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 ♦
♦ Email: jgerrish@gerrish.com ♦ psmith@gerrish.com ♦ gtuck@gerrish.com ♦
Website: www.gerrish.com

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Dear Subscriber:

Greetings from Maine, Alabama, Georgia, Texas, Louisiana, South Dakota, Illinois, and Wisconsin!

CULTURE IN ACQUISITIONS

We were recently reminded again of the importance of culture in acquisitions. That's not to say the regulatory benchmarks for capital, asset quality, management, earnings, liquidity, etc. aren't important, but culture may trump them all. We had a recent situation where the potential purchaser of our community bank client came in for due diligence after making the best offer and ultimately said they still liked the bank and the loans were good, but the credit cultures were so different they didn't think it would work. They walked away. We found another bank to fill the gap, but that situation drove home the importance of culture in an acquisition. Keep in mind what you're getting in an acquisition. You're not just getting buildings, deposits, and loans. To be successful, you need to obtain and maintain relationships - not only with the employees who generated the loans, but also with the borrowers who have the relationship with the bank. A successful acquisition needs to preserve those types of cultural and relationship opportunities.

TRANSACTION TIMING

The last edition of *Musings* mentioned that many community bank buyers and sellers are currently working to try and get deals closed prior to year-end in an effort to try and avoid any potential tax increase that may become effective in 2022. While that remains true, over the past couple weeks we have been reminded that the transaction timing is unique to every transaction. Specifically, transaction timing is unique to each of the individual parties in a transaction.

The past couple weeks has shown us both sides of this coin. In one transaction, we are representing a buyer that is frustrated at the speed at which the seller is moving. The buyer would like things to progress a little quicker than they have. In another, we are in the exact opposite situation, where we have a buyer that wants to proceed in a more diligent manner than a representative of the seller who is pushing very hard to "check the boxes" for the transaction as quickly as possible. This seller representative does not have any skin in the game in the transaction other than to take a fee at closing, so of course they want to get to that point as quickly as absolutely possible.

We have always taken the position that good deals actually get done. Part of making a deal a good deal is making each of the parties comfortable in the transaction. It is not uncommon that one party's comfort related to the speed of the sequence of events in a transaction is different than another, which sometimes works to our clients' liking and other times cuts against what our clients would like to see. Our overall approach is to try and move the deal at a speed that makes everyone feel comfortable. If that happens, there is a much greater chance that the deal will get closed. If it doesn't, and one of the parties feels like they are being pushed into something, there is a much higher likelihood the deal falls apart.

NEW-FOUND REGULATORY INTERESTS

With the change in executive administration, there has been new-found interest in various compliance matters, particularly Equal Credit, Fair Lending, and Community Reinvestment Act (CRA). We've had a number of clients who have contacted us lately about criticisms the bank has received from the examination team with respect to the bank's performance, particularly on the CRA front. These are criticisms notwithstanding the fact that the CRA delineated area and the bank's activities were the same from examination to examination. Previously, the performance of the bank under CRA was deemed "satisfactory." Now the regulators are nudging it toward "needs to improve". As most of you know, a "needs to improve" on CRA is basically a death sentence for any type of activity the bank wants to undertake that needs regulatory approval or non-objection, even the establishment of a branch. We firmly believe compliance matters, particularly involving consumers, will become paramount again under the current Presidential administration. Our suggestion is to simply be aware of that issue. Also be aware of the fact that even though the way your community bank has done things in the past was perfectly fine for the examiners, it may no longer be "perfectly fine."

INSIDER ISSUES

Historically, banks have primarily failed due to some form or fashion of insider abuse. A couple of studies done on the cause of bank failures have fleshed this out, excepting, of course, the banks that simply failed due to the recession in the 2008-2011 timeframe. Because insider abuse has always been a problem in community banking (not a prevalent one, but when it's a problem it's a big one), the examiners routinely look at insider transactions when they begin their examination.

As a practical matter, one of the first things the examiners will do in connection with a safety and soundness examination is pull all the loan and deposit records for all of the insiders, including directors, senior officers, and others. This is basically standard operating procedure. We recently had a CEO visit with us about the fact that he felt that one of his insiders was being "targeted" by the regulators. We didn't dispute that the insider had been targeted. Our only suggestion was that that particular insider hadn't been targeted more than anybody else in an examination. The bottom line is all insiders are targets. The regulators typically will allow virtually no slack for them. Keep that in mind.

BUYING MARKET SHARE

We recently facilitated the strategic planning session for a community bank that is opening a new branch location. This particular bank has a number of loans in this market, but this will be the first time the bank has actually established a physical presence in the market. During the planning session, much discussion was given to specific strategies to ensure the success of the new branch. During the discussion, the board basically took the position that one of the strategies was to get really aggressive on loan pricing in order to buy market share. What the board essentially said is it did not want to give up on credit quality but would take a lower yield and a little longer term in the new market than it would otherwise be comfortable with in one of the bank's established markets.

We see nothing wrong with getting aggressive on rates and extending term, provided the board has full knowledge of the potential ramifications of the strategy. The obvious considerations are tightening margins in a rising rate environment and the potential that the bank's new customers may become accustomed to the bank competing on rates rather than through the provision of superior customer service. This would obviously make it more difficult to price these customers up in the future.

These issues were discussed in full at the strategic planning session. None were seen as being of such concern as to make the aggressive rate strategy undesirable. Given all the directors are moving into this eyes wide open, we fully support the strategy.

EMPLOYEE MORALE

We recently had an interesting discussion with a group of bank employees as part of a consulting engagement for one of our community bank clients. This was somewhat of an employee roundtable where a number of different issues were discussed. One of the issues the employees really wanted to discuss was that of employee morale. To put it plainly, the employees said employee morale was low and that the low employee morale was threatening the bank's legacy of superior customer service. As one employee put it, no one really seemed happy to be working at the bank.

What was interesting about the discussion was that the group identified three primary culprits for low employee morale. The first was directly related to COVID. Simply put, the group said everyone was tired of dealing with masks, social distancing, and the like. The second culprit was identified as the employees' belief that they are all worked too hard and stretched too thin. This bank has enjoyed some appreciable growth over the past couple years, and it was discussed that the size of the employee base has not kept pace with total assets. (To our credit, we did remind the employees that we have never facilitated this type of employee discussion where the employees have griped about having too little to do.) The third identified factor was a little bit more interesting. It was essentially a belief among the employee base that certain of the directors had a different view of the importance of customer relations than did the employees. The general belief was that some of the directors thought superior customer service and time for employees to really get to know their customers was not of real importance in banking today.

This is not the first time we have had a discussion on employee morale since the pandemic broke. There are a number of banks that are wrestling with the issue. However, we did think this discussion was notable because we found it interesting that the employees seemed to take a different view of the importance of customer relationships than did at least certain of the directors.

TAX CHANGES

The past couple days have resulted in a couple different and more specific tax proposals coming out of Washington. These are basically the beginning of the negotiations on the tax changes that will be necessary to pay for President Biden's legislative initiatives. Some of the results to come out of the tax proposals are good, and others not so good. One of the items that falls in the latter category is the potential limitation on the Section 199A deduction for Subchapter S banks.

Section 199A is the section of the Internal Revenue Code that essentially allows Subchapter S bank holding company shareholders a 20% disallowance on corporate net income. Although the specifics of the rule are complex, the rule is generally described as passing through only 80% of a bank holding company's consolidated taxable income to Subchapter S shareholders, rather than taxing the shareholders on the full 100%. This was done (we believe) in order to ensure the total tax burden and tax costs on Subchapter S corporations to be lower than C corporations. In other words, Congress implemented this portion of the Tax Code in order to ensure it was cheaper to get S corporation gross income into the pockets of its shareholders than it would be for C corporation counterparts. This is because S corporations are seen as small business corporations, and we do not believe Congress wanted to take any action that looked to benefit larger C corporations to the detriment of smaller S corporations.

One of our clients recently asked us our thoughts on the potential limitation of the 199A deduction. We responded that we thought it would be a real shame if the deduction was materially limited or went away. More generally, we believe it would be a real shame if Congress were to make any decision that made it "more expensive" to be an S corporation than a C corporation. When looking at taking money from gross income to the shareholders' pockets on an after-tax basis, we believe the overall tax burden should be lower as an S corporation than a C corporation, or at a minimum should be the same. We do not think it would be appropriate for Congress to "flip the script" and now make the overall tax burden on S corporations higher than on C corporations.

RAISING CAPITAL

A number of our community bank clients across the nation are contemplating raising capital, for a variety of reasons. Most but not all *Musings* readers fit in the category of small bank holding companies ($3 billion or less in total assets). This provides a distinct advantage when attempting to raise capital. Pursuant to the Small Bank Holding Company Policy Statement, there is no consolidated capital test; therefore, the instrument used to generate cash at the holding company and capital for the bank does not need to qualify as any type of capital instrument - primary, secondary, or otherwise.

For a community bank holding company subject to the Small Bank Holding Company Policy of the Federal Reserve, the only issue is how best – that is, most cheaply, easily, and effectively – to generate cash at the holding company. A number of our clients are opting for subordinated debt. This is certainly a viable option - it is long term and generally interest only (fixed for five years, and then variable), the documentation is not difficult, and the cash is generated for the holding company. Some of our clients are looking at straight debt to individuals such as directors or others. Some are opting for equity offerings.

With respect to raising capital for a small bank holding company, the goal is to generate cash into the holding company that can be utilized as either a capital injection for the bank or otherwise for corporate purposes of the holding company. A number of our clients recently are contemplating equity offerings. This can be common stock, preferred stock, or some other hybrid stock instrument. This certainly generates cash into the holding company. It comes with other considerations also, however, such as ownership dilution to the existing ownership group and possible book value dilution if the stock were sold at less than book value (not likely in this environment). It also has significant legal issues associated with it.

As we have often provided in *Musings*, any time your community bank holding company issues stock, it either must do so through an SEC registration (not attractive for most community bank holding companies due to the cost) or there must be an exemption from registration. There are a number of exemptions from registration available that will allow the holding company to issue some form of equity to existing shareholders, new shareholders, accredited investors, and non-accredited investors, but the holding company needs to be careful when doing so that it follows the legal requirements. Don't try this alone. Please get professional help.

MERGER AND ACQUISITION INSIGHTS

As most *Musings* readers know, our consulting and law firms have assisted hundreds of community banks in connection with acquisitions both on the buy and the sell side over the course of the last 30 years. We often deal with community banks who have never done an acquisition transaction. As such, the board and management need some basic information about how an acquisition works. If they are planning on selling their own bank, then the question is how do we prepare the bank for sale. If they are looking to buy another bank, then what are the significant steps.

We have some good written material on both of these that provides the basics (i.e., a primer, if you would) with respect to community bank acquisitions. If any *Musings* readers would like a copy of those materials, please let us know.

THE COMMUNITY BANKING BOARD CHAIR FORUM

Many *Musings* readers in the past have participated in the Community Banking Board Chair Forum. The next Board Chair Forum will be at the Ritz-Carlton in Naples, Florida on January 13-14, 2022. The Forum will be facilitated by the three of us and sponsored by the Barret School of Banking. The Forum is designed for community bank Board Chairpersons, Vice Chairs, Directors, and Chief Executive Officers. The meeting is a forum, not a lecture or seminar type of event. It is primarily a facilitated discussion. You may register by clicking on this link: Community Banking Board Chair Forum Registration. This will be in person, and we hope to see you there.

CONCLUSION

It's hard to believe we are bumping up against the beginning of the fourth quarter. The weather is mild in most parts of the country. We appreciate that and are not looking forward to the ice and snow, which we do know is coming. Please guard yourself against the various new Coronavirus mutants.

Stay safe. We'll see you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations:

- September 22, 2021 – ICBA Webinar – "Board Governance and Structure: An Update on Best Practices" (Philip K. Smith) Registration: Board Governance and Structure: An Update on Best Practices
- September 23, 2021 – Graduate School of Banking-Wisconsin Webinar – "Community Bank Capital Raising Simplified" (Greyson E. Tuck) Registration: Community Bank Capital Raising Simplified
- September 24-25 – Community Bankers Association of Illinois Annual Convention – "Ten Strategies for Maintaining Independence" (Jeff Gerrish) and "Everything Has Changed – We May Not Return to Normal" (Philip K. Smith) Registration: CBAI Annual Convention
- October 13, 2021 – Graduate School of Banking-Wisconsin Webinar – "Liquidity Strategies for Illiquid Community Bank Stocks (Greyson E. Tuck) Registration: Liquidity Strategies for Illiquid Community Bank Stocks Registration