

The



# Chairman's Forum

*Opening the door to new ideas*

**Newsletter**

***Gerrish Smith Tuck, Consultants and Attorneys***

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Does anybody remember multiple news anchors, TV personalities or political pundits saying before the election that Donald Trump would win the presidency by a large electoral college margin? Of course not, quite the contrary. The Democrats were expected to win both Houses of Congress and Hillary Clinton was going to easily win the presidency. So, this shows that sometimes people can just be wrong whether well intentioned or not. Accordingly, in this month's edition of *The Chairman's Forum Newsletter*, we look at a couple of recent circumstances we have encountered where, in our firm's opinion, the writer of an article or a client's position on an issue was simply wrong.

We all seem to certainly be a bit more cynical about the news we receive these days and tend to question things rather than accepting them at face value, so this month's edition takes that approach and critically analyzes a couple of circumstances recently that, as Chairman of the Board, you might find applicable to your situation.

Keep us posted on how we can help.

Happy Reading!

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## Chairman's Summary

- ◆ A community bank needs a holding company.
- ◆ Directors should not vote on everything.
- ◆ Smart may not always be fun.

### A Community Bank Needs a Holding Company

A recent article in the *American Banker* daily trade publication highlighted how a bank holding company with more than \$1 billion in total assets decided to terminate its bank holding company structure and advocated that other banks do the same. It was argued that the bank holding company structure is a “relic of the past”. For community banks, particularly those less than \$1 billion in total assets, we totally disagree.

A bank holding company structure simply allows stockholders to own stock of a corporation which then in turn owns 100% of the subsidiary bank. By doing so, stockholder rights are governed by corporate laws, not banking laws, and, historically speaking, that provided much more benefit to both the organization and the stockholders through a more well developed corporate statutory structure rather than somewhat archaic banking statutes. One short example would be that historically a lot of banking statutes required two-thirds approval for transactions whereas modern corporate law permits only

a majority vote. But, beyond that type of historical and legal beneficial nuance, there are many other practical reasons why community banks of all sizes should utilize a bank holding company structure.

Capital raising is a primary benefit of the holding company structure by allowing an organization to have a tax-preferred method to raise capital in a way that does not provide dilution to existing stockholders. For an organization with less than \$1 billion in total assets, it may borrow funds at the holding company level and contribute the cash to the bank directly as tier 1 capital without the liability that is created at the holding company negatively impacting the capital ratios. That structure provides multiple benefits, not only by creating new capital in a tax efficient manner, but for organizations falling under the small bank holding company guidelines (less than \$1 billion in total assets), it often is a much better way of raising capital than selling new shares. Otherwise, a bank without a holding company that is in need of capital really faces limited alternatives other than selling more shares, creating dilution among stockholders and incurring higher fees to do so. Even for organizations over \$1 billion in total assets where capital ratios are determined on a consolidated basis, the Federal Reserve will allow the consolidated ratios to be less than standard bank capital ratios, accounting for debt that is incurred at the holding company. Therefore, preferential capital raising is available for both large and small bank holding companies.

Perhaps an even greater benefit of the bank holding company structure is the ability to provide liquidity to stockholders on an expedited basis. Without a bank holding company, if a bank stockholder wants to sell shares, the bank itself can acquire those shares, but to do so is a reduction in stated bank capital. In order to change the stated bank capital, the Articles of Incorporation or Association of the bank would need to be amended. In order to make the amendment, stockholder approval would be required. In

order to complete the entire transaction, regulatory approval would be required. So, while there might be liquidity with a bank-only structure, it is certainly “liquidity deferred” whereas an organization with a bank holding company structure can provide immediate liquidity to stockholders who want to sell shares without the necessity of regulatory and stockholder approval in almost all cases.

It is likely that organizations touting the elimination of the bank holding company structure perhaps have had some issues with the Federal Reserve as the regulator for bank holding companies. However, for most community banks who operate their bank holding company as a shell entity, they will find that the Federal Reserve is a fairly non-invasive regulator. In fact, for shell bank holding companies, we see that community banks get all of the upside benefits, but very little regulatory downside and, therefore, there is certainly no excessive regulatory burden that should prevent an organization that would otherwise want to form a holding company from doing so.

Corporate growth may be facilitated with a bank holding company structure as well. An organization with a bank holding company that wants to target another bank for acquisition may find the transaction to be more easily facilitated with a bank holding company structure and simply merging the target holding company into the acquiror’s bank holding company. That might allow the buyer to retain the separate Charter of the target organization and, for example, maintain its separate Board of Directors, maintain both a state Charter and a national bank Charter or other corporate benefits that might follow from a multi-bank holding company.

We are seeing more organizations benefit from a bank holding company structure through corporate governance of their entities as well. For example, rather than facing the difficult issues of mandatory retirement,

director evaluation or simply terminating directors, we often see community banks “promote” more senior directors to serve only at the bank holding company level rather than the bank level, so that the organization still receives their strategic input, their influence in the community and their institutional knowledge without having them remain subject to bank board service, service on bank committees and some of the more frequent duties of bank service.

So, needless to say, for the typical community bank, particularly those that are less than \$1 billion in total assets and that fall under the small bank holding company guidelines, but really for institutions of all sizes, there are multiple benefits to being in a bank holding company structure with very little downside. So, read the opinion pieces of larger organizations doing away with their holding companies with a bit of skepticism. You never know if there could be other issues behind their decisions to terminate their bank holding companies and if you choose to follow the same path, you may miss out on multiple benefits that add stockholder value and organizational flexibility.

### **Directors Should Not Vote on Everything**

There are legal technicalities and practical realities. Sometimes, the practical realities may provide the correct answer to a given situation even if the legal technicalities seem different. We have faced a number of circumstances in the past few weeks involving Boards of Directors and what you would think would be a basic and straightforward question of whether a director should vote on something with which the director has a personal interest. Your initial reaction is probably, of course not, you want to avoid even the appearance of impropriety or a conflict of interest. So, for example, if the director owns a building and offers to lease it to the bank for

a new loan production office, should the director be able to vote on approving the terms of the lease? Typically, you would say of course not even though if you were to look at the legal technicalities you might not be able to find something that specifically disqualifies the director from voting on the lease.

But, what if a director decides they want to sell shares that they own back to the holding company. Should they be able to vote on the price at which the holding company will purchase them? Should they be able to see all the detailed financial analysis that goes into the strategic decision on whether and how to fund a stock acquisition from the director? Legally, there is some argument that maybe there is no basis to keep the director from voting on that, but certainly the practical realities would suggest that they should not. Likewise, if you are selecting a new Chairman of the Board, should an individual be able to cast a vote for themselves? Should they excuse themselves from the meeting? Perhaps legally they have a right to stay and to vote, but practically speaking of course they should exclude themselves from the meeting to avoid an appearance of impropriety and to give their fellow directors the opportunity for open and honest discussion.

So, in all these circumstances, a director may just be wrong. It may be wrong practically to create potential conflicts of interest and to create difficulty among the Board members by allowing directors to stay in the room and vote on matters in which they have an interest. This is where a strong Chairman needs to take a leading role to simply establish the practical corporate governance structure that will be followed for the best interests of the organization as a whole.

## **Smart May Not Always Be Fun**

Pursuing the “fun” strategic alternative may not always be the right decision. Consider a recent circumstance with an organization looking at multiple strategic options including selling their bank, buying other banks, engaging in a capital raise, repurchasing stock from stockholders, branching into new locations, new product lines and new services, and a host of other things. All of those are certainly somewhat “exciting” alternatives and created a lot of good discussion among the Board members. However, the organization had one lingering issue, a tremendous amount of bank holding company debt. That debt, in and of itself, continues to impair growth prospects.

So, consider whether, if you were advising this organization or advising the Chairman of the Board, you might suggest that the organization look at doing something smart rather than something “fun”. By this, what we mean is that, if the organization is going to raise capital rather than using it to acquire another bank or to expand operations in a new area, perhaps they should look at substantially reducing their debt. Much like taking that Christmas bonus and adding on to the house or buying the latest toy versus accelerating payments on your mortgage, the fun alternative and the smart alternative may often be at odds. So, if your Board is constantly pushing toward the next big exciting thing, they may be wrong. It may be more beneficial to pursue the smart alternative rather than the fun alternative and stockholder value may be better enhanced by pursuing the smart alternative. Therefore, always consider all of your options.

## Meeting Adjourned

As the saying goes, if everyone thinks they are right, then someone is definitely wrong. Be cautious not to fall into the trap of assuming that all “good ideas” are necessarily the correct strategic moves or the right decisions for your organization. A strong leader will look beyond the headlines of the day or the short-term impact and focus on long-term benefits. Keep us posted on any unusual circumstances at your organization where we can be of assistance or ways we can help you on a day in and day out basis. Continue to pursue the smartest and best alternatives for your organization regardless of what others may say.

Until next time,



Philip K. Smith

and



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