GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Alabama, Florida, Minnesota, Wisconsin, Pennsylvania, Texas, and Wyoming!

SERVING ITS PURPOSE

We recently facilitated a strategic planning session for a smaller mutual community bank that is a pretty solid performer. This mutual has appropriate earnings and strong asset quality. Being a mutual with no mutual holding company debt, they have no demands on their net income other than to place them in retained earnings. This provides the bank a Tier 1 Leverage Ratio in excess of 14%. It is certainly not a bad combination for the current environment.

The discussion at the strategic planning session recognized the bank is appropriately positioned to take advantage of opportunities, should it want to do so. We discussed opportunities to supercharge growth, expand geographically, acquire other banks, or partner up with other mutuals. While the Board recognized the availability and benefits of all of those strategies, they ultimately chose to pursue none of them. Instead, the decision was essentially to continue to serve their primary purpose of enhancing member value by having a laser sharp focus on the individuals in their existing community they were chartered to serve.

We thought the discussion with this mutual was interesting. The Board and officer group certainly realized the opportunities available to expand and further their reach. Ultimately, they chose not to pursue those because they did not believe it was best for the membership. Instead,

they adopted a strategy of continuing to focus on their core mission of enhancing member value. We do not think that was a wrong decision. We see good value in understanding all available alternatives and reaffirming the core strategy.

CORPORATE DOCUMENTS

This time of year, we generally recommend to our community bank clients across the nation that, if they haven't done so, it is time for them to review their corporate documents. This includes the holding company's Articles of Incorporation and Bylaws and the Articles and Bylaws of the bank. It also includes, for those of you in a Subchapter S, your holding company's Shareholders Agreement. Every Subchapter S should have a Shareholders Agreement which, if it does nothing else, prevents the inadvertent or intentional termination of the Subchapter S by a shareholder to the detriment of the remaining shareholders.

If the Board of Directors wants to amend the corporate documents, it is not that difficult. If they are bank corporate documents (Charter and Bylaws, etc.) and the holding company owns 100% of the bank stock, that is a pretty simple task. The holding company can simply call a special meeting or amend the documents by unanimous consent. Amending the holding company Articles of Incorporation and Bylaws also may not be a heavy lift. The Bylaws typically can be amended by the Board of Directors. The Articles of Incorporation changes would need to be approved by the shareholders, but that is typically (depending on the state) a majority of the shares voting in favor.

The Amendment of a Shareholders Agreement is a little more difficult. If the existing Agreement does not address the percentage required to approve an amendment to the Shareholders Agreement (such as, for example, 85% of the shares voting in favor of the amendment to the Agreement), then amending the Shareholders Agreement is going to require every single shareholder to agree to it. If every single shareholder does not agree to it, then those who do not agree to the amendment to the Shareholders Agreement are not bound.

In any event, we recommend your corporate documents, including the Subchapter S Shareholders Agreement, be reviewed to determine whether at this stage in the organization's life the documents appropriately represent the shareholders' intentions. If not, then they may need to be modified.

TWO CLASSES OF STOCK

Over half the community banks in the United States operate under IRS Subchapter S for tax purposes. Their holding companies are generally Subchapter S corporations, and the subsidiary community bank is a qualified Subchapter S subsidiary. One requirement to maintain Subchapter S status, in addition to having not more than 100 shareholders (counting six generations of one family as one shareholder), is that the holding company can only have one class of stock.

This creates certain issues, particularly when a Subchapter S organization wants to raise capital or provide shares for employee benefit plans. Since Subchapter S community banks are by definition closely-held, the ownership group may not want to do anything that would dilute their ownership from a voting percentage standpoint. In that case, the alternative may be to issue a class of non-voting stock, provided it can be done without violating the Subchapter S rules regarding a second class of stock.

So the question is, how does the Subchapter S holding company make sure that non-voting stock is not considered a second class of stock? Surprisingly, the government is here to help you. The IRS has guidance on this particular issue that basically provides as long as the non-voting stock has the same distribution and liquidation rights as the voting stock, then it is not considered a second class of stock. In other words, if the only difference is its lack of a vote, that does not automatically constitute it as a second class of stock.

We have had a number of inquiries with respect to this issue in the last couple of months. If you would like to further discuss whether non-voting shares would be of benefit to your Subchapter S holding company, please let us know.

PREEMPTIVE RIGHTS

We recently have had multiple inquiries from community bank holding company boards about the issuance of stock. Many of these community bank holding companies are either tapped out on leveraging their holding company (always our first choice) or simply have identified some interested buyers as it relates to purchasing shares in their community bank holding company. They want to strike while the iron is hot.

The first issue we always look at is whether the existing holding company shareholders have preemptive rights. Preemptive rights simply provides the opportunity to an existing shareholder to purchase his or her pro rata portion of a new share issuance.

As a practical matter, a holding company with preemptive rights for their shareholders really gums up the issuance of shares. It also often gums up the securities exemption available to the issuing holding company. An explanation of this, for a lot of reasons, is beyond the scope of *Musings*.

Our general recommendation is to eliminate preemptive rights from the holding company's Articles of Incorporation. Careful review needs to occur. Some states indicate that if the Articles of Incorporation are silent, the shareholders have preemptive rights. Some states indicate that in order for the shareholders to have preemptive rights, the Articles of Incorporation must specifically grant those. In any event, we recommend that the community bank holding company first determine whether preemptive rights exist, and then the board make a decision whether to eliminate preemptive rights. Our experience has been when a community bank does a stock offering, typical buyers are the existing shareholders (in other words, even if preemptive rights do not exist, most boards look to their existing shareholders when they issue new shares). This is on an optional basis, not a mandatory basis, which makes a big difference in connection with the practical issues associated with the offering. In other words, don't gum up the offering with preemptive rights unless you absolutely have to.

STOCK-FOR-STOCK ACQUISITIONS

The general rule is that small community bank acquisitions are typically all cash and that large regional bank acquisitions are generally more stock than cash. We have had a number of inquiries lately from community banks that have (they think) found another community bank shareholder base and board of directors that are willing to take their holding company stock as part of the consideration (i.e., payment) for the merger transaction.

If your community bank holding company finds a seller willing to take your community bank holding company stock, then one issue that is going to come up is what is the tax treatment for the recipient of that stock. The general rule to remember is that in order for the stock to be received on a tax-deferred basis by the selling shareholders in a part-stock transaction, it must represent at least 40% of the purchase price. If it represents 40% or more of the purchase price, then those sellers who receive that stock as part of their payment in exchange for their existing stock get to defer the tax on the stock received from the buyer until they eventually sell the stock received from the buyer.

For example, if the total consideration for a hypothetical $150 million bank is $20 million in part-cash and part-stock, in order for the stock portion to be received by the selling bank shareholders on a tax-deferred basis, at least $8 million of the consideration would have to be stock. So in that example, $8 million in stock and $12 million in cash. Of course, it could be a lot more stock and a lot less cash, but it has to be a minimum of 40% stock in order for those recipients of the stock to get tax-deferred treatment.

The tax issues are the easy ones. Getting the selling community bank to accept your community bank holding company stock is much tougher.

DIRECTOR ACCESS TO CORPORATE RECORDS

Over the past couple of weeks, we have had a couple different clients ask about a director's right to access the corporate shareholder list. In each of these situations, our client indicated they had a director that asked to receive a copy of the shareholder list. In each instance, the president that received the request generally thought the company's past practice was to provide a director the list upon request. They were simply touching base with us to double check that would not create a problem.

Any time a director, or any shareholder for that matter, requests access to any corporate records, including the shareholder list, our recommendation is NOT to follow what is believed to be past practice. Instead, we recommend looking to the corporate statutes for the state in which the holding company is incorporated. Those corporate statutes will have specific provisions that answer the question of whether and how a director or any other shareholder is able to access corporate records. Our advice is to strictly follow the applicable corporate statutes.

Generally speaking, there are two different ways the corporate statutes handle this matter. Some states make no differentiation between a director and other shareholders. In these states, assuming the director is a shareholder, the director is treated the same as any other shareholder and typically has a right to access the corporate records by making a written demand of the corporation for such access. Most of these states say there are certain corporate records which the shareholder has an absolute right, oftentimes including the shareholder list. For other corporate records, the statutes typically require the demand include an explanation of the shareholder's "proper purpose" for the request.

Other states differentiate between directors and shareholders. These states generally provide a director more liberal access to corporate records, and say the director has the right to

access corporate records for any reason reasonably related to their position as a director. This is a little different than the right of access for shareholders, which typically requires the demand be made in writing and state a proper purpose.

If your community bank holding company receives a request from any shareholder, director or otherwise, to access corporate records, keep these statutes in mind. As noted, our recommendation is to strictly follow the applicable corporate statutes in determining when and how access is provided. Although we recognize most directors do not make this request in a threatening manner, failing to strictly follow the statutes could establish a precedent that could ultimately prove problematic as it relates to a future request.

DIRECTOR FINANCIAL STATEMENTS

Following our last *Musings*, we received an email from a *Musings* reader regarding annual financial statements. This email did not address financial statements prepared for the bank. Instead, the email addressed the issue of the FDIC "requesting" community bank directors to provide updated personal financial statements on an annual basis.

The individual that provided this email has previously provided professional assistance to the directors of failed banks. This individual indicated they have seen a number of times where the FDIC has used these financial statements to the individual's detriment. We can absolutely agree with that statement. We have seen a number of times where the FDIC has utilized a director's personal financial statement that was provided on a voluntary basis to the director's detriment.

The question raised by this individual was whether we are aware of any law, rule, statute or regulation that requires bank directors to provide a personal financial statement to the FDIC (or any other regulatory agency) on an annual basis. To our knowledge, the answer is no. We are not aware of any absolute requirement for a director to provide this information to the FDIC.

If your friendly federal or state regulator requests that you provide an updated financial statement due to your position as a director, give consideration to how you are going to respond. The bravest of you may answer by simply saying "no," (with various other descriptors for added color). Those with a little more polite tact may ask why it is that the regulators are requesting the information or the basis upon which it is being requested. However you respond, keep in mind that, to our knowledge (assuming the director does not also have a loan at the bank), the director is not actually required to supply what it is that the regulators are requesting.

ASSET QUALITY

Over the past couple of weeks, we have had a couple different discussions with community banks regarding asset quality issues. What is interesting is that these discussions all seemed to reflect some level of skepticism as to what the future might hold. In each of these discussions, the bankers said their current asset quality is great. They do not see anything in their portfolio that currently gives them any level of concern. However, each of these discussions has adopted generally the same view, which is that asset quality has been too good for too long and at some point the other shoe is going to drop.

These comments have all been made by what we would respectfully call seasoned bankers. These are folks that have been around for a while and have been through a number of different cycles. They have seen great times, tough times, and the transition between the two. They have all simply said they feel like things have been really good for a long time, almost to a point that it is scary. They basically said their experience tells them that at some point banks are going to have to pay the piper in terms of asset quality.

We do not profess to know what the future will hold as it relates to asset quality. Generally speaking, things seem to be going pretty well today. The question is whether that will hold. There are at least a handful of seasoned bankers out there that have some skepticism as to whether that is the case. We hope they are wrong, but we certainly respect their wisdom and insight.

CONCLUSION

It has been an interesting two weeks. A Presidential inauguration, snow in the southern part of the United States, a deep freeze in the northern part, wildfires in the West, and an airline tragedy in the Potomac.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and In-Person Presentations

- February 19, 2025 – Community Bankers Association of Illinois – The “C” Conference – 2025, Crowne Plaza Hotel, Springfield, Illinois (Greyson Tuck, presenter) Registration: The "C" Conference

- February 25, 2025 – Graduate School of Banking-Madison, Wisconsin – Online Seminar, "Strategic Planning in Uncertain Times" (Greyson Tuck, presenter) Registration: Strategic Planning in Uncertain Times

- March 4, 2025 – Graduate School of Banking-Madison, Wisconsin – Online Seminar, "Strategies and Planning for Closely Held and Family Banks" (Philip Smith, presenter) Registration: Closely Held and Family Banks

- March 11-14, 2025 – Independent Community Bankers of America - ICBA LIVE 2025 Convention, Gaylord Opryland Resort and Convention Center, Nashville, Tennessee. "*The Almost Famous Ultimate Community Bank Q&A*" (March 12) (Jeff Gerrish and Philip Smith, presenters) Registration: ICBA LIVE 2025 Convention

- March 11-14, 2025 – Independent Community Bankers of America - ICBA LIVE 2025 Convention, Gaylord Opryland Resort and Convention Center, Nashville, Tennessee. "*Gerrish's Musings LIVE*" (March 13) (Jeff Gerrish and Greyson Tuck, presenters) Registration: ICBA LIVE 2025 Convention

- March 11-14, 2025 – Independent Community Bankers of America - ICBA LIVE 2025 Convention, Gaylord Opryland Resort and Convention Center, Nashville, Tennessee. "Family-Owned Bank Roundtable" (March 13) (Jeff Gerrish, Philip Smith, Greyson Tuck and Doc Bodine, facilitators) Registration: ICBA LIVE 2025 Convention