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# GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Illinois, Kansas, Alabama, Tennessee, Washington, and Oregon!

## CAPITAL ALLOCATION

We have recently had the opportunity to meet with boards of several community banks in different parts of the country discussing big picture, long-term planning. In a nutshell, from the financial side, long-term planning involves how best to allocate capital to enhance the value for the holding company's shareholders and other stakeholders. We only have a couple of clients around the country who appear to have access to unlimited amounts of capital. The rest of our community bank clients have some limitations on the amount of capital that they can obtain. The first step in an allocation of capital exercise is to determine how much capital is available for your bank holding company. This generally involves how much excess capital is available at the bank (that particular number, while influenced by regulatory standards, is really in the eye of the beholder – i.e., the Board of Directors) and how much cash can be generated in other ways at the bank holding company. If the consolidated organization is under \$3 billion, this could be leverage from an institutional lender or a personal lender, equity purchases by the Board, the ability to sell equity outside the organization, and the like. When the holding company is under \$3 billion in consolidated assets, the real question is how do you generate cash at the holding company? Over

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\$3 billion, then the organization is subject to consolidated capital rules and the issues become a little more complicated.

From a capital allocation standpoint, once the maximum amount of available capital is determined, then the question is how is it best to allocate it. Many community banks we work with across the country put that capital allocation into three general buckets: 1) acquire another bank or other line of business, 2) acquire our own holding company shares, or 3) downstream the available capital into the bank to otherwise grow the bank organically.

The problem with the capital allocation issues and the limited amount of capital that most community banks have is that capital allocation is a zero sum game. If your holding company wants to buy another bank, then it is going to be limited as to how much of the bank holding company's own stock it can buy. If the holding company wants the bank to grow organically at 10% or 20%, then the holding company will be limited in what else it can do because it is using the capital to support the growth.

An analysis of capital allocation, however, is the place to start.

### CASH FLOW TO YOUR SHAREHOLDERS

We often get asked by community banks how important we think cash flow is to the shareholders. In other words, if your holding company is a C corporation, does it put a dividend into the shareholders' hands for which they pay their tax and move on? If your holding company is in an S corporation, does it put a distribution into the shareholders' hands from which they pay their required tax, and then have some type of dividend equivalent left over?

Our general response to these issues is, "How important is the dividend to the shareholders?" In a C corporation, the dividend is probably not terribly important to the shareholders unless the holding company has already started paying one. In an S corporation, the distribution is critical, at least to cover the taxes the shareholders must pay. Beyond that, it is another question of capital allocation (as noted above) for the holding company.

When we note that in a C corporation the payment of a dividend is not important unless your holding company has already started paying one, we still have a number of clients who have been formed within the last 15 years who have not begun to pay a dividend yet because they have plowed all the available capital into the growth of the bank. There is nothing wrong with that. We generally caution clients that once your holding company starts paying a dividend, it is very difficult to take it away. It becomes addictive to the shareholders. Our general recommendation

(and the general philosophy of most community bank holding companies that are paying dividends) is that the dividend should incrementally increase on an annual basis in dollar amount, generally not be tied to a percentage of earnings because it would vary too much, and continue to be paid unless there is a financial meltdown or the regulators simply tell you you can't. That seems to be the best way to keep your shareholders content.

### FDIC APPEALS PROCEDURE

For the majority of the community banks, their primary friendly federal regulator is the Federal Deposit Insurance Corporation. As we were recently reminded, FDIC stands for “Forever Demanding Increased Capital.” The current environment creates no exceptions to that historical definition.

As we have noted previously in *Musings*, the FDIC does have an appeals procedure for banks that may disagree with the results of an FDIC examination. With the increase in scrutiny on community banks due in large part to asset quality issues, either real or perceived, we have received a number of questions of late regarding the FDIC's appeals procedure. As we have noted previously, the FDIC's appeals procedure historically can best be considered a “kangaroo court.” Basically, when the community bank appeals, it is appealing to those who made the decision or those who employ the decision makers up the authority chain at the FDIC. For a short period of time when Jelena McWilliams was Chairman of the FDIC, she sought to and did establish an independent appeals process that involved the use of independent, but experienced, individuals to review appeals from FDIC insured banks. When Chairman McWilliams was effectively ousted from her FDIC Chairmanship, her independent appeals process was disbanded shortly thereafter, and the previous kangaroo court process, which is the current process, was reinstated. We have in the past (particularly during the last Great Recession) handled a number of appeals for community banks to the FDIC. Due to the nature of the process (i.e., not objective and with the decision makers reviewing the work of their employees who they generally support), with one small exception, the process was generally unsuccessful.

Recently, we have been asked by a number of community banks who have had adverse exams or parts of exams whether an appeal would make sense. Under the appellate guidelines, any “material supervisory determination” can be appealed. This can be a CAMELS rating, a component rating, a large loan classification, an alleged violation of the law, and a number of other areas. We generally advise clients that although it is often fun and satisfying to stand up to the

regulators, it is generally an expense that is non-productive. In other words, if the system is set up so that the community bank can't win, then why bother with the appeal? We are all about holding the regulators accountable when there is an opportunity to do so. If your community bank really wants to challenge the regulators, then have the Board refuse to consent to a proposed consent order and give the bank its day in administrative court. At least that is halfway objective. (The "halfway" comes from the fact that any decision of the administrative law judge is appealed to the FDIC Board, who is the final arbiter.)

### CONSENT AGENDAS

We have a number of clients that utilize Consent Agendas. In our experience, approval of the Consent Agenda is typically the first agenda item in the meeting of the Board of Directors. Approval of the Consent Agenda typically approves the routine and mundane items with one approval, rather than with separate approvals for each item. The items typically included on the Consent Agenda are: minutes of the last board meeting; committee meeting minutes; financial statements; reaffirmations or changes to policies; executive reports; and board appointments.

The rule for a Consent Agenda is that any Director has the ability to pull anything off the Consent Agenda at any time. If that happens, the item moves to specific discussion and is reviewed by the Board on a separate basis.

The goal of using a Consent Agenda, as noted, is to improve meeting efficiency and free up time to allow the Board to consider "forward looking" strategic matters. It allows routine and mundane items to be approved with one vote (to approve the Consent Agenda as presented) rather than going through a separate approval for each individual item.

### THE FINAL MEETING

This past week, we attended one of our client's monthly board meetings that was held in advance of the annual meeting. It was a pretty routine board meeting, with the exception of the last couple of minutes. At the end of the meeting, the President and CEO took a minute to recognize it was the last Board meeting for one of the Directors that has been on the Board for almost three decades, since the Bank's inception. This particular Director was aging out due to mandatory Director retirement and would not serve as a Director past the annual meeting.

Following the President's mention, the Director was asked if he had any comments. He thought for a second, and then gave an impromptu speech about his 30 or so years on the Board,

since the Bank's inception. The Director reflected on the years where the Bank did great, earning record profits, and years where the Bank experienced some real challenges. The Director also reflected on the important work of the Bank in the community, the value of the friendships and personal relationships, and the overall joy the individual's time on the Board provided them personally.

This is not the first time we have heard a speech such as this, and we anticipate will not be the last. What we see as notable is that speeches like this happen in community bank boardrooms all over the country with a good amount of frequency. We have said many times before that we believe community bankers are, on the whole, salt of the earth type people. This individual speech only reinforced that belief.

### DIRECTOR DUTIES IN THE M&A CONTEXT

As we have often noted in *Musings*, there is a fair amount of current activity among community banks with respect to the significant issues of whether to buy, sell, merge, or remain independent. For many boards, it is the first time that they have faced any of these types of issues (i.e., either buying another bank or selling their own). Directors' duties and responsibilities in an acquisition context are subject to "higher scrutiny" and are well beyond the scope of *Musings*; however, these guidelines generally include duties owed to the bank holding company and the stockholders, including the duty of care, duty of loyalty, duty of good faith, duty of confidentiality, and the duty to disclose, as appropriate. Keep in mind that the directors, whatever decision they make, are protected by the Business Judgment Rule, provided they make the decision using an appropriate process, acting in good faith, and without a disabling conflict. Directors are not guarantors of the corporation in an M&A context. Community bank directors do have the right to be wrong. If your community bank is getting into the acquisition arena, please make sure the Board fully understands its duties and responsibilities.

### A COMMENT ON CRYPTOCURRENCY

About a week ago, the FDIC and Federal Reserve announced the withdrawal of two prior Joint Statements regarding banking organization's crypto asset-related activities. According to the agencies' Press Release, the withdrawal of these two previous statements is to clarify that banking organizations may engage in permissible crypto-related activities and provide products and

services to individuals and business entities engaged in those activities, consistent with safety and soundness and applicable laws and regulations.

The vast majority of community banks across the country are rejoicing at the withdrawal of these two Joint Statements! If you believe that, please feel free to email us for a great opportunity to purchase oceanfront property in Arizona!

Kidding aside, the recent announcement on cryptocurrencies has almost zero impact on community banks. Why? Our view is because the vast majority of community banks across the country appear to have zero interest in engaging in any crypto-related activities. From the multiple discussions we have had on crypto at strategic planning sessions around the country, we do not recall one traditional community bank that has any interest in loaning against cryptocurrency, taking cryptocurrency as collateral, holding cryptocurrency for the benefit of customers, or otherwise being involved in it. About the most community banks are willing to do is debate whether crypto is modern day snake oil or a new, legitimate player in the financial services system.

We are not aware of any community banks around the country that are interacting with crypto in any meaningful way. We do not think the withdrawal of the previous regulatory statements on crypto activities is going to change that. Frankly, we believe community banks will be some of the last to come to the crypto party, if they show up at all.

### EDGAR CHANGES

Most community bank holding companies are not SEC-reporting. However, many community bank holding companies file notices of exempt securities offerings, typically by filing a Form D, with the SEC. Currently, this is completed through EDGAR, which is the SEC's online reporting system for notices of exempt offerings. A holding company that issues securities in an exempt offering would have a CIK, passphrase, and other log-on credentials to file the Form D through EDGAR.

Not long ago, the SEC's new EDGAR platform, which is known as *EDGAR Next*, came online. The SEC has recommended any EDGAR filers that may file anything with the SEC in the future "rollover" into the new EDGAR system during an open enrollment window because the process will be simpler and less expensive. If a company does not rollover within the open enrollment window, the company will have to reapply for EDGAR access from scratch, which is slower, more complicated, and more expensive.

If your holding company has previously filed anything through EDGAR and you anticipate you may do so in the future, it probably makes sense for you to go through the transition process during the open enrollment window. Please let us know if you would like our assistance in the process. We are happy to help.

(Please also let us know if you would like to have a discussion about the absurdity of the SEC introducing a new EDGAR filing system where not all of the prior EDGAR filers are rolled into the new system! We are kidding, kind of.)

## CONCLUSION

With the beginning of May, we are looking forward to seeing many of you at your banks, your state conventions, or even some of you younger officers at banking schools. Until then, enjoy the spring conditions in most parts of the country.

Stay safe. See you in two weeks.

*Jeff Gerrish*

*Philip Smith*

*Greyson Tuck*

## Upcoming Webinars and In-Person Presentations

- 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 18-23, 2025 – Barret School of Banking, “The Business of Banking” (Class) (May 19) (Greyson Tuck, Instructor) Registration: [Barret School of Banking - Bank Management Class](#)
- May 18-23, 2025 – Barret School of Banking, “Bank Management: A How-To Guide” (Class) (May 22) (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](#)

- June 1-6, 2025 - Independent Community Bankers of America, Commercial Lending Institute at the Embassy Suites Grapevine, Texas (In-Person Event) (June 5) (Doc Bodine, Instructor) Registration: [ICBA Commercial Lending Institute - June - Dallas TX](#)
- June 3, 2025 - Independent Community Bankers of America – (Webinar) “Ensuring Your Next Strategic Planning Session is Not B.S. (Boring Stuff)” (Greyson Tuck, Presenter) Registration: [ICBA Webinar - Ensuring Your Next Strategic Planning Session is Not BS.\(boring-stuff\)](#)
- June 5, 2025 - Independent Community Bankers of America, Bank Director Forum-Session 2, “Keys to Being a Great Outside Bank Director” (Livestreamed Event) (Greyson Tuck, Instructor) Registration: [ICBA Bank Director Forum - Session 2 - June - Livestreamed](#)
- June 8-10, 2025 – Tennessee Bankers Association Annual Meeting at the JW Marriott, Marco Island, Florida (In-Person Event) “10 ‘Impossible’ Things Directors Must Do” (June 9) (Philip K. Smith, Presenter) Registration: [Tennessee Bankers Association Annual Meeting](#)
- July 7-9, 2025 – Community Bankers Association of Kansas, 2025 Annual Convention & Trade Show at the Kansas City, Missouri Marriott Downtown (In-Person Event) (July 8) (Philip K. Smith, Presenter) Registration: [Not yet available.](#)
- July 13-25, 2025 – Graduate School of Banking at Colorado, Class: “Enhancing Shareholder Value” (July 14-18) (Greyson Tuck, Instructor) Registration: [Graduate School of Banking at Colorado](#)
- July 27 – August 8, 2025 - Graduate School of Banking at the University of Wisconsin-Madison. “Enhancing Shareholder Value With or Without a Sale” (July 28-29) (Philip K. Smith, Instructor) Registration: [GSB-Wisconsin](#)
- July 31-August 1, 2025 - Independent Community Bankers of America, Enhancing Organizational Value Conference at The Westin Edina, Minnesota Galleria (In-Person Event) (Philip Smith and Greyson Tuck, Presenters) Registration: [ICBA Enhancing Organizational Value Conference - July - Edina MN](#)