GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from New Mexico, Washington, North Dakota, Illinois, Kentucky, Florida and South Carolina!

THE TIMES THEY ARE A-CHANGIN'

Recently, as some *Musings* readers may have noted in the trade press (not important enough for the real press), the Office of the Comptroller of the Currency that regulates national banks and subsequently the FDIC, which regulates state banks that are not members of the Federal Reserve, both separately determined that examining banks' "reputation risk" was no longer appropriate. As many of you may recall in the past, examining a bank for reputation risk gave the friendly federal regulators a springboard to complain about various activities banks were involved in that, from a political standpoint, the regulators did not want them to pursue.

For this go around, as it relates to national banks, the Acting Comptroller of the Currency, Rodney Hood, indicated in part that this change in policy "makes it clear the OCC has not and does not make business decisions for banks." Really? They may not "make" business decisions for the banks, but they have always strongly influenced the banks' direction. Notwithstanding the change as a result of the current administration and the position of the OCC and the FDIC, we really do not expect this heavy hand to lighten significantly anytime soon.

THE BANK HOLDING COMPANY

It has recently come to our attention that there are still some community banks that are not in a bank holding company structure. Our clear recommendation is that every community bank be in a bank holding company structure. The time to form a bank holding company for your community bank is when you don't need it. If your community bank forms a holding company when you don't need it, then the only approval from the friendly federal regulators that is required for a plain vanilla bank holding company is the Federal Reserve.

If your community bank waits to form a bank holding company until it actually needs it, then that typically means the holding company needs it to redeem shares from a shareholder or a shareholder's estate. Typically, the way the organization would fund that share repurchase is either through an extraordinary dividend from the bank (which the friendly bank regulators will look at) or leverage at the holding company (which the Federal Reserve will look at upon formation). Leveraging a community holding company upon formation does not provide an insurmountable obstacle, but it does add a complication that could easily be avoided if the holding company is formed before your community bank needs it.

Formation of a bank holding company, in most cases, is pretty simple. It involves corporate documentation (i.e., formation of the company and its charter and bylaws), regulatory approval of the formation of the bank holding company (any corporation that controls a bank has to be approved by the Federal Reserve to be a bank holding company), and shareholder approval, which in most cases at the bank level would require two-thirds of the shares. These days, most states provide that shareholders can simply approve an exchange of their bank shares for bank holding company shares so that post-holding company formation they would own the exact same percentage of the holding company as they previously owned of the bank, and the holding company would own 100% of the bank.

The benefits of a community bank holding company are numerous. If any *Musings* readers would like additional information, please let us know.

BRANCH OPPORTUNITIES

It's springtime again, when apparently the large banks' fancy turns to closing branches. Large banks again are on a branch closing spree (and an opening branch spree in growth markets). Closing branches for large banks sometimes provides a good opportunity for community banks to enter markets that the community bank can be very successful in, even though the large bank was not. The only problem, typically, is the large banks market their branches (if they want to do it on

an open bank basis) in a lot. It is possible to put a group of community banks together to bid on one lot of branches, but of course it adds to the complexity of the acquisition. If you have an opportunity to acquire a branch that is open, that simply means that you get the deposits and the relationships. A lot of banks that get rid of branches keep them dark for six months, and it is simply a real estate transaction, not a branch (deposit) acquisition. The geographic expansion and the establishment or acquisition of branches should be on every agenda for long-term planning for every community bank. Opportunities will be presented.

OFFERING WINDOWS

Over the past couple of weeks, we have had a similar discussion with a couple of different clients related to Private Placements of Common Stock. In each of these situations, our client is a bank holding company that is looking to raise additional capital. Each conducted a Private Placement of Common Stock that began in late 2024. Both have been relatively successful, to the point that each offering has been extended to allow time for additional investment.

Based on the circumstances, each of the clients has asked us if it is possible to have what is essentially an ongoing offering of common stock. In other words, the question was whether we could dispense of some specific beginning and end date for the offering and instead just have a perpetual offering where shares could be sold any time an investor may choose to invest.

In short, our response was no, we cannot have an ongoing offering. This response is based on the applicable securities registration exemptions and the related issues of ensuring appropriate disclosure.

Simply put, we do not see a clear path to a perpetually open Private Placement of Common Stock for a non-SEC reporting company. Instead, to ensure adherence to the applicable securities laws, our recommendation is to have a specific offering window, which has a defined opening and closing date where the information provided to potential investors is current within that timeframe.

CONFIDENTIAL INFORMATION

We are currently assisting a number of different clients in M&A transactions. Each of these transactions are at a different stage. Some are post contract, meaning that we actually have the Agreement and Plan of Merger signed and the deal publicly announced. Others are at an earlier stage, where we are either trying to bring them together or are in due diligence following agreement on the general terms of a transaction. One of the questions that often arises in M&A transactions,

particularly for the target bank, is what confidential information is to be provided to the potential acquirer, and when?

At the beginning of a potential transaction, it is typical for each of the parties to sign a Confidentiality Agreement, which is ongoing and covers the exchange of confidential information throughout the process. That said, just because a Confidentiality Agreement has been executed, we recommend the seller to not completely show all of their confidential information right away. Our recommendation is that it is more of a gradual process.

At the onset, where we are trying to bring a deal together, we recommend our clients not to overshare confidential information. At this point in the process, the potential acquirer does not need to know everything about the potential target, particularly as it relates to specific customer identities and terms. That comes later in the process.

As the transaction unfolds, the more sensitive confidential information is typically "rolled out" to the potential acquirer. Following the execution of the transaction agreement, there are generally no secrets. At that point, everything is fair game, and the potential acquirer usually has unfettered access to the target's confidential information.

If you are thinking about being involved in the M&A game, keep these issues in mind, particularly if you are the target. It is important to take a measured approach to rolling out your sensitive confidential information. As the deal progresses, so too does the level of detail and disclosure that is provided.

TOO MUCH TO OVERCOME

Speaking of M&A, we recently had a deal that we thought would come together but ultimately did not. In this transaction, the seller was a small community bank with limited resources. We represented the buyer and worked our way through the process, getting as far as having what was essentially a fully agreed upon agreement, disclosure schedules, and the like. It was very close to coming together.

Throughout the process, multiple different issues came up. In the end, the deal ultimately did not come together. It was not one of the issues in particular that stood in the way of the deal. Instead, it was the aggregate of all the issues. In other words, it was not one big thing that was insurmountable but the combination of a number of small things.

We have previously relayed in *Musings* that the current environment is a tough one in which to ultimately bring deals together. We continue to see that as the case. Between transaction timelines, acquisition accounting requirements, costs of capital, contract termination fees, and

potential asset quality concerns, the stars really have to align to be able to bring a deal from conception to completion in today's environment.

STOCK REDEMPTION CONSIDERATIONS

Many community bank holding companies serve as the primary source of liquidity for their holding company common stock. This makes sense because there is a limited trading market for most holding companies, and, more importantly, a share repurchase transaction has a number of benefits. For those holding companies that act as a primary source of liquidity by repurchasing their shares, one of the issues that should be considered is the taxation of the transaction to the selling shareholder. Of course, that is an individual tax issue and not a corporate tax issue, but it still is relevant to the overall transaction.

Generally speaking, the repurchase of shares is treated as either a redemption or a dividend. The selling shareholder typically prefers the transaction to be taxed as a redemption because that has favorable tax treatment when compared to taxation as a dividend. Generally, a redemption taxes only the taxable gain, which is the consideration received by the selling shareholder minus their basis in the stock. This is distinct from taxation as a dividend, which taxes the entirety of the amount received.

The Internal Revenue Code has specific rules on when a transaction is accounted for as a redemption as opposed to a dividend. A selling shareholder must be able to meet one of four tests in order for the transaction to be accounted for as a redemption. If one of the four tests cannot be met, the transaction is properly accounted for as a dividend.

We have a Memo to Clients & Friends that addresses the taxation of these transactions. Please let us know if you would like a copy.

MUTUAL CAPITAL STRATEGIES

Mutual community banks are like stock community banks with one notable exception: mutual banks do not have shareholders. Instead, mutual banks are "owned" by their mutual members, who generally are the mutual depositors and borrowers. Because of this structure, mutuals have a limited ability to raise additional capital, should that be desired for any reason.

One opportunity for mutuals to raise capital is through the use of mutual capital certificates. These are somewhat akin to subordinated debentures. In our view, we see it as somewhat of a quasi-debt and equity instrument that can be issued by the mutual and, if certain requirements are met, be counted as capital.

Mutual capital certificates are not the only capital raising option for mutuals. They can reorganize into a mutual holding company structure and borrow funds at the holding company level to create capital at the bank, similar to all other bank holding companies. Mutuals can also engage in a "step-and-a-half" or "second step" conversion and convert from a mutual to a stock bank and then sell stock to increase bank capital.

We have a research memo that addresses the unique issues related to mutual community banks. If any of you are interested, please let us know, and we will be happy to send it your way.

UNCERTAINTY

In previous *Musings* we have noted the uncertainty and turmoil resulting from some of the quick executive actions that the current administration has taken, particularly as it relates to the banking arena and the CFPB. That uncertainty has not been abated. It has been replaced, for the most part, not with executive actions, but with court litigation. From a community bank standpoint, we believe the overall direction of the changes being proposed (and challenged in court) are positive. We believe it will end up in reduced regulatory burden and the like. Also, the fact that the current administration has nominated a former community banker/bank commissioner as Vice Chairman of Supervision for the Federal Reserve is an excellent sign. We will comment in *Musings* as we see appropriate changes being solidified moving forward, but overall we view it as a positive.

CONCLUSION

The first quarter of 2025 has simply flown by. We have enjoyed seeing many of you at your banks and at meetings across the country. We look forward to seeing more of you as the weather continues to moderate.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and In-Person Presentations

- 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: ICBA Webinar - Building a Better Community Bank Board

- April 14-17, 2025 – Barret School of Banking, Barret Executive Leadership Academy (In-Person Event) (April 17) (Doc Bodine, Instructor) Registration: Barret Executive Leadership Academy

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

- April 28-30, 2025 – Tennessee Bankers Association, Leadership Convention at The Peabody Memphis "Current State of Community Banking" (In-Person Event) (April 29) (Greyson Tuck, Presenter) Registration: Tennessee Bankers Association Leadership Convention

- May 19-22, 2025 - Independent Community Bankers of America, Credit Analyst Institute at the Embassy Suites Minneapolis Airport (In-Person Event) (May 20) (Doc Bodine, III, Instructor) Registration: ICBA Credit Analyst Institute - May - Bloomington MN

- May 22, 2025 – Barret School of Banking, "Bank Management: A How-To Guide" (Class) (Doc Bodine, III, Instructor) Registration: Barret School of Banking - Bank Management Class

- May 27 - June 6, 2025 - Southwestern Graduate School of Banking Foundation, Dallas Texas. "Enhancing Shareholder Value With or Without a Sale" (June 2-4) (Philip K. Smith, Instructor) Registration: SWGSB