GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Minnesota, Michigan, Iowa, Pennsylvania, West Virginia, South Dakota, and Tennessee!

DISSIDENT SHAREHOLDERS

As we have noted in prior *Musings*, there seems to be a rash of dissident shareholders at community bank holding companies around the country. Some of these are simply trying to "stir the pot." Some are trying to get a director on the board. Others are simply trying to make enough noise to get their stock bought back. With respect to the group that is trying to get directors on the board or get their own proposals approved by the shareholders, it is important for community bank holding companies to make sure they have appropriate "advance notice" provisions in their holding company bylaws. These bylaw provisions require shareholders who desire, for example, to nominate a director for the board to do advance work (e.g., give notice to the board of directors, fill out a questionnaire, certify that the proposed nominee meets certain qualifications, etc.).

With respect to advance notice bylaws, many states follow the Delaware rules and case law. The Delaware Supreme Court has recently upheld advance notice bylaws, recognizing that "stockholders ignore clear deadlines in advance notice bylaws at their significant peril" and "[c]ompanies . . . are likely to be scrupulous in enforcing deadlines in their advance notice bylaws."

It is appropriate for every community bank holding company to double-check its bylaws with respect to advance notice requirements. If we can help, please let us know.

To ensure compliance with the requirements imposed by the U.S. Internal Revenue Service, we inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the U.S. Internal Revenue Code or (2) promoting, marketing or recommending to another party any transaction or tax-related matters addressed herein.

PANDEMIC ISSUES

If your bank plans to hold a planning session at any time in the near term, make sure you deal with "pandemic issues." These issues fall in multiple categories. What worked? What didn't work? What do we do for the future? How do we mitigate the risk thrust upon community banks as a result of the pandemic? Pandemic risk generally fits into two main categories – asset quality risk due to the economic uncertainty and on-balance sheet liquidity risk (i.e., too much cash and no place to put it). These are obviously both strategic risks.

We have had numerous conversations about these risks with community bank clients during planning sessions. With respect to pandemic risks, the risk focused on most often is the asset quality risk – as well as the resulting tightening of underwriting standards, at least in the near term. Some clients, particularly those with hospitality concentrations (restaurants, bars, and hotels), are much more attuned to the asset quality/credit risk than others. We were recently with a community bank client facilitating a planning session when, in connection with the credit risk discussion, the CEO indicated that credit risk was "eerily good." We thought that was a great description of what is going on. Things are still good, but almost "eerily" so. We are not all waiting for the other shoe to drop and hope that it never does, but things are kind of "quiet on the western front" currently. We will see what happens.

ORGANIZATIONAL STRUCTURE

When is the last time you looked at your bank's organizational structure? We have been with a number of banks recently that have grown significantly in the last five years. That may have grown from $500 million to $1 billion or $100 million to $250 million. Any bank that has that type of growth in a relatively short period of time needs to make sure their organizational structure has kept up. There does become a size when not everyone can report to the CEO. We have had a number of consulting projects lately and over the years that deal with recommendations regarding management and organizational structure. It is important going forward to be in an appropriate structure to make sure the bank grows and risk issues are addressed.

OWNERSHIP SUCCESSION

In community banking, we hear a lot of noise about management succession and board succession. As we have indicated in *Musings* in the past, we believe that community banks in general are doing much better in that regard. The third type of succession that you do not hear much about, but on which closely-held banks should focus, is ownership succession. Having appropriate management and board succession does not help much if there is not appropriate ownership succession. If the future

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owners of the bank (i.e., generally the "kids") do not want to hold the stock, then management and board succession will not really matter because the bank will likely be sold. Ownership succession is geared toward getting the shares of stock that may be volatile or at risk with respect to family ownership into the hands of either a family member who would like to hold onto the shares for the long term or a new investor. In other words, it is not unheard of for a family member to cash out and have a new investor buy those shares held in treasury. There are lots of different alternatives. Sometimes the stock of the family member can be shifted over to an ESOP or a KSOP so ownership moves from the family to the "employee family." In any event, don't get caught flatfooted. While you are dutifully working on management and board succession, also dutifully work on ownership succession. As a practical matter, it is likely more important.

RESOURCE ALLOCATION IS FRUSTRATING

We recently had an interesting telephone discussion with a couple senior executive officers of a subpar performing community bank. These newly hired individuals are not part of the problem. Rather, they have been brought into the bank to be part of the solution. The former management team made a number of decisions that put this bank in somewhat of a bad spot, and now the challenge for the new management team is to turn the bank around.

The frustration of these two was evident during our discussion. The frustration was with resource allocation. Simply put, these officers knew what needed to be done in order to turn this bank around. Unfortunately, limited resources, particularly with capital but also time, is causing progress not to be achieved at the speed at which they would like. Rather than getting everything on their wish list, they are having to pick and choose their battles in order to ensure they do not outrun their resources.

What struck us as interesting about this discussion is the fact that frustration with resource allocation is not limited only to banks that are experiencing difficulties. Instead, every community bank in the country makes decisions regarding resource allocation. This is true whether you are a have or a have not. As we have indicated previously in *Musings*, the secret to resource allocation is putting whatever resources you have to their highest and best use. There will always be something on the to-do list. It is just a question of where it falls in order of priority.

LIBOR TERMINATION

About a week ago the friendly federal banking regulators issued another statement relating to the forthcoming termination of LIBOR. As a quick reminder, LIBOR will no longer be used as a reference rate beginning in 2022. The regulators have put out a number of different statements relative to the

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termination of LIBOR and managing the LIBOR transition. Please let us know if you would like a copy of any of these statements. We are happy to provide them.

One question we often get is whether community banks need to be paying attention to the termination of LIBOR. The answer is yes. We would be very surprised if your community bank or bank holding company did not have anything that was somehow tied to LIBOR. You likely have loans that are tied to LIBOR as a reference rate. If your holding company has issued Trust Preferred Securities, you almost certainly will be impacted by the termination of LIBOR.

Given that we are a little bit more than 12 months from the termination of LIBOR, we recommend you begin planning now. Our recommended first step is to take a look and figure out the extent that the termination of LIBOR will affect your bank. In other words, what contracts and rates do you have that are tied to LIBOR? If it is one or two, the next step will likely be a little bit different than if you have a couple hundred. Once you get your arms around the exposure, the next step will be in developing a plan for how to address the termination of LIBOR. There are going to be a couple different options, but it is almost certainly going to be amending contracts to reinsert a new reference rate, which will most likely be the Secured Overnight Financing Rate.

Be sure not to get caught flatfooted as it relates to the termination of LIBOR. We recommend figuring out how it will affect you and then developing a workable plan to address the issue. Please let us know if we can help. We are happy to do so.

HEADACHES VERSUS HANG-UPS

We are in the thick of community bank strategic planning season. Over the last two to three months we have assisted numerous community banks through the facilitation of their strategic planning sessions. The vast majority of these have occurred in person with appropriate safety measures employed.

At virtually every strategic planning session we facilitate, we talk about the uncertainties in the current environment. This includes uncertainties and unknowns related to COVID-19, politics, economics, agriculture, and all other matters. Notwithstanding each of these uncertainties, we do not see doing nothing as an option. We believe paralysis by analysis is a bad spot.

In order to avoid paralysis by analysis, we recommend giving specific discussion at your planning session to the difference between headaches and hang-ups as it relates to future strategic items. Headaches are temporary distractions that will not significantly or permanently affect the pursuit of a strategic item. Hang-ups may cause a permanent change in direction. When we really dig into it, we find that much of the discussion around future uncertainties is a discussion about headaches, not hang-ups.

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Our encouragement is not to let the noise and the unknowns of 2020 hijack your strategic priorities. These types of challenges will always be present. The key is recognizing them as headaches, not hang-ups.

SMALL BANK BUYERS

We have relayed in a number of *Musings* that there is currently a very active community bank M&A environment. We are working a number of deals where one community bank is looking to make an acquisition of another. However, this is not the exclusive activity in the space today. One of the areas where we have seen a marked interest over the past month or two is that of non-traditional community bank acquirers looking to buy small banks.

Over the past couple months we have received a number of calls from non-traditional buyers that are looking to buy a small bank. They typically identify themselves as some type of technology company, mortgage operation, or group of investors that are looking to get their hands on a charter for one reason or another. Whatever their motivation, they are all looking for the same thing, which is essentially a small community bank (e.g., less than $100 million in total assets) that is willing to sell and that has a management team that is willing to stay. The buyer often touts a bifurcated strategy of allowing the "legacy operations" to continue without change while they take the charter and do whatever strategy it is they are looking to achieve in what they often refer to as a new division of the bank.

If you are a small bank, keep this in mind. You are a desirable entity. If you are thinking about selling, there are buyers out there. If your strategy is one of independence, be aware that buyers are on the prowl.

CONCLUSION

It is hard to believe there are only six weeks left in 2020. Certainly a memorable year. We would like to report that we are glad that all the political maneuvering has calmed down (not yet). We hope all of you *Musings* readers have a wonderful Thanksgiving. Stay safe.

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Upcoming Webinars:

- November 18 – Indiana Bankers Association webinar – "Liquidity Strategies for Illiquid Community Bank Stocks" Registration link: https://indiana.bank/reimagined
- December 1 – Graduate School of Banking at Wisconsin webinar – "Community Bank Capital Raising Simplified" Registration link: Community Bank Capital Raising Simplified

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