

UPDATE

News of Developments in the Financial Sector and Related Areas

* *IN THIS ISSUE* *

Shareholders' Inspection of Subsidiary Bank Records

Subchapter S Corporations

Cases, Releases and Rulings

Shareholders' Inspection of Subsidiary Bank Records

Danziger v. Louse, 2004 Ohio Lexis 2343, is a recent decision by the Supreme Court of Ohio regarding the rights of shareholders of a bank holding company to inspect the records of its wholly-owned bank subsidiary. In this case, the shareholders owned stock in the bank holding company, which had one asset, the bank. The bank had only one stockholder, which was the company. Shareholders did not own any stock in the bank, which was a wholly-owned subsidiary of the bank holding company. The shareholders filed suit, and asserted a right to inspect the corporate minutes of the bank holding company and the bank. The bank holding company then informed the shareholders that it would permit them to examine its corporate minutes, but it would not permit them to examine the bank's corporate minutes because they were not stockholders of the bank. Exhibits that the shareholders filed with the court demonstrated that the bank holding company and the bank had the same directors and the same officers, that the bank holding company owned all of the bank's stock, and the bank holding company's sole source of income was dividends paid by the

bank. The Supreme Court of Ohio found that the bank holding company had such ownership and control of the bank that the shareholders had a common law right to examine the bank's records even though they were not shareholders of it and the separate corporate existence between the two entities should be disregarded.

Subchapter S Corporations

A Subchapter S corporation is a corporation that has elected a special tax status with the Internal Revenue Service ("IRS") which permits the income to be passed through to the shareholders and avoids the double taxation of a "C" corporation. In 1996 the Small Business Job Protection Act was signed into law making it permissible for small banks to become Subchapter S corporations beginning on January 1, 1997. Since its passage, many closely held banks have become Subchapter S corporations. Recently, President Bush signed into law the American Jobs Creation Act (the "Jobs Act") which increased the maximum number of shareholders for Subchapter S corporations from 75 to 100 and allows up to six generations of a family to be counted as one shareholder. The Jobs Act also lifts the current rules that prohibit banks from converting to a Subchapter S corporation if any of their shares are held in individual retirement accounts. Among the requirements that a corporation must meet in order to qualify as a Subchapter S corporation is that it only have one class of stock. As a condition of being a director of a national bank, a person must own a qualifying equity interest of either the national bank or its holding company. In order to limit the total number of shareholders, the qualifying shares held by a director are sometimes subject to buy-sell

agreements that require a director to sell back his shares on specified terms upon ceasing to be a director. A Subchapter S corporation is treated as having only one class of stock outstanding if all of the shares confer identical rights to distribution and liquidation proceeds. A bona fide buy-sell agreement is generally disregarded for purposes of determining whether a corporation's outstanding shares confer identical rights to distribution or liquidation proceeds. However, a buy-sell agreement is not disregarded if, among other things, the agreement establishes a purchase price that, at the time the agreement is entered into, significantly deviates from the fair market value of the stock. In IRS Private Letter Ruling 2002-17-048, the IRS stated that buy-sell agreements that provide for a purchase or redemption of stock at book value or at a price between fair market value and book value may not be considered to establish a purchase price based on fair market value. As a result, buy-sell agreements which contain a repurchase provision significantly in excess of or below the fair market value or which causes a director to assign to the corporation all dividends or other distributions on his shares create a separate class of stock and disqualify the corporation from Subchapter S treatment. In 2003, the Federal Deposit Insurance Corporation ("FDIC") adopted a final rule regarding the eligibility of state banks chartered as limited liability companies for purposes of granting deposit insurance coverage. This rule provides that a bank that is chartered as a limited liability company under State law would be considered to be "incorporated" under State law if the four traditional corporate characteristics are met, which are: (i) perpetual succession; (ii) centralized management; (iii) limited liability; and (iv) free transferability of interests. However, the FDIC noted that, unlike other limited liability and Subchapter S corporations, a state bank chartered as a limited liability company would not qualify under existing IRS regulations for

partnership tax treatment. Any eligible small business corporation desiring to make the election to be a Subchapter S corporation must file IRS Form 2553, *Election by a Small Business Corporation*, before the 16th day of the third month following the close of the "C" corporation's tax year if the election is to be effective for the current year. The "C" corporation must qualify as an eligible corporation during those 2½ months and all shareholders during those 2½ months must consent, even if they do not own stock at the time of the election. If the election is filed after the 15th day of the third month of the tax year, the election will be in effect for the next tax year and all shareholders at the time of the election must consent. The Subchapter S corporation allows a bank to enjoy the benefits of incorporation but to be taxed as if it were a partnership. A revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of the corporation.

Cases, Releases and Rulings

The Federal Deposit Insurance Corporation has indicated its desire to have the ability to examine all thrifts, all national banks and state banks. Currently the FDIC coordinates its examinations with the primary regulator before conducting an examination of an institution in which it is not the primary federal regulator.

Maryland Financial Bank recently received banking regulatory approval and is now operating as a bankers' bank in the state of Maryland. Although there are a number of bankers' banks operating throughout the United States whose shareholders are only other banks, a majority of the shareholders of Maryland Financial Bank are not banks and five members of its board of directors are not bankers.