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# GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Illinois, Iowa, Georgia, Colorado, Virginia, Minnesota, and Wisconsin!

## BANK HOLDING COMPANY TERMINATIONS

If you recall, a couple years ago there were a very small number of larger bank holding companies that chose to abandon their holding company structure and move back to a bank-only structure. The very small number of banks pursuing this transaction led to much speculation about whether these banks were some type of industry leaders such that a number of other banks would follow suit. At the time, we went on record saying we strongly recommended against banks, particularly community banks, terminating their holding companies and moving back to a bank-only structure. Our thought was, and continues to be, that the benefits of a bank holding company far outweigh any cost savings or relief of administrative burden that might come from the termination of a holding company.

We recently read with interest an article in the *American Banker* that is entitled “Why most banks are holding on to their holding companies.” As the title suggests, the article looks back at the small number of banks that terminated their holding companies and shows that these really were one-off transactions and not the impetus for any sort of trend. The article then goes on to cover the benefits of a bank holding company, particularly for community banks, from a very high-level perspective. (The article references the Small Bank Holding Company Policy Statement as being applicable to all banks with less than \$1 billion in total assets. This is incorrect. The actual threshold is \$3 billion.)

In summary, the article follows what we were touting a couple years ago. The bank holding company is the most beneficial organizational structure, particularly for community banks. There are a

number of benefits to the holding company structure, and we do not believe terminating the holding company provides any set of benefits that is close to the available benefits when a bank is in the structure.

Please let us know if you would like a copy of the *American Banker* article. Please also let us know if you would like additional information on the benefits of a community bank holding company. We are happy to provide both.

### TIS THE SEASON

Tis the season, apparently, for stock repurchase plans. A number of community bank holding companies we have worked with recently have contacted us about implementing voluntary stock repurchase plans for their shareholders. Some of the boards of directors of these community bank holding companies believe it is appropriate to get cash in the hands of their shareholders in time for the holidays if they want it. Others are pursuing a strategy of consolidation of ownership. Still others are simply looking at a way to return cash to the shareholders. For an overcapitalized bank, our general thought is that the board needs to provide the holding company shareholders with either a “return on equity” or a “return of equity.” A return of equity is generally going to be through either a dividend or a voluntary stock repurchase plan. The community bank holding companies we have been working with lately do not want to go the dividend route simply because of the concern that it may become an expectation on the part of the shareholders. They would rather provide a voluntary stock repurchase plan and let shareholders liquidate some or all of their stock as they see fit. Wise choice.

### CHANGE IN CONTROL

As we have reported in Musings previously, any time a company acquires control of a bank, or an individual acquires control of a bank, a change-in-control filing needs to be made. Sometimes those “acquisitions” are not as obvious as simply going out and buying a bank. Sometimes an “acquisition of control” could be a result of a redemption of shares where post-redemption there are fewer shares outstanding and the individual affected now has a larger percentage of shares. The percentage may trigger the Federal Reserve to consider it a change in control. A change-in-control requires prior approval by the Federal Reserve. Often in these unusual circumstances, the change-in-control occurs and no application is filed because the individual involved simply does not know they needed to do it.

The good news is that the Federal Reserve is fairly forgiving on these after-the-fact change-in-control notices. We are working on a couple now. It appears the Federal Reserve actually understands

the circumstances and is not rattling the saber about civil money penalties or anything else. At least not yet.

### DIRECTOR ISSUES

As most *Musings* readers know, community bank and holding company directors have three fundamental duties. These include a duty of care, a duty of loyalty, and a duty of confidentiality.

We were recently confronted with several situations where, for whatever reason, a particular community bank/bank holding company director thought he/she should receive special treatment. One circumstance involved loans (Reg. O prohibited). Another involved fee waivers (again, typically a Reg. O issue). Another involved the holding company repurchasing shares at a higher price than normal.

Our general advice is that although every situation is fact-dependent, the board really needs to assess why it should take any additional risk to benefit one of its own when it did not need to or have to.

### BANK MERGER APPLICATIONS

If you have not heard, Senator Elizabeth Warren recently announced a new Bill to “improve” the bank merger review process. Senator Warren has stated she believes the Bill to be necessary based on the recent BB&T and SunTrust merger, which was consummated last week. (If you are not aware of this, the new company will be called Truist Financial – which is probably the worst name we have ever heard.) Apparently, Senator Warren believes the existing process is deficient, particularly as it relates to consumer protection, so her idea is to add the Consumer Financial Protection Bureau to the list of governmental agencies that are required to review and approve a proposed transaction.

In a recently published article on the issue, Senator Warren is quoted as having her “worst suspicions” confirmed that the Fed has not declined a single merger request since before the financial crisis. While we do not specifically refute the statement, the statement reflects Senator Warren’s lack of understanding of the process of Federal Reserve approval.

Senator Warren is probably technically correct that the Federal Reserve has not declined a single merger application in quite some time. That is because the Federal Reserve’s practice is not to decline a merger application. Instead, if the Federal Reserve is inclined not to approve an application, rather than actually denying the application, it not so politely suggests that the application be withdrawn. We have experienced this dozens of times since the beginning of the financial crisis, so the idea that the Fed is just automatically approving everything is not accurate.

In our view, the proposed legislative change is certainly unnecessary as it relates to community banks. The current bank merger review process is appropriate to fully vet the issues while also allowing good deals to move ahead in a timely manner. We do not see any reason, particularly as it relates to community bank mergers, that the Consumer Financial Protection Bureau needs to be added as another layer of bureaucracy in the approval process.

### LOAN DUE DILIGENCE REVIEW

We are currently assisting a community bank client in the due diligence phase of a potential acquisition opportunity. As you likely know, due diligence is the equivalent to the home inspection in a home purchase. It is a review of the financial (including asset quality), legal, and compliance issues at the target bank. The whole point of due diligence is to ensure the acquirer understands exactly what it is buying, particularly as it relates to the risks associated with the transaction.

Our client recently asked for our thoughts specifically regarding the loan review. The question was essentially how much of the loan portfolio needs to be reviewed, what percentage of each lender's loans should be reviewed, and the like.

Our response was that there is no specific set of numbers that must be followed in this type of due diligence review. Instead, it is important that the loan due diligence accomplish the following: (1) assess overall credit quality, loan administration, and target bank risk profile; (2) identify expected future losses or problem credits; and (3) understand specific target bank Loan Officer tendencies, loan administration, and credit characteristics.

How exactly each of these goals is achieved depends on the specifics relative to the circumstance. Generally, a thorough loan due diligence review takes a look at approximately 60% to 70% of the total dollar volume of credits, all watchlist credits, and an appropriate sampling of the remaining credits. Whatever the case, it is important to keep these three primary goals in mind as it relates to loan due diligence.

### ESOP LOANS

Many Employee Stock Ownership Plans are what are referred to as "leveraged" plans. What is a leveraged ESOP? It is an ESOP that has borrowed money from a third-party lender and used the proceeds of the loan to buy holding company stock for the benefit of the ESOP participants. In a leveraged ESOP, the shares purchased with the loan proceeds are held in an ESOP suspense account and are released to the ESOP participants as the loan is paid down. The ESOP services the loan by receiving tax-deductible contributions from the bank.

A leveraged ESOP setup works very well. One thing to keep in mind is that a loan to a leveraged ESOP must strictly comply with the IRS rules for ESOP loans. The tax regulations contain specific requirements for the loan to an ESOP. If an ESOP loan does not meet these requirements, there is a possibility the loan could create undesirable collateral damage.

Please let us know if you would like additional information regarding the rules and requirements for an ESOP loan. We are happy to provide it.

### THE CLOSELY-HELD BANK

As we have noted often in *Musings*, we work with many closely-held community banks across the country. We often facilitate planning for these banks. Often, that planning involves meeting with the family members and then meeting with the Board and senior management to set direction for the bank and holding company. We had one such meeting where the planning session for the bank and holding company management and directors was very refreshing. It was refreshing because even though the bank was very closely-held, the ownership was very receptive to suggestions and direction from the non-owning directors as well as management. Often in a planning retreat for a closely-held bank, when a question is asked with respect to strategy, all heads turn toward the ownership end of the table. That was not the case in this particular meeting. Ownership was receptive and transparent, and management was unafraid to challenge and put forward what they thought was in the best interests of the bank, even if it was something ownership disagreed with. A refreshing change.

### BANKING THE MARIJUANA BUSINESS

Shortly before one of us spoke at a recent banking conference, the previous presentation involved and heavily promoted community banks banking the marijuana business. Of course, the presenter was in a state where recreational marijuana and medical marijuana were permitted by state law. The speaker recommended the community banks pursue banking the marijuana business to generate additional fee income primarily, since apparently “gouging” marijuana producers and dispensers when you permit them access to the banking system is acceptable. After visiting with a number of community bankers and community bank directors at this conference, there was not much appetite, notwithstanding the push from this particular speaker, to bank the marijuana business. Most of the bankers felt it was simply still too risky from a regulatory, reputation, and other risk perspective. We of course know there are many banks in the country who are banking the marijuana business. We respect their choice, but this group took a pretty conservative approach.

## CONCLUSION

Since this will be the last *Musings* before Christmas, we wish all of you and your families a very Merry Christmas. Each of us looks forward to being off the road at least for a few days while we spend time with our families and friends over the Christmas holiday. We hope you have an opportunity to do so as well.

See you on New Year's Eve.

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