



THE

Board Chair Forum

Opening the door to new ideas

NEWSLETTER

Gerrish Smith Tuck, Consultants and Attorneys

August 2021

In this month's edition of *The Board Chair Forum Newsletter*, we zero in on the roles and responsibilities of the Board, particularly as it relates to corporate governance matters, the nature of how the Board Chair conducts his or her business and whether that makes the individual an Executive Officer, and other best practices.

We are beginning to see increasing focus on the Board from the regulators in terms of what it does and how it does it. In particular, we all need to remember that the "M" component of the CAMELS rating does not apply only to executive management, but the Board and its activities are covered under that evaluation as well. We hope you find useful information in this month's edition on how to continue to improve your organization at the highest levels and make those strategies permeate throughout the organization. Let us know how we can help you.

Happy Reading!

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Board Chair's Summary

- ◆ Is the Board Chair an Executive Officer?
- ◆ How Important is Corporate Governance?

Is the Board Chair an Executive Officer?

Recently we received a question regarding the sometimes confusing issue of whether your Board Chair is, in fact, also an Executive Officer for regulatory or other purposes. Recently, we have experienced that some of the regulatory agencies are beginning to focus on the role of the Board Chair and scrutinizing whether or not the individual is classified as an Executive Officer.

Many of our clients have taken the step of adopting Board Resolutions specifically indicating that the Board Chair is an Independent Director and is not a member of the Executive Team. However, we have found that the regulators often will question the validity of that Resolution if it appears that the Board Chair duties, responsibilities and actions are more closely aligned to those that an Executive Officer would perform.

We recently outlined our additional thoughts and research on this matter for a party that had contacted us and we thought it might be beneficial for a wider audience. So, note the following additional information which we hope provides some clarity.

The issue regarding whether a Board Chair should be deemed to be an Executive Officer most often arises in the context of Regulation O. In the regulation, Part 215.2(e) generally defines "Executive Officer" to include the Board Chair, "*unless the officer is excluded, by resolution of the board of directors or by the bylaws of the bank or*

company, from participation (other than in the capacity of a director) in major policymaking functions of the bank or company, and the officer does not actually participate therein.” So, does your Board Chair participate in major policy making functions of the Bank aside from his or her role as a Director? If so, what difference does it really make?

The significance of whether the Board Chair is classified as an Executive Officer, under Regulation O, comes into play because the Regulation imposes significant additional restrictions and limitations on loans to Executive Officers. Generally, loans to Executive Officers are limited to no more than 2.5% of the bank’s unimpaired capital and unimpaired surplus (subject to a floor of \$25,000 and a ceiling of \$100,000) other than specified categories of loans, which include:

- (i) loans to finance the education of the executive’s children,
- (ii) loans to finance or refinance the purchase, construction, maintenance or improvement of a residence (construed as primary residence even though not specifically stated as such in the regulation, and very limited such that even refinancing of fees and the like can be excluded from this category), and
- (iii) loans secured by certain limited collateral (such as government securities and deposits at the bank).

For most banks, this means that loans outside the specified categories to executive officers are limited to \$100,000, including business related loans.

The regulators used to be fairly willing to accept a resolution or bylaw provision that a Board Chair is not an executive officer. In recent years, however, the regulatory agencies have been looking at these determinations much more closely. The onus is on the bank to demonstrate that the individual is not authorized to or actually exercising “major policymaking functions” at the institution. In cases where the Board Chair is no more involved than other directors, is not otherwise involved in management, not involved day-to-day, etc., the regulators should accept such Resolution or Bylaw

provisions. But, if the Board Chair has more authority to be, or actually is, more involved, such as having an office, coming in daily, is a former member of management, involved in drafting policies and strategies before they are presented to the full board, or similar activities, the regulators often push back on the determination that the Board Chair is not an executive officer.

This matter can really become an issue when the Bank has (or wants to issue) loans to the Board Chair, their close family, or their businesses (“related interests” as defined in Reg. O). It is best to address this on the front end, well before any such loans are outstanding, by structuring the Board Chair position to avoid being construed by the regulators as an Executive Officer if it is likely the Board Chair will need or want loans from the Organization. It is important that this structure is not only well documented, but also accurate and reflective of actual practices. Even for banks where it is not yet an issue, unless the organization wants their Board Chair to be more involved in an officer-like capacity (our experience is this is rare in community banks), it is best to structure the Board Chair position now in a non-executive capacity so that it accurately reflects the institution’s intention if it ever becomes relevant.

The short answer is the regulators are looking at the substance of the position and what is actually occurring over the form of the position outlined in the bylaws or by resolution. Let us know how else we can help.

How Important is Corporate Governance?

If your bank holding company is an SEC-reporting public company, corporate governance is part of the institution’s daily existence. Corporate governance for those companies permeates everything the organization does on a formal basis with statutorily and regulatorily required steps and processes the organization must take to demonstrate corporate best practices. As a side note, the additional time, cost and complexity of complying with all of those mandates is one of the key reasons why for most smaller community banks, being a public company as opposed to a private company, rarely makes any economic or business sense.

However, notwithstanding that private companies avoid many of the required corporate governance procedures of public companies, it is still in the best interest of even the smallest community banks and holding companies to ensure some level of appropriate corporate governance and follow “best practices” to the extent they make economic and practical sense. The distinction between those kinds of organizations and public companies, though, is that the types of corporate governance activities in which you engage should be scaled to the size and complexity of your organization and should reflect the realities of how your organization operates on a day-in and day-out basis.

For example, an SEC-reporting public company is required to have an individual who qualifies under the regulations as a “financial expert” serving on the Audit Committee. A non-public organization might not want to try to mandate that its committee meets that technical definition, but rather simply have qualified men and women for the complexity of its organization serving on that committee. So, our key advice to smaller organizations is to utilize the benefits of being a private company by not adopting every mandated corporate governance provision that larger organizations are required to adopt, but also do not fail to implement appropriate procedures that can help improve your organization. We are conducting a number of sessions this Fall for organizations around the country who are targeting improved corporate governance recommendations as part of their planning process.

On a broader scale, if you are not a public company, can the failure to implement best practices that would improve your organization be a basis upon which the regulatory agencies could find a safety and soundness violation? The answer is a blunt “absolutely” as evidenced by a recent Notice of Charges brought by the FDIC against a bank. Among the charges being leveled against the organization include the following:

- *The bank has engaged in unsafe or unsound practices by operating with bank management whose practices are detrimental to the bank and jeopardize the safety of its deposits.*

- *The bank's Board of Directors has failed to provide effective corporate governance related to the bank's management of risk.*
- *The Board has allowed the bank's Chairman of the Board, President, and Chief Executive Officer to almost exclusively drive strategic direction of the bank without development of a comprehensive strategy, without adherence to bank policy or procedure and without measurement of risk and subsequent monitoring of risk.*
- *The Board has failed to hold management accountable when operating the bank outside of established policy by allowing management to repeatedly exceed policy limits without strategies to regain policy compliance.*
- *The Board has allowed the bank's risk profile to escalate without adequate and appropriate compensating controls.*
- *The bank operated with an insufficient number of Directors (for four months).*
- *The bank has been engaging in unsafe or unsound practices by operating without adequate supervision and direction by the Board.*

As you can see, this organization is being taken to task primarily because the Board of Directors is alleged to have failed in its corporate governance and supervisory activities. So, while adherence to Sarbanes Oxley type requirements that SEC companies are required to implement does not make practical sense for most community banks, it does not mean that corporate governance can be ignored or taken lightly. Let this bank's problems be a wake-up call to all of us, and make sure your Board sees these criticisms and evaluates its own actions against them.

Meeting Adjourned

Fulfilling all the roles that a Board Chair and board members encounter can often be more difficult than it might seem. It is not a job for the faint of heart, but it is also not an insurmountable task, provided you adhere to a few basic tenants of oversight, corporate governance and active engagement in fulfilling your role. The job of being a Board Chair or any Director is no longer merely honorary. It requires active work and participation. Given the liability that can exist for Directors individually and for the organization as a whole, if your Board members are not actively engaged in the oversight of the organization, it may be time to strategically plan for better corporate governance, consider modifications to your Board of Directors, or simply light a bigger fire of engagement under your board members!

Until next time,



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