

UPDATE

News of Developments in the Financial Sector and Related Areas

* *IN THIS ISSUE* *

Factoring of Accounts

State Regulation of National Banks

Trust Preferred Securities

-

Factoring of Accounts

In *Carter v. Four Seasons Funding Corporation*, 2003 Ark. Lexis 69 (2003), the Arkansas Supreme Court held that the sale of accounts receivable at a discount were not loans. Carter was the sole shareholder of Commerce Alliance which contracted with customers to assist them in making bids to federal government agencies for the purchase of certain supplies. Under the Commerce Alliance contract, customers assigned their rights in the government purchase orders to Commerce Alliance. Upon receiving notification of the delivery of supplies to the government agencies, Commerce Alliance issued an invoice to the government agency, instructing it to remit payment to Commerce Alliance or its agent. Commerce Alliance kept a percentage of the profit on each invoice, paid any balance to the supplier, and paid the rest to its customer. Four Seasons agreed to purchase these accounts receivables from Commerce Alliance. Under the purchase agreement with Four Seasons, Commerce Alliance assigned all of its rights, title and interest in the accounts receivable to Four Seasons. Commerce Alliance was paid the face value of the accounts receivable minus a discount of three percent with the discount

increasing by three percent every subsequent fifteen-day period. In the event that an account receivable turned out to be uncollectible within ninety days for any reason except for bankruptcy, Four Seasons had the right to collect the monies from the reserve of proceeds from other factored accounts from Commerce Alliance with Carter having guaranteed all the obligations of Commerce Alliance under the purchase agreement. Carter and Commerce Alliance argued that the transactions were loans and subject to the Arkansas usury law, while at the same time, Four Seasons argued that the transactions involved the purchase of accounts receivables both on its books and in its tax returns. The Court noted that Carter and Commerce Alliance had the burden of showing by clear and convincing evidence that the transactions were loans and subject to the Arkansas usury law. The Court then analyzed the facts in the case to determine if there was clear and convincing evidence that the transactions were loans. The Court concluded that the purchase agreement was between sophisticated parties and the terms of the agreement expressly contemplated the sale of accounts receivable at a discount. Caution: This case may only be applicable in the factoring of accounts receivable transactions involving sophisticated parties.

State Regulation of National Banks

Recently, the Office of the Comptroller of the Currency ("OCC") issued Advisory Letter AL 2002-9 in which the OCC described its statutory authority to regulate national banks. The Advisory Letter advises national banks to consult with the OCC in the event a state authority seeks the enforcement of state laws over a national bank. The Advisory Letter also urges state governmental officials to

contact the OCC in the event a national bank may be violating applicable state law or if the state authority seeks information concerning a national bank's operations. The Advisory Letter indicates that the OCC has exclusive authority over national banks. In a recent letter to the California Department of Corporations, the OCC asked the Department to cease its examination of Wells Fargo Home Mortgage, Inc., a subsidiary of Wells Fargo Bank, N.A. In another letter sent to Bank of America, N.A., the OCC advised that the California Department of Corporations had no authority to examine B.A.Mortgage LLC, a subsidiary of Bank of America and the subsidiary did not need a license to conduct business in California.

Trust Preferred Securities

In Interpretive Letter No. 908, the Office of the Comptroller of Currency ("OCC") held that trust preferred securities may be purchased and treated as loans by national banks. In its request to the OCC, a bank holding company proposed to form a business trust as a wholly-owned subsidiary for the sole purpose of issuing trust preferred securities to investors. The business trust would then lend the proceeds that it received on the sale of the trust preferred securities to the holding company in exchange for a subordinated debenture with terms that were identical to the terms of the trust preferred securities. The payments on the debentures would be the sole source of cash flow from which the trust's obligations to the holders of the trust preferred securities would be satisfied. The OCC noted that trust preferred securities are instruments that possess characteristics particularly associated with debt securities. Like debt holders, the holders of the trust preferred securities do not have voting rights in the management or the ordinary course of business of the trust. In addition, holders of the trust preferred securities do not share in any appreciation in the value of the trust and are protected from changes in the value of the principal of the instruments except for

credit risk. Since the trust's only source of revenue for the dividends on the trust preferred securities is the interest on the underlying subordinated debt, the trust preferred securities must be redeemed upon redemption of the subordinated debt. Before purchasing trust preferred securities as loans, the OCC noted that a national bank should conduct a complete review of relevant credit information and loan administration practices, and determine that the purchases meet the bank's own internal loan underwriting standards. The interpretive ruling by the OCC provides a vehicle for a bank holding company to convert debt to equity while allowing a bank purchaser of the trust preferred securities to treat the purchases as loans. The amount of trust preferred securities that may be included in Tier 1 capital of a bank holding company is limited to 25% of Tier 1 with the remainder being classified as Tier 2 capital. The issuance of trust preferred securities must be approved by the Federal Reserve Bank in the district in which the holding company is located. The guidelines of the Federal Reserve provide that the subordinated debt and the trust preferred securities must have maturity of not less than thirty (30) years and the subordinated debt must be subordinate to all other debt of the holding company. The holding company has the option to call the subordinated debt and the trust preferred securities after ten (10) years but not prior to the expiration of five (5) years. Both the subordinated debt and the trust preferred securities must allow for a consecutive five (5) year deferral on interest and dividends, respectively. The holding company must guarantee the distribution, liquidation, and redemption rights of the trust preferred securities. Any redemption of the trust preferred securities must be approved by the Federal Reserve. Payments on the subordinated debt and the trust preferred securities are "interest only" until maturity. Trust preferred securities may be useful for bank holding companies that are Subchapter S corporations. A Subchapter S corporation cannot have more than one class of stock,

but trust preferred securities are not considered a separate class of stock and purchasers of trust preferred securities will not be counted as additional shareholders.