GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Nebraska, North Dakota, South Dakota, Montana, Oklahoma, Texas, West Virginia, Georgia, and South Carolina!

SHARE REPURCHASE PRIORITY

In a recent strategic planning session we facilitated, we had another iteration of a very common discussion related to stock liquidity. This particular discussion addressed share repurchase priority. In this particular circumstance, the bank has an Employee Stock Ownership Plan ("ESOP"), and the bank is doing pretty well. The holding company stock has been a solid investment, and the ESOP, directors and other shareholders have all expressed interest in acquiring additional shares.

The central point of discussion was the share repurchase priority. In other words, when a block of stock becomes available for purchase, who gets the right for first crack as a buyer? Is it the holding company? The ESOP? The directors? Some other person or entity?

In our view, the answer is, "it depends." If there is a Shareholder Agreement, the provisions of the Shareholder Agreement control. If there is none, it is most likely that none of the entities have any legal right to a priority in the repurchase. It is not really a legal issue as much as it is a reputational and relationship issue.

In some instances, we have seen holding company boards simply address the issue on a case-by-case basis. In other circumstances, we have seen boards establish share repurchase priorities. In some circumstances, the board gives priority to the holding company, with the idea that if the holding company repurchases shares, all of the shareholders benefit in the repurchase. In other circumstances, we have seen the board adopt a policy that basically splits the shares repurchased, in some instances with one-third going to the ESOP, one-third to the directors, and one-third repurchased as treasury shares.

If your holding company is in this situation, keep in mind that it is likely not a legal issue unless you have a Shareholder Agreement. Instead, it is really a reputational and business issue. In our view, the best way to address this is to determine the circumstances under which all shareholders receive the most benefit.

REGULATORY ENFORCEMENT ACTIONS

The last five weeks, as it relates to the federal financial regulatory agencies — the FDIC, the OCC and the Federal Reserve—has been interesting, to say the least. The new administration has hit the ground running. There is no need in *Musings* to recap what is already in the trade press, but we thought it might be significant to give our take on what this really means for bank regulation and enforcement actions.

We believe that in the short term there will be a “regulatory lull.” The regulatory agencies, by direction of the administration, have already begun to reduce their workforce (i.e., eliminate probationary employees). The regulators also, we believe, have received a clear message from the administration that previous overregulation or politically targeted regulation is no longer going to fly.

Does this mean “happy days are here again”? Probably not. Particularly for those banks where the FDIC is the primary federal regulator, we believe FDIC will continue to produce tough exams, enforcement actions, and the like due to the FDIC’s overall mission, notwithstanding whatever the administration says, to protect the insurance fund. The other agencies should have the same mission, but since it is “not their money,” it probably doesn’t matter as much to them.

We anticipate that, overall, things will be slightly lighter, and that new regulations will not be promulgated, at least as quickly as they have been, but that the examination process will continue on unabated, as well the enforcement process for those banks that the friendly federal regulators deem need to have enforcement actions.

As we have often said in *Musings*, the regulators regulate by intimidation because they don’t have much choice. If the bank demands its day in court, then it gets it, and it slows the process tremendously for the bank regulatory agency. Keep in mind, the MOUs, Resolutions, and

Consent Orders are all by consent. If your board decides the bank does not want to consent, then let us negotiate or help the bank get its day in court. Our only other suggestion to boards is to pick your fights because the regulators have long memories, and although some bankers would dispute this with us, most of the regulators are human.

THE IMPORTANCE OF CULTURE

Over the years, our firm has been known for literally and figuratively pounding the table with community bank boards of directors about the importance of enhancing shareholder value. This is generally a financial metric analysis of growth of earnings per share, return on equity, creating liquidity for the shares, and providing shareholders cashflow off the shares. Sometimes, particularly early on in this 35-year discussion, we have ignored the importance of culture. We have recently been reminded by boards and executives of multiple banks that culture trumps strategy any day, and culture often drives the profitability level desired by the board of directors and/or ownership. In other words, the impact of culture cannot be underestimated.

Because of that, the community bank really needs to identify, as best it can, what can best be described as its culture and how to preserve that. This is assuming the bank's strategy is to remain independent over the long term. If the independence strategy doesn't matter, then the culture for the bank will be whatever the acquiror dictates it to be. We have over the last several months been with banks where the culture is totally profitability-driven (i.e., we don't care how you get there, just get there), one of family focus (i.e., we are willing to operate at less than the most highly profitable status in order to make it a nice place to work), or some combination of the two. Whatever the culture is, it needs to be identified and strategies need to be developed to preserve and enhance it in order to keep the bank independent.

STRATEGIC DECISIONS

As most *Musings* readers know, one job of the board of directors is to set the strategic direction for the bank. That strategic direction often involves a discussion of geographic or other expansion. This generally involves branching, loan production offices, acquisition of other banks, acquisition of other lines of business, and the like.

Should strategic decisions also include possible contraction of the bank's footprint? This would involve the sale of branches, the sale of other lines of business, the closing of branches, the closing of LPOs, and possibly the sale of the institution. The answer to that is clearly "yes." We are strong advocates for the long-term independence of community banks, but we believe the independence issue as well as the closing or sale of branches should be addressed on a regular basis.

The large regional banks, based on our observation, close branches if they "lose a penny" more than two quarters in a row. We are certainly not advocating following that model. We do advocate, however, at least determining whether branches are profitable and, whether profitable or not, whether they should remain open. We also understand that even the not profitable branches may need to remain open depending on the overall strategy, culture, and long-term goals of the bank and its ownership. We believe the issue should be evaluated, however. The same goes for any other geographic outpost, LPOs, ITMs, ATMs, and the like. For discussion purposes, we believe all these issues should be on the table. We do not advocate that community banks act like the large regionals in this regard (i.e., shut it down if it's not making a profit), but we do believe the matter should be discussed.

GATHERING DEPOSITS

We have been in several banks lately, both large and small, where notwithstanding the need for deposits to fund the balance sheet, the bank has taken virtually no action to incent or require bank personnel, both retail and lenders, to make efforts to gather those deposits. Our recommendation as a best practice is to not only incent but require, evaluate against, and the like the ability of both retail and the lending side to gather deposits. Some banks are very draconian in this regard and simply refuse to make a loan brought in by a lender unless the lender also brings a deposit. Most have a little more long-term vision than that. Nevertheless, it is going to be important to continue to incent all bank personnel to grow the balance sheet the best way they can with low-cost deposits. This is generally through financial incentives, financial penalties, or an individual evaluation process. Obviously, deposits are simply borrowing money. The bank needs to borrow at the lowest cost, which generally is not wholesale funding from the Federal Home Loan Bank or someplace else. This is generally core deposits, money markets, and the like.

THE WOLF IN SHEEP'S CLOTHING

We were recently asked to review the provisions of a non-solicitation agreement created by a large, non-community bank with respect to the employment of a lower-level commercial lender. The agreement was titled "Non-solicitation Agreement." Based on our review, what we really saw was that the agreement was a wolf in sheep's clothing because it went much further than a traditional non-solicitation agreement and was more akin to a non-competition agreement.

Traditionally, non-solicitation agreements, as the name implies, prohibit individuals from directly soliciting the customers or employees of a bank following their departure of employment from that bank. That makes all the sense in the world. If a bank is going to employ an individual and give them access to customers, we do not see it as unreasonable for the bank to protect its interest by prohibiting a former employee from directly seeking to take its customers or employees after they have left employment.

This non-solicitation did that. It also went further, though, and contained an express prohibition from the former employee accepting the business of any individual with whom they were associated as an employee of the bank. In other words, once they left the employment of the larger bank, they violated the agreement if an individual sought them out and looked to move their business to the former employee, and the former employee accepted the business on behalf of its new employer (i.e., the community bank). That is not a traditional clause in a non-solicitation agreement and goes well beyond what you would typically expect to see. Frankly, it is much more akin to a non-competition agreement than a non-solicitation agreement.

Overall, we do not believe this provision was fair as it relates to this employee. We also did not like the fact that the agreement had a liquidated damages clause that provided that the former employee owed the bank an amount that was approximately 34 times the amount the individual was paid for signing the agreement in the event they breached the agreement. Our overall view was that the agreement was way too much stick and not enough carrot, particularly for a lender that is properly characterized as a small fish in a big, big pond.

RESTRICTIVE STOCK LEGENDS

It is not too uncommon to see a community bank holding company stock certificate with a restrictive legend. As the name implies, the legend notes any type of restriction on the transfer of shares. The most notable types of legends are those that memorialize the shares as restricted securities or subject to the terms of a Shareholder Agreement.

Restricted securities are securities that are issued in an issuance that is exempt from registration with the SEC. Those securities are subject to certain requirements in order to be transferred. Shares that are subject to a Shareholder Agreement are obviously restricted by the terms of a Shareholder Agreement.

If your community bank holding company is issuing shares or is attempting to facilitate the transfer of shares that have a restriction, be sure you understand its importance. The restrictive legend is there for a reason. If a shareholder is attempting to transfer ownership of any shares that have a restrictive legend, the transfer can be deemed null and void and of no force or effect if the transfer is not made in accordance with the restrictive legend and in a manner that allows the restrictive legend to be removed.

WORDS MATTER

If you are a parent, you have probably more than once in your life reminded your children that words matter. In the context of parenting, we are talking about being kind to others with your words. As it turns out, when drafting wills and trusts for estate planning purposes, words also matter.

Over the past couple of years, we have seen a number of different instances where wills and trusts were drafted in a less-than-ideal manner as it relates to the disposition of community bank/holding company stock. In these instances, the drafter of the will or trust was (we assume unintentionally because we assume the best in people) careless with their words. In these situations, the documents referred to and directed the disposition of bank stock, rather than holding company stock. As an example, the will or trust would address the disposition of American Community Bank stock rather than the stock of American Bancshares, Inc.

In drafting wills and trusts, words matter. If you have shareholders that are addressing the disposition of their shares, be sure they are referring to the correct stock. The reference needs to be specific to the holding company stock, rather than the bank stock or some generic description of the bank ownership. If the will or trust is incorrectly drafted, it can unnecessarily create problems with the administration and disposition of the shares.

UPCOMING ICBA LIVE

This will be the last *Musings* to be produced before the upcoming ICBA Convention (ICBA LIVE). ICBA LIVE will take place in the great state of Tennessee at the Opryland Hotel in Nashville on March 11-14, 2025. We look forward to seeing many of you there. Members of the firm will be participating in numerous presentations, roundtables, and the like. Two in particular we would enjoy seeing all of you at is “Gerrish’s *Musings* LIVE” and “The Almost Famous Ultimate Community Bank Q&A.” When you register for the Convention, check the Convention app to find the times and locations for these two (hopefully) entertaining events.

CONCLUSION

For some reason, these past two weeks each of us has traveled to what can best be described as some of the coldest parts of the country. In fact, some of the cold was all time record cold. We enjoy our travels to those places, but we also enjoy returning to more moderate temperatures and less frozen precipitation.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and In-Person Presentations

- March 3, 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

- April 1, 2025 – Community Bankers Association of Illinois – Remaining Independent: Community Bank Directors' Conference, CBAI Headquarters in Springfield, Illinois. (Philip Smith and Greyton Tuck, presenters) Registration: Remaining Independent Conference

- April 16, 2025 – Independent Community Bankers of America – Webinar, "Building a Better Community Bank Board" (Philip Smith, presenter) Registration: Building a Better Community Bank Board

- April 24, 2025 – Independent Community Bankers of America – Webinar, "Family-Owned and Closely-Held Bank Strategies" (Philip Smith, presenter) Registration: Family-Owned and Closely-Held Bank Strategies

