The
Board Chair Forum
Newsletter

Opening the door to new ideas

Gerrish Smith Tuck, Consultants and Attorneys
April 2021

The role of the Board Chair, as well as the roles of all board members, and the corresponding fiduciary duties associated with those positions, in some ways remains unchanged over time and in other ways is constantly evolving. To show some of those unique aspects, in this month's edition of *The Board Chair Forum Newsletter*, we take a look at the overall Board's responsibilities somewhat from a regulatory perspective, looking at criticisms that are often leveled at board members during a bad exam.

We also then look at the positive side of the board member's role, including the obligation to create and promote shareholder value, and how to do that while maintaining independence in the current environment. In particular, we are going to take an interesting look at what we often see are some mistakes that boards of directors make in their goal to preserve long-term independence. The idea of preserving independence in and of itself certainly is not a mistake, but we see ways that process can be improved upon.

We hope you find this month's edition informative and helpful. In addition, we often have clients ask if there is a problem with printing copies of this newsletter and including it in the board package or taking similar steps. All organizations are welcome to do that, and we hope it serves as a vital resource for you.

Happy Reading!

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Board Chair's Summary

- Fiduciary Duties in a Regulatory Context
- Common Mistakes in Preserving Independence

Fiduciary Duties in a Regulatory Context

In last month's edition of *The Board Chair Forum Newsletter*, we commented that the Board's job is "oversight," whatever that means. We then attempted to utilize some examples to demonstrate what that could entail. To expand on that concept a bit further, this month we take some other practical examples from clients across the country dealing with regulatory criticism of the Board as a way to demonstrate regulatory expectations and the obligation of the Board Chair and board members in conducting oversight of the organization. Consider some of these examples.

A board of directors was criticized because "corporate governance is inadequate." What does that mean? If you are a public SEC-reporting company you have specific statutory corporate governance responsibilities. However, this was a privately-held company, so what all does corporate governance really entail? Actually, in our opinion, the use of corporate governance in this scenario by the regulators was really intended to mean comprehensively that the Board was not doing its job on a number of other fronts. Therefore, by cleaning up all of the other detailed items that were presented to the Board, the Board could thereby ensure it was having better "corporate governance." That is why it is important for boards to discuss topics like board governance on a periodic basis at board meetings, in addition to the other mundane things that are covered on a monthly basis. As board members we should be asking the question of whether we are doing the right things, analyzing the right issues, and overseeing the bank appropriately.

A further explanation of what corporate governance means, at least for this client, was a criticism that the Board's oversight of the lending and audit function needed to be strengthened. As you might suspect, this bank had some asset quality problems and, since regulatory hindsight is always 20/20, the asset quality problems must have occurred because the Board did not exercise enough oversight of the lending and audit functions to prevent losses from occurring. The takeaway from that regulatory observation is that if your organization begins to experience even a small amount of asset quality problems, more past due loans and the like, it not only is an obligation of the Board to begin questioning the lending team about those losses and require good explanations for what the organization is doing to prevent further losses, but it also requires the Board to take a more introspective analysis to ask if there is more the Board could or should be doing. For example, has the Board set its risk profile in a way that is causing loan officers to make loans for which we are having collectability problems?

Another specific comment directed by regulators at a different board of directors was that the Board was responsible for establishing consistency among policies and procedures across the bank. That is a pretty direct commentary from a regulatory agency, but what if the organization intentionally has a decentralized decision making authority where various branch locations are given the autonomy to operate with their own unique procedures? What if the organization has made acquisitions of other entities, allowed them to maintain their separate charter and corporate identity, and therefore they have different methods of operating?

We could certainly argue whether the regulatory criticism is on the mark, but it is important to realize that the regulatory expectation is that the Board was the party responsible for establishing consistency of policies and procedures, not senior management necessarily. Consider whether, as a Board Chair or a board member, you have ever even asked the question about whether policies and procedures are administered consistently among various locations. In many circumstances, the culmination of these various types of criticism and the focus on corporate governance leads the regulators to conclude that overall risk management practices are deficient. The Board's obligation is to set the core strategic direction on risk tolerance and risk management in a host of areas from capital maintenance to lending philosophy to growth and expansion. Your Board should know how risky or not the institution may be, and should work in conjunction with your management team to identify where the institution should fall on the risk continuum, and how close the institution is maintaining the desired level of risk.

Finally, if your organization has received an adverse regulatory exam, then the Chair and the board members should require updates on the status of complying with areas of criticism in the exam report at least at every board meeting. In fact, even if you have recently had a positive exam, any minor areas of criticism ought to be areas for discussion at the next board meeting. Far too often, board members may tend to brush aside specific comments in an exam report in favor of the overall findings being "not too bad." But consider using your exam reports as a great guidebook to point directors toward the things that management should be addressing. It is, in fact, your periodic report card and can help shine a light on those areas that need improvement before they become problem areas. Following those basic guidelines can help the organization meet the regulatory and fiduciary expectation of proper corporate governance.

Common Mistakes in Preserving Independence

Recently, we were asked to deliver a presentation regarding common mistakes in the merger and acquisition arena since, over the past 33 years we have seen practically every situation you might could imagine. However, as part of this presentation we took a bit of a unique approach by pointing out common mistakes we see of both buyers and sellers that may either hurt long-term shareholder value from either side, or may prevent a deal from coming together at all. The most unusual part of this presentation, though, was that we also looked at the merger and acquisition environment from the standpoint of those institutions which are simply trying to maintain their independence. The question we posed was whether there are mistakes, in light of the current M&A market, that those of you who are trying to manage long-term independence might be making. So, we thought we might share a few of those with you to at least spark some additional conversation at the board level for how to properly manage your long-term independence.

Surviving, Not Thriving

The number one mistake we see, particularly among community banks, is trying to "merely survive" rather than take a more positive approach toward actually thriving. That means the Board and Management should have an agreed upon mission and vision to create and enhance shareholder value, which could be measured by a positive and growing earnings per share, a healthy return on equity compared to alternative investments, liquidity in share ownership (the ability to convert it to cash whenever needed), appropriate cash flow from stock ownership in the form of dividends, and maintaining the organization overall in a safe and sound manner. We find that organizations merely trying to play defense wind up losing ground anyway. Therefore, taking the time to engage in robust strategic planning, outlining a positive course of action that creates shareholder value, is the core element of maintaining your independence. Doing that may also require you to look at those elements of your organization that need to be eliminated to create more value. That may mean critically assessing your branch structure, eliminating unprofitable products and services, finding better utilization of employees or otherwise improving your efficiency, and similar factors. All of those should be incorporated in what you do from a strategic planning standpoint.

Not Protecting Independence

Independence is not guaranteed. We often suggest that you no longer get to claim independence by merely opening the doors and flipping on the light switch every morning. Rather, being independent requires action, and oftentimes that action is centered around taking the necessary steps that protect independence.

Those types of protections often come in the form of appropriate amendments to your Articles of Incorporation (or sometimes called Charter), and your Bylaws. Those documents should be drafted in a way that gives the Board of Directors the ultimate control on preserving independence, but which allow for the entity to freely engage in a transaction should it desire to do so. The idea of appropriate amendments to your Articles and Bylaws is to put the power to make those decisions clearly in the Board's hands and eliminate outside influences. Typical steps might mean eliminating preemptive rights, eliminating cumulative voting rights, clarifying who has the ability to call special meetings, listing elements that are required to be considered by the Board when considering any type of change-in-control offer, and similar factors.

Most organizations rarely focus on the true language that exists in their corporate documents unless or until there is some type of crisis. Recently, we have encountered clients in different parts of the country who for one reason or the other were dealing with a shareholder issue, a potential impact on an annual meeting, and were looking toward their corporate documents which had not been reviewed for years and years to determine what strategies they should employ so that the organization maintains its independence. So don't let your corporate documents go for a long period of time without being reviewed and updated for the most current corporate provisions that will help you maintain independence. If we can help in that evaluation process, please let us know.

Lack of Strategic Planning for Independence

This final mistake centers around the idea that strategic planning is more than just talking about strengths, weaknesses, opportunities and threats. Part of your strategic planning should be in committing yourself to your stated objective (in this case, hopefully, long-term independence), and ensuring that you are taking the other strategic steps that are necessary in order to preserve independence. Examples of those would include ensuring an appropriate board succession process, an appropriate management succession plan, and appropriate ownership succession through the ability to repurchase shares from shareholders as desired. Similarly, strategic decisions regarding organizational structure would come into play. As mentioned above, that would include an evaluation of your branch structure. However, it might also involve an evaluation of your entire organizational structure to ensure, for example, that you have and are using your bank holding company, that if you qualify you are in a Subchapter S structure, and that you provide an employment structure that helps you attract and retain the best talent. So utilize your strategic planning process specifically for the objective of maintaining your independence.

Meeting Adjourned

We look forward to seeing many of you in the coming weeks for in-person strategic planning sessions, on our virtual M&A Workshop (for more information see ICBA Mergers & Acquisitions Workshop), and in a few upcoming conferences and state presentations. Until then, don’t hesitate at any point to pick up the phone and call us, drop us an email or arrange a video chat with us. We would love to talk to you.

Until next time,

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