GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Ohio, Wisconsin, Minnesota, Mississippi, Texas, New Mexico, Colorado, Vermont, and North Dakota!

D&O POLICY ISSUES

Every community bank we work with has a directors' and officers' insurance policy. These policies generally consist of two parts. One part insures the directors and officers in the event they are accused of committing "wrongful acts." These policies typically describe "wrongful acts" as negligent acts, though they typically exclude fraudulent acts. The second part of the policy insures the company in the event it is required to indemnify a director or officer under the indemnification provisions contained in most bank holding company Articles of Incorporation and Bylaws. That is the fundamental framework for the policy.

The Delaware Supreme Court recently made an unusual unanimous decision affirming a trial court judgment that required the D&O insurer to pay a claim that was based on the fraudulent conduct of a director and CEO of a corporation. The Court held that those losses caused due to the CEO's fraud are still insurable under Delaware law and coverage is not barred by Delaware public policy.

Although this is an unusual decision, we think it will be helpful for the community banking sector, particularly as banks review their D&O policy and coverage. Although the case involved a Delaware corporation and the Court held that Delaware law applied, notwithstanding this corporation's significant presence in another state, even if your community bank holding company is not chartered in Delaware, the courts generally follow the Delaware Supreme Court in matters of this nature.

If any *Musings* readers would like a copy of this case, please let us know.

EMPLOYEE OWNERSHIP – IMPORTANT?

We recently had the opportunity to meet with a high-performing community bank, primarily rurally based (not fully) that had made a consistent effort to make sure that its officers and key employees were owners of the organization. Although this is a fairly closely-held organization, the board of directors has determined it is important for the key employees and officers to be given the opportunity to buy stock. This does not involve the establishment of an ESOP, a KSOP, stock options, restricted stock, or anything else. It simply provides certain key, selected officers who the community bank is trying to retain the opportunity to buy shares of the holding company at market value. Financing is also provided so it is not that difficult. This is also a Subchapter S that throws off a lot of cash, so theoretically the distributions on the purchased stock should be able to service the debt.

The key factor with this community bank holding company is that they recognize, even though the control ownership lies in one spot, that it is critical that employees are part of the ownership. They recognize having employees think like owners, especially when they have to buy the stock themselves (as opposed to through a gift or some other favorable tax treatment entity), is important.

It was a pleasure to be with this group, particularly with their outlook on ownership and considering the success their bank has had over the years. Not surprisingly, we attribute a large part of that success to their favorable view of employee ownership.

ON BALANCE SHEET LIQUIDITY

Virtually every community bank we have visited over the last several months has "massive" amounts of on balance sheet liquidity. As we have noted in prior *Musings*, this is primarily due to the government stimulus programs - PPP and others - and the recipients of the government stimulus having not yet spent the money. Several of the trade publications have recently run articles citing conversations with various chief financial officers of the larger banks (the $100 billion and above category). It is interesting to note that as we visit with our community bank clients and politely inform them that we have no idea when that liquidity is going to run off, these CFOs of the super large regionals and bigger are singing out of the same hymnbook. The great uncertainty currently is what to do with all of this excess liquidity. We all feel that it is going to run off at some point in time, but we are not exactly sure when.

As a result of the significant balance sheet liquidity, virtually all our clients around the country, from a business strategy standpoint, are focusing on profitability with very little, if any, balance sheet growth. In fact, many of them, where the Board can "stomach" it, are looking at balance sheet shrinkage. In most cases, the strategy is to reallocate assets from cash and securities into loans to drive profitability.

LOAN GROWTH POSSIBILITIES

As noted in this *Musings*, one of the current critical issues is how does a community bank grow its loan portfolio now that it is saddled with excess on balance sheet liquidity? We were recently visiting a large community bank client that we have worked with for a number of years and discussing what is happening with their loan portfolio. The Chief Executive Officer indicated that not only is asset quality amazingly good, but they have also seen significant loan growth. The CEO attributes part of that to sales training provided to the loan officers and part to the fact that the lenders are now being held accountable by their supervisors for loan goals. In addition, he indicated that the lenders now have sales meetings, not just credit quality meetings. A combination of all those factors has resulted in a nearly 10% (exclusive of PPP) net loan growth for this particular organization. Pretty significant in this environment.

If your community bank is looking for loan growth, it is important not to do the same thing your community bank has always done unless you want to get the same result you have always had. If your community bank wants something different, it will likely have to do something different, whether it involves sales training, holding the lenders accountable, incenting them to bring in quality loans, and the like. Loan growth drives profitability, so community banks need to figure out a way to establish a mechanism to actually accomplish loan growth that makes sense.

THE UNFAIR EXAMINATION APPROACH

We recently received a call from a client who indicated their community bank did not get a fair shake during their most recent examination with their friendly federal regulators. This particular community bank, like most others around the country, has seen a significant increase in assets since the beginning of the COVID-19 pandemic. Like many other banks, the significant growth in assets is not attributable to loan growth but is instead sitting on this bank's balance sheet as cash.

According to this community bank CEO, the bank examination team essentially backed out an amount it deemed "excess cash" in reviewing the bank's liquidity. Apparently the bank examination team took the position that for purposes of reviewing liquidity and determining the liquidity component rating the bank should not get credit for 100% of the on balance sheet cash. However, when reviewing capital, there was no similar reduction of assets to back out what the examination team determined to be "excess cash." Instead, the examination team used the bank's actual numbers.

As you might imagine, this particular community bank CEO was pretty inflamed at this examination approach. We share this sentiment. The examination resulted in satisfactory ratings across the board, so there was not any specific reason to appeal the examination. Nonetheless, it did not inspire a lot of confidence or goodwill from this particular banker.

As we have relayed a couple times in *Musings* previously, we are beginning to hear more stories from bankers that are experiencing more strenuous regulatory examinations. Keep this in mind as you approach your next exam. We are not seeing much of what we would describe as regulatory forbearance.

PLANNING IN THE FAMILY OWNED OR CONTROLLED BANK

About half the banks in the country are family-owned or controlled, or at least closely-held. The strategic planning process in those banks often is different simply because it is the family who is going to direct the strategy, particularly at the holding company level, not necessarily the outside directors who often sit only at the bank level. To have effective strategic planning, the participants need to understand that. Frankly, it is the family's bank. They can send it in whatever direction they want to, including a sale. The goal is to figure out what it is the family wants to set as the direction and then provide input as to whether that makes sense from an outsider's perspective, particularly as an outside director.

Independent directors in closely-held banks provide a critical sounding board, assuming they are not afraid to express their opinion to the control group. The reason outside directors are on the board is not just for regulatory window dressing. Rather, the reason is to provide a perspective that the closely-held group may not have simply due to their lack of involvement in the bank, family issues, or otherwise.

NON-PIRACY AGREEMENTS

One of our recent editions of *Musings* summarized President Biden's recently announced Executive Order to increase business competition in America. We specifically provided our thoughts in opposition to President Biden's proposal that non-competition agreements be made void as a matter of public policy. Following our publication of this *Musings*, we received a follow up from a community bank chairman that took just a little different spin on non-competition provisions. This chairman essentially said that they were fine with their bank not having non-compete agreements with their key producers, provided they have non-piracy agreements in place.

What is the difference between a non-compete and a non-piracy agreement? A non-compete essentially says that an individual cannot go and work for a competing business. A non-piracy agreement, on the other hand, does not prohibit an individual from working for a competing business. However, it does prohibit the individual from having any business relationship with the customers or employees from their previous job. In other words, a non-piracy agreement essentially says an individual can go work for a competitor, but while they are working for the competitor they cannot have any business relationship with anyone that was a customer or fellow employee from the former employer. Similar to a non-compete, a non-piracy agreement does not run forever. It is typically a one to two year timeframe.

Some banks prefer non-compete agreements. Some banks prefer non-piracy agreements. Whatever the case, we think it is important that you give consideration to protecting your customer and employee investments.

CREDIT UNION CAPITAL ACCESS

This past two weeks brought yet another announcement of a large, non-taxpaying credit union acquiring a larger, taxpaying community bank. As you may know, these transactions are structured as purchase of assets and assumption of liabilities transactions and are always all-cash deals (since a credit union has no stock ownership and "membership interests" in credit unions have no value).

One question that often gets asked in these types of deals is how credit unions access the capital needed to fund the purchase price and support the increase in additional assets. The answer used to be only "retained earnings." However, thanks to a final rule adopted by the National Credit Union Administration (the federal regulator and insurer for credit unions) at the end of 2020, credit unions now have access to an additional avenue for capital.

Beginning in 2022, credit unions can issue subordinated debt that will count as either the equivalent of bank Tier 1 Capital or bank Total Capital, depending on the circumstances. The terms of the subordinated debt are generally the same as subordinated debt that is issued by community bank holding companies. For credit unions that have less than $500 million in total assets or credit unions that have more than $500 million in total assets and operate in an area designated as low income, the outstanding principal amount of the sub debt will count as regulatory capital with respect to the credit union's "Net Worth Ratio" and "Risk-Based Capital Ratio." The Net Worth Ratio is essentially the same as a community bank's Tier 1 Leverage Ratio, and the Risk-Based Capital Ratios are essentially the same. For a credit union that is more than $500 million in total assets and does not operate in a designated low income area, the amount of the subordinated debt counts as regulatory capital only with respect to the Risk-Based Capital Ratios. In other words, for these credit unions, it does not have the equivalent of Tier 1 Capital.

This NCUA rule becomes effective in early 2022. In our opinion, this rule is only going to act as fuel to the fire to continue to accelerate credit union acquisitions of banks. Right now, subordinated debt, which is a ten-year, interest-only instrument with a bullet payment at maturity, is pretty affordable. We believe this affordable source of new funding coupled with the NCUA's capital allowance will result in even more credit union acquisitions of community banks.

ESOPS IN ACQUISITIONS

We have had discussions with many clients recently about the role of ESOPs and KSOPs in connection with an acquisition. Several of these have been where our firm is on the sell side and the selling bank is curious as to the ESOP's involvement in the transaction. Keep in mind, the ESOP is "just another shareholder." The general rule is that in an acquisition transaction the vote in favor or against the transaction passes down to the ESOP participants so they can vote yea or nay on their own. Having been involved in many acquisition transactions on the sell side where ESOPs are involved, we have never found any significant dissent on the part of the ESOP participants with respect to voting for a transaction that the board has recommended. We believe this is primarily because those community bank officers and employees who are participants in the ESOP will certainly vote in their best financial interest, irrespective of any recommendation of the board.

On the buy side, we have also had some recent interesting discussions about the use of an ESOP in connection with an acquisition transaction. As many of you know, in a C corporation, an ESOP can engage in an IRS Section 1042 transaction. This basically involves a transaction where anyone selling to the ESOP, such that the ESOP after the sale has at least 30% of the holding company stock, can take the proceeds from the sale and reinvest it in American corporate securities without paying any tax. The issue involved in an acquisition transaction is can the acquiring bank holding company give the target shareholders holding company stock and then allow them to do a 1042 transaction? The answer is "yes," provided that the target shareholders hold that stock in the C corporation post-transaction for at least three years. If the target is looking for a tax-free transaction on top of the tax-free transaction of the sale itself, then an ESOP 1042 transaction a few years down the road would provide that cash liquidity and diversification without tax, and with a carryover in basis. If your community bank holding company maintains an ESOP or a KSOP, do not forget about its possible use in either financing an acquisition transaction or, as described above, in ultimately providing the possibility of a tax-deferred liquidity event for those original selling shareholders.

BYLAWS PROVISIONS

Over the past couple months we have received quite a few requests from clients to review their existing holding company and bank bylaws. In each of these instances, our client has mentioned that it has been some time since someone has reviewed and actually provided comments related to the bylaws, if at all. The request is simply to review the bylaws and provide our comments and recommended changes.

What has struck us as interesting is the different approach that is taken to the bylaws. Some holding companies and banks lean into their bylaws pretty strongly and want very detailed and specific provisions related to the various items covered. Others take a much more passive approach, asking for what is essentially described as the bare minimum in terms of language and the maximum in terms of flexibility.

In our view, either of these approaches work. We see the important thing as determining what works best for your organization. For some organizations, a very detailed set of bylaws helps them in the administration of their affairs. For others, more general and open provisions are more accommodating to their business. As long as the bylaws achieve their intended purpose of facilitating the administration of the company, we see them as sufficient.

CONCLUSION

Here we are at mid-August. At least in the southern states the kids have gone back to school, some with masks and some without. Labor Day will be upon us soon for another long weekend. Enjoy time with the family. Please stay safe and healthy.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- August 22-27, 2021 – ICBA Commercial Lending Institute (Cliston V. "Doc" Bodine, III)
- September 8, 2021 – ICBA Webinar – "M&A Advice for the Current and Future Environment" (Greyson E. Tuck) [M&A Advice for the Current and Future Environment]
- September 15, 2021 – Community Bankers of Michigan Directors College – "Stay Independent? Stay Relevant!" (Philip K. Smith) [Stay Independent? Stay Relevant!]

