Garland W. Binns, Jr.
Dover Dixon Horne PLLC
Attorneys at Law
425 West Capitol, Suite 3700
Little Rock, Arkansas 72201
Telephone: (501) 375-9151
Facsimile: (501) 372-7142
Email: gbinns@ddh-ar.com
Web Site: www.GWBinns.com

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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Consolidation in Banking

The banking industry continues to consolidate throughout the United States, but at a much slower pace than in the past two decades. Consolidation occurs from a number of factors with banks experiencing loan portfolio problems resulting in inadequate capital on one hand and the pricing of banks in acquisition transactions on the other hand.

There were only 77 transactions announced during the first six months of this year, compared to 153 transactions in the first half of 2007. Mergers and acquisition sector has substantially slowed in part due to loan portfolio problems facing banks and the uncertainty about the ability of banks to raise capital for bank acquisitions. The cost of trust preferred securities by potential acquirers has gotten much more expensive during the past year.

Recent published reports reflect that the price at the end of the first six months of 2007 was 2.4 times tangible book value, compared to an average of 1.92 times tangible book for the first six months of 2008. Although there are still acquirers for banks, they are much more selective in the acquisitions that are being made and some have gone into a capital preservation mode because of the high cost of raising capital for acquisitions.

Probably the biggest issue facing banks during the coming year will be the ability to raise capital, not only for acquisitions but for credit quality issues relating to loan portfolios. Because of the higher interest rate spreads on trust preferred securities with institutional purchasers, banks will need to look for alternatives for capital, one of which would be the private placement of its equity, debt or hybrid (trust preferred and non-cumulative perpetual preferred) securities with local investors, existing shareholders and major customers.

Our firm is available to answer questions on the benefits of issuing securities in a private placement with local investors and with other banks.

State Banks Chartered as LLCs

Recently, Senators Blanche Lincoln and Orrin Hatch introduced legislation known as the *Small Bank Tax Equity Act* ("Small Bank Act") which would permit state chartered banks organized as limited liability companies to be taxed on a flowthrough basis meaning that the bank's shareholders would be taxed each year on the bank's income, rather than the bank.

Under the proposed legislation, the election to be taxed as a limited liability company is available to state chartered banks organized as limited liability companies. If a bank makes the election allowed under the Small Bank Act before the end of a two taxable

year transition period following its enactment, the election would not subject the bank to immediate tax on any appreciation in its assets. Instead, the electing bank would be subject to special rules with respect to the taxation of gains and losses that are recognized during the ten-year period following the election which are substantially the same rules that apply when a bank elects to convert to a Subchapter S corporation. However, these rules would not apply to an electing bank organized as a limited liability company which commenced banking activities after February 12, 2003.

In 2003 the Federal Deposit Insurance Corporation ("FDIC") adopted a final rule (12 C.F.R. § 303.15) permitting a state bank to be chartered as a limited liability company for purposes of granting deposit insurance coverage even though the Internal Revenue Service did not permit banks to be taxed as a limited liability company. This final rule provided 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, unlike other companies, a state bank chartered as a limited liability company would not qualify under existing Internal Revenue Service regulations for partnership tax treatment.

Although regulations by the Treasury Department permit limited liability companies to be classified for tax purposes as flowthrough entities, i.e., not being subject to the double taxation characteristic of corporations, banks are denied this advantage by regulations of the Treasury Department. Following the adoption of the rule by the FDIC, several senators wrote letters to the Treasury Department requesting action be taken allowing banks to be taxed as limited liability companies, but to no avail.

A number of states have passed laws permitting banks to be organized as limited liability companies. In addition, since the adoption of the rule by the FDIC, banks have pursued this avenue for organization in those states specifically permitting this type of organization by banks. A number of organizations, including the American Bankers Association and the Conference of State Bank Supervisors have gone on record in supporting the enactment of the Small Bank Act.

As in the case of a Subchapter S corporation, a limited liability company does not pay corporate taxes because its owners are taxed on the income of the bank. However, by becoming a limited liability company there are significant advantages in that the number of owners are not limited, as in the case of a Subchapter S corporation, which are limited to 100 shareholders, and a limited liability company may have more than one class of security interest, whereas a Subchapter S corporation is limited to only one class of stock.

Our firm is available to assist and answer questions involving the organization of a bank as a limited liability company.

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In Interpretive Letter No. 1100, the Office of the Comptroller of the Currency confirmed the authority of an operating subsidiary of a national bank to impose and export the interest rates and fees permitted by the home state of its parent bank without regard to the usury laws of the state of residence of the borrowers. However, if either loan approval, receipt of deposits or disbursement of loan proceeds occur, then the laws of the state in which a branch is located may apply.

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