GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Illinois, Minnesota, Wisconsin, California, Texas, Georgia, West Virginia, and Louisiana!

REG. O AGAIN!

Most *Musings* readers are familiar with Regulation O of the Federal Reserve, which applies to all FDIC insured banks. It was a result of the Bert Lance fiasco in 1979 (if you remember that you're pretty old) that dealt with insider dealings. The regulators decided they were going to clamp down on that, and, voilà, Reg. O appeared.

We have recently been involved in multiple Reg. O situations with several different community banks. Keep in mind, the concepts of Reg. O are not difficult. Reg. O is designed to make sure that the bank neither loans too much money to insiders nor loans money on more favorable terms than to non-insiders. It provides loan limits as it relates to insiders, defines who is an insider, and defines who is an affiliate of an insider (i.e., a company, for example, that the insider may control). It also requires that loans to Reg. O officers of the bank receive prior approval by the Board without the borrowing officers being involved or influencing the vote in any way. It does not seem too difficult.

In the recent matters in which we have been involved, the issues generally involve failure to disclose appropriately to the board the relationship of the inside officer to various companies through which he or she is borrowing the money. This is not only a Reg. O violation, but it could, arguably, involve criminal violations if the bank records are falsified.

Our general recommendation from a board of directors' standpoint is that every time a Reg. O loan comes to the board for prior approval, the board should insist that the management team or compliance officer indicate the loan has been reviewed and, to the best of their knowledge, complies with Regulation O in all respects. While Regulation O violations are "strict liability" (i.e., there does not need to be any intent to violate), this effort of good faith would help when dealing with the regulators when they allege a Reg. O violation. Although it generally takes multiple Reg. O violations for the bank or the individuals to be assessed civil money penalties, as a practical matter, multiple violations are not required. Keep an eye on Reg. O for your community bank.

THE EXAMINERS FROM DISTANT LANDS

We were recently contacted by the CEO of one of our long time community bank clients. She was curious as to why her friendly federal regulators would send an examination team based in the state of California to her small 1-rated community bank in the eastern United States. Our response was twofold. First, they are likely using her healthy bank as a training ground for some of these California examiners who may not have seen or not been in a bank that has good strong policies and procedures and management. Second, the regulators, like everybody else, are trying to allocate resources where they make the most sense. Because the state of California is currently locked down due to the pandemic and battling wildfires (our thoughts and concerns are with those affected by the fires), the friendly federal regulators need something for the examiners to do. Why not ship them off 2,000 or 3,000 miles away to do an examination? We are optimistic this California team will understand how this community bank in this part of the country does business. Hopefully, the exam will go well.

CONSOLIDATION OF OWNERSHIP

Over the last several months we have had several clients come to us to help them address ownership. It seems the pandemic has provided everyone a good time for reflection. Internal reorganizations which may have been delayed over the years due to the press of other business are now moving front and center. Some of the community banks that have approached us have multiple bank charters, different structures, affiliated holding companies, different ownerships for each, etc. Our task is to review the situation and advise as to how best to consolidate these entities into one (hopefully) more efficient, streamlined, and better able to compete in the future entity.

Mechanically, most of these deals are fairly easy to do. Most involve some kind of a merger transaction that forces all the shareholders, subject to majority approval, to do what is in the best interest of getting the transaction done. As with most consolidation or ownership restructuring transactions, the mechanics are not the problem. The problem, if any, is found in the politics, the emotion, the legacy shareholders, and the like. All of these need to be addressed. Ignoring the legacy shareholders is simply not an effective strategy. So the plan, as a practical matter, needs to be twofold. One is how do we actually effect the restructuring? What is the value of the shares? What does the resulting shareholder base and ownerships structure look like? And two, how do we deal with the shareholders so they understand that what is occurring is in their best interest?

MANAGEMENT SUCCESSION

We often mention issues of management and board succession in *Musings*. That is primarily because we deal with it on a regular basis. Looking back over the past 25 years, management succession in particular has come much more to the forefront as the CEO base has gotten significantly older. We do credit the community bank boards of directors for recognizing the issues early on and addressing them appropriately. We have had a number of community bank clients in various parts of the country where we would only describe the management succession process and result as "highly successful."

If you have management succession issues in your bank, give yourself a two or three year runway to address them. That seems to be generally what needs to occur with respect to planning and executing senior management succession.

STRATEGIC PLANNING IN LIGHT OF COVID-19

We are entering into what we often refer to within the firm as our strategic planning season. We have coined this time of the year as such because we facilitate numerous strategic planning sessions in the fall months. We have already facilitated a number of planning sessions within the past couple months or so, and we have a number more scheduled on the books through the end of the year. One question that has come up a number of times recently is whether there are any unique strategic planning issues in light of COVID-19. Put another way, we are often asked whether strategic planning is different in this environment.

Generally speaking, we do not believe strategic planning is fundamentally different in today's environment than it is in any other operating environment. The ultimate goal of strategic planning remains the same, which is to identify specific action items to enhance shareholder value. However, there are a couple unique considerations that we believe are important to note relative to strategic planning in the current environment.

First, the strategic planning horizon falls on the shorter end within the current environment. Most of the time we encourage community banks to think about strategic planning as planning for the next 24 to 36 months. Given the uncertainty of the current environment, primarily related to COVID-19 but also related to political and other issues, in today's planning sessions we are focusing thoughts over the next 12 to 18 months.

Second, planning in the current environment is heavily impacted by your organization's risk tolerance. There is obviously a lot of unknown as to what is going to happen over the next 12 to 18 months. The pursued strategies within that timeframe are going to be heavily impacted by risk tolerance. Those community banks that trend on the conservative side seem to be adopting more of a defensive strategy, while those that are a little more aggressive seem to have an increased appetite to proactively pursue strategic opportunities.

In summary, planning within the current environment is not significantly different than planning within any other environment, normal or not. We do recommend that as you approach your strategic planning you be thinking about the timeframe for which you are planning, as well as your risk appetite. We think nailing those down will be very beneficial to the rest of the discussion.

ESTABLISHING A VIRTUAL BANK

We have had multiple inquiries or discussions at planning sessions over the last couple of months about a community bank establishing a "virtual bank." Keep in mind, a virtual bank is simply a "marketing arm" of the existing bank that may be branded with a separate name, logo, and the like. It is of course "virtual," which we are all used to now, and as a practical matter, in this case, all electronic/digital/online. Prior to the pandemic, most of our clients were using their "virtual bank" to gather deposits. Now that all our community banks seem to be flush with deposits and do not know what to do with them, the virtual bank concept is shifting gears a little bit to online loan applications and similar ways to deploy their cash. It probably needs to be a point of discussion at your next planning session.

SHAREHOLDER LOST STOCK AFFIDAVITS

The vast majority of community bank holding companies have some or all of their common stock represented by physical share certificates. A not uncommon byproduct to the issuance of physical share certificates is lost, stolen, or destroyed share certificates. It is not all that uncommon for a shareholder to misplace the actual certificate representing ownership of the shares. When this happens, the shareholder typically requests the holding company issue a replacement stock certificate.

One question we often receive in this situation is what, if anything, the holding company should receive in order to issue a replacement stock certificate. The answer is that it generally depends on the risk tolerance of the issuing board of directors. At a minimum, a shareholder should execute a Lost

Stock Affidavit, which is the shareholder's affidavit that the stock certificate has been lost, stolen, or destroyed and the shareholder has not purported to sell any of the shares represented by the certificate. Most Lost Stock Affidavits include an indemnification provision whereby the shareholder indemnifies the holding company for any loss or expense that may be realized due to the shareholder losing their share certificate and the holding company issuing a replacement. Other holding companies require an actual indemnity bond, which is basically an insurance policy for the value of the shares, typically issued at a cost of about 2% to 3% of the stock represented by the lost certificate.

We recently ran across a situation where a shareholder was claiming to be extremely offended at the idea of a holding company requesting indemnification for the issuance of a replacement certificate. The holding company asked us about this, and our recommendation was for them to stick to their guns and require the indemnification. As we put it, the holding company's obligation is to issue the share certificate, which it did. The shareholder's obligation is to keep track of what was provided, which they did not. Given that set of circumstances, if there is any loss as a result of the lost certificate, we think it should fall on the shareholder, not the company.

ANNUAL MEETING DISCUSSIONS

We recently received an inquiry from a bank president that is preparing for the community bank holding company's annual meeting. Similar to most other annual meetings in today's environment, the shareholder meeting will be held electronically via Zoom. We talked through a number of the issues relative to the annual meeting. During the discussions, one of the questions the president posed was whether they could discuss the recent formation and implementation of their Employee Stock Ownership Plan. Our response was absolutely. We take the position that the board fully considered the formation and implementation of an Employee Stock Ownership Plan and decided to use it to both provide an employee attraction and retention tool as well as an additional avenue of stock liquidity. These are all perfectly legitimate reasons, and we see no reason at all why the shareholders could not be informed of the board's thought and decision making process.

While there are some things that may be off limits to discuss at annual meetings, such as potential acquisition transactions that are not finalized, employee-specific issues, and other similar circumstances, those should be the exception and not the norm. For the most part, we think a board's decisions are fair game for explanation at the annual meeting.

DIRECTOR MANDATORY RETIREMENT

As most *Musings* readers know, we are not, as a general principle, in favor of mandatory retirement for community bank board members. We were recently reminded of why. The issue of mandatory retirement came up in a planning session in the context of director succession issues. The circumstances were such that a couple of this community bank holding company's board members would be reaching the age for mandatory retirement in the next three or so years. The board began the discussion with respect to the process to identify replacement directors. The discussion then migrated to whether the board should eliminate mandatory director retirement. The general consensus of the directorate was that the two individuals who were approaching mandatory retirement age and being forced off the board were not anywhere close to no longer being valuable board members.

We believe that this discussion supports our position of not being in favor of mandatory retirement. We do not see any reason these individual board members should not be allowed to stand for election simply because of their age. Instead, we believe that the board should have the backbone and appropriate policies in place to ensure against older directors' re-nomination if the directors' contributions to the board do not warrant a continued board seat.

COMMUNITY BANKING COMMENTARY

Gerrish Smith Tuck has recently launched a new initiative, which is essentially a video blog on matters of importance to community banking. The blog is entitled Community Banking Commentary and is available on YouTube. You can click here to access the couple videos that have been uploaded: https://www.youtube.com/channel/UC8NUEl2_RDd9Qzc-ZUjUD1g/featured. We anticipate continuing to add to the library on a going forward basis, with new videos added every couple weeks. Please feel free to contact any of us if you have any specific questions or topics you would like us to address. We would be certainly happy to do so.

CONCLUSION

The end of the third quarter is rapidly approaching. Some of us have spent part of the last two weeks in the northern part of the United States where it already appears to be cooling down fairly dramatically. It does not seem that the winter weather and snow can be far behind. Can't wait.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinar:

- September 30, 2020: "Practical Tips for Community Bank M&A" (Graduate School of Banking at the University of Wisconsin-Madison)–Philip Smith. Registration Link: Practical Tips for Community Bank M&A

