GERRISH'S MUSINGS

Jeffrey C. Gerrish
Philip K. Smith
Greyson E. Tuck
Gerrish Smith Tuck
Attorneys/Consultants
700 Colonial Road, Suite 200, Memphis, TN 38117
♦ Phone: (901) 767-0900 ♦
♦ Email: jgerrish@gerrish.com ♦ psmith@gerrish.com ♦ gtuck@gerrish.com ♦
Website: www.gerrish.com

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Dear Subscriber:

Greetings from Alabama, Wisconsin, Texas, Tennessee, North Dakota, Kansas, and Louisiana!

THE REGULATORS ARE COMING

That's right, the regulators are coming. They are already here, of course. They just seem to be, based on our anecdotal evidence from our community bank client base across the country, coming quickly and with a strong arm for the community banks.

In just the last couple of weeks, we have had multiple situations where a community bank client has been criticized or received a regulatory enforcement action dealing with fair lending, equal credit, bank secrecy, asset liability management, you name it. The only thing yet we haven't seen, but we anticipate we certainly will, is safety and soundness, focusing on asset quality. As most of you remember from the last recession, the asset quality snowball occurs when asset quality begins to soften. This softening is followed by excessive provisions to the reserve, which reduces income, which reduces the growth of capital, all of which rolls downhill directly toward management (including the board of directors) who, though competent for years, suddenly becomes incompetent in the eyes of the regulators. Keep a wary eye out, particularly for your next compliance exam. This administration seems to be very bent on changing the landscape as it relates to consumer credit and the like.

THE MANAGEMENT RATING AS A "CLUB"

The regulators in this environment are now using the Management rating as a "club." We have seen this before. In one past instance, we saw a long-time client that was a 1-rated bank for years and years have an examination and receive a 1 on every component (i.e., Capital, Assets, Earnings, Liquidity, and Sensitivity) except for Management, on which it received a 2. The client was understandably concerned. The regulators' response was basically, "We were trying to get your attention." We are beginning to see "green shoots" of that philosophy again.

Keep in mind, as a 1 or a 2 rated bank with a 1 or 2 rating in Management, your bank is still deemed to be "well-managed" by the regulators. A 3 rating in Management, however, pushes the bank out of the "well-managed" category, which can prevent the bank holding company from becoming a financial holding company and engage in other activities, and can result in a roadblock to any bank holding company action requiring any type of regulatory approval. Keep in mind, directors who may be reading *Musings*, Management includes the board of directors. Most of the criticism leveled has been at the directors' failure to appropriately exercise their fiduciary duties as directors and for management taking their eye off the ball during the COVID period. Look out for your next federal exam. Our information, based again anecdotally, is that the states are still "playing nice." The friendly federal regulators, however, are becoming less friendly by the day. We have a tremendous amount of regulatory enforcement experience. Although we hope we do not need to, let us know if we can assist your bank.

OWNERSHIP ISSUES

Every board of directors has an obligation as part of its job to enhance shareholder value to make a determination what ownership should look like. Should the holding company be private and closely-held, should it be SEC-reporting and likely more widely-held, or should it be full blown public? The real issue is what does the board want the bank and holding company to look like over the long term. This is not an issue for many community banks because they are family-controlled. For others, however, it is certainly a focus. In fact, much of the focus lately has been on whether Subchapter S still makes sense in view of the pending Biden administration proposals. As we have indicated previously in *Musings*, it is still too early to tell, but the board should keep an eye on the eventual changes. Several holding companies we have worked with lately are still SEC-reporting. For them, the question is whether to continue as an SEC-reporting company listed over-the-counter or on NASDAQ, or whether to change that over the long term. Multiple factors go into that decision making process, but it is still an obligation of the board to make that decision.

BOARD VERSUS SHAREHOLDERS

We often get questions from community bank boards regarding the relationship of the board of directors to the shareholders. This occurs whether the bank holding company is a Subchapter S or more widely held. Our answer is that the board of directors is a representative of the shareholders and is elected by the shareholders, but it has to make its own decisions on behalf of the shareholders. We often run into situations in acquisition transactions where there may be some conflict on the board as to whether the bank should sell, whether it should sell at a certain price, and the like. Often, one of the outside directors will make the suggestion that they should simply take a referendum of the shareholders and see what they want to do. Our general response is, "Sorry, directors, but that is what you get paid the 'big bucks' to decide." In the acquisition context (or in any other really), the shareholders do not get to make a decision unless the board of directors recommends whatever action it is to the shareholders, in which case appropriate proxy material will be provided and the shareholders get to vote "yes" or "no." In the acquisition context, if the board thinks the proposal to sell the bank is not adequate, then it stops right there. If they think it is adequate and they are willing to recommend it, then it goes to the shareholders for a vote. No recommendation from the board - no shareholder information or contact. All that is part of the directors' job. Do not shy away from it.

DIRECTOR EDUCATION

We have been reminded again these past couple weeks about the importance of director education. For some of our clients around the nation who have been criticized by their friendly federal regulators for not taking appropriate action, it really comes down to the fact that perhaps the directors were not appropriately educated that the matter receiving criticism was part of their group of duties and responsibilities.

Banking is changing rapidly. Our general recommendation is to get your directors educated as much as is feasible. This does not necessarily mean traipsing off to some exotic tropical island for a week of emersion (in education issues), but it does mean having them participate in webinars, seminars, conferences, and the like. The big benefit of those, of course, is that the directors get to interact with directors from other banks. Although CEOs are often hesitant to have their directors get their "fragile minds filled with mush" from whomever is speaking at the particular conference, it is still on balance probably beneficial to expand the directors' horizons.

BOARD SIZE

What is the appropriate board size for a community bank and bank holding company? The answer is, it varies. We have been with boards that are as small as five members (particularly closely-held banks where you have to have the appropriate last name to sit on the board of directors), and boards as big as 20 plus. Mostly the larger boards have resulted from acquisition transactions where the acquirer had to add the target board members, or many of them, simply to get the deal done.

Our general answer as to the ideal board size, unlike the CEO's answer preferrable response of "one," is somewhere between 7 and 11. We are pretty practical on this in that we really believe the board needs to have enough board members to appropriately populate its committees without wearing the directors out from a time standpoint. Usually somewhere between 7 and 11 fits the bill. Some of our boards worry about having an even number of directors. That is not much of a worry for ours, since we rarely see a close vote in community banking, let alone even a "no" vote. One thing the directors should do is decide what is an appropriate size for their board and work toward getting there eventually.

ACQUISITION FRUSTRATION

Over the past couple months we have facilitated a number of different strategic planning sessions for what are essentially frustrated, "wish we could be" acquirers. As the name implies, these are community banks that want to acquire another bank but are experiencing some frustration with that strategy. In today's environment, there are two primary sources of frustration for banks that find themselves in this position.

The first source of frustration is a lack of acquisition targets. The board simply cannot find an acquisition target that makes sense. In some circumstances, there are no banks that really fit the bill. In others, there are viable targets, but those targets are not interested in selling.

The second source of frustration for these acquirers stems from a lack of excess capital, which oftentimes has not historically been the case. The growth in the bank's total assets over the past 21 or so months has resulted in lower than historical capital ratios and has diminished whatever excess capital existed prior to the pandemic. This is particularly frustrating for banks where their growth has not been profitable growth.

Any bank that finds itself in this situation must acknowledge the reality of the situation and then formulate a plan to work around it. Those banks that cannot find targets need to either adjust their acquisition criteria or be willing to make a better offer to try and entice a bank that has previously decided not to sell. For those that are lacking capital, the board must evaluate the available alternatives to increase capital, look at ways to reduce the size of the balance sheet, or do a combination of the two.

We have said a number of times previously that the community bank M&A environment is an active one. We still see that as the case. However, there are some would-be acquirers that are not able to make acquisitions because of these frustrations.

PROTECTING INDEPENDENCE

We recently had an interesting discussion with a community bank board on strategies to protect independence. This particular board is properly characterized as aging. A number of the directors have been in their position for multiple decades and are nearing the end of their tenure. The group recognizes that there will be a new crop of directors coming into the bank, and part of the discussion focused on strategies that could be put in place today to ensure the bank's ongoing independence.

The result of the discussion was the adoption of an action item to pursue an amendment to the holding company articles of incorporation and bank charter to impose supermajority voting requirements on any change in control, acquisition, or similar transaction. If you are not familiar, supermajority voting requirements are one of a number of available anti-takeover defenses. As the name suggests, a supermajority voting requirement imposes a higher approval threshold for a change in control, acquisition, or similar transaction. In this case, the board decided to go with an 80% vote requirement, meaning that a change in control or acquisition transaction would only be properly approved if at least 80% of the holding company's shares voted in favor of the transaction. Many banks also structure a supermajority such that the supermajority (e.g., 80%) is only applicable to a transaction the board does not recommend.

In any event, this was an interesting board discussion. We thought it a smart move to take steps today to ensure ongoing independence, or at least make it more difficult to abandon that strategy.

A MODEL APPLICATION PROCESS

We have been assisting a group of investors in acquiring a bank for much of this year. In the transaction, we formed a new company that had a pretty good number of new shareholders, and that new company acquired ownership of an existing bank. The application process for this type of transaction is technically a bank holding company application. However, it really is more of a hybrid between an acquisition application and a de novo bank application. In these types of applications, the regulators require extensive information about the parties involved, a detailed business plan, and a significant amount of related information. It is a more involved application process than a typical acquisition application where one bank is buying another.

We have seen these types of applications where they move slowly and are bogged down by regulatory concerns. Fortunately, this particular application was not weighed down by any of these. Instead, this application process went about as well as anyone could have hoped. The regulators approved the application in about six weeks, which we see as likely record time for this type of deal.

We attribute the smooth application process to good communication all around. We began the application with a prefiling meeting with the regulators where we laid out exactly what it was that we were doing, and we talked with the regulators specifically about the business plan. When the application was submitted, there were no surprises. We also had great communication and a strong working relationship with our client.

There was a lot of hard work that went into the application. The good part is that the hard work was rewarded in the form of a quick transaction approval. The deal is now closed, and the investor group has their bank. They are now off to the races and are working to grow the newly-acquired bank. Kudos to them on a successful transaction!

CLOSING SHOULD BE A NON-EVENT

These past couple weeks have been particularly busy for acquisition closings. We have closed a number of transactions over the past two weeks—some on the buy-side, and some on the sale-side. These closings have reminded us that closing an acquisition transaction *should* be a non-event.

If a closing goes as it should, it is the most anticlimactic part of the deal. Closing bank acquisitions is not like closing a real estate transaction where documents are actually signed in person. Rather, a bank acquisition closing that goes to plan is all done electronically, and the work completed prior to the actual closing date. In a deal that goes smoothly, two or three days prior to closing all of the documents are signed, exchanged among the lawyers, and "held in escrow." On the date of the actual closing, the lawyers simply confirm everything to be correct and give written instructions to release the documents from escrow. The transaction is then closed.

Of course, there are a number of different items of work to be done following closing. This includes exchange of the consideration, integrating the banks, and the like. These activities, particularly integrating the banks, are big ticket events. However, the actual closing, if properly conducted, really seems like somewhat of an afterthought.

DIVERSITY, EQUITY AND INCLUSION

As most *Musings* readers know, diversity, equity, and inclusion (DEI) has been a major issue and certainly a major talking point, at least for large bank holding companies (and large public corporations in general). Over the years, we have generally found that whatever happens to the large bank holding companies seems to "trickle down" to the community banking sector. Within the last couple of months, the SEC issued its Order approving a proposed NASDAQ Board Diversity Rule request. In general, the Rule requires that the board of a NASDAQ listed company either be diverse by having at least two diverse directors, including one self-identified woman director and one director who self-identifies as an underrepresented minority or as LGBTQ. The Rule provides that if the company does not meet this threshold, the company has to indicate why not. This new disclosure for NASDAQ listed companies will likely eventually trickle down into the community bank regulatory system and eventually require disclosure for community bank holding companies. Be prepared. If anyone wants any further information about the specifics of the rule, please let us know.

UPCOMING COMMUNITY BANKING BOARD CHAIR FORUM

As many of you know, Gerrish Smith Tuck facilitates and the Barret School of Banking sponsors the Community Banking Board Chair Forum. This is an in-person forum designed for community bank Board Chairpersons, Vice Chair, Directors, and Chief Executive Officers. This meeting is a "forum," not a lecture or seminar type event. It is primarily discussion facilitated by the three of us. The Forum will be held January 13-14, 2022 in person at the Ritz-Carlton in Naples, Florida. If you would like to register for the Forum, please follow the link: Community Banking Board Chair Forum . Although in view of the pandemic and other issues, we will need to limit attendance, there are still several slots remaining. We hope to see you there.

CONCLUSION

It is mid-November. There is definitely a chill in the air in most parts of the country. Winter can't be far ahead. We continue to look forward to seeing many of you in our travels around the nation. Since we won't have another *Musings* before Thanksgiving, we wish you all a wonderful Thanksgiving holiday.

Stay safe and healthy. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations:

- November 17, 2021 – Financial Education & Development Webinar – "Seven Keys to Effective Succession Planning" (Greyson E. Tuck) Registration: [Seven Keys to Effective Succession Planning]