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UPDATE

News of Developments in the Financial Sector and Related Areas

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Loans to Insiders

Regulation O became effective in 1979 and governs extensions of credit by banks to executive officers, directors or principal shareholders and their related interests (commonly referred to as insiders) and was a result of the allegations of shady bank dealings by Burt Lance, who served as director of the Office of Management and Budget in President Jimmy Carter's administration during the 1970s. Regulation O was adopted with the intent to prevent insiders from obtaining extensions of credit on preferential terms, and it limits the amounts and terms a bank may lend to insiders. On April 1, 2003, Regulation W became effective placing additional quantitative and qualitative limitations on transactions a bank may have with an affiliate with the intent to limit the exposure that a bank may have to one or more affiliates. Regulation W requires that transactions with affiliates be adequately collateralized to assure that transactions are not unsafe or unsound. In recent years, a number of banks have been criticized in connection with loans involving insiders such as in loan transactions (depending on the facts in each case) where the insider is an agricultural land owner and the bank makes loans to tenants of the insider. An extension of credit is attributed to an insider of the bank to the extent that the proceeds are "transferred to" or used for the "tangible economic benefit of" the insider or if the loan or extension of credit is made to a "related interest" of the insider. This "attribution rule" was designed to prevent circumvention of Regulation O through the use of nominee borrowers. Regulation W was designed under the "attribution rule" to prevent a bank from evading statutory restrictions by using intermediaries and to limit the exposure of a bank. Any transaction by a bank with a person will be deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate, subject to certain exemptions. Both Regulation O and Regulation W were designed to prevent a bank from evading the statutory restrictions by using intermediaries and to limit the exposure of the bank. A loan will be attributed to an insider if the loan proceeds are transferred to or used for the tangible economic benefit of the insider or if the loan is made to a related interest of the insider. A loan will be attributed to an insider (other than the borrower) when either (i) the proceeds of the loan are used for the direct benefit of the insider or (ii) a common enterprise exists between the borrower and the insider. The common enterprise test will be met if the borrower is under common control (including where one of the persons in question controls the other) and there is a substantial interdependence between the borrower and the insider, *i.e.*, where at least 50% of the gross receipts or expenditures of the borrower comes from transactions with the insider. The facts in any given situation would have to be reviewed to determine the benefits of a specific loan transaction.

Trust Preferred Securities

A number of bank holding companies have issued trust preferred securities and continue to utilize trust preferred securities for a

number of reasons. Trust preferred securities are advantageous to bank holding companies because they are treated as equity for bank regulatory purposes and as debt for tax purposes. Trust preferred securities qualify as Tier 1 capital up to a maximum of 25% and any remainder qualify as Tier 2 capital. Effective March 31, 2007, the aggregate amount of trust preferred securities and certain other capital elements will be limited to 25% of Tier 1 capital elements net of goodwill. This will mean that bank holding companies will have to deduct goodwill from their equity before making the calculation. The issuance of trust preferred securities must be approved by the Federal Reserve Bank in the district in which the bank holding company is located. Trust preferred securities are typically issued as non-perpetual cumulative preferred stock by a wholly-owned trust subsidiary of a bank holding company. Revenue from the sale of the trust preferred securities by the trust subsidiary is exchanged for junior subordinated debentures issued by the bank holding company. The debentures feature a coupon payment and term to maturity, which are identical to those of the trust preferred securities. The guidelines of the Federal Reserve provide that the subordinated debt and the trust preferred securities must have a maturity of not less than thirty (30) years and the subordinated debt must be subordinate to all other debt of the bank holding company. The bank holding company has the option to call the subordinated debt and the trust preferred securities after 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 bank 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. In accordance with the Financial Accounting Standards Board Interpretation 46, the subordinated debt is shown on the consolidated balance sheet of the bank holding company as long term debt and the securities issued by the trust are not consolidated. Trust preferred securities are useful for bank holding companies that are Subchapter S corporations. Although a Subchapter S corporation cannot have more than one class of stock, trust preferred securities are not considered a separate class of stock and purchasers of trust preferred securities will not be counted as additional shareholders. 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. 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 purchase meets 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. Trust preferred securities provide an excellent vehicle for funding of acquisitions, stock repurchases and internal growth.

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