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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Phantom Stock Plans

Phantom stock plans, which are also known as shadow or unit stock plans, are a type of stock based incentive compensation to permit key employees the ability to share in a company's success without giving the employee any actual equity in the business. Phantom stock option plans are generally administered by a committee, selected from non-employee members of the board of directors of the company who will not be participants, that award compensation units to key employees of the company. The award of units by the administrative committee does not convey any actual ownership in the company. A phantom share unit is a credit in a participant's account for an amount equal to the value of the company's actual shares. Once the units are awarded to the participant's account, it is credited with changes in share value, along with dividends and other distributions by the company to its stockholders of actual shares. Generally, phantom stock plans provide that dividends and changes in a company's capital structure are taken into account in valuing the participant's interest under the plan. If a dividend is paid on the company's outstanding stock, an equal prorated amount is credited to each unit held by a participant. In addition, if a company changes its capital through a stock split or stock dividend, the number of units held by a participant is adjusted accordingly in proportion to the change. There is generally no taxable income for the participants in phantom stock plans until units are redeemed in the participant's account. At the same time, there is no tax deduction for the company until it becomes obligated to pay the employee for units held in his account. Payments to participants are taxed at ordinary income tax rates. Since participants in phantom stock plans do not hold "real" shares or have any actual equity in the company, participants are not eligible to vote at stockholder meetings of the company. Phantom stock plans are ideal and provide flexibility for privately owned businesses, since units awarded to participants do not dilute the ownership interest of stockholders of the company. Phantom stock plans are also attractive to Subchapter S corporations. Under the provisions of the Internal Revenue Code, a Subchapter S corporation can have no more than 100 stockholders and may only have one class of stock. Phantom stock units are not treated as a separate class of stock and do not count toward the maximum number of stockholders. Phantom stock plans are an effective tool in providing incentives to attract and retain key employees, while at the same time maintaining the equity interest of the existing shareholders.

Regulation of Banks by States

In January 2004, the Office of the Comptroller of the Currency ("OCC") issued regulations relating to the preemption of state laws by federal law over national banks. Because of the controversial nature of these regulations as to state versus federal regulation of national banks, a number of lawsuits have been filed by state regulatory authorities regarding the position taken by the OCC as reflected in its regulations, particularly in the area of corporate subsidiaries of national banks and the applicability of preemption of state laws relating to these corporate subsidiaries. In upholding the regulations issued by the OCC, the United States District Court for the District of Maryland recently held that Maryland law, which restricts prepayment fees imposed by mortgage lenders, was preempted for national banks and their operating subsidiaries. This decision is similar to rulings that have been reached in court cases in California, Connecticut and Michigan. The Federal Deposit Insurance Corporation ("FDIC") held a public hearing in May of this year on a petition from the Financial Services Roundtable requesting the FDIC to issue a rule that would provide that a state bank's home state law governs its interstate activities and those of its subsidiaries to the same extent that the National Bank Act governs a national bank's interstate business. The petition seeks to put state banks on a competitive level with national banks in connection with the regulations issued by the OCC. It is unknown at this time what action the FDIC will take in connection with the petition.

Cases, Releases and Rulings

The latest Federal Reserve Board survey of senior loan officers on bank lending practices reflects that banks have eased standards and terms on business loans, having done so in large part because of increased competition from other sources of business credit. The lessening of credit standards in the most recent survey is also consistent with surveys conducted by the Federal Reserve Board during the past year. Domestic institutions reporting to the survey indicated that they had eased their lending standard and terms based on more aggressive competition from other banks or nonbank lenders and reflecting a higher tolerance for risk and greater liquidity in the secondary market which is somewhat inconsistent to the fact that the Federal Open Market Committee of the Federal Reserve Board has raised the federal funds rate eight times from one percent to three percent since the spring of last year, citing in its most recent increase that the solid pace of spending growth has slowed partly because of increases in energy prices.

In the competition to attract new customers and encouraging existing customers to sign up for additional services, a number of banks on a national level are offering sweepstakes and in connection therewith offering customers unlimited check writing, free checks, unlimited ATM usage, free internet banking, free bill payment with direct deposit and free telephone banking. The prizes in some of the sweepstakes included landscaping, free shopping sprees, vacation packages, televisions, cash giveaways, cars, savings bonds and more. A good sampling of marketing being done by banks to attract customers is available on the internet by using the search terms *bank sweepstakes*. Since lotteries and gaming are generally prohibited, it is interesting to read the "Official Rules" of banks offering sweepstake giveaways.

In Interpretive Letter No. 1028, the Office of the Comptroller of the Currency concluded that a debt cancellation contract offered by a bank known as *Guaranteed Automobile Protection* to consumers who borrowed money to buy automobiles did not constitute a product separate from the underlying loan. The bank could not offer the debt cancellation contract to third parties who had not borrowed from the bank.