse.** | **No.** | **No.** |

| **Is there value if the share price goes down below grant price?** | **Yes.** | **No.** | **No.** |

| **Do the awards affect dilution and EPS calculations?** | **Yes, but normally fewer restricted shares are issued than options because of their downside protection.** | **Yes, even if the awards are underwater.** | **Yes, even if the awards are underwater.** |

| **Can employees delay exercise after vesting?** | **No, shares belong to employee when restrictions lapse.** | **Yes, usually for several years.** | **Yes, usually for several years.** |

| **How is value affected by decrease in stock value below date of grant value?** | **Value of stock decreases, but not worthless.** | **Worthless.** | **Worthless.** |

| **Does the employer recognize an expense in its income statement?** | **Yes, in an amount equal to the fair value of the stock at grant.** | **Yes, in an amount equal to the fair value of the stock at grant.** | **Yes, in an amount equal to the fair value of the stock at grant.** |

| **How is the compensation expense recognized?** | **Accrued on the vesting or performance period.** | **Accrued on the vesting or performance period.** | **Accrued on the vesting or performance period.** |

| **Can the employer reverse compensation expenses for forfeited awards?** | **Yes, for forfeited awards with “service” or “performance vesting”.** | **Yes, for forfeited awards with “service” or “performance vesting”.** | **Yes, for forfeited awards with “service” or “performance vesting”.** |
VII. Enhancing Value through Appropriate Corporate Governance

Corporate governance is simply a fancy way to refer to the inter-workings of the bank or bank holding company at its highest levels including the board of directors, board committees and senior management. Because of the recent scrutiny applied to corporate governance issues, a review and analysis, or in many cases an overhaul, of the corporate governance processes in our community banks is likely necessary.

The following Ten Commandments will provide food for thought on the key areas where our attention should begin to focus.

I. Realize, the Times, They Are A Changin!

Corporate governance for most banks and bank holding companies, other than the largest, was a non-issue prior to the corporate abuses of the early 2000s. Times are changing even for the smallest bank, which now will require certain corporate governance restructuring. Thanks to the apparent lack of integrity and values in the operation of large corporations, all of us large and small have to pay.

II. Establish an Effective, Capable and Reliable Board of Directors.

Every community bank or bank holding company should have an effective, reliable and capable board of directors. This means having individuals with integrity who are qualified and successful in their own fields and who have the capacity, understanding and interest to focus on the financial services industry. That means that a majority of your board of directors should be truly outside, independent directors. Outside independent directors will have some stock ownership (you really don't want somebody running the company who has no financial interest) but would otherwise be independent; being “independent” typically implies the individual does not work for the company, does not have a material business relationship with the company, and is otherwise able to provide independent advice. The board must be effective and should meet in executive session at least monthly without the CEO, even if the CEO is a member of the board. The board also should set the long-term strategy, policy and values for the organization. However, the board should not micro-manage the institution.


As Yogi Berra said, “if you don’t know where you are going, you will wind up someplace else.” If corporate ethics, values and the like are not established at the top, at the board level, and used to govern the operations of the company, both from a long-term strategy and a daily basis through executive management, then executive management certainly cannot anticipate the rank and file employees will follow such a code on their own. Establish a workable, reliable and realistic corporate code of ethics for the way the company will conduct business internally.
and externally and review the code of ethics annually. Have board members and executive officers assist in the development of the code of ethics.

IV. **Consider Establishing an Office of the Chairman of the Board.**

Many organizations have considered establishing an Office of the Chairman of the Board. This may be a paid, full or part time position. It will be compensated only by salary and not subject to any type of supervisory authority by the executive management of the company. A separate Chairman of the Board will report only to the board and will be the board’s eyes and ears on a daily basis in connection with the workings of the company. While this certainly may not be feasible for many smaller community banks, it is still a concept worth exploring with respect to having a truly independent board chairman.

V. **Have an Effective and Operating Audit Committee, Compensation Committee and Nominating/Corporate Governance Committee.**

The audit committee, compensation committee and nominating committee should be composed of all independent, outside directors of the company who operate independently. These committees should have access to attorneys and consultants, paid for by the company, other than the corporation’s customary counsel and consultants. Clearly, under Sarbanes-Oxley and subsequent legislation for SEC reporting companies, the audit committee and compensation committee are entitled to such independent counsel and representation. In addition, the audit committee should directly retain the auditors and set the scope of the engagement. The committee also should monitor outside, non-audit work performed for the company by the auditors.

The independent nature of the compensation committee and nominating committee is also critical. The compensation committee should consist of all independent directors and should not be a rubber stamp for management. The nominating committee should consider establishing an evaluation system for board members. Simply because you are a board member elected at the last election, you should not automatically be re-elected at the current annual meeting, unless you bring some value to the institution.

VI. **Consider Effective Board Compensation.**

Directors, particularly with their new duties, responsibilities and liabilities, should be fairly compensated. However, admittedly, directors never will be truly compensated for the risk inherent in the position. Appropriate questions to consider are as follows. Should directors receive additional compensation for serving on some of the critical committees, such as audit, compensation and nominating? Probably so! Should directors receive stock options or restricted stock? Many do, as a way of keeping directors focused on the value of the company. If the bank or bank holding company’s goal is to attract and retain the
highest quality employees, it also should attract, retain and maintain the highest quality directors.

VII. REQUIRE CONTINUING EDUCATION FOR DIRECTORS.

The financial services industry is moving rapidly in a number of different directions. It is critical, even for the smallest institution, that directors be educated about the options and opportunities for the institution. Only then can they make wise choices with respect to its effective long-term strategies. Many state associations and other trade groups are now offering educational programs targeted specifically for directors. Your directors should take advantage of these options.

VIII. ESTABLISH PROCEDURES FOR BOARD SUCCESSION.

A critical issue of corporate governance is to make sure qualified board members are available. This involves issues of succession. Does the holding company have a mandatory retirement age that is actually enforced? Does a board self-evaluation process exist to rid the board of non-productive directors? Does the company have a plan to maintain a fully staffed board of directors with capable people, no matter what the ages, as it moves forward for the next several years? All of these must be addressed under the umbrella of corporate governance.

IX. DISCLOSE, DISCLOSE, DISCLOSE.

Publicly held banks and bank holding companies (reporting to SEC) will find that disclosure will be quicker and more onerous than in the past. Even for private companies and banks, disclosure needs to be stepped up. This may be through quarterly letters to your shareholders or other types of communication. But some means of communication, though not legally required, will go a long way toward furthering the confidence of your shareholders in your institution.

X. RECOGNIZE THAT YOUR DUTY IS TO ESTABLISH CORPORATE GOVERNANCE PROCEDURES THAT WILL SERVE TO ENHANCE SHAREHOLDER VALUE.

The primary job of the board of directors is to enhance the value of the shares held by its shareholders. This is generally done through growing earnings, providing an adequate return on equity, providing liquidity in the shares and some type of cash flow off the shares. All of that is contemplated within an overall strategy established by the board. Corporate governance procedures now should be part of that strategy and should be designed to enhance the long-term value for the shareholders.
The following are real signs that your organization’s corporate governance is not working:

1. **Directors Sign and Approve Documents Without Adequate Review.**

   The directors have a duty of care to act as reasonably prudent bank or bank holding company directors. This duty is heightened in the banking context more so than the corporate context. Directors are often presented with material which they have not had adequate time to review yet they are asked to sign off on it. Directors must be provided with adequate time to review material and must actually review that material before they execute it.

2. **Committee Charters Are Boilerplate.**

   Larger companies are required to have committee charters for the audit and compensation committees and advised to have charters for other committees. Smaller non-reporting companies often do not have such charters. Those that do, often have adopted a boilerplate charter they have gotten from someplace else.

   The creation of a committee charter should be a “real” exercise. The committee charter should indicate what the committee’s obligation is and how they perform it.

3. **The Nominating Committee Is A Social Club.**

   Most nominating committees for public or private companies could be best characterized as a “joke”. Very few boards have any type of board evaluation system (although some good ones are available). A nominating committee’s job is often simply to re-nominate those who were nominated and elected last year. The only exception in most community banks is if there is a death or a departure of one of the existing board members, at which point the board searches for someone who will come in without disrupting the board dynamic (whatever that is).

   A nominating committee exercise needs to be a real exercise. It is very difficult to make that a real exercise without also implementing some type of board evaluation. The board evaluations that are in place generally involve either the Chairman evaluating the board members or each board member evaluating each other board member, or a self-evaluation.

4. **Board Meetings Are Not Regularly Held.**

   Board meetings need to be planned out in advance and held regularly so the board members can attend. For most bank and bank holding companies, this is not an issue as it is with non-regulated private companies, since the bank regulators demand that the board meet regularly and exercise governance over the company.

   Meetings also should be based on adequate information provided early and discussed in as much detail as the board wants. Short meetings are not always the best meetings.
5. **Tough Questions Are Regarded As Undesirable.**

Directors need to be independent. They need to ask tough questions. If the climate is such that you have to "go along to get along", you need to get off the board.

6. **Corporate Minutes Are Useless.**

There is a fine line between transcribing verbatim the discussions at a board meeting and providing minutes that have no valuable information. Minutes should not be a detailed description of a meeting, but they should indicate particularly any dissention or the substance of a discussion over particular issues. Generally, if you dissent from a transaction and vote against it at the board level, even if the board approves it, if it turns out to be negligent, you as a director are off the hook. Make sure that dissent is recorded.

7. **The CEO Shields The Board From Other Members of the Management Team.**

If you don’t see management members at your board meetings, it is generally that you either have an extremely insecure CEO or there is something to hide. Board members should not try and micromanage the company, but should feel free to call upon the management team both at the board meeting and before and after, to answer questions, provide additional information and assist them in exercising their oversight duties.

8. **The Chairman Demands Unanimity, Not Consensus.**

On many boards, the Chairman views dissent as a sign of weakness. However, the reality is that unanimity is more a sign of weakness because it means that the Board is likely simply a rubber stamp for management. Dissent is healthy and unanimity should not be demanded.
VIII. Get the Right Board

Often, the directors neglect to "focus on themselves". If the goal and purpose of the Board of Directors is to direct the institution, then the Board must focus on numerous critical areas of its own existence. These include answering the following questions:

1. What is the ideal board size?

   Most charters for banks and bank holding companies provide a range for the size of the board of directors, e.g. 5 to 25. The Board simply needs to decide what its most effective operating group is. Once that is decided, the Board will recognize whether there are board succession issues or board attrition issues which need to be addressed. In other words, do we need to add directors or get rid of some of the existing directors?

2. What qualifications should there be for board membership?

   As part of an institution's anti-takeover plans, often board members are required to live in the community, etc. Does the Board also want qualifications that deal with minimum stock ownership, age, active trade or business, and the like?

   In addition to general qualifications, what specific skill sets does the Board require when a vacancy exists? In other words, do you need an accountant? A lawyer? An individual with real estate experience? These considerations are very important depending on your current Board’s expertise and the needs of the bank at the time of the vacancy.

3. What should the composition of the Board look like?

   This generally means has diversity been adequately addressed on the Board. Does the Board have minority members? Does the Board have women? What should the Board composition be? As with qualifications, this consideration is particularly important when there is a vacancy on the Board.

4. What about Board compensation and incentives? Is the Board adequately being compensated?

   It is pretty clear the Board cannot be compensated for the risk, but can they be incented to bring business to the bank and the like?
Gerrish McCreary Smith
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Commandments for Community Bank Directors

Now in its third edition, this 221 page book represents a compilation of the noted "Ten Commandments" articles published by Gerrish McCreary Smith over the years. Topics include Commandments for Bank Directors, Commandments for Enhancing Shareholder Value, Commandments for Strategic Planning, Commandments for Dealing with Regulators and other topics.

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Gerrish's Musings is designed for CEOs and board members of community banks. Gerrish's Musings reflects our firm's insights and experiences as we travel weekly visiting with community bank clients from coast to coast. The newsletter is delivered by e-mail twice a month to subscribers.

This is a free publication.

Quantity

The Chairman's Forum Newsletter

The Chairman's Forum Newsletter is designed specifically for Chairman of the Board. The newsletter is the response to the overwhelming success of the Chairman's Forum Conference hosted by Jeff Gerrish and Phillip Smith twice yearly. The newsletter is published electronically each month governing topics unique to the changing role of the Chairman of the Board.

This is a free publication.

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Dear Subscriber:

Greetings from Missouri, Florida, Minnesota, New York, Vermont, Maine and Texas!

THE MORTGAGE BUSINESS

I recently had a discussion with a client about whether a community bank should be involved in the mortgage business at all. By mortgage business, I mean originating first mortgages on single-family residences, which the community bank would then either portfolio or sell in the secondary market. A number of our community bank clients exited the mortgage business back when the QM (Qualified Mortgage) Rules came on (i.e. the verification of income, ability to repay, etc.). Another bundle of our community bank clients exited when the Truth in Lending and RESPA requirements were combined (TRID). So what are the triggering factors as to whether a bank should decide to stay or go from the mortgage business?

It seems to me the real answer to the question is this: when a customer comes into your bank and asks for a first mortgage home purchase loan or refinance, does your community bank have a “solution” for the current customer or potential customer’s need? If the community bank does have a solution and that solution is its own mortgage operation, great. If it is a legitimate referral under RESPA to another company from your community bank, great. But it seems to me we are community banks and that mortgage piece is important. The real question, of course, is does your community bank have enough volume to be profitable. Keep in mind that any community bank board of director’s goal must be to enhance shareholder value. Part of this
means to continually grow earnings per share. If your community bank is losing money on the mortgage business, that is not helpful with respect to the profitability analysis. Generally there are a couple of choices: your community bank gets out of the mortgage business altogether, the community bank outsources it someplace (which hopefully will be seamless), or the community bank ramps it up.

**MANDATORY RETIREMENT**

Over the past several months, I have been with several community banks that have a mandatory retirement age for their directors. The age varies from as young as 70 to as high as 80. I always kid the boards that have mandatory retirement that they simply put it in because they do not have the “fortitude” to make the hard decision to tell one of the older directors that he or she is no longer productive and needs to get off the board. Of course, the counter to that problem is that the community bank also locks in non-productive directors until they get to that mandatory retirement age.

On some of the boards I have recently been with, the retiring director is one of the better directors on the board. Of course, these long-time directors have significant institutional/corporate knowledge, but they also have real world experience and general wisdom. I fully understand and agree with the need to continue to refresh the board with younger members with different skillsets, but still I am not a firm believer that mandatory retirement is the way to do that.

**DUE DILIGENCE ADJUSTMENTS**

In the course of a “normal” community bank acquisition, the potential acquirer submits a non-binding Indication of Interest that outlines the general terms of the transaction that is being proposed. The Indication of Interest is always subject to due diligence. What typically happens is the seller accepts the Indication of Interest and then allows the buyer to come in and complete due diligence to confirm their Indication of Interest or, in some instances, revise the contemplated terms, typically downward.

If I were to take a guess, I would say that probably 75% to 80% of the time the acquirer comes in and confirms the terms of their Indication of Interest. Maybe 20% to 25% of the time the terms of the Indication of Interest are adjusted based on the due diligence review. In these instances, the adjustments are typically not enough to kill the deal. My experience has always
been that if due diligence is really that bad, the acquirer simply walks away because it is not buying what it thought it was actually bidding on.

We are currently assisting a seller in figuring out how to address a significant change to an Indication of Interest based on due diligence. In this instance, an acquirer came in and proposed a purchase price the board was willing to accept. Following the execution of the Indication of Interest, the acquirer came in and did due diligence, and then came back and said they were going to reduce the purchase price by 25%. That is a significant amount of money. We are working through the process. However, I told my client that I thought this was very unusual based on what I have seen in other transactions. I really wonder whether this acquirer was genuine in their original offer or whether they were just “buying their way into the winner’s slot” with the thought that they would significantly reduce the purchase price following due diligence. Not a really great approach. I will keep you updated.

THE “MERGER OF EQUALS”

I assume many of you, like me, read with interest the recent announcement regarding the “merger of equals” between Chemical Financial and Talmer Bancorp, two Michigan bank holding companies. I also read with interest a summary of Talmer’s investors’ comments related to the transaction. To put it kindly, Talmer’s shareholders were less than enthused.

In the interest of full disclosure, our consulting and law firms are not representing either of the parties to this transaction. However, the press release had plenty of information to figure out what is going on. In the transaction, Talmer is selling to Chemical in a 90% stock and 10% cash transaction. At the end of the deal, Chemical’s current shareholders are going to own 55% of the combined organization’s common stock. Chemical’s current board of directors will make up seven of the 12 directors of the combined organization.

Talmer has worked very hard to publicly acknowledge this transaction as a merger of equals. From an outsider’s perspective, I do not see this as a merger of equals. In my opinion, this is a sale of Talmer to Chemical, plain and simple. After the transaction, Chemical’s shareholders and directors are going to control the majority of the stock and the majority of the board seats. I see that as an acquisition.

I have seen this scenario play out in community banks many times. It is not terribly uncommon for two parties to sell a transaction as a “merger of equals” to make the selling shareholders feel like they are getting more in the deal than they really are. Apparently it works
on big bank transactions as well. It is probably not a bad deal for Talmer at all. It is simply not a true merger of equals.

THE STRUCTURAL TRADEOFF

We are currently working with a community bank that is looking to make an acquisition of a smaller, troubled institution. The target really has quite a few difficulties. It includes the usual suspects, such as problem loans, OREO, compliance issues, etc. It is not a “squeaky clean” institution by any means.

In any bank acquisition, the parties have two structural alternatives. The first is to structure the transaction as a whole bank merger, where you simply merge the target bank into the acquiring bank and the acquirer operates as a combination of the two organizations. The second alternative is a purchase of assets and assumption of liabilities transaction, where the acquirer purchases certain assets and assumes certain liabilities of the target. In this second type of transaction, any asset that is not purchased or liability that is not assumed remains with the seller.

Both of these transaction structures have positives and negatives. In the merger transaction, the positive is that the merger of the target into the acquirer is a fairly simply process that, once completed, leaves no loose ends for the seller to tie up. The tradeoff is that the acquirer takes the target “warts and all” and is responsible for any and all of the target’s liabilities, both known and unknown. In a purchase of assets and assumption of liabilities transaction, the opposite is true. The target has a little bit of cleanup work left to do after the transaction in terms of dissolving the organization, and the acquirer is only responsible for the liabilities for which it expressly assumes responsibility. If there are any unknown liabilities, such as a lawsuit that pops up six months after closing, it is the target, not the acquirer, that has to deal with that. There are also positives and negatives from a tax perspective.

In one of the acquisitions we are currently working on, we are assisting the acquirer in weighing all of these options. Based on the condition of the target, it appears the purchase of assets and assumption of liabilities is the more appropriate structure. There are some financial reasons that it would make sense to structure this as a merger transaction, but those reasons are outweighed by the benefits of selecting only the assets the acquirer wants to purchase and limiting any future unknown liability. This analysis comes up in almost every community bank acquisition we evaluate, but it just seems to be a little more magnified in this situation.
ICBA NATIONAL CONVENTION

As most of you know, the ICBA National Convention will be held March 6th through 10th in New Orleans. The recent ICBA daily email indicates the “early bird” registration ends February 5th. From our standpoint, the ICBA National Convention is an opportunity for us to visit with many of you. This year our firm will be making a number of different presentations at the Convention. Both of us (Jeff and Greyson) and our partners, Philip and Doc, will all be doing breakout sessions on various topics. We hope to see you there!

CONCLUSION

You will note from the “Greetings” line that we have crisscrossed the country in the last couple weeks. Miraculously we avoided Snowmagedeon in the D.C. and upper Northeast area. In fact, other than some flight delays trying to get in through some of the hubs, we managed to get to all of our client meetings.

Keep an eye out for spring. It is around the corner. See you in two weeks.

Jeff Gerrish and Greyson Tuck
Congratulations on making it to 2016! As we move into the new year, issues impacting Chairmen of the Board, their Boards of Directors and their organizations abound. As always, the materials for The Chairman’s Forum Newsletter will be shaped by the events of the day, interesting developments we have experienced in our interactions with clients throughout the year or circumstances we deem worthy to comment upon as they impact your job and duties, as Chairmen.

Throughout the year, if you have topics of interest, please forward those to us or provide us with anecdotal information that other Chairmen and directors might find useful. As you will see in this first edition of 2016, we look at a number of different issues that we have taken from circumstances involving our clients or comments others are making about the current state of financial institutions and, in particular, community banks. We hope you find this information worthwhile and we look forward to your continued support during 2016 and we hope to see many of you at your banks soon to lend a helping hand.

Happy Reading!

Philip K. Smith

and

Jeffrey C. Gerrish

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Chairman’s Summary

♦ Don’t believe everything you read.
♦ Implement the fundamental requirements for a successful organization.
♦ Basic fiduciary duties still matter.

Professionals Can Be Wrong

We recently read an article in the *American Banker* which highlighted discussions from the annual “Acquire or Be Acquired” seminar. Many of you may have heard of this conference which is normally held out west each year and purports to be geared toward community banks. Often our clients have asked us why they have never seen our firm listed as a speaker at the conference since community bank M&A is our specialty and we speak at most other similar conferences. To us, that particular conference often seems to take a turn toward publicly traded institutions, market multiples of publicly traded banks, and issues not really relevant to traditional family-owned or community banks. Therefore, it was a bit difficult, though not overly surprising, to read of the major conclusion presented at the conference by some of the professionals in attendance. That conclusion was reported recently in the *American Banker* and was simply that banks have to get bigger to survive.
It seems a major principle of the conference was that banks needed to buy other banks in order to survive and, guess what, the professionals are there to help them do that. On the other hand, if you happen to have been a smaller bank attending thinking this would be a conference to help you figure out ways to improve your community bank, it seems the thrust of the conference was that you are not going to be able to make it and you need to sell to some of the other folks who are in attendance. That does not sound like an uplifting conference for community banks or one that instills much empowerment. And, we think they are dead wrong.

Community banks and smaller banks will continue to have a place in the financial services market going forward. That doesn’t mean you will be standing still or that you will not do things differently (as we outline further in this newsletter), but that does not mean you necessarily have to double or triple your asset size in order to be successful or even to survive. When is the last time a stockholder called you as Chairman complaining about your relative asset size compared to your peer group and the quartile that you are in in your Uniform Bank Performance Report? Probably never. Rather, stockholders might very well call and want to know why their dividends have been decreased or when is the next dividend or when can they sell their shares? So, if you are fed up with being told you are not good enough and you are not going to make it (whether it’s in a national conference or not), and you would like a bit of a different perspective, consider attending the ICBA Annual Convention where we will be presenting a number of topic discussions including one by Philip Smith titled “How NOT to Sell Your Bank”. Perhaps you would like to hear a bit of the good news that not
everyone thinks you are doomed to failure. No wonder they don’t ask us to speak at that conference.

**Must Haves for 2016**

As outlined above, being a community bank or Chairman of a financial institution does not mean you have to grow the bank or sell it to survive, but it also does not mean that you should consider the status quo as the appropriate strategy. There continue to be fundamental organizational steps institutions need to make to ensure their long-term vitality and success. Among the multiple options that are out there, we highlight four key ones here that many organizations still have not pursued and which apply to a lot of smaller organizations.

First, there still remain a number of banks across the country that have not formed a bank holding company. That structure is a necessity for most organizations because it helps with capital raising, leveraging debt for capital and acquisition or other purposes, may help with board structure and board governance and helps to create a mechanism for liquidity for stockholders. The bank holding company structure helps to improve overall organizational operation and efficiency, and is very non-invasive from a regulatory standpoint. Consider taking that step in 2016 if you have not already. If you would like more information on that structure, please contact us at psmith@gerrish.com.

Similarly, for organizations that qualify or can qualify, Subchapter S status is still the way to go. Improving the overall tax structure in a beneficial way for the organization and for stockholders creates more overall
organizational value. While there are limitations on the organizations that can qualify (having fewer than 100 stockholders, counting six generations as one shareholder being a key component), do not be misled by those professionals who indicate that, unless you have fewer than 100 stockholders to begin with, it is impossible to do. There are numerous ways to structure transactions to reduce your stockholder base in order to qualify or to remove non-qualifying stockholders. Furthermore, a reduction of your stockholder base in order to qualify for Subchapter S can often be undertaken in a way that does not disrupt key stockholders, does not upset your community or cause other unwanted side effects. For example, it could be that the stockholders whose shares are to be acquired in order to reduce the number might simply be those who live out-of-state, those who no longer have a desire to be connected to the organization, or some other function. In that regard, a Subchapter S reorganization can help further solidify the bank as a true community bank owned locally. Therefore, Subchapter S is a transaction that all community banks should consider even if it means eliminating a few stockholders because of the tremendous economic and other benefits it provides. Put this on your list of considerations for 2016 as well.

An additional component of “must haves for 2016” relates to the notion of creating liquidity for stockholders. In simple terms, it means providing a buyer for shares when stockholders want to sell. Far too many community banks wind up with disgruntled stockholders because they don’t ever really give them an opportunity to sell their shares if they desire to do so. Therefore, the first time some professional comes knocking on the door and indicates they have a potential buyer, the stockholders want to jump at
the opportunity to get cash for their shares. The better alternative is for the bank holding company to be its own market maker by creating liquidity through stock repurchase transactions.

Whether it is a targeted transaction at only out-of-state stockholders (for example) or a repurchase transaction that utilizes excess capital in an effective way to create liquidity, the organization is almost always benefited financially by structuring ways to buy back its own shares. Your shares are probably undervalued in terms of trading history compared to what the true market value is, so, rather than selling your organization to someone else as a way of creating liquidity, why not have your organization buy back your own shares at what might arguably be a discount to the market value in order to create liquidity for the selling stockholders and more benefit to the remaining shareholders. You will find that earnings per share, return on equity and other economic components are positively benefited.

A final component of this four-part plan of “must haves for 2016” is to continue to focus on strategic planning. In the past 15 years, almost all organizations have undertaken formal strategic planning in one form or the other. Continue to make that a part of your overall yearly process whether it’s a formal strategic plan facilitated by an outside professional (like our firm or many other qualified firms) or whether it is something you informally do yourselves. As Chairmen, require your board to undertake that process at least on an annual basis and make sure you honestly address real, hard questions. For example, who is the next Chairman? When are you, as Chairman, going to retire? Do we need to implement a board evaluation process? Do we have true management succession at levels
beyond the CEO? Are we willing to take the steps necessary to continue to create value, or should we take advantage of merger and acquisition opportunities before the window of deals closes? If you don’t know where you are going and how you are going to get there, you are surely to wind up at a spot that you do not want to be.

**How Not to Exercise Your Fiduciary Duty**

We were recently involved with a transaction where we were representing a bank that was structuring what most people would call a “merger of equals”. Actually, our client was going to have more board seats, be the larger organization following the deal, was in better general overall economic health and so, in essence, our client was really buying the other bank. But sometimes bankers like to use terms like “mergers of equals” to make themselves feel better that they have not sold their bank, so we agreed to call the transaction by that term. Through the typical series of negotiations back and forth between the parties and among the professionals involved, the two respective banks had agreed on all of the financial elements of the deal that provided the best economic benefits, created value for the stockholders of both the buyer and the seller, and would produce a great institution for their respective communities going forward. It was really going to be a positive transaction for both organizations. However, the deal fell apart at the eleventh hour. At issue was the fact that, of the eight current board members of the other organization, only six of them were going to be offered full-time board positions of the combined organization. The selling bank agreed to that division of board seats and the selling bank was going to be able to select which six of the eight that they wanted to have
serve on the combined board to represent their interest in the combined “merger of equals”. The purchasing bank would maintain eight board seats.

The selling Board of Directors ultimately decided that the two board members who would not be selected for full-time board service should be offered some type of advisory board positions on the combined banks, should be paid exactly the same board fee as other true board members, should be able to come to all the board meetings and participate just like any other board member except not vote and otherwise be given the opportunity to “save face” by not being labeled as the directors who did not get to continue with the combined organization. The purchasing bank had “given in” on a number of different areas to try to accommodate the selling Board of Directors, but when it came to this final piece, they finally stood their ground and said they were unwilling to compromise on that basis. Board members would be selected for the combined organization and they would even let the two non-selected board members continue in an advisory position for one year at a reduced board fee, but that was it (as Chairman, consider whether you would want to pay “advisory” or “observing” people who merely show up at your board meeting with no fiduciary duty or true liability the same fee as board members who have 100% liability and all fiduciary duties). The selling bank’s Board of Directors then walked away from the deal because these two directors could not get more personal cash in their back pocket. Clearly, in our opinion, this was a breach of fiduciary duty to put their own financial self-interest ahead of the organization’s financial health and the overall economic value to stockholders in a transaction. As Chairman of the Board, there comes a time when you have to stand up to your own directors occasionally and tell them they are doing
the wrong thing. This was one of those cases where strong Chairman of the Board leadership could have helped hold a deal together and prevent a disgruntled stockholder of the selling organization from having a claim for breach of fiduciary duties at some point in the future. Let’s hope their stockholders don’t find out.

**Chairman’s Forum Conference Update**

In the last edition of *The Chairman’s Forum Newsletter* prior to the end of the year, we announced that there would be two Chairman’s Forums held in 2016. We have a slight updated modification to that. In 2016, we will be holding our general annual Chairman’s Forum conference (the one we have held in Las Vegas a number of times) in Napa, California, on November 14 and 15 at the Meritage Resort. It’s going to be a great venue and a great occasion, so please sign up early. On June 13 and 14, in St. Paul, Minnesota, at the St. Paul Hotel, which is also a wonderful location, rather than holding a complete Chairman’s Forum conference, that conference is going to be structured around the current merger and acquisition environment from a community bank standpoint, but will also have some elements of discussing Chairmen’s roles and duties in that context and otherwise. We typically establish that event as a bit of a hands-on workshop as well. So, if you personally do not plan to attend that, it would be a conference to send your President, CEO or CFO to attend. We hope to see you there.
Meeting Adjourned

It is time to get moving in 2016. That does not mean selling your bank necessarily, but it does mean looking at new opportunities. Ensure that your Board of Directors is appropriately exercising its fiduciary duties and engaging in appropriate strategic planning to set your course for the new year. We will look forward to seeing many of you “on the road” and we appreciate your continued loyalty and support of our legal and consulting firms. Your business and your friendship are paramount to us and always know that at Gerrish McCreary Smith, The Client’s Needs Come First.

Until next time,

Philip K. Smith

and

Jeffrey C. Gerrish
GERRISH McCREARY SMITH
NEWSLETTER

PLEASE SEND YOUR EMAIL ADDRESS TO:
sloudermilk@gerrish.com

If you would like to be added to our database of clients and friends who receive this publication by email free of charge, please contact us or leave your business card with the speaker.
Why You Need to Look Beyond Traditional M&A Metrics

A lot of focus is placed on the purchase price of a community bank merger or acquisition. The reason for this does not need much explanation – purchase price is an easily understood figure that is quantifiable to shareholders and analysts through metrics like price to book value, price to earnings, etc. For directors and officers of community banks, the primary obligation is to enhance value for the organization’s shareholders. Within the mergers and acquisitions context, enhancing value is tied directly to a transaction’s purchase price because it represents the economic value of the transaction to the shareholder. In many cases, however, focusing on the purchase price alone is not enough.

Striking a good deal requires identifying the true costs and benefits of a merger or an acquisition, which requires you, as a bank director or member of management, to look beyond the current face value of the purchase price. Every transaction is unique, but there are common costs that are either overlooked or overemphasized that impact the ultimate value and cost of a deal to your organization’s shareholders.

The Opportunity Costs

One of the often overlooked costs is the opportunity cost associated with the transaction. Purchase prices are often viewed in a vacuum at the time of sale. The real issue is whether the price your holding company is paying for the target is the best allocation of capital now and in the future, or if you are a seller, is the price you are receiving today better than the value of the bank in a few years?

Everything changes when you sell your institution, and everything has the potential to change if you buy another institution. Once a deal is done, it is done. Once you commit to a transaction, you forfeit other opportunities. No bank director has a crystal ball, but in order for boards of directors to make as best a decision as possible, they have to weigh options. That weighing has to occur through very strategic planning. This means actually comparing on a side-by-side basis the benefits of doing a transaction versus not doing it. For a buyer, it may mean comparing the economic benefit of an allocation of capital to repurchase shares, as opposed to purchasing another organization. For a selling organization, it may be the economic benefit of converting to Subchapter S status and remaining independent versus accepting a current cash purchase. The bottom line, though, is to actually know the full impact (economic and social) of other opportunities.

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that exist and compare them to the impact of the transaction at hand.

The Hidden Costs

Regardless of what community bank buyers and sellers tell you, very few organizations actually have a hard line in the sand when it comes to purchase price. The buyer will generally pay a little bit more if the seller can identify tangible cost savings to the buyer as a result of the transaction. On the other side, sellers are typically willing to take a little less to push a deal through, but the seller might want to negotiate for some non-financial elements, such as retaining key employees and the like.

If you are willing to dig even deeper into the technical aspects of a transaction, typically with the help of your professionals, you will find other aspects of a transaction that can benefit one side or the other. Often, these hidden costs are associated with relative taxation or termination of data servicing contracts, for example. If you can identify these components, you have an extra negotiating chip. If the other party is going to get a benefit after the transaction closes, then that benefit should be taken into account early in the negotiation process.

The Unexpected Costs

A bank merger or acquisition will likely cost the holding company more than it anticipates on the frontend, particularly if you are a buyer. Legal expenses, state filing fees, integration and deconversion costs, personnel expenses, and the like are a reality in every bank deal. Institutions that have significant merger and acquisition experience learn to build the otherwise unexpected costs into their model. However, many smaller institutions with little to no merger or acquisition history are often surprised when all transaction costs are ultimately accounted for.

Do not let these unexpected costs steer you away from a good deal. Some of these costs, such as state filing fees or “fair value” accounting under FASB 141R, are simply costs of doing business. Other costs, such as legal and consulting expenses, should pay for themselves in value added to the deal if you have picked your professionals wisely.

There are also costs associated with certain transaction structures, such as when stock is being issued in a transaction. In the current environment, as more buyers look to utilize stock as a currency, it is important that the buyer do its homework on the front end to ensure that a securities exemption is available for the issuance of the shares in order to avoid additional costs that could be incurred. Depending on the number and location of target shareholders, there could be multiple regulatory filings (with accompanying fees) that need to be made and numerous certificates to print and issue.

While a bank deal’s purchase price serves as a simplified indicator of an institution’s value, there are many costs that a purchase price does not illuminate. In our firm’s nearly 30 years of serving as transaction counsel and financial advisors to community banks on both sides of the negotiating table, we have seen the failure to identify opportunity costs, hidden costs, and unexpected costs result in a potentially good deal going bad.

In order to ensure that your shareholders are getting the most value out of a merger or acquisition, you must identify these costs on the front-end. Doing so will ensure that you have all of the information you need to ensure you negotiate the best deal for your shareholders.
THE CHAIRMAN’S FORUM NEWSLETTER

The Chairman’s Forum Newsletter is a complimentary monthly email newsletter exclusively designed for community bank Chairmen, Vice Chairmen, and senior directors. The Newsletter is the response to the overwhelming success of the ICBA’s Community Bank Chairman’s Forum Conference hosted by Gerrish McCreary Smith.

If you would like to subscribe to the complimentary Chairman’s Forum Newsletter, please contact Carolyn Martin at (901) 684-2326 or cmartin@gerrish.com.

Four Ways to Improve the Board of Directors

Since the beginning of the Great Recession, community bank boards of directors have experienced a different reality than they had in the past. Not only did regulatory expectations for boards skyrocket, but director liability for failure to properly oversee the institution did as well. With new regulations and new expectations, many community bank boards simply feel overwhelmed. While the sky is not falling, it may be time for the board to step back and assess how to improve its overall structure, efficiency, and effectiveness. Considering the following four issues will help in that regard.

Make the Most of the Meeting

One of the simplest ways to improve your board is to make sure board meetings are efficient and focused on issues related to risk and strategy. Unfortunately, far too many boards engage in the time consuming discussions and decisions on routine tasks based on how things have always been done. Many community bank boards of directors got understandably short-sighted during the Recession. To be successful in the new environment, however, boards of directors need to stop looking in the rear view mirror and look forward to more strategic and risk-related matters. As a practical solution, consider providing each director with an electronic packet of materials to be considered at the meeting at least three days prior to the meeting. This will allow the directors to spend more time considering and discussing strategy for the bank rather than reviewing numbers that could have been distributed electronically a week earlier. Another practical consideration is to utilize a consent agenda, which combines routine items that must be approved by the board, such as the prior month’s board or committee meeting minutes, into one document. The consent agenda would be distributed to the directors for review prior to the meeting along with the other materials. Then, rather than presenting and voting upon each of those items one-by-one at the meeting, the board would approve all items on the consent agenda as a whole with one motion and spend the meeting discussing more substantive items.

Know “Enough” About the Regulatory Environment

“They don’t really expect me to know that, do they?” is almost always the first question asked by at least one director when a regulatory or compliance concern comes to light at the bank. Although regulators recognize community bank directors are often not banking experts

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and cannot be expected to know every one of the laws and regulations, as soon as a violation arises at the bank, the violated law or regulation is generally viewed by the regulators as one of the “important” ones that all directors should know inside and out. As a result, directors are practically expected to guide the bank through a litany of laws and regulations that are beyond the director’s professional experience and expertise.

The best way to meet and exceed this expectation is for the institution to establish manageable knowledge standards for the directors and implement an education program specifically geared to meet this standard. Practically, the bank should arm directors with a small amount of information regarding all laws and regulations that apply to their institution, with the goal of them being able to identify potential issues or concerns and then seek additional input and guidance. This can be accomplished in many ways, all of which fall under the umbrella of “director education.” Fortunately, there are a large number of quality telephone audio seminars and internet-based webinars that address a large variety of subjects with little logistical inconvenience for the director. These opportunities can be supplemented with live conferences that provide networking and idea sharing opportunities in addition to educational opportunities on a variety of topics, and/or bringing outside experts to your institution to address subjects of particular interest. The key is for there to be a cost effective program that provides periodic education on a large number of topics in manageable levels of detail.

Know Your Bank

Just as a director is expected to understand regulatory issues that impact his or her bank, the director is also expected to understand what makes the bank tick. This, of course, means all directors should have a working understanding of the bank’s operations, risk profile, and profitability. Often overlooked, however, is how critical it is for a board to understand the cultural elements of the bank.

Since the end of the Great Recession, our firm has conducted numerous management studies for community banks. The reality is the management team that led the bank through the recession or worked well together in “crisis” mode may not be the best fit for the bank’s profitability and independence moving forward. Also, the management team that did well running a $200 million institution may be overwhelmed running a $600 million institution.

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 Community Bank Directors, 2nd Edition – The second edition of Gerrish’s Glossary for Bank Directors is now available! Providing over 200 pages of definitions for customary industry terms, the revised second edition is the ideal tool for your board to use when it encounters unfamiliar terminology. This edition is available as a paperback book or a searchable .pdf format for directors to access on the board’s electronic board portal.

To obtain information about purchasing either of these books, please contact Shelley Loudermilk at (901) 684-2306 or sloudermilk@gerrish.com.
million institution. A management study conducted by an independent third party can often uncover, or at least identify the existence of, issues that exist in management that need to be addressed sooner rather than later. On the other hand, the management study may indicate that management is fit and positioned to lead the bank into a successful future. Either way, the board has done its due diligence and is better prepared to make the strategic decisions that need to be made.

Another way to understand the bank more fully is to conduct a corporate culture survey. This involves surveying all (or at least most) employees in the organization, on an anonymous basis, regarding various issues, such as management, culture, compensation, accountability, etc. Our firm has conducted corporate culture surveys for small institutions and institutions with over 100 employees. In all cases, the board has walked away with an understanding of “front line” issues that it could not have seen otherwise.

Implement Director Evaluations and Succession Planning

In the current environment, director succession planning is a requirement. For some institutions, that is simply a mandatory retirement age and, for other institutions, it is an evaluation of current director qualifications. But, regardless of the process, simply allowing directors to remain “directors for life” is no longer acceptable. Periodic director evaluations, whether conducted internally or by a third-party advisor, are a useful way of ensuring everyone is focused on the shareholders and headed in the same direction. Additionally, engaging in succession planning helps keep the board focused. This process should analyze the current board structure, assess needs of the board, define qualifications for new directors, and identify potential candidates that meet the criteria. Effective succession planning not only assists the board in transitioning smoothly through changes, but also forces the board put its current and long-term needs on paper and evaluate whether the current board measures up.

As your board strives to become more effective and efficient, consider these four practical tips. We believe they will serve your board well. Let us know how we can help.

Follow us on Twitter!
@GMS_Memphis

Gerrish’s Musings

Gerrish’s Musings is a complimentary, twice-per-month newsletter based on Jeff Gerrish’s and Greyson Tuck’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.

As noted, Gerrish’s Musings is a complimentary, twice-per-month newsletter and available by email for your entire board and officer group. For further information, please contact Shelley Loudermilk at (901) 684-2306 or sloudermilk@gerrish.com.
The Benefits of Independent ESOP Advisors

For years, our firm has preached the benefits of an Employee Stock Ownership Plan (ESOP) to community banks. An ESOP is a qualified, defined contribution plan that must be primarily invested in the employer company’s stock and ultimately serves as a vehicle for the company’s employees to invest in the company. While an ESOP provides numerous advantages to the company, such as tax benefits, leverage financing, facilitation of stock repurchase plans, and anti-takeover defense, an ESOP’s primary purpose must be to operate for the exclusive benefit of its participants, and it must not discriminate in favor of the highly compensated and others in the prohibited group including officers, directors, and shareholders. To ensure this primary purpose is accomplished, an ESOP is required to have a trustee.

According to federal law (ERISA Section 403(a)), the trustee “shall have exclusive authority and discretion to manage and control the assets of the ESOP.” The trustee of an ESOP can be anyone, including members of management or the employer board of directors. Regardless of who acts as the trustee, however, the trustee must make decisions regarding the assets of the ESOP, including the purchase or the sale of the employer shares, in a way that will best benefit the plan participants. In general, members of the community bank’s board of directors and management typically serve as the ESOP trustees in order to maintain control over disposition of the stock. With that said, considering that many members of management will own shares in the ESOP and many members of the board of directors will own shares of the company alongside the ESOP, it does not take too much creativity to come up with a scenario in which there is a conflict of interest, particularly in merger and acquisition transactions. For this reason, our firm always recommends use of an independent consultant when considering these type of transactions.

Inside trustees, such as members of management or the board of directors, have an advantage over outside trustees in that they are familiar with the bank’s operations and, as a result of their personal investment, they likely have a high level of diligence when it comes to carrying out duties as trustee. This often translates into a more intimate understanding of what is in the best interest of the bank and its shareholders, including the ESOP participants. This appeal, however, does

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GERRISH McCREARY SMITH
AFFILIATED RESOURCES

Over the last 30 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 branch location specialists, IPO managers, securities transfer agents, loan review specialists, auditors, bank technology specialists, executive placement firms, and the like.

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

Jeff Gerrish
jgerrish@gerrish.com
have some drawbacks. Primarily, the inside trustees are in the business of banking, not managing ESOP assets. As a result, they may not have the same level of familiarity with applicable laws and regulations or the full ramifications of their decisions. Perhaps more importantly, however, inside trustees will not provide the same level of objectivity as an outside party who would operate free of pressures from employees, ownership, and the like.

This latter situation is why our firm recommends the use of an independent advisor for the ESOP, and possibly an independent trustee under more complex circumstances, in situations such as a merger or acquisition transaction. For most community banks, engaging a full time independent trustee for the ESOP has significant disadvantages, such as cost and additional red tape, as well as loss of control over the stock. On the other hand, an independent trustee does offer a level of protection for plan participants, as well as eliminate potential liability for the inside trustees on the grounds of a conflict of interest. An independent advisor can bridge that gap.

As an example, consider a situation where the employer company/bank is considering a sale, and a member of management serves as a trustee of the ESOP. Members of management have a myriad of considerations that could impact their decision as to whether to sell the bank. Will they be retained by the acquirer post-transaction? What payments will they receive according to the terms of their employment agreement and/or supplemental benefit plans for the executives? Even if the insider trustee can compartmentalize the issues and truly make a decision in the best interest of the ESOP participants, the insider still has liability concerns simply as a result of the appearance of a conflict.

An independent third party has a much more simple framework in which to operate—what is best for the ESOP participants? The third party is able to assess the benefit of a transaction for the participants without the other considerations. There are no conflicting interests at play, which in practically every case is better for the ESOP participants. Thus, management and the board of directors would maintain control over the ESOP stock during normal operations while ensuring they and the ESOP participants are protected in case of an acquisition.

Consider as another example an anti-takeover attempt. According to federal law, an ESOP may not purchase stock for more than fair market value. Other than this rule, the plan trustee can take any action that would

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assist in hindering an unfriendly takeover attempt. Community bank shareholders traditionally have little if any liquidity for their shares in the open market. However, because community bank shareholders typically prefer to keep the local bank independent, they are more likely to sell shares to the ESOP rather than an outsider, such as a bigger out-of-town bank. So long as the ESOP trustee does not pay more than fair market value for the shares, the ESOP serves well in this case as an anti-takeover device.

In anti-takeover situations, an inside trustee has clear benefits for control purposes. However, the fiduciary responsibilities of a trustee in such situations can be somewhat unclear. There are a growing number of cases and positions taken by the Department of Labor that can help to offer a guideline to the trustee in determining a prudent course of action, but those documents must be examined very carefully. Because a breach of fiduciary responsibility by a trustee can result in personal liability, it is often a relief to management and the board of directors to have an independent advisor that can assist the trustees in making a decision on behalf of the ESOP while also allowing management and the board to strive to keep the bank independent.

While no two community banks are alike and each must make a decision that is in the best interests of the specific organization and its shareholders, it is a best practice to have an outside, independent advisor for the community bank’s ESOP when dealing with merger and acquisition issues. ESOPs offer too many advantages to not have one in place, and management and directors have too much on their plate already.

If any of you are in need of independent counsel for your institution’s ESOP, or if you would like to discuss setting up an ESOP, please let us know.
RESOURCES

Gerrish McCreary Smith has created numerous Memos to Clients and Friends on various topics (available free of charge). Set forth below are sample Memos to Clients and Friends:

Acquisitions
- Responding to Unsolicited Offers
- Restrictions on Stock Received in a Merger or Acquisition Transaction

Employee Benefit Issues
- Incentive Compensation Plans
- Requirements of Employee Stock Purchase Plans
- Key Employment Contract Provisions Utilized by Community Banks

Raising and Allocating Capital
- Raising Capital Without Registering with the SEC
- Stock Repurchase Plans

Regulatory
- Qualified Mortgage Rule
- Civil Money Penalty Process
- Basel III's Capital Conservation Buffer

Subchapter S
- Maintaining a Subchapter S Election
- Use of S Corporations by Financial Institutions

Miscellaneous
- Loan Production Offices
- Efficient Conduct of Board Meetings
- Enterprise Risk Management
- Tax Allocation Agreements
- Institutions with Over $500 Million in Total Assets

Gerrish McCreary Smith, in connection with various speaking engagements around the country, has created high quality “handout” booklets. The publications below are available for a nominal charge:

A Director’s Guidebook to Effective Board Compliance
A Fresh Start: Shareholder Value for a New Environment
A Positive Look at Community Banking Corporate Governance
Directors’ Responsibilities in Mergers & Acquisitions: Responding to the Unsolicited Offer
Evaluating Bank Options: Remaining Independent or Preparing to Merge
Family-Owned or Closely-Held Bank Issues
How to Flourish in a Dodd-Frank World
Is a Holding Company in Your Bank’s Future?
Mergers & Acquisitions Are Back: Don’t Miss Your Opportunity
New Truths About Directors, Shareholders and Regulators (Including Compliance)
The Community Bank Survival Guide: How to Survive and Thrive
The Pros and Cons of Converting to Subchapter S
Strategic Planning: Don’t Make Me Do It!
Understanding the Director’s Role

If you are interested in any of these memos or publications, please call or email Shelley Loudermilk at (901) 684-2306 or sloudermilk@gerrish.com.

Please visit our website at: www.gerrish.com
A REAS 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

- Acquisition Financial Analysis
- Fairness Opinions
- Transaction Pricing Analysis
- Capital Planning
- Subchapter S Financial Modeling
- Directors’ Liability
- Mergers and Acquisitions
- Executive Compensation
- Acquisition Pricing
- Employee Benefits
- Bank/Stock Valuation Analysis
- Estate Planning
- Strategic Planning
- New Bank Formations
- Tax Planning
- Going Private
- Subchapter S Corporations
- Expert Witness

### LEGAL SERVICES

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

### 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:

- Alabama Bankers Association
- American Bankers Association
- Arkansas Community Bankers
- Bank Holding Company Association
- California Independent Bankers
- Community Bankers Association of Georgia
- Community Bankers Association of Illinois
- Community Bankers of Iowa
- 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
- Michigan Association of Community Bankers
- Montana Independent Bankers
- Nebraska Independent Community Bankers
- Pennsylvania Association of Community Bankers
- Pennsylvania Bankers Association
- South Carolina Bankers Directors College
- Tennessee Bankers Association
- Virginia Association of Community Banks
- Washington Bankers Association
- Western Independent Bankers

Topics include strategic planning, mergers and acquisitions, enhancing/maintaining shareholder value, dealing with the regulators, employee benefits, mediation, corporate governance, 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.
Recent Transactions

First State Bancshares of Dekalb County, Inc.
Bank Holding Company for

Fort Payne, Alabama

has announced its intention to acquire

First Rainsville Bancshares, Inc.
Bank Holding Company for

Garnavillo Bank Corporation
Bank Holding Company for

Gerrish McCreary Smith, Attorneys, served as legal advisors to First Rainsville Bancshares, Inc. and First Bank of the South.

Planters Holding Company
Bank Holding Company for

Planters Bank
Indianola, Mississippi

has acquired

Covenant Financial Corporation
Bank Holding Company for

Covenant Bank
Clarksdale, Mississippi

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Covenant Financial Corporation and Covenant Bank.

Docking Bancshares, Inc.
Bank Holding Company for

Arkansas City, Kansas

has acquired

Relianz Bancshares, Inc.
Bank Holding Company for

Wichita, Kansas

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Docking Bancshares, Inc. and Union State Bank.

Community Financial Corp.
Bank Holding Company for

Covenant Savings Bank
Edgewood, Iowa

has acquired

Garnavillo Bank Corporation
Bank Holding Company for

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Garnavillo Bank Corporation and The Garnavillo Savings Bank.

Olympic Bancorp, Inc.
Bank Holding Company for

Kitsap Bank
Port Orchard, Washington

has acquired

Puget Sound Financial Services, Inc.
Bank Holding Company for

BANK
Fife, Washington

Gerrish McCreary Smith, Consultants and Attorneys, served as financial and legal advisors to Puget Sound Financial Services, Inc. and Fife Commercial Bank.

To discuss your institution's strategic transaction opportunities, please contact Jeff Gerrish at jgerrish@gerrish.com or Philip Smith at psmith@gerrish.com.
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