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 ♦ Fax: (901) 684-2339 ♦
♦ Email: jgerrish@gerrish.com ♦ psmith@gerrish.com ♦ gtuck@gerrish.com ♦
Website: www.gerrish.com

December 31, 2020, Volume 431

Dear Subscriber:

Greetings from Illinois, Ohio, Wisconsin, Minnesota, and Michigan!

IS COMMUNITY BANKING AT A CROSSROADS?

Over the past two weeks, we have had a couple different meetings with community bank boards to discuss very generally the strategic future of the holding company and bank. The discussion topics, tone, and setup for each of these meetings was strikingly similar. In each case, the board was wrestling with the idea that community banking is at a significant crossroads and was questioning whether there is a future for small community banks. Another interesting similarity between these meetings is that both banks were very strong performers with plenty of capital, better than average profitability, and strong asset quality.

The board members are generally concerned about the bank's ability to thrive in the current and anticipated future environment. These concerns generally revolve around the "typical" issues—management and shareholder succession, rising technology costs, changing customer and employee preferences, and similar strategic issues. The central question for each of the meetings was essentially whether the fundamental strategy should be to buy, sell, or remain independent.

Our comments to each of these boards was similar. Although we are strong proponents of independent community banks, we view each of the available strategies as viable. Each of these banks could be buyers or sellers, and each could simply choose to remain independent. We recognize there are challenges to each of the strategies. This is nothing new. Community banks will continue to serve their communities, and there are and will continue to be challenges. Our advice to these boards was to basically create a three-step plan, which was to first adopt the primary strategy, second to identify the challenges to achieving the primary strategy, and third (and most importantly) develop specific action items to overcome those challenges.

PPP IS NOT DEAD

Congress recently passed, and President Trump (finally) has signed into law, another round of stimulus to address the coronavirus pandemic. The approximately $900 billion Bill has a little bit more than a couple hundred billion dollars in additional PPP funding. The regulations relative to this third round of PPP funding are not finalized. However, the Bill passed by Congress has two notable items related to these PPP funds. First, it expands the universe of available corporate expenses the PPP funds may be used to cover and still be forgivable. Second, the legislation has a specific lender liability protection provision that insulates lenders from potential liability when they rely in good faith on a borrower's certifications and follow all other applicable laws and regulations.

We anticipate this third round of PPP funding will be much like the first. We anticipate there is a strong demand for the funds such that the supply will be exhausted rather quickly. We also anticipate community banks will, once again, be very active participants in PPP lending. We anticipate there are a number of community banks that will be "ramping up the production line" in order to serve their communities and to fund as many third round PPP loans as possible.

FAMILY OWNED BANKS

Over the last nearly 33 years, we have worked with literally hundreds of family-owned banks. These banks are unique in many respects and very similar in others. Generally, the focus needs to be on ownership succession, management transition, and the involvement of the next generation of the family. Many of these family banks are Subchapter S. As we have often noted in *Musings*, an ESOP or a 401(k) ESOP ("KSOP") in a Subchapter S is an excellent tool for a variety of reasons. We have had multiple conversations with families over the last several months with respect to establishing an ESOP or KSOP. The first issue that needs to be addressed is whether the family is willing to reduce its ownership percentage from where it is now to something less in order to bring the employees in as owners through an ESOP or a KSOP. If the answer is "no" to that issue, then there is not much reason to further discuss the ESOP or KSOP. If the family is willing to reduce its ownership (that is, reduce it in favor of the employees) while continuing to maintain control, then the discussion of an ESOP or KSOP makes sense. Also, although a full explanation is beyond the scope of *Musings*, with respect to family-controlled institutions that are Subchapter S, the ESOP anti-abuse rules apply. The ESOP anti-abuse rules are complex and need to be reviewed in any family-controlled Subchapter S with an ESOP or KSOP to determine whether family members who are employees in the bank can participate in the ESOP or KSOP. If anybody needs or wants any further information about the ESOP anti-abuse rules, let us know.

THE STRONG CHAIRPERSON

As most *Musings* readers know, our firm also produces a Board Chair Newsletter directed at community bank Board Chairpersons, Lead Directors, and CEOs. We advocate consistently for a strong Chairperson who exhibits leadership qualities for the bank. The issue we have run into recently is the possibility that a bank could have "too strong" a Chairperson. A "too strong" Chairperson is one that is not a consensus builder by any means, but simply runs roughshod over the remainder of the Board. A "too strong" Chairperson is one who intimidates the remaining board members who, although they are smart, sophisticated, and good bank directors on their own, wither like a daisy on a hot day in the face of the Chairperson. A "too strong" Chairperson is not a bad thing if the Chairperson makes good decisions (a benevolent dictator, as we like to say). If the Chairperson, however, is driven primarily by his or her own interests and not the interests of all shareholders, as well as the community bank and its other constituents, then a "too strong" Chairperson is not a good thing.

We have had multiple situations in the last year where we have had a Chairperson who, in our opinion, was "too strong." The issue is what do you do about it when the Chairperson is firmly entrenched and the board is intimidated. We will leave that issue for another *Musings*, but it certainly creates an interesting situation.

TRUST REVIEWS

In the last quarter, we have found ourselves reviewing on behalf of community bank Subchapter S clients across the nation numerous Trust documents that have recently come into existence. Our review is generally to determine whether the Trust qualifies as an eligible Subchapter S shareholder. We reasonably believe that the significant increase in the number of Trusts and the subsequent Trust review is due primarily to estate planning done at year-end. Whatever its source, however, that Trust review not only needs to look at whether the Trust itself is an eligible Subchapter S shareholder, but also whether putting the holding company stock into the Trust creates a Federal Reserve issue with respect to change in control. The rules with respect to change in control involving Trusts and the Federal Reserve are complicated. The key for most community bankers is simply to be aware that there may be an issue associated with change in control when a shareholder puts their holding company stock into a Trust. We are happy to help you review the issue.

THE FRIENDLY FEDERAL REGULATORS

We are beginning to see the friendly federal regulators become not so friendly as it relates to community banks' asset quality, BSA, and all the usual suspects. We are a little concerned that the pandemic honeymoon, such as it existed, is coming to a screeching halt. The enforcement actions typically brought against community banks at this stage have mainly been informal. Most of them involve some type of "Memorandum of Understanding" or something similar that the federal agency issues as an informal and unenforceable agreement.

We hope your next exam goes well. If it goes less than well, please let us know. We are very familiar with the regulators' tools, available opportunities, and how to negotiate and move through enforcement actions. Keep in mind, even in connection with informal actions, which cannot technically be enforced by your friendly federal regulator, a violation by the community bank serves to destroy the credibility of the management group at the bank. Also keep in mind "management" includes the board of directors as well as its Chairman. We hope we are not entering into a period of enforcement actions, but unfortunately, we suspect that we probably are.

THE ESOP AS A BANK HOLDING COMPANY

Most community banks that maintain ESOPs are aware that it is possible for the ESOP to be considered a bank holding company, but most are not at the level of ownership where that becomes a reality. Typically, if an ESOP controls 25% or more of the stock of a community bank holding company, it, in and of itself, becomes a bank holding company subject to the regulation of the Federal Reserve. An ESOP that is not a holding company is what we like to refer to as "simply another shareholder." An ESOP that is a holding company is subject to the regulation of and examination by the Federal Reserve, and more importantly, enforcement actions by the Federal Reserve. With no disparagement intended, we have found often that the friendly federal regulators, whether it is the Federal Reserve, the FDIC, or the OCC, simply have not had the experience to understand the innerworkings of an ESOP or a KSOP. If you get into a regulatory situation that involves your ESOP or KSOP, make sure that the regulators understand what the laws governing ESOPs and KSOPs require versus what they are asking the bank to do. There will be some conflicts and some differences that need to get on the table.

EMOTIONAL INTELLIGENCE, EMPLOYEE WELLBEING, AND SIMILAR ISSUES

We are currently working with a community bank that takes what we consider a very advanced approach to employee engagement, wellbeing, and similar issues. This bank, and in particular the bank President, puts quite a bit of effort into these areas, such as by doing routine employee satisfaction surveys, emotional intelligence tests, and similar data mining and analytical strategies. The bank also has a Wellness Committee, which is a committee of Board members and personnel that is dedicated to these matters to keep the bank "on track" in this regard.

Some may think of these type of employee engagement and emotional wellbeing efforts as a bit over the top. We do not. We think they are important, particularly in light of the coronavirus pandemic. We believe an engaged and satisfied workforce to be the strongest asset a community bank can possess. We also see the proof in the pudding. We have yet to see a high performing community bank that has what we describe as a disengaged and unhappy workforce.

"FUN" IN DYSFUNCTIONAL

At year-end it is always fun to look back and remember situations where we believe a community bank board of directors put the "fun" in dysfunctional. We have had several opportunities over the last year to visit with multiple community bank boards that had issues that resulted in the board being dysfunctional as it related to overseeing the affairs of the bank. Our recommendation to each of these boards was to identify the issues and address them head-on. These discussions are often stressful, difficult, and not pleasant, to say the least. Our general experience, however, has been that these tough discussions are necessary and useful, and the end result, once the board works itself through the issue, is a better community bank. Most boards do not fit in the "fun in dysfunctional" category. If yours does, then address the issues with or without outside help.

GOOD RIDDANCE 2020!?!?

It is hard to believe that 2020 is in the books. What a year! It would be impossible for us to try and sum up 2020, particularly in *Musings*. However, we think it fair to ask the question as to whether we should be wishing good riddance to 2020?

From a personnel and operational perspective, 2020 has been wrought full of challenges for community banks. Day-to-day bank operations were and continue to be significantly affected by the coronavirus pandemic. As one community banker recently put it, 2020 has been nothing but putting out one fire after another. From lockdowns to remote working to lobby closures to quarantines, there are seemingly no easy days.

From an actual banking perspective, particularly as it relates to profitability, 2020 has been pretty good to community banks. On the whole, banks have enjoyed strong profitability, buoyed particularly by PPP origination and secondary market mortgage origination income. Asset quality at community banks has also held pretty well thus far.

On the whole, we think community banking historians will view 2020 as a mixed bag. There certainly were a number of challenges, but the overall financial results were pretty strong. As we move into 2021, our hope is the personnel and operational challenges fade quickly but the financial performance continues to improve!

CONCLUSION

A lot of keyboards have been clicked, computer screens filled, and words printed (including in *Musings*) dealing with the issues of 2020. As stressful as 2020 was on human resources, as noted above, we did find 2020 to be fairly beneficial (at least not detrimental) with respect to financial issues. Our word for community banks for 2021 is "hope." As the old Christmas carol states, in part, "The thrill of hope, the weary world rejoices." We hope that your 2021 is fabulous. We also thank all of you as clients and friends for making our 2020 successful.

This *Musings* is being produced on New Year's Eve (*Musings* never sleeps). Enjoy your New Year's Eve, New Year's Day, the weekend, and stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

