GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Texas, Louisiana, Tennessee, Wisconsin, Minnesota, Indiana, Ohio, Florida, and California!

FDIC GETS A WIN

In an opinion published several days ago, the Federal Sixth Circuit Court of Appeals provided support for FDIC decisions against a community banker in connection with a removal from banking action and civil money penalty. Section 8 of the Federal Deposit Insurance Act provides that under a variety of circumstances, an institution affiliated party (director, officer, or other) can be removed from banking or prohibited from future participation in banking if a number of standards are met. Section 8 also provides for the assessment of civil money penalties in certain other circumstances.

The facts of this case arose as a result of activities occurring during the Great Recession in the 2008 time period and beyond. Normally, a case like this would have been resolved a little bit more quickly, but part of the delay in this case was a challenge to the appointment of the Administrative Law Judge who initially heard the case. So, as a practical matter, the FDIC had to go back and start over with a new judge. We have always said that if your community bank wants to buy time to comply with one of these proposed enforcement actions, challenge the agency. Buying 10 or 12 years of time, as in this case, is a little bit out of the norm, however.

Interestingly, one of the community banker's challenges to the FDIC was the bias of the Case Manager. Here, the Case Manager and the borrower against whom the bank had claims, according to the community banker, were in cahoots evidenced by bias in connection with the examination. At the end of the day, that claim was not well taken, but it is one we hear often.

As we mentioned in recent *Musings*, we anticipate more enforcement actions will be forthcoming. Although the area is complex, if any *Musings* readers want a copy of this lengthy published opinion, please let us know and we will forward it on. Forewarned is forearmed.

LONG MEMORIES

No, this article is not about "long, fond memories" of multiple years in the community banking sector of the industry. It is about the long, never-forgetting memories of the friendly federal regulators. We recently had a couple of community bankers contact us with similar circumstances that reminded us of the long memory of the regulators. Each had applied to their respective friendly federal regulator for approval to do something at a community bank. Each of these individuals filled out the long and obnoxious Interagency Biographical and Financial Report (the IBFR), which is notoriously one of the easiest forms to make a mistake on. The regulators love to look for mistakes in the IBFR because then they can disqualify the applicant for not being truthful (as well as make criminal referrals for filing a false statement with the bank regulators if they really want to). As we always say with an IBFR, you are better off disclosing you were convicted of murder in the past than failing to disclose a parking ticket when you were 22 years old.

One question on the IBFR deals with the issue of whether you have been involved in a prior enforcement action with the regulators at any insured institution. Both of these community bankers during the last recession were attached to banks that were subject to consent cease and desist orders. As we have indicated in *Musings* previously, consent orders are just that – they are orders consented to by the board that provide a corrective program for the bank. They are serious. They are enforceable with civil money penalties and in federal court for violation. Each of these bankers in their history had been involved with a community bank that had been subject to a consent order. Each disclosed that on the IBFR. Each was denied approval for what they were requesting because of that association with separate troubled banks 15 years ago. (As you may recall, there were over 800 banks on the problem bank list during the last recession, so association with a troubled bank in that time period would not have been an unusual event.)

The regulators turned down both applications from these separate individuals. Not surprising, we suppose, since there are no regulatory "atta-boys" for giving community bankers a break. From the regulators' standpoint, if they let these individuals do what they have asked to do with their new banks and the new banks get in trouble, the friendly federal regulators will simply be criticized for letting someone who was involved in a troubled bank 15 years ago now be involved in other banks that had gotten into trouble. Not much for risk-taking for a risk-assessing agency.

In any event, keep in mind when you are dealing with the regulators - they have long, long memories.

COMPLIANCE ISSUES

We have reported in the last several months of *Musings* that we are seeing an uptick in compliance criticisms at community banks. That is continuing across the nation. Many of these violations involve statutory violations for which the regulators take the position they have no alternative (i.e., no discretion) but to go after the bank. Flood insurance is a good example (although typically a minor issue). Others that are not so minor involve fair lending, equal credit, and RESPA. We have had a number of RESPA situations lately where the regulators are looking to see whether some service provider received an illegal "kickback" (nasty word) from the bank for providing services.

Our only caution is to up your community bank's compliance game because the regulators are certainly upping theirs in the current environment. Let us know how we might assist.

TRANSACTION CLOSINGS

Fridays in June are a very busy time for M&A transaction closings. We have closed a deal each of the past two Fridays and fully expect to have another deal closed this coming Friday.

If you have never been through a transaction closing, it is probably not like you think. If you are thinking the closing is some big to do where everyone involved gathers together and signs a large stack of documents (similar to a real estate closing with a mortgage), you will be disappointed to hear that is not exactly the case. In fact, we often tell our clients that closing is the most anticlimactic part of the deal. (No champagne!)

If the lawyers have done their job correctly, the actual day of closing should be rather uneventful. That is because all of the closing documents have been drafted and signed in advance of the closing. The lawyers for each of the parties exchange documents with the other, and those documents are held "in escrow" until the time of closing. On the actual day of closing, there is usually a closing telephone call where each of the lawyers confirm everything to be correct and final, and then they exchange emails directing that all documents held in escrow be released. There is also typically a filing with a Secretary of State.

On the date of closing, the acquirer funds the purchase price. That is typically done by the acquirer placing the amount of funds into a specific account. Following closing, the shareholders of the selling organization submit Letters of Transmittal along with their stock certificates to the acquirer. When those come in, the selling shareholder is actually paid their portion of the transaction consideration. The same process is followed if it is a stock deal, only the shareholder will receive a stock certificate rather than cash.

We are currently in the midst of a flurry of closings. Fortunately, the last two have gone pretty well. That means that the actual day of closing has been much closer to a non-event than a big to do.

CHARTER CONVERSIONS

We recently received a telephone call from a client that is fed up with its friendly federal regulator. This community bank had recently undergone an examination, and it did not turn out quite like the bank hoped. The examination resulted in a proposed Memorandum of Understanding, which the bank management team does not believe is necessary and does not believe will be beneficial to the bank or some of its business endeavors.

The client called us to discuss the results of the examination. There were a number of different topics discussed, one of which was the possibility of either converting the bank's charter or changing the bank's primary federal regulator. Unfortunately, given the results of the examination, that is not a current possibility.

The Dodd-Frank Act, which has been around a little more than ten or so years, included prohibitions on what is often referred to in the industry as "charter shopping." The Dodd-Frank Act basically provides that a bank is not allowed to engage in a charter conversion or change its primary federal regulator if it is subject to any unresolved supervisory criticisms. For all practical purposes, this applies to any bank that is 3 or worse rated or has any type of formal or informal enforcement action.

For banks that may find themselves in this position, the only option is to improve the bank to get out of its current position. Once that happens, the door to a conversion is wide open, and the bank is free to choose whatever regulator it thinks might give it a better result.

LOAN DEMAND

We have had several recent discussions with community banks about loan demand. This typically comes up in the context of a strategic planning session. One of the initial questions we almost always ask is what the bank is seeing in terms of loan demand. Almost universally, the answer over the past 60 to 90 days has been something akin to "very strong." While we see that as a great answer, it usually is followed by some type of comment to the effect that the concern is whether borrowers are rushing to get applications in the door and loans funded due to the rising rate environment.

It is no secret we are in a rising rate environment. Almost everything the Federal Reserve is doing right now is in an effort to slow down economic activity. So, we see it as appropriate that banks have concern about the potential that borrowers are rushing to get in the door and lock in lower interest rates. Of course, there is nothing that can be done about that. It is just interesting that it seems to be a universal refrain among community bankers.

COMMON STOCK VALUE

We recently had an interesting discussion about the differences in "market value" and "appraised value" of community bank common stock. The discussion was with an individual that was recently appointed as CFO of their community bank. This was made in conjunction with the departure of a long-time president. For a number of years, the president had talked about the "market value" of the holding company common stock. The CFO was questioning this because, like many community bank holding companies, this holding company has no active trading market. There are not buyers and sellers, and the stock is not quoted on any exchange.

This particular bank holding company has received an outside appraisal for a number of years. The long-time president always took the value of the stock as determined by the appraisal and referred to it as "market value." The CFO asked whether this was a correct reference. We told the CFO that, in our view, a more appropriate reference would be to the "appraised value" of the common stock.

We recognize this is somewhat of a matter of splitting hairs. Nevertheless, there are instances where words do matter. In this instance, we do not think the preferred route is to refer to the stock market value because there is no trading market for the shares. Instead, we see it better to refer to the stock's appraised value since the appraisal is really the source of the quoted value.

DIRECTOR EDUCATION

For some reason, we are seeing a number of Chairmanship changes in community banking this spring. Of course, it is spring annual meeting season. Also, many banks are trying to diversify as their older white male Chairman resigns and they seek out a more diverse individual as replacement Chairman. Often, the new Chairman coming in looks at the bank and tries to set their agenda for the future, as they should. Recently, we have had a number of inquiries from these incoming Chairmen as to director education. Our position has always been that the industry, moving as fast as it is, lends itself toward requiring education for directors. This is not technical education, as such (which many directors get). It is not designed to make a community bank director an expert on Reg. O or BSA or any of those things. This is education on the bigger picture items including corporate governance, mergers, strategic issues, share liquidity, and the like. We have had a couple inquiries lately asking us to assist the community bank in establishing a director education program.

One of the issues that generally arises in creating a director education program is whether a minimum number of hours should be required. Currently, we are only aware of one state in the nation that requires director education for its directors of state-chartered banks. This state requires 12 hours every two years. Our concern with a community bank internally establishing a minimum number of education hours for its directors is that they will "get hung on their own petard." In other words, they have established a standard, and if they do not meet it, then they will just be subject to regulatory criticism. If they have no standard, then it would be viewed as a positive they are doing something in education, not a negative.

Our general recommendation is that an education program is appropriate. It needs to be in addition to the technical education the directors now receive several times a year on various specific topics as mandated by the regulators. It needs to be much more broad-based so they can do their job of oversight and be a credible challenge to management.

MUSIC CITY MERGERS AND ACQUISITIONS

We look forward to seeing many of you at the ICBA sponsored Merger & Acquisition Workshop coming up in a couple of weeks (June 27-28) in Music City, Nashville, Tennessee. This is a hands-on workshop, ideal for any level - from Chairman of the Board, outside directors, CEO, to CFO. For more information, click on the link: ICBA M&A Workshop

CONCLUSION

It continues to be interesting for community banks across the country with the economic uncertainty, the rising rates, and the unprecedented (at least recently) inflation. Our suggestion is "hold on." It is only going to get more interesting.

Stay safe. Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and Presentations

- June 21, 2022 – Independent Community Bankers of America Webinar: "Maintaining Organizational Relevancy: Ensuring Regulatory Compliance for Intercorporate Transactions" (Cliston V. "Doc" Bodine, III, Presenter) Registration: Maintaining Organizational Relevancy
- June 27-28, 2022 – Independent Community Bankers of America Community Bank Mergers & Acquisitions Workshop (In Person) (Philip K. Smith and Greyson E. Tuck, Presenters) Registration: ICBA M&A Workshop
- July 15, 2022 – Independent Community Bankers of America Webinar: "Maintaining Organizational Relevancy: Liquidity Strategies for Illiquid Community Bank Stocks" (Greyson E. Tuck, Presenter) Registration: Maintaining Organizational Relevancy