The

Chairman's Forum

Opening the door to new ideas **Newsletter**

Gerrish Smith Tuck, Consultants and Attorneys

June 2017

In this month’s edition of *The Chairman’s Forum Newsletter*, we look at a current situation we have encountered where a client was dramatically frustrated by what they viewed as outdated and simply dumb regulations. Also, we review a current situation where a bank set aside short-term economic value for longer term impact to the community. We also discuss ways in which that might be an appropriate focus to consider in the future for all organizations.

We also specifically review your role as Chairman in terms of whether occasionally the Chairman may need to assume the role of chief cynic. That may help draw out more appropriate discussion among Board members to see the flaws in key items that are being considered. Similarly, if the Chairman’s role is to promote a robust discussion on key items, that may be hard to do if we all look alike, act alike or come from the same background. Therefore, the Chairman may very well have a role in promoting diversity within the organization from a number of different standpoints in order to create a diversity of thought to enhance the Board of Directors.

Finally, we focus on the notion of confidentiality in Board meetings and how it is of paramount importance. We hope you find some bit of information that will be of assistance to you and your organization in this month’s edition and we look forward to speaking with you soon.

Happy Reading!

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Chairman's Summary

- Many regulations are still dumb.
- Doing right may outweigh financial value.
- The Chairman's role: consensus versus unanimity.
- Improve the diversity in your Boardroom.
- Ensure the "sanctity" of the Board meeting.

Dumb Regulations

If you know anything about the game of golf, you know that at the professional level there are thousands of detailed and nuanced rules intended to protect the integrity of the game, but which drive the average player crazy. For example, if you approach your ball and are about to hit it, but you don't touch it and the wind blows it and it moves, you are assessed a penalty. Similarly, if your ball goes a little off-course and you are not in the perfect soft green grass of the neatly mowed fairway and your ball is in some type of hazard and you rest your club on the ground for a second as you prepare to take your backswing, you are assessed a penalty. Understanding those differences between detailed professional rules and what the average golfer experiences, there has been some effort by the United States Golf Association to modernize and improve what some view as outdated rules and regulations that may be harming the future development of the game. We see a similar parallel related to a lot of banking regulations where the rules and regulations themselves no longer seem applicable, they frankly just seem dumb and outdated, and they result in more harm, particularly to community banks, than the benefit they are trying to derive.

Take for example a recent circumstance we encountered involving change in bank control regulations. The purpose of the regulations certainly seems to make sense that if there is a fundamental change in the parties and/or stockholders who own and control a financial institution, then the regulatory agencies certainly want to know that and have the right to review and approve that ownership change. In fact, it would seem appropriate that the regulators would even have the ability to deny certain individuals the right to come into possession or control of a financial institution. So, anytime there is a material change in ownership at the organization, that should be subject to review. Generally speaking, the rule applies oftentimes in very straightforward and fundamental ways such as if there is a change in the largest stockholder of the organization, if there is a new stock issuance and a party acquires over certain thresholds of ownership such as 25% or 50% and other similar requirements. But the rules also have a way of being applied in a strict sense that make no practical application to community banks.

Consider a $100 million community bank that is family-owned and has been family-owned for decades. In fact, many years ago, the family as a group even filed a Change in Bank Control Act application under the arguably incorrect regulatory premise that all of the adults who happened to be family members could possibly “act in concert” and, therefore, need to file as an ownership group for the family. The family has continued to own the shares as a group for many, many years without material changes, but in a recent transaction one of the family members sought to purchase additional shares from a retiring Board member. The result is that this individual’s stock ownership will increase from slightly below 25% to slightly above 25%. However, another member of this stockholder’s family is the largest stockholder, continuing to own more than 25% and the entire family group’s ownership percentages changed only marginally and, of course, the entire family continues to own well in excess of 50%. The regulatory view of this change is that the individual must go through the cumbersome process of filing a Change in Bank Control Act application because the ownership increased above 25%, even though the family group, which has already filed a change in control application does not materially change, and, here’s the kicker. Because this is a recent triggering of the Change in Bank Control Act requirements where there have not been any filings in many years, the regulators are requiring that the entire Board of Directors, both inside and outside directors, now must file their own updated biographical and financial forms and go through a new vetting process. It does not matter that the directors have served for a long time and it does not matter that the bank is obviously trying to recruit new directors to fill the vacancies.

So, an existing director or a new director in a local community with a small community bank of $100 million and who may own a few miscellaneous shares, and where the family controls 90% of the shares, may now be asked to fill out financial, biographical and related data. Fingerprint cards may be required also. Obviously, this bank is going to have difficulty finding new directors to jump through these hoops and existing outside directors may choose to leave the Board rather than dealing with this regulatory burden. The organization's growth, therefore, is likely to be impeded, it is going to lose the ability to have key individuals within its community want to serve on the Board and the family is having to spend a lot of time and effort to file a Change in Bank Control Act form because formalities say you are supposed to even though there has been no actual change in bank control. Ridiculous.

As Chairmen, we must be aware that sometimes regulations and their implementation are dumb. Seek professional assistance to structure transactions in ways that benefit the organization when regulations tend to impede the value of your organization, make it difficult to recruit new Board members or otherwise and make sure your directors are doing their best to stay abreast of the sometimes ridiculous manner of implementation.

Maximizing Immediate Value May Not Always Be the Right Thing To Do

For many years, if you have ever read any publication from our firm, you understood that we are strong advocates for the principle of enhancing value for your stockholders. Maybe what we have failed to express often enough is that value for stockholders may take many different forms and may not always be able to be measured through increases in net income, an improved efficiency ratio or some other "hard" metric. Sometimes overall stockholder value can be measured through the overall value a community bank actually brings to its community. This past year one of our clients was in a community that experienced tremendous property, personal and emotional damage from a natural disaster. The result was that some of the bank's branches were nearly completely destroyed, the bank had to trigger its emergency recovery processes and ultimately had to reassess what to do with these now unusable locations. Interestingly, one of the locations damaged the most was also one of the least profitable branches. Therefore, the Board and management easily could have taken the position of simply not reestablishing the branch at all, permanently closing operations within the community and migrating the customers to other locations. In essence, the natural disaster would have been a perfect excuse for the difficult decision the Board otherwise would have had to make to close an unprofitable location.

However, the Board and management took the unique position of deciding to totally rebuild the location and, therefore, put a tremendous amount of new money back into the local community. The core focus of the Board and management was remembering that the first word in community banking is "community". Therefore, while the short-term best strategic decision might have been to improve the organization's overhead cost, add more revenue to the bottom-line and focus on fundamental earnings value, the Board, through the leadership of the Chairman, purchased itself unlimited amounts of future goodwill by helping the entire community get back on its feet again by ensuring that the bank remained in the community for the long-term. Your role as Chairman often may take the notion of "value" to a whole different level in times of crisis.

Stop Trying to Make Everyone Happy

As Chairman of the Board, you may not necessarily need to have all of your directors happy all of the time. For example, if you are voting on a key proposition, as Chairman do you strive to get the Board to unanimously agree on the particular point or do you merely focus on trying to build a strong consensus? It is arguable that if you strive for unanimity and you are often able to achieve unanimity, then perhaps you do not have strong enough voices on the Board to vocalize differing thoughts or opinions, or perhaps you do not have enough diversity of thought on the Board. Unanimity in Board actions may be a sign of weakness, not a sign of strength. Understand that crucial bank decisions do not require a unanimous vote of the Board. Maybe your goal as Chairman is to try to avoid a split in the Board where, for example, there is a five to four vote, but maybe if you have a fairly strong consensus on a six to three basis that is sufficient. As Chairman, you may want to make exceptions on the most major of decisions such as acquiring another organization, selling the bank or something else, but overall the most successful Boards may exhibit characteristics of some differing thoughts and opinions among the Board members, but yet continuing to move forward as consensus is reached on substantive matters.

Likewise, in consideration of that approach, perhaps the Chairman's role should be that of chief cynic. If no one else is willing to question a particular issue or proposition, we would suggest the Chairman's role is perhaps to ask those types of negative questions that spur discussion. Perhaps the Chairman should be asking these types of questions: What are we missing?; What could go wrong if we make this decision?; What are the key risks of doing this and is that consistent with our overall risk tolerance profile?; If we are wrong, let's try to figure out what the downside will be. In that way, the Chairman balances against overall "group think" among the Board and raises the outside argumentative position that perhaps no one else is willing to share.

You Need More Diversity

A quip we often use is that the Board of Directors of a typical community bank can best be described as pale, stale, frail and male. While that may be funny, it is not too far from reality. For today's modern Board, the Chairman should be an advocate for diversity. However, that does not mean diversity for diversity's sake on the basis of race, gender, ethnicity, etc., it may mean simply promoting diversity of thought by ensuring that the composition of the Board includes individuals from different age categories, different business backgrounds, different educational make-ups and the like. If you can further enhance diversity in one of those ways by adding more gender diversity, more racial or ethnic diversity, our experience has been that the Board of Directors is strengthened and your personal and business relationships are enhanced. Do not seek out quotas in any one area, but look for opportunities to promote diversity where you are able.

Creating a Culture of Trust

A Chairman of the Board of one of our clients recently expressed a key component of corporate governance and Board action that we thought was well said. Her comment, in trying to encourage open and honest debate and dialog among the Board, was that "The only thing sacred at the Board meeting is confidentiality". By this, she meant that everyone should be able to express whatever thoughts or opinions they had, should be open to questioning anything, should be willing to challenge other Board members about the actions the Board members are taking or the direction the organization is going, and we ought to be able to do that in a way where all the Board members know that confidentiality will be maintained by every other member. In essence, a culture of trust among all of the Board members is paramount to a well-functioning Board. In this particular case, the organization had taken it a step further by asking that the directors be contractually bound to maintain confidentiality through a Confidentiality Agreement.

By heightening the fiduciary obligation to confidentiality either through a contract or through constant reminders to the Board, the sacred bond of confidentiality is created among your Board members and the culture of trust is established. Strive for that at every meeting.

Meeting Adjourned

As we move into the Summer months, all of our schedules seem to change in some way through our work schedules, vacation schedules, children's schedules, etc. As a result, occasionally the corporate formalities of Board meetings tend to be set aside. We hope that this month's edition of *The Chairman's Forum Newsletter* has refocused you on some of those corporate obligations and given you some new insights into ways to improve your organization. If we can continue to help, please let us know.

Until next time,

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