GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Illinois, Wyoming, Iowa, California, Washington, Texas, and New Mexico!

IT'S ANNUAL MEETING SEASON

Most community bank holding companies hold their annual meetings sometime within the first half of the year. Several of these meetings will likely be "virtual." Since the beginning of the year, we have assisted a number of holding companies in preparing the documents for their annual meeting. One question we often receive at the forefront of these projects is what are the actual documents that should be provided to shareholders in relation to the annual meeting.

Our recommendation is that community bank holding company annual meeting materials include three specific documents. The first is the Notice of Annual Meeting, which, as the name implies, is the document that actually provides notice of the date, time, and place of the annual meeting, as well a summary of the matters that are to be considered. The second document is the Proxy. This is the document that allows a shareholder to appoint an individual to vote their shares as proxy at the annual meeting. It is essentially a transfer of voting power to the individuals named as proxy at the annual meeting. The final document is the Proxy Statement. This is the document that contains the actual information related to the annual meeting, such as additional information on the time and place of the meeting, the votes required for approval of the matters to be considered at the meeting, information on the individuals nominated for election to the board of directors, and similar information.

Although preparation for the annual meeting may seem to be simply an administrative or "ministerial" project, the documents and their contents are important. Be prepared.

LOAN GROWTH STRATEGIES

In virtually every strategic planning session we have facilitated over the past six months or so, strategies for loan growth have been a significant topic of discussion. With the exception of PPP loans, our general understanding is that many community banks are seeing tepid loan demand at best. It is tough to create a plan to significantly grow loans, particularly in today's environment. Given what we view as our responsibility as strategic planning facilitators to direct the bank toward creating achievable plans from these sessions, we are always mindful to try to protect against leaving the planning session with a plan to grow loans without actually having a plan to grow loans.

The available strategies to significantly grow a community bank's loan portfolio include: (i) obtaining a higher success rate in capturing loan opportunities (the overarching goal); (ii) taking loans from competitors within the bank's current footprint; (iii) taking on additional credit risk; (iv) taking on additional interest rate risk; (v) allowing different types of loans than the bank currently makes; or (vi) expanding the geographic footprint in which loans will be made. We also recognize there are some one-off strategies to grow loans, such as increasing participations, purchasing loans (or other assets) from brokers, and the like, but these strategies generally do not provide enough loan growth to be seen as a standalone solution to the loan growth problem (and do not deal at all with the bank's need to develop relationships).

Loan growth in today's market is tough. Unfortunately, there are multiple banks chasing a limited number of deals. If you are looking for loan growth, make sure you have an actual plan to achieve the loan growth, however that may be accomplished.

BRANCH ACQUISITIONS

We have recently had the opportunity to assist a couple different clients in evaluating branch acquisition opportunities. These are situations where a community bank (or a larger bank) has made the decision to sell one or more of its branches, and has proactively marketed the branch sale opportunity to other banks. From a purchaser's standpoint, a branch acquisition is structured as a purchase of assets and assumption of liabilities. This means that the purchasing bank assumes liability for paying the deposits at the branch and then receives enough assets to fill out the balance sheet. These assets typically include the facilities and equipment at the branch, possibly a few loans or securities, and a significant amount of cash. These transactions also count the "deposit premium" as an asset, which is essentially the premium paid in the transaction.

The recent branch acquisition opportunities we have seen have all proposed filling out the asset side of the balance sheet with cash (instead of earning assets such as loans or securities). The problem is that cash today does not have much value. Most community banks are flush with "excess deposits," and additional cash is not very attractive. Given the soft loan demand of today's environment, many community banks do not see a meaningful opportunity to redeploy the cash into earning assets in any timely manner.

If you are presented with a branch acquisition opportunity, keep in mind the type of assets you are going to receive. This will be the driving force behind whether the proposed acquisition is profitable. Chances are that it will be much more attractive to an acquirer if loans are offered rather than cash.

ESOP/KSOP SECTION 1042 TRANSACTION

Although many community banks and their holding companies are taxed under Subchapter S of the Internal Revenue Code, not all of them are. For those community bank holding companies and banks that are still C Corporations and are considering ownership transition, there is a mechanism that allows the larger owner or owners to sell their stock to an ESOP or 401(k) ESOP (KSOP) Plan on a tax-deferred (i.e., no taxes currently) basis. The transaction can be structured so that the selling shareholders may never pay income tax on the gain from the sale to the Plan.

Section 1042 of the Internal Revenue Code, which is applicable to C Corporations, provides (generally) that once an ESOP or a KSOP acquires 30% or more of the company stock, then any selling shareholder that sells to the Plan can receive their cash proceeds from the sale of the stock to the ESOP or KSOP and invest the proceeds in qualified replacement securities (which are generally stocks that are readily tradeable on a securities exchange) without paying any tax on their gain on the sale to the ESOP or KSOP. If the sellers to the ESOP or KSOP hold the reinvestment until their death, then the sellers would never pay income tax on the gain from the sale of that stock to the ESOP/KSOP.

For example, if the community bank holding company had a 20% owner and a 10% owner and a bunch of 5% owners, and the 20% owner and two of the 5% owners wanted to sell and the rest did not, then the 20% owner and two 5% owners could combine forces, sell their stock to the ESOP/KSOP (such that it has at least 30% ownership) and reinvest the proceeds in qualified replacement securities. No income tax would be imposed at the time of the sale. If the sellers held the qualified replacement securities until their death, the heirs of the decedent would receive a stepped-up basis and no income tax would be imposed on the gain from the sale.

Also, the qualified replacement securities can be collateral for a loan, with the loan proceeds invested in a diverse investment portfolio that can be traded from time to time.

As we have indicated often in *Musings*, one of the reasons community banks sell is the failure to plan or provide for ownership transition. For a C Corp., Section 1042 provides a tax incentive for that ownership transition from existing holding company owners to an ESOP or a KSOP (i.e., the employees).

A holding company is free to elect to be an S corporation after the 1042 transaction is complete. If *Musings* readers would like any further information on this, please let us know.

BANK FRAUD

Over the last literally dozens of years that we been assisting community banks, we have encountered numerous "bad actors" that are either operating within the bank or preying upon the bank from the outside. Most of the ones operating in the bank are, frankly, not terribly creative. It is typically an issue of nominee loans (i.e., a loan to a borrower who likely exists but never got the money), fictitious loans (i.e., a loan to a borrower who never existed), or outright theft from somewhere (investment portfolio, cash in the vault, or something else).

Of course, the issue, from an operational and risk management standpoint, is how do you stop the theft/fraud from occurring. Once it occurs, however, it is imperative upon the board to not just write off the loss but to think about how to recover the loss that has been written off. Community banks are required, in virtually every state and at the federal level, to maintain fidelity bond coverage. This coverage is fairly standard and provides for coverage against a lot of things, but primarily fraud and dishonesty by an employee. The general bond provides a certain basic level of coverage, and then most banks will have an excess employee dishonesty bond which provides additional coverage for employee dishonesty.

If your community bank runs into a situation where you may have a bond claim, please keep in mind that the claim must be filed "as soon as reasonably practicable" after the bank becomes aware of the loss. This may be well before the bank becomes fully aware of the extent of the fraud or the extent of the loss. The key is to provide notice to the bonding company as rapidly as possible so the community bank can eliminate the bonding company's defense of not having appropriate notice. The fidelity bond also contains multiple exclusions which the insurance companies (in the interest of holding onto their own money) will attempt to utilize to deny coverage under the bond. Something like a teller theft of cash from the vault (which we have had multiple times over the years), to the extent it is significant, will generally result in a full recovery on the bond. It is fairly "cut and dry." With respect to nominee loans or where an outsider is providing false financials, or somebody in the bank is in cahoots, those are a little bit more difficult to prove and usually involve a longer "discussion" with the bonding company. Keep in mind, with respect to fraud and dishonesty of an employee, the bank must not only show fraud and dishonesty but also show that the employee received some material financial benefit from the transaction.

The basic lesson is don't just write it off when you know it becomes a loss. Write it off and then try and recover it through alternative sources.

BANK-OWNED LIFE INSURANCE

We had an interesting conversation with the Chairman of the Board the other day of a bank that was contemplating purchasing bank-owned life insurance. As we advised him, our firm certainly does not sell bank-owned life insurance, although we have, over the years, reviewed multiple BOLI/deferred compensation/benefit proposals for community banks across the nation. We also have some good friends that are experts in bank-owned life insurance for community banks.

This Chairman's question was a little bit in the "macabre" arena. He was not so interested in how BOLI worked and supported deferred comp after the employee retired and all that. He was simply wondering whether we ever ran into a circumstance where BOLI actually "paid off." You probably understand he meant have we ever run into a circumstance where the insured executive officer actually died and the bank got paid the death benefit. Unfortunately, on that one we had to answer in the affirmative (multiple times). We have been in multiple situations where we will review a bank's numbers and notice a significant bump in the capital account. When we inquire what happened, we generally get the response that it was a BOLI event. We certainly do not recommend acquiring BOLI simply out of the hope that some of the community bank insured employees will "expire soon." That said, we also realize that banks purchase BOLI for a lot of reasons: 1) because it makes financial sense, and 2) because it provides a backstop in the event of an employee death.

FOURTH QUARTER FINANCIAL PERFORMANCE

As many *Musings* readers are aware, the FDIC on a quarterly basis slices and dices its Call Report data and puts it together into a quarterly publication which we affectionately and descriptively refer to as the "FDIC Quarterly." The numbers for the fourth quarter just came out a few days ago. If anybody is interested in reading the raw data you can access it on the FDIC's website, or we can assist you in obtaining it should that be helpful.

The bottom line of the numbers is that things look pretty good. Community banks reported a 21.2% increase in quarterly net income year-over-year. That net income number was notwithstanding a significant (38%) increase in allowance for loan and lease loss expense. Asset quality is stable. Loan balances have declined somewhat, but pretty much for community banks, as defined by the FDIC, things are looking up.

We certainly acknowledge the importance and impact of the significant government stimulus that has already been provided and is likely to be provided in the future. It will be interesting to see what happens once all that shakes out. We have noticed the regulators rattling their saber a little bit more in the nature of enforcement actions. We expect under the new administration this will continue to intensify.

TAXES, TAXES, TAXES

Notwithstanding the ongoing pandemic, springtime always brings thoughts of taxes. From our perspective, it is not so much paying taxes (we are always happy to contribute to a worthy cause) as it is structuring transactions in an appropriate manner from a tax standpoint. If your community bank is engaging in any kind of acquisition transaction of another bank, branch acquisition, redemption of shares, or any other strategic transaction, there are typically tax issues involved. Do not head down the path without taking a look at (or having your special consultants and attorneys take a look at) the tax ramifications of the proposed structure or what could be even a better structure. Even a simple stock repurchase transaction, which we often recommend for community bank holding companies, could, under an inappropriate structure, result in the cash received by the selling shareholder to have dividend treatment. Although under the current tax structure that is not so bad (except the selling shareholders do not get to deduct their basis when calculating their taxes), in the future that may be significant.

The moral of the story, however, is that as the old saying goes, "the only thing certain is death and taxes." The only thing certain in community banks is to make sure that the board is appropriately advised on tax considerations of the transaction being contemplated.

CONCLUSION

It is hard to believe we are at the end of February 2021 already. We are looking forward to continued improvement in the health of the population and the health of the economy moving forward.

Please stay safe and healthy. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- March 3, 2021 – Graduate School of Banking-Wisconsin Webinar – "Community Bank Capital Raising Simplified" (Greyson E. Tuck) Registration link: Capital Raising Simplified
- March 4, 2021 - Graduate School of Banking-Wisconsin Webinar – "Practical Tips for Community Bank M&A" (Philip K. Smith) Registration link: Practical Tips-M&A
- March 31, 2021 – Graduate School of Banking-Wisconsin Webinar – "Liquidity Strategies for Illiquid Community Bank Stocks" (Greyson E. Tuck) Registration link: Liquidity Strategies