GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Texas, South Dakota, Minnesota, Maryland, Kansas, Missouri, Arkansas, and South Carolina!

OFF TO A RUNNING START

If the month of January is any indication for the remainder of 2022, then 2022 is off to a blistering start. Two areas in particular draw our attention. The first is continuous merger and acquisition activity, particularly among the community banks. There seem to be lots of buyers and plenty of sellers at this stage in the market. Prices are holding strong, and regulatory approvals, at least at the community bank level, have not been difficult.

The second major area that we are seeing off to a blistering start is not so optimistic. It is the regulatory piece, particularly compliance. Many of our community bank clients that have recently "suffered" through a compliance exam have had to call us to tamp the examiners down a little bit in their enthusiasm for the new consumer compliance culture. We see both these areas continuing to grow in 2022.

As a corollary, particularly to the M&A area, capital raising, debt offerings and the like will also stay strong through 2022. Unfortunately, from that aspect, it is likely the interest rates will go up, so the debt capital will cost a little bit more, but probably not significantly over the short term.

ACCEPTABLE LEVERAGE RATIO?

As we noted in prior *Musings*, most of our community bank clients around the country have enlarged (we don't any longer say "artificially") balance sheets, which have caused their capital ratios to decline from their previous levels. Our position has generally been unless your community bank has a less than 8% leverage ratio, then why spend any money to inject capital (primarily through debt) just to satisfy a regulatory complaint that has not occurred. In other words, if no examiner is "fussing at the board" about not having enough capital, why would you leverage the holding company to inject capital in the bank until that occurs?

After the last issue of *Musings* where we addressed this topic, we received emails from a number of clients who had had recent exams and had experienced some regulatory pressure because their leverage ratios were hovering either just above or just below 8%. Most of them indicated the regulators wanted something either 9% or above, or in the high 8%s for a leverage ratio. Of course, the regulators are not even supported by their own regulations when they make these types of demands, but that never has made a difference, has it?

FURTHER COMPLIANCE ISSUES

As most community bankers understand, asset quality, notwithstanding early predictions during the pandemic that it would turn south, has remained strong. When asset quality is strong yet the U.S. has had a change in Presidential Administrations to one that is heavily focused on consumer issues, then what do the examiners have to do during their examination? Not much unless they focus on consumer issues. As noted, we have had multiple consumer compliance issues in the last three months that would not have even been raised in the prior Administration. We are not taking the position that it is bad, just that it is a fact. The Consumer Financial Protection Bureau is also hot on the trail of the bigger banks, and we all know what happens in the larger banks generally filters down to the community banks eventually.

OVERDRAFT FEES

"Evil" overdraft fees have been in the news a lot lately, both in the trade press and in the regular press. Also, other "junk fees" charged by banks (the Consumer Financial Protection Bureau's term, not ours) are being attacked. I am not sure where the "evil" comes from, but that is the general line of the press. As a result of the pressure through the Consumer Financial

Protection Bureau and the current Administration, many of the large banks have reduced, dropped, adjusted, or changed their overdraft protection programs. It seems that nobody really realizes that overdraft protection is just that—protection for those people who overdraw on their accounts. It seems to us community banks should get paid a fee for that service. In any event, keep an eye on how this plays out. We anticipate significant pressure from the examiners with respect to overdraft programs. If they cannot get community banks to drop the fees altogether, then they will probably just make it so cumbersome that it is hardly worth pursuing. The other strategic issue associated with this is how do community banks replace the income that would be lost if overdraft fees are eliminated entirely or significantly reduced. The time to think about that is now.

IRA PROHIBITED TRANSACTIONS

As most *Musings* readers know, most community bank holding companies that look to raise capital through the sale of additional shares of common stock do so through an offering that meets the requirements for a securities registration exemption. In this regard, most holding companies utilize a Regulation D Rule 506 offering, which generally allows for shares to be sold to an unlimited number of accredited investors. Accredited investors are generally rich or smart people and include the holding company directors and executive officers.

One of the questions that we often get in a Regulation D Rule 506 offering is whether a director or executive officer can use their IRA to purchase shares in the offering. The answer is "it depends." The facts and circumstances, particularly related to the holding company shareholder base and control concentrations, are extremely important.

There are some circumstances that would allow for such a purchase without any adverse effect. There are other circumstances that would cause the IRAs purchase of shares to be an IRA prohibited transaction. It should come as no surprise that our recommendation is to avoid a circumstance where a transaction is considered an IRA prohibited transaction. Doing so has a number of negative tax consequences and related penalties. The rule generally provides that if an IRA engages in a prohibited transaction, the IRA is deemed to be distributed to the owner in full, and the owner would owe tax on the deemed receipt of the IRA. As noted, there are also associated penalties. This is not a good result for the director.

Keep these issues in mind, and take a close look at the facts and circumstances to determine whether a director or executive officer's purchase of shares through their IRA might constitute an IRA prohibited transaction.

THE RESTRICTIVE LENDER

We have recently been assisting one of our community bank holding company clients in obtaining a holding company line of credit. This is a pretty straight forward and common transaction. The holding company is thinking about some strategic alternatives that, if completed, would likely leave the holding company needing to access $3 to $5 million in debt to ensure the bank maintains appropriate capital while also completing the strategic transactions.

The first lender the bank approached approved the loan and provided the actual loan documentation. Our community bank client sent the documents to us for review. Upon reviewing, we commented to our client that this was the most restrictive holding company line of credit loan agreement we had ever seen. The documents reflected normal asset quality, earnings, and capital ratio loan covenants in the agreement. However, they also had many additional items that we viewed as simply too restrictive. For example, it said that the bank would not open or close any branch location or pursue any merger or acquisition transaction without the lender's prior written approval. Failure to abide by the covenant would have resulted in an automatic default, which would give the lender the right to require immediate repayment of all principal and accrued but unpaid interest.

We raised our objections with the lender and its counsel. We told them we had no problem agreeing to appropriate operating covenants, but that we saw many of the covenants included in their loan documents as being well beyond reasonable and placing too much control over corporate activities with the lender. Their answer was essentially that they are reasonable people and operate in a reasonable manner, but that they would not change the covenants.

Our advice to our client was to go explore other lenders. We have seen plenty of these holding company line of credit documents, and none of them have the level of restrictions that were contained in the proposed loan documents. We saw the covenants as too restrictive and believe there is a better deal for our client out there.

TRANSACTION AGREEMENT DISCLOSURE SCHEDULES

We have previously discussed the importance of transaction agreement disclosure schedules in prior *Musings*. As a quick reminder, the disclosure schedules are the opportunity for a party to disclose to the other party exceptions to representations and warranties in the transaction agreement. We have always encouraged our clients to err on the side of caution in creating disclosure schedules, because disclosure provides protection against an alleged breach of the representation and warranty.

We were recently reminded of the importance of properly completing the disclosure schedule. A couple years ago, we helped a client sell a bank, and one of the representations was that there was no basis for potential litigation against the selling bank. We discussed this with our client and disclosed in the disclosure schedule a circumstance where a customer had fallen on the bank premises and injured themselves. We basically told the buyer that this was a possible source of litigation and excepted the circumstance from the representation and warranty.

Within the past couple weeks, the customer has filed suit as it relates to the fall. At the time the bank was merged with and into the acquiring bank, the acquiring bank took liability for that lawsuit. The acquiring bank's sole source of potential recovery would be a breach of a representation and warranty in the Stock Purchase Agreement. However, we do not see potential liability there since the issue was fully disclosed to the buyer. In short, the buyer assumed the risk of the litigation by moving forward with the transaction having full knowledge of the facts and circumstances as an exception to the representation and warranty.

This circumstance is a good example of appropriately drafting a disclosure schedule. Had the issue not been disclosed, our client would have had potential liability for a breach of the representation and warranty.

FAMILY CONTROLLED BANKS

As noted in *Musings,* we have had multiple consulting assignments lately with respect to issues associated with family-controlled banks. Often, these involve ownership transition and management succession—essentially the transfer of power from one generation to the next. We are strong believers that although the next generation will pay excellent "lip service" to keeping the bank independent, it will not occur unless the stock provides some benefits to them. The further the stock gets away from the original generation, the less emotional attachment there is to it, so the financial benefits need to be paramount. The financial benefits, in the simplest terms, involve share liquidity (i.e., the ability of the holder to sell a share of stock at a fair price at the time they want) and cash flow (i.e., a dividend or distribution in a Subchapter S). Both these financial attributes are critical when considering family-controlled banks. The goal is to make the stock attractive enough for the next generation to continue to hold, be a good investment for the owner, and keep the community bank independent over the long term.

GEOGRAPHIC EXPANSION

Virtually every strategic planning session we facilitate has an agenda item dealing with geographic expansion. The issue is basically does the strategy involve additional branches or acquisitions of other banks, and, if so, what is the geographic footprint (i.e., how far from the world headquarters is too far to go). We have watched a significant change in the "how far is too far" issue over the last several years with the improvements in technology, the mobility of the customer base, and the like. Historically, the usual answer to how far the typical community bank would be willing to expand was "100 miles from the world headquarters." Now that has changed fairly dramatically. We still have to manage the expansion area, but it is a lot easier to do it with technology these days. Don't limit yourself necessarily by geography.

CONCLUSION

It is hard to believe we are at the end of January 2022 already. We have had the opportunity to travel to some very "frigid" parts of the United States visiting our community bank clients. We enjoy the visit, but not as much the snow and ice. We look forward to spring springing around the country.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Meetings and Webinars:

- February 27-March 3, 2022 – 2022 ICBA LIVE Annual Convention Registration: https://www.icba.org/

    - Bank Director Current Issues Seminar
        - “What Every Bank Director Needs to Know” (Jeff Gerrish)
        - “The Board’s Role in the Current M&A Environment” (Philip Smith)
    - “For Sale? Strategies on Staying Independent” (Philip Smith)
    - “Liquidity Strategies for Illiquid Community Bank Stocks” (Greyson Tuck)

