
GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Maine, New Hampshire, Massachusetts, Vermont, New York, Pennsylvania, Ohio, Illinois, and Wisconsin!

IMPORTANCE OF CULTURE IN ACQUISITIONS

We have commented previously in *Musings* about how important culture is in acquisitions. We were recently with a larger community bank/holding company which, for lack of a better term, had become somewhat of a “serial” acquiror. Although the holding company did not necessarily acquire large banks relative to their size, they had done a number of acquisitions.

Of the criteria for acquisitions that they considered, the most important one was whether the target bank was an excellent cultural fit. It was clear - even if the numbers worked, the return on investment was good, earnings per share accretion was in the teens, book value earn-back was less than three years - those did not matter if the culture wasn't right. We heartily subscribe to this. This is not just a credit culture issue; it is an overall bank culture issue. Keep that in mind when you are looking to do an acquisition. If culture is aligned, then the likelihood of success of the acquisition is significantly greater.

WHAT IS A COMMUNITY BANK?

We recently had the opportunity to participate in a board-level discussion with a larger community bank. The board was curious as to how large this bank could get and still be considered a community bank. Is \$1 billion too big? Is \$5 billion too big? Is \$10 billion too big? Is asset size

even relevant? The board in this case identified basic characteristics that identified a community bank. These should be familiar to *Musings* readers (i.e., accessibility to decision makers, quick decisions, flexibility, local decisions, relationships, dealing with the customers in good times and bad, and the like). It was noted the FDIC also did a community bank study that resulted in the creation of FDIC's definition of a community bank. This originally occurred in 2012. FDIC updated that study at year-end 2020. That study has a number of criteria that point toward whether a bank is, in fact, a "community bank." If any *Musings* readers would like a copy of the current FDIC's study, please let us know, and we will forward it on. The bottom line for this board was that they felt that pretty much any asset size which was in their range, their bank would still be considered a community bank because it serves the local communities and decisions are made locally (i.e., you do not have to go to San Francisco for somebody 20 steps removed to make the call).

ORGANIZATIONAL STRUCTURE

We are working with a number of community banks that are crossing a meaningful asset threshold (at least meaningful for the friendly federal regulators) of either \$500 million or \$1 billion. Several of these banks have come to us asking for our assistance with respect to organizational structure. We are obviously happy to assist in reviewing and making recommendations regarding organizational structure. Our general recommendation is that the bank take a long-term view. If the community bank is a \$1 billion bank, isn't it likely that it is going to continue to grow to a \$2 billion community bank in a few years? If so, an organizational structure needs to be established that will manage that type of asset base over the longer term. If the community bank is a \$500 million bank, it is likely it will continue to grow and bump over \$1 billion in the future. It is the same thought process. Management and the board need to look out and see what it would take to manage that type of asset base for the future.

For example, in a larger bank, when do you establish the position of Chief Risk Officer? When do you establish a separate Risk Committee and take it out from under the Audit Committee (where it is for most community banks)? Do you need a Chief Operating Officer in addition to a Chief Executive Officer? Should the bank establish some type of General Counsel position? These and many other questions come up as your community bank begins to grow through certain asset thresholds. Again, our advice is to take a long-term view of what is necessary. Of course, most community banks can't afford to "hire in anticipation" but at least bank management and directors can understand what will be necessary as the bank approaches the various benchmarks.

REGULATORY CONCERNS

As noted, we have been with a number of community banks recently that are crossing some specific threshold. Some are crossing \$500 million, some \$1 billion, and some even \$10 billion. In each of those asset thresholds, different regulatory issues kick in. In a recent discussion of these issues, an outside director indicated that she was concerned whether the bank could afford the cost associated with the compliance and other issues caused by crossing this particular regulatory threshold. Our response and the way the discussion went was to take a much longer view. Historically, community banks, for the life of the bank, had to deal with the regulatory burden. We view this as no different. “The price of admission” to continue to grow profitably through some artificially constructed asset threshold is the cost of compliance. It should be noted there is a move afoot to change those asset thresholds, particularly the \$500 million and \$1 billion to \$1 billion and \$3 billion, respectively. We will see where that goes.

SHAREHOLDER LIQUIDITY

As we have often indicated in *Musings*, enhancing shareholder value is the primary obligation of the directors and officers of a stock community bank. One aspect of that is making sure there is liquidity for the shareholders. Shareholder liquidity in this context means the ability of a shareholder to sell a share of stock or lots of shares of stock at a fair price at a time they want to.

In view of that obligation, a number of our community banks are interested in allocating their excess capital toward creating liquidity for the shareholders through holding company share repurchases. Many of these community bank holding companies have never done a share repurchase, so some of very fundamental questions arise such as: Can the repurchase be targeted at a certain category of shareholders? How do we set the price? How many shares should we buy back? What if it's oversubscribed? What if nobody tenders? How expensive is it?

All those are valid questions in connection with a share repurchase. With respect to a share repurchase, two issues need to be addressed:

1. Are the remaining shareholders better off after the share repurchase than they were before? This is usually an earnings per share test.
2. Has the bank complied with its legal obligations with respect to the share repurchase? The general legal obligation for a non-SEC reporting company is that the repurchase must

be open for at least 30 business days and the selling shareholders must be given some appropriate disclosure, (i.e., enough to meet the anti-fraud rules).

If you're looking toward a share repurchase and haven't done one before or want to restart and need some assistance, please let us know.

SHAREHOLDER REQUEST FOR RECORDS

It seems that the late summer/early fall (possibly due to the heat or otherwise) has brought out a number of disgruntled community bank holding company shareholders in our client base. They all have different reasons for being disgruntled. Some want to sell their shares, but there is no market. Some want to sell the whole bank. Some do not like the management. Some simply do not like the bank's performance.

Most disgruntled shareholders will start their process with a request for books and records. Those of you who have been in this situation know the real issue is does the community bank holding company have to comply. That is a question of state law. Many community bank holding companies are chartered in Delaware or states that mirror Delaware law. Delaware law is pretty specific. The shareholder, or the beneficial owner of the shares, can request certain books and records as long as they have a proper purpose. Proper purposes have been very broadly defined including "I want to sue the directors." In some states, such as California, the beneficial owner, for example, does not have the standing to bring a request for records because they are not defined as a shareholder of record by state law. An odd quirk from a recent California case, but one to consider the next time a request is made if your holding company is chartered in California.

THE CHANGING FACE OF STRATEGIC PLANNING

In our companion monthly publication, *The Board Chair Forum Newsletter*, we recently addressed the various different types of strategic planning and the changing face of it in the current environment. Planning still involves a long-term look forward, but some of it can be more operational and tactical, and some more long-term, strategic and even "dreaming about the future."

The issue for community banks is, should we change the way we have done strategic planning in the past? We have recently worked with a number of community banks who have historically not involved the board in long-term planning. For several of these banks, planning has been an officer event and simply a report to the board, and for the most part, a rubber stamp by the board. We believe that the best structure is fairly simple. Identify the issues that need to be addressed over the long

term. Get the board and senior management together to discuss them and set direction. Let the board of directors set the direction from a conceptual standpoint. Then let management come up with the operational and tactical plans. That seems to be the way most of our clients are going, although it can be disruptive and a little bit frightening for those who have done it differently in the past. The goal for strategic planning is to identify the issues and make determinations about the strategy going forward. Following a particular format or set of rules, frankly, is not terribly important.

STRATEGIC PLANNING FOR MUTUALS

We have recently had the opportunity to facilitate several strategic planning sessions for mutual community banks. If you are not immediately aware, a mutual is distinct from a stock-owned community bank in the fact that mutuals do not have stockholders. Instead, mutual banks have members, which are the bank's depositors and borrowers. Other than the distinction related to stock ownership, there really is not a material difference between a mutual community bank and a stock-owned community bank (mutuals do pay taxes).

Strategic planning for mutuals is similar to strategic planning for a stock-owned community bank. The major difference is that much of the discussion at the planning session is devoted to enhancing member value, as opposed to enhancing shareholder value. One of the questions that must be addressed is what it means to enhance member value.

In our view, mutuals are best to think of enhancing member value by making corporate decisions that benefit the bank's customer base, communities, and employees. In other words, we view enhancing member value as making decisions and adopting strategic action items that are intended to make the bank as beneficial as possible for these three key constituencies. This often involves discussions that are identical to the discussions for stock-owned banks, such as in the areas of geographic expansion, technology, management succession, and the like.

MULTI-BANK HOLDING COMPANIES

Over the past six months or so, we have assisted a number of multi-bank holding companies in considering the possible merger of their separately chartered subsidiary banks. In a couple of the circumstances, the holding company has decided that they are going to move forward with the merger of the subsidiary banks. In others, they have decided to keep them as separately chartered institutions. The central question for each of these multi-bank holding companies in making the decision whether to merge the subsidiary banks is whether the cost saves and related financial benefits that will be

realized as a result of the merger are worth whatever reputational or public relations risks come from merging the separately chartered banks. This is always a case-by-case analysis, and the best result depends completely upon the specifics of each individual transaction.

Of course, it is no secret that it is usually more efficient to operate one bank rather than two separately chartered banks. However, there are often competing reasons that make it appropriate to forego the increased profitability to realize other benefits.

The important thing is that all of these items be considered in making the strategic decision.

CONCLUSION

The end of the third quarter of 2021 is upon us. For most community banks, we believe that profits will be near or above records. Congratulations on that.

Fall is here. Enjoy it. See you in two weeks.

Jeff Gerrish

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Upcoming Webinars and Presentations:

- October 6, 2021 – ICBA Webinar – “Building a Better Board” (Philip K. Smith)
Registration: [Building a Better Board](#)
- 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](#)
- October 20, 2021 – Graduate School of Banking-Wisconsin Webinar – “Community Bank Capital Raising Simplified” (Greyson E. Tuck) Registration: [Community Bank Capital Raising Simplified](#)
- November 2, 2021 – ICBA Webinar – “Liquidity Strategies for Illiquid Community Bank Stocks” (Greyson E. Tuck) Registration: [Liquidity Strategies for Illiquid Community Bank Stocks](#)