GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Ohio, Kansas, Minnesota, Wisconsin, Massachusetts, Vermont, Texas, New York, and Florida!

REMAINING INDEPENDENT

Although our consulting and law firms are very active and historically have been in the community bank merger and acquisition market representing both buyers and sellers, our constant refrain, particularly with those contemplating selling, is to seriously consider remaining independent and continuing to serve your community bank's shareholders, employees, communities, customers, and other constituents. Since we are now in the midst of the strategic planning "season," we have had a number of opportunities to have discussions with community bank boards of directors and senior management groups with respect to independence. We firmly believe that for a community bank to remain independent, particularly in a consolidating environment, it must not only deal with the typical issues of community bank financial performance, share liquidity, ownership transition, management succession, and board succession, but it must also determine how it can best remain relevant to its constituents, including customers, shareholders, employees, and the community. Remaining relevant has been a continuous discussion point in these meetings.

Relevance generally involves being willing to make appropriate changes in approach, products, revenue streams, and the like. We also heard during one of these sessions a senior officer express what we thought was one of the better summaries of how a community bank remains relevant: "the bank needs to not only be willing to change, but it also must get comfortable with the uncomfortable." We really believe getting comfortable with the uncomfortable is the first step toward relevance for the long term. Think about that in your own organization.

A GREAT EXAMPLE OF EMPLOYEE COMMUNICATION

During a recent federal holiday when most community banks were closed, one of our community bank clients used the opportunity to improve internal communications. The employees when previously surveyed had said that communication was lacking throughout the organization (this is a typical refrain). In response, this bank held an all-employees meeting at the local country club on that federal holiday to hold business sessions, lunch, and enjoy some social time. (As a preliminary matter, don't worry, the employees were each given a floating holiday to replace the bank holiday.)

This employee meeting incorporated a couple different components. Bank management spent some time at the employee meeting to discuss the state of the bank, what things were happening, and what would likely happen in the future. They also brought in some very interesting outside speakers that gave some unique perspectives on a couple different corporate and related issues. The final portion of the presentation included our firm jointly presenting with bank management the results of the strategic planning session we recently conducted with the director and executive officer group. We spent about an hour before all of the employees talking about the process we went through in strategic planning, what it was that we were planning to achieve (enhance shareholder value), the items that were discussed, and, most importantly, the action plan that came from the planning session.

We received a number of good comments from the bank employees regarding the meeting. The comments were all geared around the fact that the employees now felt like they were more informed as to what was going on in the organization, rather than feeling like they were in the dark. One person described it to us as feeling much more a part of the team rather than on the outside wondering what it is the team was looking to accomplish.

We view this as a great example of appropriate corporate communication. Of course we did not reveal all the specifics related to the strategic plan to all the employee base. However, we provided an appropriate overview of the importance of strategic planning, what it was we were planning to achieve, and how it was that that would be accomplished. We really do believe the employees genuinely found the exercise useful.

LOAN GROWTH

As we have often indicated in *Musings*, the road to independence is generally financial performance. Financial performance in a community bank is typically driven by loan growth and, to a lesser extent, noninterest income. Most all of our community bank clients, particularly in the planning context, discuss how best to grow the loan portfolio. Do we need to do things differently than we have done them in the past? Do we need to have someone focus solely on growing the loan portfolio, such as a Business Development Officer? Do we need to free up the Lenders who are the salespeople to go out and sell instead of doing the back office duties of underwriting and preparing loan documents? In other words, what do we need to change?

For most community banks today, growth of the loan portfolio does not necessarily require growth of the balance sheet. It simply involves a strategy to reallocate assets from cash and securities into loans. But still, even with that strategy, the community bank needs to find the loans. We were involved in a recent planning session where the suggestion (not unusual) was that the bank retain a Business Development Officer. This particular bank had had a Business Development Officer in the past. This individual is the one who went out and established the relationships with the customers, primarily on the loan side but also on the deposit side, and brought those customers into the bank so that the community bank could continue to grow the loan portfolio. As we began to discuss the characteristics of a Business Development Officer, they indicated that what they were really looking for is someone who is a "former bartender." This bank has had numerous Business Development Officers, and the best one they ever had was a former bartender who could "talk to anyone." Having collectively spent a little bit of time at bars in our lives (typically only eating), we certainly understood the concept. This bank also decided that as they began to hire, because relationships were so important, they were going to follow what we have always referred to as the Southwest Airlines philosophy (i.e., hire for personality, train for skill). We will monitor whether the "bartender strategy" succeeds.

ORGANIZATIONAL EFFICIENCY STUDIES

Most community banks right now are dealing with the reality that their total assets are significantly higher than they were a couple years ago. Many community banks in our client base across the nation have experienced total asset growth of greater than 25% over the past couple years and are experiencing some growing pains in this regard. These growing pains are often discussed in strategic planning sessions. The general refrain, which we have heard in most of the planning sessions we have done over the past six months or so, is that the bank's employee base and operations were established when the bank was half the size that it is today, and the bank, at its current size, is not operating in an efficient manner. To address this issue, many of the planning sessions we have facilitated lately have resulted in the adoption of an action item to complete an organizational efficiency study.

As the name implies, an organizational efficiency study is a detailed look at a community bank's organizational structure, processes, and procedures. The central question this study looks to answer is whether the bank is structured, situated, and operating in a way that maximizes operational efficiency. We have completed many of these type studies over the years. We basically put an outside set of eyes on the organization's employee structure, processes, and the like to offer recommendations on how the organization can operate in a more efficient and effective manner. As we put it to one bank recently, this helps to ensure that a bank operates in the way that it does because it is the most effective way to operate, rather than because it is the way it has always been done.

If your community bank has experienced significant growth, give consideration to whether your community bank is structured to operate in its most efficient manner. If not, you may want to consider taking a fresh look at your community bank or having a third-party come in to review and provide some perspective and suggestions for improvement.

ILLIQUID COMMUNITY BANK STOCKS

We have had multiple conversations with multiple community banks over the last several months with respect to not only creating liquidity for their shareholders, but also analyzing various capital allocation alternatives.

The bottom line of this is it is incumbent upon the board of directors as part of their obligation to enhance shareholder value to create liquidity for what are typically illiquid bank holding company stocks held by community bank holding company shareholders. The board also needs to make a decision whether that is an appropriate allocation of capital. We were recently visiting with a large community bank that was contemplating buying out one of its larger shareholders. This buyout would result in the payment of millions of dollars to this larger shareholder. They asked our thoughts. Our response was that with redeeming shares from a large shareholder, the community bank holding company is a) buying something it knows, b) having virtually no execution risk, c) utilizing excess capital that was otherwise not being productive, and d) benefitting all of the remaining shareholders who do not sell in that their ownership percentage will go up, their earnings per share will go up, return on equity will go up, and their cash flow (since this bank paid a percentage of earnings in dividends) will also increase. It looks like a win-win for everybody.

As a community bank director or officer, keep in mind that the allocation of capital to redeem shares should not be simply as a "last resort." It should be one of the first considerations for appropriately allocating capital to enhance shareholder value.

ACQUISITION ALTERNATIVES

The traditional structure for an acquisition of a community bank with a holding company is to acquire the target holding company, either through the direct merger of that company into the buyer or into a subsidiary of the buyer, followed then by the merger of the target into the buyer, followed by the merger of the target bank with and into the buyer bank. These two transactions typically happen simultaneously and result in the acquiring holding company and bank continuing its prior structure, being a one-bank holding company where the holding company is a combination of the two holding companies and the subsidiary bank is a combination of the two banks. However, this is not always the case. We are currently working on a couple different acquisition transactions where the buyer has chosen to acquire the target bank's holding company but has decided to keep the target bank as a separately chartered subsidiary rather than merging that bank with and into the acquiring bank. This will cause the buyer holding company to become a multi-bank holding company until the two subsidiary banks are merged together, if that ever happens.

Why would a buying holding company want to maintain a target bank as a separately chartered subsidiary? The answer depends on the specific facts and circumstances of the acquisition. Sometimes it is due to the fact that the target bank has a unique name, image, and likeness in its existing market that the buyer does not want to lose. If this is the driving force behind keeping the banks separate, it is essentially an acknowledgement that maintaining the public perception of the target institution is more valuable than the cost saves that can be realized as a result of merging the two together. Other times operational matters drive the decision. It may be that the data processing systems of the two banks cannot be merged at the time of acquisition, and the buyer thinks it is easier to maintain separate institutions rather than merge the two banks together and operate them under different systems. Sometimes it is simply due to the fact that the buyer sees the acquisition as enough change for the target bank customers and wants to forego the merger in order to ease them into the transition.

Regardless of the reason, if you are thinking about buying a target bank, give consideration to how your community bank holding company is going to hold the target bank post-closing. Most of the time the target bank is merged with and into the acquiring bank. However, that is not always the case, and sometimes it makes sense to hold the target bank as a separately chartered institution, either permanently or for some interim period.

NON-COMPETE AGREEMENTS

As we have commented in previous *Musings*, the Biden Administration is taking a hardline approach on non-compete and similar agreements. The President, by Executive Order, instructed the Federal Trade Commission to "curtail the unfair use of non-compete clauses" as well as "other clauses or agreements that may unfairly limit worker mobility." We are not quite sure whether this is going to include both noncompete agreements and non-solicitation agreements, but we wouldn't be surprised if it did.

We were recently with the board of a community bank who was inquiring about whether there was another way to skin the cat with respect to the likely future unenforceability of non-compete and non-solicitation agreements under state or federal law. We noted that the line of attack would likely be against the use of private financial information made portable from one bank to another. In other words, if your Senior Lender leaves and takes the financial information that is confidential to your bank to his or her new employer and utilizes that information, then that seems to us to be a valid basis for litigation. As we have mentioned in *Musings*, there was a situation in Wyoming that was not terribly dissimilar. There, the bank who had lost employees to another bank sued the former employees and the other bank, alleging misappropriation of trade secrets, breach of the fiduciary duty of loyalty, and tortious interference based on the bank's employee handbook and strict privacy policies highlighting that the bank's information, files, and data were property of the bank. Eventually, both of the employees at issue were removed from banking by their friendly federal regulator. The moral of the story is even if your community bank cannot obtain non-compete or non-solicitation agreements with your employees, it does not put your bank totally at risk from actions of departing employees.

NATIONAL BANK CONVERSIONS

If you have not seen it in the trade press or otherwise, President Biden has recommended Saule Omarova to be the Comptroller of the Currency. This would put Ms. Omarova as the head of the

Office of the Comptroller of the Currency, which regulates national banks and certain savings & loans. If you are not familiar, Ms. Omarova is currently a law professor at Cornell University. If you did not know that, you may also not know that Ms. Omarova takes what can only politely be characterized as some non-traditional views of the banking system. As some outlets have put it, she has a radical view of how the U.S. banking system should be redesigned.

We do not know the future of Ms. Omarova's nomination. However, our anticipation is that if her nomination does succeed, there will be a number of community banks that are currently regulated by the OCC (national banks and savings & loans) that will begin to inquire about a potential charter conversion. We say that because we are already beginning to hear some whispers in this regard.

The obvious concern of these small banks that are chartered as national banks or regulated by the OCC is that their views on the banking system are totally different than those of Ms. Omarova's. Their fear is that her radical view of banking will trickle throughout the OCC and will show up in their bank examinations. To ward this off, we anticipate there will be multiple national banks that will look to convert to state charters in order to be subject to examination by a friendly federal regulator that has a leader that shares their more traditional views of the U.S. banking system, as well as the state leader. Time will tell what transpires.

CONCLUSION

Mid-October has found us traveling to some very special places, and we have spent a fair amount of time in the last couple of weeks in New England and Upstate New York where the foliage has been and continues to be spectacular. We have also been in the Upper Midwest where it is cooling down fairly dramatically. It appears summer is waning (to say the least) and winter is not far behind.

Enjoy the nice fall weather. Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations:

- 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
- November 5, 2021 – Oregon Bankers Association Virtual Northwest Bank Directors Series – "Dusting Off the Crystal Ball - Community Banking Past, Present and Future" (Greyson E. Tuck) Registration: Dusting Off the Crystal Ball
- November 10, 2021 – Graduate School of Banking-Wisconsin Webinar – "Maintaining Community Bank Independence in a Consolidating Environment" (Greyson E. Tuck) Registration: Maintaining Independence

