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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Regulation of Banks by States

During 2004, the Office of the Comptroller of the Currency ("OCC") issued two final regulations regarding the preemption of state laws by federal law over national banks. The first regulation clarifies to the extend the operations of a national bank are subject to state laws and identifies the type of state laws that are preempted by federal law under the National Bank Act. The second regulation is directed toward the exclusive authority of the OCC under the National Bank Act to examine, supervise and regulate the affairs of a national bank. Because of the controversial nature of these regulations as to state versus federal regulation of national banks, particularly in the area of corporate subsidiaries of national banks and the applicability of preemption of state law relating to these corporate subsidiaries, a number of lawsuits were filed by state regulatory authorities regarding the position taken by the OCC. The most recent case decided is *Office of the Comptroller of the Currency v. Cuomo,* No. 05-6001 and *The Clearing House Association, LLC v. Cuomo* (2d Cir., December 4, 2007). In 2005, the New York State Attorney General, Andrew Cuomo, began investigating evidence of possible racial discrimination in the residential real estate lending practices of mortgage lenders, national banks and their operating subsidiaries. On the basis of these apparent racial disparities, the Attorney General sent letters of inquiry to mortgage lenders implicated by the data, including several national banks and their operating subsidiaries requesting that the lenders voluntarily produce certain non-public information regarding their mortgage policies and practices. Based on the regulations of the OCC, both the OCC and The Clearing House Association, a consortium of national banks, filed lawsuits seeking to enjoin the Attorney General's investigation and enforcement efforts. In upholding the regulations issued by the OCC, the Court held that the regulations were a reasonable interpretation of the National Bank Act. The *Cuomo* case is available on the website of the OCC at www.occ.treas.gov.

Due Diligence

In the financial sector, due diligence is a term that has been used and defined in many ways, but the best meaning of it is the *level of judgment, care, prudence, determination, and activity that a person would reasonably be expected to do under particular circumstances*. Due diligence involves exercising the degree of care in investigating a matter by verifying facts in order to eliminate unknown risks. The origin of the term due diligence came about following the passage of the federal Securities Act of 1933 which afforded a defense to persons selling securities when accused of inadequate disclosure of material information to investors. As a result, persons selling securities to the general public, such as broker/dealers, instituted a standard practice of conducting due diligence investigations into the company having a stock offering in order to protect themselves from nondisclosure of material information. Although the term was originally limited to public offerings of stock, it has now become associated with all types of investigations. The purpose of exercising due diligence is to cut down the risk to a manageably small level. A considerable measure of judgment is involved, not only in deciding what to do, but in determining the level of investigation into a particular matter. Due diligence investigations frequently arise in a number of different contexts. These include (i) acquiring a company, (ii) loaning monies to a company, and (iii) marketing a new product. For instance, in the acquisition of a company, a careful analysis of the target company would involve an analysis of financial statements, environmental reports on real estate, existing contracts, pending litigation and regulatory proceedings and a review of contingent liabilities not reflected on the financial statements. In loaning money to a company, due diligence would involve reviewing the business plan of the company, analysis of financial statements, possible environmental issues if real estate is involved, and making sure that the lender is the first lienholder on any collateral for the loan. Due diligence in marketing a new product may involve such things as whether the product would infringe upon the rights of other similar products and whether a patent or trade mark is available for the new product. In connection with the issuance of stock by a company, due diligence is a requirement on the part of the company as the issuer to insure that the offering does not misstate or omit material information to a prospective purchaser of its securities. To some degree, due diligence is involved in the day-to-day activities of everyone as they relate to a purchase of a car or home such as obtaining an appraisal, inspections and making sure that everything works. In more complicated transactions, the due diligence will take place between the time of the signing of an agreement outlining the terms of the transaction, sometimes referred to as a letter of intent, and the execution of a definitive agreement which sets forth, among other things, the representations and warranties of the parties to the transaction. Due diligence reduces the risks by ensuring the creditability and accuracy of information.

Cumulative Preferred Stock

In Interpretive Letter No. 1086, the Office of the Comptroller of the Currency ("OCC") confirmed the authority of a national bank to purchase and hold shares of fixed-rate cumulative preferred stock based in part on *reliable estimates* [12 C.F.R. § 1.3(i)] that the issuer of the security would be able to satisfy its obligations under the security, and that the bank would be able to sell the security with reasonable promptness at a price that corresponds reasonably to the fair value of the security. 12 C.F.R. § 1.3(i) limits all securities in a bank's portfolio acquired on the basis of *reliable estimates* to no more than five percent of the bank's capital and surplus. The OCC concluded that cumulative preferred stock is similar to debt instruments in that the securities do not confer voting rights on the holder so long as the yield is current and the issuer is not attempting to alter the holder's rights under the security. The OCC also noted that dividend payments were cumulative, similar to a typical debt instrument, and that the securities were callable by the issuer. Fixed-rate cumulative preferred stock is an excellent vehicle for maintaining share-holder ownership, funding acquisitions, stock repurchases and providing funds for internal growth. Our firm is available to answer questions on the benefits of utilizing this security and its placement with third parties.