GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Mississippi, Wisconsin, Minnesota, Colorado, Nevada, Washington, California, and Arizona!

A PERSONAL NOTE FROM PHILIP SMITH

I wanted to take a moment to extend a personal thank you to our many wonderful clients and friends around the country who took the time to write me or my family a personal note, to say a kind word when we met in person, or for just including us in your thoughts and prayers, as we dealt with the tragic murder of my youngest son on September 1, 2023, and the resulting aftermath. As recently reported in *Musings*, we are happy to now have the sentencing behind us without the need for a trial and without the possibility of any appeal, as we look forward to better and brighter days ahead. The road we traveled would have been much more difficult without your support, and we will be eternally grateful for all the love and kindness extended to us.

THE RATIONAL REGULATOR

Every now and then we chastise the regulators for what we see as an inappropriate regulatory stance on a current issue. We figure if we are willing to oblige and call the regulators to the mat when we think it appropriate, we also ought to give regulatory credit where it is due. In that regard, we recently had a discussion with what we consider the "rational regulator." What is

the rational regulator? It is a regulator that takes a rational stance on a given set of circumstances and works to put a bank and holding company in the best position possible rather than having to cut through the maximum amount of regulatory red tape.

Our recent interaction with a rational regulator related to a bank's repossession of an asset. In short, the bank is taking back an ownership interest in an LLC. The bank's state regulators began down a trail of thinking that the LLC was going to be an operating subsidiary of the bank, there needed to be regulatory applications, and things like that. The federal regulator took a different view. The federal regulator recognized the asset as a repossessed asset rather than a corporate entity through which the bank would be conducting corporate activities. Their comment was that they were going to do everything they could to make sure the State saw that as well so that we did not start down a path of thinking some type of regulatory application was required.

As noted, we are more than happy to give regulatory credit where we think it is due. We certainly are happy to pass along stories about interactions with rational regulators.

DISSOLUTION OF THE HOLDING COMPANY?

Another approximately $100 billion total asset bank and holding company has determined it is in the best interest of the organization to dissolve its bank holding company (apparently, they believe, a cost saving measure). As a result of that, we received numerous emails over the last few days from community bankers as to whether we believe it appropriate for their organizations to dissolve their holding companies. (Many of these holding companies we formed for these community banks over the years.) Our uniform response is that for a community bank, particularly a "small" community bank (consolidated assets under $3 billion) subject to the Federal Reserve Small Bank Holding Company rules, a holding company is essential. We anticipate based on what is currently being discussed in Congress that the asset size for a small bank holding company will likely move to at least the $10 billion range.

As we have often noted in *Musings*, the biggest benefit in a nutshell to a community bank holding company is the fact that the holding company and bank are not tested for capital purposes on a consolidated basis. Sure, the bank still has a capital requirement and has to be at a minimum leverage ratio, etc. The holding company, however, has no capital test. This allows the holding company, under the current Fed rules, to leverage significantly. As we have often put in *Musings*, the real issue for a community bank holding company (under $3 billion) is the ability from any source to raise cash at the holding company. That cash could then be downstreamed to the bank

as capital or used to repurchase shares or acquire other business entities, including other banks. Our advice – just because something works for a large bank, doesn't mean it makes sense for a community bank holding company. In this case, certainly do not dissolve your holding company. Those *Musings* readers who do not have holding companies, you should. Please let us know how we can assist.

DISPARATE IMPACT

For those community banks who have been on the "wrong end" of a fair lending exam, your Board is probably all too familiar with the concept of disparate impact. Disparate impact involves a situation where the bank's policies and procedures on their face are fair and do not discriminate against any protected class, but, through no fault of the bank, there is a disparate impact upon a protected class. Hence (historically), a fair lending claim.

President Trump last spring signed an executive order directing the elimination of the use of disparate impact liability. The OCC, the primary regulator for national banks, has followed suit, and we anticipate the FDIC and Federal Reserve will follow along in the not-too-distant future. Bank regulators, of course, will still criticize the bank and bring fair lending claims for disparate treatment, just not disparate impact.

We have always felt that disparate impact claims in fair lending matters were, at best, "unfair." We are glad to see the change. If anyone would like a copy of the OCC's press release, please let us know.

IS NO AMOUNT TOO SMALL?

As we have noted in *Musings* previously, on the fourth Friday of each month the FDIC (which regulates the majority of community banks) releases its enforcement actions for the previous month. This includes Cease and Desist Orders, Orders Voluntarily Terminating Deposit Insurance (almost always as a result of a merger), Orders for Civil Money Penalties (the most typical is for flood insurance violations), and Removal actions. The Removal actions are always of interest because they deal with individual bank officers and directors (institution affiliated parties) who have done something so egregious that the FDIC believes they should be banned from banking for life.

The most recent release of FDIC enforcement actions included an action against an employee of Truist Bank. This individual employee apparently obtained several loans from the

SBA during the pandemic that were based on false financial information or dummy corporations that, as a practical matter, did not exist. The SBA caught the individual and advised the bank regulatory authorities, and the bank regulatory authorities are in the process of tossing him out of banking (subject to his rights to a hearing).

What surprised us about this particular matter was the dollar amounts involved. One of the loans was $15,000. The other loan was $35,000. We give kudos to the SBA and the bank regulators for diving this deep, but we are also a little bit surprised. We anticipate that this is a situation where the bank itself (Truist) filed a Suspicious Activity Report, which triggered the regulator's review. It does make for interesting reading, however.

THE OLD GUARD

We recently had an interesting discussion regarding the "Old Guard." When we reference the Old Guard, what we are talking about is the previous generation of holding company and bank directors and executive officers. The discussion was held in light of what the Old Guard previously did, particularly as it relates to corporate documentation, and how that affected certain situations primarily at the holding company level today. For example, the Old Guard had previously put in place a Shareholder Agreement, certain side agreements to supplement or amend the Shareholder Agreement, and similar documentation. There were also certain provisions in certain shareholders' Wills that affected the holding company stock.

The discussion related to the Old Guard was primarily related to the "New Guard" trying to unravel and understand what had previously been done. In other words, it was the next generation of this community bank's leadership trying to understand the Shareholder Agreement, addendums to the Shareholder Agreement, and related issues, to ensure all of the stock was appropriately treated in light of certain circumstances which may arise in the future.

As you might imagine, the New Guard's job was not viewed as particularly easy. It is often a difficult task to go back and try to piece together what has been done over a number of decades in order to fully understand what may or may not need to happen given a certain set of circumstances.

This is not an issue of "first impression" for us. In fact, we have seen it a number of times. It is not all that uncommon for a holding company to have multiple different documents that either actually or purport to effect interests in the holding company shares. The challenge for the New

Guard is trying to separate the wheat from the chaff and understand what is the proper treatment for the stock given a specific set of circumstances.

TRANSACTION EXCHANGE RATIOS

We recently received a question from a client regarding transaction exchange ratios. Simply put, the client asked how the exchange ratio in a community bank stock-for-stock merger transaction is established. In a stock-for-stock transaction, the exchange ratio is typically determined utilizing a Contribution Analysis. In summary, this analysis evaluates each of the separate organization's contributions to the combined organization's earnings, equity, and assets. Typically, earnings are weighted at 50%, equity at 40%, and assets at 10% based on their relative importance.

The Contribution Analysis shows how much of the combined organization's stock each of the respective shareholder groups should own. For example, a Contribution Analysis may demonstrate that the acquiror's shareholders should own 80% of the shares and the target shareholders should own 20% of the shares. It then becomes math to determine how many acquirer shares need to be issued to the target shareholders to provide the 80/20 split post-transaction. The number of shares to be issued is then compared to the number of target shares outstanding to determine the transaction exchange ratio, which is how many acquirer shares a target shareholder will receive for one share of target common stock.

SHAREHOLDER VOTING

We recently received a question from a community bank director that we anticipate other directors around the country may be considering. The question is simply this: How does shareholder voting work? In other words, do shareholders get one vote per shareholder, or do shareholders get one vote per share? Put another way, if a majority approval is required for a specific transaction, is the required approval a majority of the number of shareholders, or is a majority of the shares outstanding?

Voting in the U.S.A. is on a one-person/one-vote basis. Voting in corporations is not. Instead, shareholder voting is based on the number of shares outstanding. It is correct that each share has its own vote. It is not correct that each shareholder has their own individual vote.

For example, let's suppose we have a holding company that has 10 shareholders with 100 shares outstanding. One shareholder owns 80 shares. The other nine shareholders collectively

own 20 shares. If a transaction is put to a vote that requires majority approval, the way the individual owning 80 shares votes will ultimately control the transaction. That individual could vote in favor of the transaction, with the other nine individuals voting against, and the transaction would be approved.

Unlike our democratic electoral system, corporate shareholder votes are based on the number of shares owned by an individual and total shares outstanding, not the actual number of shareholders.

CONCLUSION

As we travel the country, we are certainly experiencing all it has to offer, including torrential rains and blistering heat. We anticipate all this will lift soon.

Stay safe. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and In-Person Presentations

- July 31-August 1, 2025 - Independent Community Bankers of America, Enhancing Organizational Value Conference at The Westin Edina, Minnesota Galleria (Philip Smith and Greyson Tuck, Presenters) Registration: ICBA Enhancing Organizational Value Conference - July - Edina MN

- August 12, 2025 - Independent Community Bankers of America – (Webinar) "Keys to Being a Great Outside Bank Director" (Greyson Tuck, Presenter) Registration: ICBA Webinar - Keys to Being a Great Outside Bank Director

- August 12, 2025 – Community Bankers of Washington, Northwest Virtual Conference Series "Creating Value in an M&A Environment" (Philip Smith, Presenter) Registration: Community Bankers of Washington Northwest Virtual Conference

- August 12-14, 2025 - Independent Community Bankers of America, Credit Analyst Institute (Livestreamed Event) (August 13) (Doc Bodine, III, Instructor) Registration: ICBA Credit Analyst Institute - August Livestreamed

- August 17-29, 2025 - Pacific Coast Banking School. "The Board, Shareholder, and M&A: Legal and Practical Concerns" (August 18-22) (Philip Smith, Instructor) Pacific Coast Banking School

- September 7-9, 2025 – Indiana Bankers Association, 2025 Annual Convention & Expo at the French Lick Springs Resort in French Lick, Indiana. "Staying Rooted: Strategies for

Independent Bank Success" (Sept. 8) (Philip Smith, Presenter) Registration: IBA Annual Convention

- September 10-12, 2025 – Community Bankers Association of Oklahoma, 2025 CBAO Annual Convention at the Skirvin Hilton Hotel in Oklahoma City, Oklahoma. "Remaining Independent When No One Else Is" (Sept. 11, 2025) (Philip Smith, Presenter) and "Five Impossible Things Directors Must Do" (Sept. 12, 2025) (Philip Smith, Presenter) Registration: CBA of Oklahoma Annual Convention

- September 10-14, 2025 – Community Bankers Association of Georgia, CONNECT 2025 at the Ritz-Carlton in Amelia Island, Florida. "Critical Information for Community Bank Executives" (Sept. 13) (Jeff Gerrish, Presenter) Registration: CBA of Georgia CONNECT 2025

- September 16-19, 2025 – Community Bankers of Washington, 2025 CBW Annual Membership Convention and Trade Show at The Historic Davenport Hotel, Spokane, Washington "Independence, Directors & Shareholders: Everything You Need To Know!" (Sept. 18) (Philip Smith, Presenter) Registration: CBW Annual Convention

- September 18-20, 2025 – Community Bankers Association of Illinois, 51st Annual Convention & Expo at the Kansas City Marriott Downtown, Kansas City, Missouri "Ten "Impossible Things Directors Must Do" (Sept. 19) (Philip Smith, Presenter) Registration: CBAI Annual Convention

- September 24-26, 2025 – Community Bankers of West Virginia, CEO/Directors Conference at the Stonewall Resort in Roanoke, West Virginia. (Sept. 25) (Philip Smith, Presenter) Registration:

- October 16, 2025 – Graduate School of Banking-Madison, 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

- October 20-22, 2025 - Southwestern Graduate School of Banking at Southern Methodist University, National Certified Community Bank Directors' (NCCBD) Program. "Role of a Bank Director" and "Corporate Governance & Fiduciary Responsibilities." (Oct. 20) (Philip Smith, Presenter) Registration: National Certified Community Bank Directors Program

- October 26-28, 2025 – Western States Director Education Foundation 48th Annual Symposium for Community Bank Directors at The Grand Hyatt Scottsdale Resort, Scottsdale, Arizona. "What is the Next Chapter for Your Bank?" (Oct. 27) (Philip Smith, Presenter) Registration: WSDEF Annual Symposium for Community Bank Directors

- November 13, 2025 - Independent Community Bankers of America – (Webinar) "Preparing Today for Community Bank Leadership Tomorrow" (Greyson Tuck, Presenter) Registration: ICBA Webinar - Preparing Today for Community Bank Leadership Tomorrow