

UPDATE

News of Developments in the Financial Sector and Related Areas

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Loans to Insiders and Affiliates

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. The term *affiliate* under Regulation W is broadly defined and includes parent companies, companies under common control and companies with interlocking directorates. Regulation W implements and interprets Sections 23A and 23B of the Federal Reserve Act and 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.

Real Estate Activities

In connection with a number of Interpretive Letter rulings by the Office of the Comptroller of the Currency ("OCC") which are discussed in detail in the April 2006 issue of *UPDATE*, the OCC has issued Interpretive Letter #1053 in response to issues raised by the National Association of Realtors questioning, among other things, the authority of a national bank to establish a hotel facility, the establishment of a mixed-use office complex that included retail space, restaurant space, office space, hotel space and condominiums, and acquisition of a 70% equity interest of a limited liability company that would operate a wind energy project that produces electricity. In its response to the National Association of Realtors, the OCC took the position that the development of the property by the national banks served existing banking operations and that the investment in the limited liability company was structured in a form that was functionally equivalent to a loan and was underwritten like a loan. The OCC also noted in its response that activities by a national bank must be evaluated on a case-by-case basis, which was done in its Interpretive Letter rulings. In regard to the development and sale of condominiums in a mixed-use building, the OCC noted that a bank's sale of excess space in its bank premises would better enable the bank to keep its capital flowing in commerce, prevent speculation as to future real estate

values and would mean that it was holding a smaller amount of property in its "in mortmain." Following the Interpretive Letter to the National Association of Realtors, the OCC issued Interpretive Letter #1048a to the bank that was permitted to acquire approximately 70% of the equity interest of the limited liability company that would operate a wind energy project, setting forth ten conditions that the bank must meet, including, among other things, (i) the bank would not participate in the operation of the wind energy company, (ii) the bank would not share in any appreciation value of its interest in the wind energy company, and (iii) at the end of its ten-year holding period, the bank will sell at book value its ownership interest in the wind energy company. In analyzing the response of the OCC to the National Association of Realtors, a bank seeking to pursue similar activities would need to meet the following tests:

- Demonstration of a legitimate reason, based upon accommodating its business operations, for acquiring and/or developing property.
- The percentage of use or occupancy of property in conjunction with the bank's business as a measure of *good faith* use of the property for banking purposes.
- The investment must not be speculative or motivated by realizing a gain on appreciation of the real estate property value.

Banking Industry Continues To Consolidate

The banking industry continues to consolidate throughout the United States. Recent published reports reveal that the average price on the fifty-five transactions announced in the first quarter of this year had a price/book multiple of 2.30 and a price/earnings ratio of 26.5. During 2005, there were 253 bank and thrift acquisitions announced at an average multiple of book of 2.28 and an average price/earnings ratio of 26.16.