GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Minnesota, Texas, Nebraska, Arizona, Florida, Louisiana, Kansas, and Mississippi!

THE SURPRISING CONVERSATION

We recently had an email conversation with a friendly regulator that was pleasantly surprising. The backstory is that this particular regulator had received a copy of a prior *Musings* and asked to be put on the mailing list. We happily accommodated the regulator's request (we would like to have as many state and federal regulators on the list as possible). In our transmittal email to the regulator, we expressed our hope they would not be surprised that "we call them as we see them" with respect to regulatory overreach and the like. The regulator's response was pleasantly surprising. It included the statement, "We too are concerned with 'friendly regulatory overreach' or what we call mission creep. We have spent considerable time making sure our processes, suggestions, and edicts come from our laws and regulations and not our feelings. The number of times we recognize how far off the trail a regulatory response has gotten never ceases to bewilder us." We thought this very refreshing from a regulator (who approved this message).

CONSENT ORDERS

Last Friday, one of the friendly federal regulators (FDIC) released its enforcement actions for the month of January. Interesting reading. There were 15 enforcement actions, all Consent/Cease and Desist Orders or Consent Removal Actions. As most *Musings* readers know,

most of the federal regulatory enforcement actions are by consent, although they do not have to be. The bank and/or individual does have a right to request an administrative hearing and have their day in court. As noted, all of these orders were by consent. Of the 15, there were multiple orders involving a single bank and several individuals of that bank, which not only removed some of the individuals from banking permanently, but fined a number of them anywhere from $1,000 to $100,000. The violations involved a violation of the Federal Trade Commission Act by mortgage lenders who allegedly were deceiving borrowers with respect to interest rates and repayment terms and the like.

There were also a couple of other orders that dealt with BSA/AML issues. All these orders were compliance related (i.e., not safety and soundness). What does that tell us about where the friendly federal regulator's emphasis is?

COMMUNICATION WITH THE REGULATORS

As noted in *Musings*, the regulatory environment is getting more and more "brutal" (the term used by several of our clients with respect to their recent examinations). When faced with a difficult exam, whether management and the Board agree with the examiners or not, the critical issue is to continue to communicate respectfully when the bank addresses any regulatory criticisms. The bottom line is that the bank needs to begin working on regulatory criticisms even prior to the receipt of the examination report or any enforcement action. As the bank makes progress on the regulatory criticism, it is critical to communicate the progress to the regulators. In all likelihood, the communication will not change the results of the examination (if the report has not been issued). This is primarily because the regulators view their examinations as a "snapshot in time." So whatever good things the bank does after the examination are not relevant for purposes of determining the conclusions in the examination report (for the most part). Notwithstanding that, it is still important to communicate the improvements to the regulators. Those communications may go into the regulatory "black hole," but at least they will be in the regulatory file to show the bank's good faith efforts with respect to improvements and to be reviewed by the examiner prior to the next exam. None of that hurts.

M&A INTEREST

We frequently write about the M&A environment in *Musings*. We do so in an effort to keep you updated as to what is currently happening in the industry. Several of our recent *Musings*

have noted the slowdown in M&A activity and the challenges that are creating the slowdown. While those challenges remain, we are beginning to see an uptick in the level of interest in M&A opportunities.

Over the past couple of weeks, we have facilitated a number of different strategic planning sessions where one of the action items from the planning session is to "run the numbers" on an acquisition opportunity. This is the first step in moving towards a transaction. In running the numbers, we are seeking to assist the Board in understanding what an opportunity might look like from a financial perspective. The financial analysis answers the question of the financial effects of a particular transaction given a certain set of assumptions, mainly related to price, composition of consideration, anticipated cost saves, future growth and profitability, and similar concerns. This financial analysis is typically presented to the Board and is accompanied by a discussion on the financial and social issues related to the transaction. This provides the Board an appropriate framework for decision making on whether a particular opportunity makes sense.

As we have previously noted, there are still a number of challenges to successfully completing a community bank M&A transaction. Notwithstanding these challenges, we are currently seeing what we think is properly described as an uptick in interest for these opportunities.

UNSOLICITED OFFERS

We recently facilitated a strategic planning session where a good part of the discussion focused on potentially making an unsolicited offer to another community bank holding company. During the Board's lengthy discussion related to unsolicited offer strategy, one of the directors asked why it is that the holding company may choose to make an unsolicited offer of another holding company and bank. The answer is pretty straightforward. It is because the potential target holding company and bank are viewed by the potential acquiror as a desirable acquisition target that is worthy of pursuit, notwithstanding the fact that the potential target is not actively marketing itself for sale. In other words, a potential buyer has determined they would like to make an acquisition and are willing to submit the unsolicited offer to force the potential seller to respond to their overture and indication of interest.

If your community bank holding company or bank has identified a desired target, keep in mind it is not absolutely necessary for the potential target to be marketing itself for sale. You can always put together an unsolicited offer and present it to the target Board of Directors. The worst they could say is "no." The best they could say is "yes." A close second is "no" to the original

offer but a "yes" to further discussions and negotiations to see if the central tenets of the deal can be reached.

FORCE-OUT TRANSACTIONS

We have recently been with a number of community bank boards who have discussed restructuring ownership for a variety of purposes. Some of those boards are contemplating conversion to a Subchapter S. Others are simply looking to restructure their holding company ownership or do an acquisition with an affiliated company. Either of those transactions could be deemed a force-out transaction. Typically, if a majority of the shareholders (bank-only, usually two-thirds) agree to the transaction, then all shareholders are forced to go along. Those that do not agree can dissent and get paid fair value for their shares, but they cannot stop the transaction.

Some of the boards, particularly in the Subchapter S or restructuring of ownership context, are concerned about forcing shareholders to do anything. We view this situation with a little different lens. That lens is, overall, what is best for the shareholders collectively? Is it best for the shareholders to convert to Subchapter S? If it is, then why would you let one or two dissident shareholders stop that process? If it is best for the shareholders overall to restructure ownership and, for example, get rid of out-of-state shareholders, then why would your holding company board let a couple of out-of-state shareholders who do not participate in the bank as either customers or as active shareholders stop the process?

As we advise community bank boards, a freeze-out transaction is not a bad thing as long as it is designed to enhance shareholder value. In that context, it is actually a good thing.

HOLDING COMPANY INVESTMENTS

Over the past couple of weeks, we have had several different discussions with various clients regarding opportunities for bank holding companies to own assets other than the common stock of their subsidiary bank. In each of these discussions, the holding company has been looking for ways to diversify and increase its net income by putting "excess" capital to work. In each of these discussions, the client asked what opportunities were available to make alternative investments at the holding company level.

In summary, there are generally a couple of different holding company investment alternatives. These are best thought of as falling into one of two general categories.

First, bank holding companies are allowed to engage in "any activity closely related to banking." Holding companies can generally engage in these activities directly or can own the equity of a company that engages in these activities. The Federal Reserve has taken a fairly expansive view of activities that are closely related to banking. The list of specific activities is beyond the scope of this *Musings* but generally includes an array of financial activities, with the most common being trust, wealth management, securities, insurance, real estate appraisal, factoring, and similar activities.

Second, bank holding companies are allowed to own up to 4.9% of the common stock of any other entity. This allows bank holding companies to make minority, passive investments in a wide array of businesses.

As you might imagine, due to the highly regulated nature of the banking industry, the devil is in the details. If your bank holding company is looking to engage in these types of activities, it is very important it does so in a compliant manner. If you are looking for opportunities to put excess capital to work, you might think about alternative investments at the holding company level.

SUBCHAPTER S TRUST SHAREHOLDERS

Currently, about a third of the banks in the country have elected to be taxed as S corporations. The S election is beneficial because it reduces the overall tax burden that is associated with taking gross income to the shareholders' pockets. Simply put, it is about 10% cheaper to move gross income to the shareholders' pockets as an S corporation than it is as a C corporation. While the S election is beneficial from a tax perspective, it is not available to every company. The rules generally allow an S election only when a bank holding company has no more than 100 qualified Subchapter S shareholders (counting six generations of one family as one shareholder).

Bank holding companies that have elected to be taxed as S corporations must ensure that their shareholders all remain qualified Subchapter S shareholders. This can become somewhat challenging, and a source of risk, when trust shareholders are involved.

Most trusts either qualify or can be amended to qualify as Subchapter S shareholders. The difficulty is not so much in the initial qualification as it is in ensuring ongoing qualification. It is possible that a trust could be amended in such a manner as to cause a qualified trust to become a non-qualified trust. It is also possible the settlor could die and the shares could be transferred from a qualified trust to a non-qualified shareholder. Each of these potential circumstances present risk

to bank holding companies, and that risk is something we are seeing many holding companies have concern on how to manage.

If you have elected to be taxed as an S corporation, keep these trust issues in mind. It is important to establish some type of framework to ensure the trust is currently qualified, and continues to remain qualified on an ongoing basis. This is typically done through the Shareholders Agreement. There are other strategies that might work as well, such as ensuring your shareholders provide notice of an intended amendment to the trust documents before the amendment occurs or making sure shareholders know to provide notification in the event of the death of a settlor of a trust shareholder.

Transferring even one share of company common stock to a non-qualified Subchapter S shareholder can have the effect of automatically terminating the S election. Obviously, that is to be avoided. Because of this reality, many holding companies are looking at opportunities to gain more control over their trust shareholders to ensure the ongoing validity of the S election.

ICBA CONVENTION

As noted below, several members of our firm will be making presentations at the ICBA LIVE 2024 Annual Convention in Orlando. The Convention will be held March 14-17 at the Orlando World Center Marriott. For those *Musings* readers who plan to attend, we look forward to seeing you there. Please come and visit with us. Also, our firm sponsors the diamond/expensive watch giveaway at the Convention. Please make sure to return your "pink card" to the ICBA Education Booth and get in the running.

CONCLUSION

Many of us often say we wish there was more time to get something done. Well today is your day. Leap Day is upon us. Use the time wisely.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and In-Person Presentations

- March 1, 2024 – Oregon Bankers Association, 2024 Northwest Bank Director Series (Webinar) – "A Practical Guide for Community Bank Leadership in the Current Environment" (Greyson Tuck, Presenter). Registration: A Practical Guide for Community Bank Leadership
- March 14, 2024 – Independent Community Bankers of America, Bank Director Current Issues Seminar, Orlando World Center Marriott (Philip Smith and Greyson Tuck, Presenters). Registration: Bank Director Current Issues Seminar
- March 14-17, 2024– ICBA LIVE 2024 Convention, Orlando World Center Marriott (Jeff Gerrish, Philip Smith, Greyson Tuck, and Doc Bodine, Presenters). Registration: ICBA LIVE 2024 Convention
- April 2, 2024 – Graduate School of Banking at Wisconsin (Online Seminar) – "Creating Value for Community Banks: M&A and Beyond" (Philip Smith, Presenter). Registration: Creating Value for Community Banks - M&A and Beyond
- April 4, 2024 – Graduate School of Banking at Wisconsin (Online Seminar) – "Strategic Planning in Uncertain Times" (Greyson Tuck, Presenter). Registration: Strategic Planning in Uncertain Times
- April 11, 2024 – Graduate School of Banking at Wisconsin (Online Seminar) – "Strategies and Planning for Closely Held and Family Banks" (Philip Smith, Presenter). Registration: Strategies and Planning for Closely Held and Family Banks
- April 16-19, 2024 – Independent Community Bankers of America Credit Analyst Institute (Virtual) (Cliston V. "Doc" Bodine, III, Presenter, April 17) Registration: Credit Analyst Institute
- April 23, 2024 – Independent Community Bankers of America (Webinar) "Community Bank Compensation Issues" (Cliston V. "Doc" Bodine, III, Presenter) Registration: Community Bank Compensation Issues
- May 6-8, 2024 – Indiana Bankers Association 2024 Mega Conference "Ten Things Every Community Bank and Its Directors Need to Know Now" (Philip Smith, Presenter, May 7) Registration: Indiana Bankers Association 2024 Mega Conference
- May 9-10, 2024 – Independent Community Bankers of America Enhancing Organizational Value Conference at Embassy Suites in San Antonio (Philip Smith and Greyson Tuck, Presenters) Registration: Enhancing Organizational Value Conference