



Opening the door to new ideas

THE *Board Chair Forum*

NEWSLETTER

Gerrish Smith Tuck, Consultants and Attorneys

August 2022

It looks like the dog days of summer are upon us! It is certainly hot in most parts of the country, but the banking world marches on, and so does the newsletter!

In this month's edition, we first discuss two problems that the Board Chair often encounters, in dealing with difficult shareholders and trying to sort out fiduciary duties. In particular, with fiduciary duties, it is often hard to put your finger exactly on where the line of responsibilities is drawn between serving as a director and serving as a shareholder. We will give you an interesting example to consider in this regard.

We also look at the role that FinTechs can play in a positive manner for our organizations, and suggest the board should be at the forefront of trying to help the organization move in that direction. Finally, we address an issue with regard to audit committees for those of you dealing with those issues.

We hope you find this month's edition interesting and thought provoking, and hope you find some pearls of wisdom to take with you in the coming days. Let us know how we can continue to help on these or any other matters.

Happy Reading!

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Board Chair's Summary

- ◆ *Have You Ever Had a Shareholder Problem?*
- ◆ *Board Members Wear Two Different Hats*
- ◆ *Are FinTechs Competitors or Compatible?*
- ◆ *When is a Director "Independent of Management"?*

Have You Ever Had a Shareholder Problem?

Many of you at some point will likely find yourself in the perhaps awkward position of having a current or potential future shareholder who wants to become more actively involved with the bank or the board and is pressuring for more information or involvement. Sometimes this begins with the individual acquiring some shares or beginning to request certain information or otherwise trying to wield power. At other times this comes from an existing shareholder who subtly decides they need to try to influence the course or direction of the institution and they start requesting things that seem threatening like a list of shareholders, a list of recent trades, copies of contracts or something similar. Sometimes these types of shareholders are just curious, other times they are trying to be disruptive or sometimes it could even be an existing director who believes they are not getting enough information.

If you have seen any of the recent headlines regarding Twitter and Elon Musk, you might at least be happy you don't have those kinds of problems. It seems Mr. Musk acquired a significant number of shares and then built a position large enough to request a seat on the board. The request for the seat on the board was to, allegedly, help fix perceived problems with the company. Then he decided he didn't actually want to be on the board and maybe he just wanted to buy the entire company. Twitter, of course, opposed that effort to acquire the company and a public debate began,

but ultimately the parties reached an agreement for Mr. Musk to acquire Twitter. Then, as part of continuing due diligence, he decided he didn't actually like what he saw at the company (he actually alleged there was some misleading information) and so he decided he shouldn't buy the company under the current conditions. Interestingly, Twitter then tried to force him to buy the company at the agreed upon price. This situation remains unsettled, but we think you can see how it could relate to your own organization if you have a disgruntled shareholder, director, employee, etc.

For those of you who are closely held or private companies, avoiding these kinds of prospective activist shareholders should be easier but not completely unavoidable. In most cases, though, those individuals do have the right to request certain documents (subject to state law) so anything that is legally required to be produced should be produced quickly. However, there is no reason you can't inquire as to the purposes for that, require the person to state a legitimate purpose, and investigate the circumstances a bit more. For those of you who are traded publicly, it may be easier for outside individuals to become activist shareholders so you need to be diligent about monitoring ownership changes and communicate with any new shareholders to determine true desires for the organization.

In dealing with problem shareholders, normally the best practice isn't to simply ignore them, but to directly address their questions and concerns. Diffuse the situation early with facts and information because often trying to circumvent their requests may create unnecessary suspicion on their part.

Board Members Wear Two Different Hats

Most board members are also shareholders. So, they wear two different hats that could require them to take different points of view on the same item depending on whether they are viewing it as a shareholder or a board member. Arguably, this can present some difficulties in sorting out what a director's fiduciary duties are. Let's consider an unlikely example to demonstrate this.

Suppose the board of directors is presented with an opportunity to change the bank's logo and marketing comprehensively. Assume, for example, the bank has historically used an oak tree as the logo to demonstrate strength and security. The historic brown and orange colors are even the same as the local high school football team and have been a source of marketing pride for decades. However, now there is a push underway by some members of the board to totally change the bank's

image and use a palm tree as the logo. This strategy is intended to reflect a new laidback attitude, a more casual environment and a decision to no longer have gentlemen wear ties. Likewise, the color scheme will be changed to blue and green to give a sense of the ocean. We know, this sounds silly, but stick with us on this example for a minute longer. If anyone decides to change their logo to a palm tree, we will certainly accept the licensing royalties!

The whole situation comes up for a vote by the board of directors and the board of directors by a vote of 5 to 4 approves the change and so, on behalf of the board of directors, they decide to submit the ultimate decision to the shareholders to vote and approve. (To be clear, that type of operational decision would never actually be submitted to shareholders for a vote, but we are getting to the punchline below.) So, you perhaps see the fiduciary dilemma that is coming. Would a director who voted against the logo change as a board member be required to support the decision of the board outside of the boardroom? Could that director, wearing their shareholder hat, vote against it as a shareholder even though a majority of the board has voted in favor of the transaction? As you might be able to see, there is a bit of a fine line here in terms of the fiduciary duties of board members in separating their roles as board members from that of being a shareholder. Arguably, the board member has a fiduciary obligation to support the direction of a majority of the board (or at least not actively work against it) but the individual certainly has the right as a shareholder to vote their shares against the proposal as an independent stockholder. The point being that fiduciary duties are not necessarily always black and white, so as board chair or as a director you need to be aware of sometimes competing issues. To make this come into focus even better, take the example above and change the circumstances where, rather than the situation involving a mere logo change, what if the issue was a director and shareholder vote on whether to sell the bank?! Now can you see the dilemma?! Would a board member's fiduciary duties change? Sometimes there are no easy answers, and sometimes directors may have to wear different hats for different situations.

Are FinTechs Competitors or Compatible?

Let's be honest, historically as the board chair, directors or bankers, we have viewed financial technology companies or "FinTechs" as the enemy. It was not so long ago that we viewed them as taking over the world, buying up all of the small bank charters and basically being disruptors. But could there be a new role where banks and FinTechs become more compatible rather than competitors?

As the effects of the pandemic continue to play a role in shaping relationships and communications between community banks and customers, we believe it is important to highlight the continued importance of “modern banking” through online services, apps, and the possibility for strategic partnerships with FinTech companies.

The FinTech industry has brought competitive challenges and disruption for banks, particularly community banks, across the nation during the last decade or so. FinTechs are often better positioned to offer more convenient services when it comes to online banking and mobile services, which continue to grow as the categories of services offered through mobile banking applications expand. But recently, the focus has shifted from a competitive view to a compatible view between the two sectors. This is primarily because, while a FinTech may have the convenient and modern technology sought after by customers, it is community banks that have the customer base, the strong relationship experience, and the compliance “know-hows” that can bring benefits in partnership to build modern financial solutions.

Across various sectors, customer expectations have risen, or changed altogether, as younger generations who grew up in the digital era have now joined the workforce and require banking services for their daily lives. As the “digital economy” expands, areas such as crypto currencies, IT security, cloud computing, and customer accessibility will continue or begin impacting the services offered by community banks. Banks of all sizes should be focusing on updating their processes and shifting their customer acquisition and retention strategies by creating technically sophisticated, yet accessible and convenient, services that meet the mobility and convenience needs of our digital economy and the future customer base. The board should be a leader in setting that tone for the organization.

This trend is continuing to grow as more and more community banks seek to establish relationships in one fashion or another with FinTechs. Just last year, the FDIC, Federal Reserve Board, and the OCC issued new guidelines to assist community banks with conducting due diligence and partnering with FinTechs in a number of operational areas and products including:

- digital and mobile payments and deposits
- customer interface and experience technology
- provision of money management and wealth management
- expedited credit underwriting and loan origination processes
- data breach and identity protection tools

It is expected that there will be further regulatory changes in the near future to better serve and promote these types of partnerships.

As these trends continue, we believe it is imperative for banks and their boards to review their vendor relationships and seek to develop mobile banking systems with an emphasis on the bank's technology and mobile banking services, to ensure customer satisfaction and convenience is being attained. These steps help ensure the organization's relevance and viability well into the future.

When is a Director "Independent of Management"?

As banks grow, there are certain regulatory considerations they must keep in mind. We recently worked with a bank that was dealing with membership on its audit committee. The FDIC has two different requirements for membership on the audit committee depending on if a bank is greater than \$500 million or \$1 billion.

According to 12 CFR 363.5(a), if a bank is over \$500 million, all members of the audit committee must be outside directors, the majority of whom shall be "independent of management," unless a waiver is granted by the appropriate federal banking agency because the bank can't find and retain competent outside directors. If a bank is over \$1 billion, all members of the audit committee must be outside directors who are independent of management. Additionally, banks with assets of more than \$3 billion must include members with banking or related financial management expertise and cannot include any large customers of the institution.

The interesting question about the language in the regulation is who the definition of "independent of management" precludes from serving on the audit committee. First, we know that the directors of the audit committee must be "outside directors." Those are individuals who are not, and within the preceding fiscal year have not been, an officer or employee of the institution or any affiliate of the institution. As to whether an individual is "independent of management," the rules provide that the analysis of each individual must be fact-based. When assessing an outside director's relationship with an institution and whether the person is independent of management, the board of directors should consider the persons or organizations with which the director has an affiliation. There are generally a few guidelines outlined to help in making that determination.

If you or your organization are looking at audit committee rules and requirements and would like to see these guidelines, please let us know. The bottom line, though, is that as your bank grows it is important to continuously monitor membership on the audit committee for compliance with these rules. As board chair, you should constantly remind your board members that the growth and

success of the organization often leads to heightened fiduciary duties and also different legal and regulatory standards by which the organization must operate. So, in looking at your community bank's asset size, it may be necessary to reevaluate board membership and assign new individuals to your audit committee so that the bank remains in compliance with these rules and regulations.

Meeting Adjourned

Even though we are in the midst of the dog days of summer, before too long cooler weather will start in many parts of the country that will be followed by a pretty harsh winter. As a result, many of you look for ways to escape the winter cold and overcast conditions. So, we wanted to let you know that it is not too early to begin thinking about the 2023 Community Banking Board Chair Forum in Naples, Florida. Registration has opened, and the event will be held January 9th and 10th at the Ritz Carlton. It is always a great event, well attended and tremendous discussion by board chairs and other directors and senior management from across the country. We hope you will make plans to attend. If you would like information on the Forum, please let us know, or you can register at the following link: [Board Chair Forum](#).

Until next time,



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