GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from South Dakota, Minnesota, Wisconsin, Illinois, Tennessee, Mississippi, and Georgia!

WEIGHING THE RISK

In our consulting and law firms, every member is trained as a lawyer and is a member of a state bar. Each individual is also trained/educated on the business side of community banking and understands the financial piece. We often get asked legal questions about a variety of topics. One recently was from a community banker who inquired about an inaccuracy in documentation on their part that had been distributed to their shareholders and others. We discussed the reality that it, in fact, was an inaccuracy. It was also , in fact, immaterial, so we discussed and weighed the business risk (i.e., who is going to get hurt and complain), to determine whether it should be corrected. Our advice was "don't bother." We felt that the low degree of business risk outweighed the technical legal violation that may have occurred through the publication. We believe it is important for community bankers to weigh risks and balance decision making with some reasonableness as to the risk of the institution of taking a particular action. In other words, just because your lawyer says it is "wrong" doesn't necessarily mean it needs to be fixed.

THE ACQUISITION DILEMMA

Following up on the risk/reward issue addressed above, in connection with acquisitions in which our client community bank/bank holding company is the seller, often – and invariably before a transaction is announced or even under contract - one of the shareholders of the selling bank holding company (who is not aware of a pending transaction) will want to sell his or her shares back to the holding company at a price that the Board and management knows is going to be much less than the sale price that may be announced in a couple of months. The dilemma for the board and CEO is what to do with this particular shareholder. Do you bring them into the loop regarding the potential sale and what is going on? (It probably depends on how many shares they own.) If you do, you better get them under a Confidentiality Agreement. More often than not, the bank holding company will go ahead and execute on the repurchase transaction regarding the shares at the depressed price, and then agree to make up the difference for that particular shareholder when the full sale is announced. Again, it is a question of whether the holding company should buy that stock back based on inside information it has. No, of course not. But what is the risk to doing so? The risk is making up the difference for the selling shareholder once the sale transaction is announced. For a small number of shares, that is a small risk.

REGULATORY ENFORCEMENT ACTIONS

As we have indicated in *Musings* previously, we believe the regulatory enforcement climate is heating up dramatically. In connection with the FDIC's monthly pronouncement of enforcement actions entered in the prior month (fourth Friday of every month), it was noted that a Texas bank consented to a cease and desist order with the agency. Interestingly enough, since we have been involved in regulatory enforcement actions for over 40 years, the substance of the corrective program provided in the order really hasn't changed much. It seems to always involve providing acceptable management (it doesn't mean you have to get rid of current management), achieving a minimum capital level (in this order, 8% leverage), engaging in strategic planning, and establishing a profit plan, as well as notifying the bank shareholders. The boilerplate requirement in the order to notify the bank shareholders is one we have never really understood since virtually all banks in the country are controlled by their holding company. As a result, notification to the shareholders simply means sending the holding company a letter that the bank is under a consent order (which is public anyway).

We suppose the good news with respect to this particular consent order is that there is nothing new, exciting, or even creative in connection with the current version of the enforcement actions. Unfortunately, we think there will be a lot more of them. Keep in mind, as we have indicated in prior *Musings*, consent orders are called "consent orders" because they do not come into place unless the board actually consents (i.e., agrees).

THE DISAPPOINTED COMMUNITY BANKER

We were with a community bank board of directors recently to assist them in determining the bank's strategic direction. Of course, one of the topics for discussion was whether the bank should remain independent. The CEO of the bank expressed some dismay that he had never even been approached about an acquisition. This wasn't that he had never received an unsolicited offer. This was that he had never even had a discussion with anybody interested in acquiring his bank. He was insulted. Interestingly, the bank is a good, strong performer. We assured him it wasn't a problem with the bank - it was the message the bank was sending to potential acquirors. The bank is an S corp. It is closely-held by one family. The family had never signaled any interest in doing anything other than keeping the bank. The bank has succession for management, the board, and ownership. So, we suggested to him that most interested parties decided they probably did not want to waste their time on a deal that wasn't going anywhere. The flip side is, if your bank is for sale and you want it to be in play, then you pretty much have to "pretty it up" and get the message out before you get any interest.

MANDATORY RETIREMENT

We have utilized a lot of electronic ink in these pages with respect to mandatory retirement. We recently were involved with a couple of situations where several community bank directors were approaching the point of getting forced off the board as a result of mandatory retirement. In some cases, a number of directors had already mandatorily retired off the board and were serving as Director Emeritus on the board of the community bank. In a number of these situations, there is generally some subtle "griping" about the impact of mandatory retirement. In a number of them, we have pointed out to the board of directors that the reason the bank has mandatory retirement is that they themselves established mandatory retirement. As a result, they themselves can "unestablish" mandatory retirement. Interestingly, in each of these situations, those older directors who had gone off the board did not really want to come back in on a monthly basis and be responsible for serving as board members. In each case, we have come up with an alternative resolution as to how to repopulate the board with younger board members, but we thought it interesting that notwithstanding the griping about mandatory retirement, nobody that was subject to it really seemed to want to stay on the board.

BANK-OWNED LIFE INSURANCE

We recently received an email from a long-time *Musings* reader asking if we would provide a *Musings* article on bank-owned life insurance ("BOLI"). We are happy to oblige this request. If you are not familiar, BOLI is exactly what the name implies. It is life insurance that is owned by the bank. The insurance policy typically covers a key officer, director, or principal shareholder. Like all other life insurance policies, the policy pays a death benefit to the policy beneficiary upon the death of the insured. These policies also have a cash surrender value and can be surrendered for cash prior to the death of the insured.

BOLI is an earning asset on the bank balance sheet. These policies are most often single-pay premiums where the bank takes some amount of cash and purchases the policy at its inception. The cash surrender value of the policy then grows over time, and the bank recognizes as income the increase in the cash surrender value of the policy.

Most of the time BOLI is paired with some type of executive retirement plan. It is not uncommon for BOLI to be paired with a Supplemental Executive Retirement Plan or a Split-Dollar Benefit Plan. These plans provide post-employment benefits to executives and are an expense to the bank as the benefit gets closer to payout. This means that the general strategy of pairing these two items is to have an earning asset that offsets the expense of the associated liability.

As you might suspect, there are a number of considerations related to BOLI. There are tax implications, regulatory concentration limits, and the like. There are also a number of specific considerations in the M&A context when a target bank has BOLI. Please let us know if you would like additional information.

THE NOVEL APPROACH TO LENDER COMPENSATION

We recently facilitated the strategic planning session for a community bank that is heavily focused on loan growth. Similar to most other banks around the country, this particular community bank has excess on-balance sheet liquidity and is looking to generate new loan opportunities. At the planning session, we engaged in a lengthy discussion concerning loan growth opportunities. One of the discussion topics was strategies to hire a new lender or lenders to bring new loan opportunities to the bank.

As part of this discussion, we talked about loan officer compensation. This group took what we see as a very appropriate approach to loan officer compensation. The group basically said the bank needs to ensure it has a loan officer compensation system that compensates the loan officer in direct proportion to the benefit their loans provide to the bank. For example, the group said a loan officer with a $40 million loan portfolio yielding an average of 4% should make significantly more in annual compensation than a loan officer that has a $20 million portfolio yielding 4%. (The group also acknowledged that there needed to be some asset quality considerations or deferral of compensation while asset quality is determined, or even clawbacks as part of the system.)

During the planning session, we were asked whether we agreed with this approach. Our response was absolutely. We also noted that we do not see this as an atypical approach in most community banks. In our experience, loan officers with larger portfolios typically receive higher compensation than do loan officers with smaller portfolios. However, the increase in compensation is usually not in direct proportion to the benefit to the bank. We think the strategy makes sense and that it will give this bank a leg up in trying to hire additional talent.

ELECTRONIC ANNUAL MEETINGS

Annual meeting season is upon us. For this reason, several times over the last couple weeks we have been asked by clients whether it is possible to hold the holding company annual meeting via Zoom. This has been a common question about this time of year for the past two or so years. In 2020 and 2021, the question was driven by the pandemic and social distancing concerns. Today, the question seems to be borne out of convenience.

The answer to the question of whether the annual meeting can be held electronically is: it depends. There are a number of factors. The two most pertinent are state law and the corporate documents. If your community bank holding company is contemplating holding its annual meeting electronically, our recommendation is to review the applicable state law to determine whether the state law allows it. Some states may require the annual meeting to be held in person.

Also, take a look at your holding company corporate documents (your Articles and Bylaws) to determine whether there is any provision that either expressly prohibits or denies the ability to hold an annual meeting electronically.

In our experience, the most common answer is that the applicable state laws and corporate documents do not currently provide for an annual meeting to be held exclusively electronically. If this is the circumstance, our general recommendation is to hold an in-person annual meeting that also has an option to attend electronically. This technically satisfies the requirement for an in-person meeting while also allowing the convenience of electronic participation.

CONCLUSION

It is hard to believe we are already at the end of the first quarter of 2022. We have enjoyed seeing many of you at recent banking association conventions. We are glad to see the weather warming up and the snow becoming only "occasional."

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations

- April 24, 2022 – Western Bankers Association 2022 Annual Conference; "Independence? You Must Stay Relevant!" (Philip K. Smith, Presenter) Registration: Western Bankers Association Annual Conference
- May 5, 2022 – Graduate School of Banking-Wisconsin Webinar; "Strategies to Remain Independent in a Consolidating Environment" (Greyson E. Tuck, Presenter) Registration: Strategies to Remain Independent in a Consolidating Environment
- May 12, 2022 – Graduate School of Banking-Wisconsin Webinar; "Financial Analysis of Bank M&A Transactions" (Greyson E. Tuck, Presenter) Registration: Financial Analysis of Bank M&A Transactions
- May 18-20, 2022 – Louisiana Bankers Association 122nd Annual Convention and Exposition; May 18th - "Practical Advice for Community Bank Directors" (Greyson E. Tuck, Presenter) Registration: Louisiana Bankers Association Annual Convention
- May 23-26, 2022 – Abrigo ThinkBIG Conference; May 25th - "Dusting Off the Crystal Ball: Banking in 2042" (Greyson E. Tuck, Presenter) Registration: THINKBIG