

**ADVANCED “PROBLEM SOLVING” UNDER REGULATION O,  
REGULATION W, AND THE LEGAL LENDING LIMITS**

**By:**

**Holly A. Smith**

**Locke Liddell & Sapp LLP  
600 Travis Street, Suite 3400  
Houston, Texas 77002  
[hsmith@lockeliddell.com](mailto:hsmith@lockeliddell.com)  
(713) 226-1617**

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## **HOLLY A. SMITH**

### **BIOGRAPHY**

Holly A. Smith is an associate in the Houston office of Locke Liddell & Sapp LLP. Her practice focuses primarily on transactional work related to mergers and acquisitions as well as financial institutions regulation.

Ms. Smith received her J.D. in 2000 from the Georgetown University Law Center, and her B.S. in Biology, *summa cum laude*, from The Ohio State University in 1997. She is a member of the State Bar of Texas, Houston Bar Association, Houston Young Lawyers Association, and the Texas Association of Bank Counsel.

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## I. INTRODUCTION

Three primary groups of regulations address loans and other transactions between a bank and its associated persons and entities – Regulation O, Regulation W, and the applicable Lending Limit Rules (together the “Regulations”). Each Regulation contains certain definitions, limitations, restrictions and exemptions. While there are certainly many differences between the Regulations, there are important general concepts that underlie each, such as attribution rules, the definition and importance of control, and the impact of guarantees and other similar arrangements.

Bankers, lawyers and examiners sometimes confuse these general concepts and apply a Regulation O concept to a Lending Limit or Regulation W situation. This paper is intended to achieve two goals. First, the paper will provide a basic overview of each Regulation. Then, the paper will compare and describe the similarities and differences of these general concepts among the Regulations. Understanding and recognizing the similarities and differences is essential in reaching correct conclusions regarding compliance issues.

## II. BRIEF REGULATORY OVERVIEW - THE BASICS

### A. Regulation O – 12 C.F.R. Part 215

***Purpose Underlying Regulation O.*** Regulation O, which implements sections 22(g) and 22(h) of the Federal Reserve Act, limits how much and on what terms a bank may lend to its own insiders and insiders of its affiliates. Generally speaking, Regulation O is intended to prevent insiders from obtaining extensions of credit on preferential terms. The thought is that insiders should not be allowed to exert their influence to obtain an extension of credit from an institution, if the institution would not make the same extension of credit to a non-insider.

***Applicability of Regulation O.*** The terms and provisions of Regulation O apply fully to all member banks. Insured nonmember banks are subject to 12 C.F.R. Part 215, subpart A, with the exception of 12 C.F.R. §§ 215.5(b), 215.5(c)(3), 215.5(c)(4), and 215.11. Additionally, pursuant to 12 CFR §563.43, the Office of Thrift Supervision (“OTS”) has made Regulation O applicable to savings associations, except for certain civil penalty provisions contained therein. The Texas Administrative Code also makes Regulation O, in addition to the lending limits established by the Texas Finance Code, expressly applicable to Texas state banks.

***Who is an “Insider” pursuant to Regulation O?*** An “insider” is defined to mean an executive officer, director, or principal shareholder, and includes any related interest of such person. A “related interest” of a person means either a company that is controlled by that person or a political or campaign committee that is controlled by that person or the funds or services of which will benefit that person.

***Restrictions.*** Regulation O places certain restrictions and limitations on extensions of credit made by a bank to any bank insider or to any insider of its affiliates, including, without limitation, the following:

1. **Terms of the Extension of Credit.** Requires that an extension of credit must be made on substantially the same terms as those prevailing at the time for comparable transactions with other persons, does not involve more than the normal risk of repayment, and does not present other unfavorable terms.
2. **Individual Lending Limit.** Establishes an individual insider lending limit (subject to certain exceptions) of 15% of the bank’s unimpaired capital and unimpaired surplus in

the case of loans that are not fully secured, and an additional 10% of the bank's unimpaired capital and unimpaired surplus in the case of loans that are fully secured by readily marketable collateral having a market value at least equal to the amount of the loan.

3. **Aggregate Lending Limit.** Establishes an aggregate lending limit (subject to certain exceptions), such that when a particular insider extension of credit is aggregated with the amount of all outstanding extensions of credit by the bank to all insiders, it does not exceed the bank's unimpaired capital and unimpaired surplus.
4. **Approval by the Bank's Board of Directors.** Requires that every extension of credit by a bank to any insider of the bank or insider of its affiliates that would exceed the higher of \$25,000 or 5% of the bank's unimpaired capital and unimpaired surplus, when all extensions of credit to the person and the person's related interests are aggregated, be approved in advance by a majority of the entire board of directors of the bank, with the interested party abstaining from voting.

Please note that § 215.5 of Regulation O establishes additional restrictions applicable to extensions of credit made by a bank to any of its executive officers relating to loan size limits.

***What Constitutes an Extension of Credit under Regulation O?*** Under Section 215.3 of Regulation O, an extension of credit is defined to include the making or renewal of any loan, a granting of a line of credit, or an extending of credit in any manner whatsoever, and specifically includes the following:

1. A purchase under repurchase agreement of securities, other assets or obligations;
2. An advance by means of an overdraft, cash item, or otherwise;
3. Issuance of a standby letter of credit or an ineligible acceptance;
4. An acquisition by discount, purchase, exchange or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety;
5. An increase of an existing indebtedness, unless the additional funds are advanced by the bank for its own protection for accrued interest or taxes, insurance or other incidental expenses;
6. An advance of unearned salary or other unearned compensation for a period in excess of 30 days; and
7. Any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of any endorsement on an obligation or otherwise, or by any means whatsoever.

***Recordkeeping, Reporting & Public Disclosure Requirements.*** Section 215.8 of Regulation O requires each bank to maintain records to document compliance with the insider lending restrictions of Regulation O. In addition, each bank is required to include with its quarterly report of condition a report of all extensions of credit made by the bank to its executive officers since the date of the bank's previous report of condition.

With regard to reporting requirements, if an executive officer of a bank becomes indebted to any other bank(s) in an aggregate amount greater than that allowed under Section 215.5 of Regulation O, the officer must report that indebtedness in writing to the board of directors of the bank of which he/she is an executive officer. In addition, each executive officer or director of a bank, the shares of which are not public traded, must report annually to the board of directors of the bank the outstanding amount of any extension of credit that is secured by shares of the bank. Furthermore, each executive officer and principal shareholder of a bank must report annually, to the bank's board of directors, the maximum amount of his/her own outstanding indebtedness (and that of related interests) to each of the bank's correspondent banks during the preceding calendar year and as of the date ten business days before the report is filed. The written report must include a description of the terms and conditions of each reported extension of credit.

Upon receipt of a written request from a member of the public, a bank must disclose the names of its executive officers and principal shareholders who, along with their related interests, received extensions of credit, either from the bank or from all correspondent banks of the bank, that in the aggregate equaled or exceeded 5% of the bank's capital and unimpaired surplus or \$500,000, whichever amount is less.

## **B. Regulation W – 12 C.F.R. Part 223**

***Purpose Underlying Regulation W.*** Regulation W, which implements and interprets sections 23A and 23B of the Federal Reserve Act, establishes certain quantitative limits and other restrictions on transactions between a member bank and its affiliates. Through implementation of these provisions of the Federal Reserve Act, Regulation W is intended to limit the amount of exposure that a bank may have to any one affiliate or all affiliates in the aggregate, to require that any credit exposure to an affiliate be adequately collateralized, and to ensure transactions with affiliates are not unsafe or unsound. Furthermore, Regulation W deals with competitive and safety and soundness issues arising out of bank affiliations with a broad range of financial and nonfinancial companies and focuses on ensuring that transactions between banks and their affiliates are on an arm's length basis and at fair market value.

***Applicability of Regulation W.*** By its express terms, Regulation W applies to any national bank, state bank, trust company, or other institution that is a member of the Federal Reserve System. An operating subsidiary of a member bank is treated as part of the member bank. Although Regulation W does not by its terms apply to FDIC-insured state nonmember banks, the Federal Deposit Insurance Act requires that insured state nonmember banks comply with sections 23A and 23B, and thus Regulation W, as if they were member banks. Furthermore, under the Home Owners' Loan Act, an FDIC-insured savings association must comply with sections 23A and 23B in the same manner and to the same extent as if the association were a member bank. Please note that the Home Owners' Loan Act prohibits certain additional types of savings association transactions with affiliates and authorizes the OTS to impose additional restrictions on savings association transactions with affiliates.

***Who is an "Affiliate" pursuant to Regulation W?*** Regulation W defines an "affiliate" with respect to a bank to include, without limitation, the following:

1. Parent companies – any company that controls the bank;
2. Companies under common control by a parent company;
3. Companies under other forms of common control with the bank. (For example, a company controlled by a trust for the benefit of shareholders that also control the bank.);

4. Companies with interlocking directorates between the bank or any company that controls the bank;
5. Companies sponsored and advised on a contractual basis by the bank or its affiliate;
6. Registered investment companies for which the bank or its affiliate serves as an investment advisor;
7. Unregistered investment companies for which a bank or its affiliate serves as an investment advisor, if the bank and its affiliates own or control in the aggregate more than 5% of any class of voting securities or of the equity capital of the fund;
8. Depository institutions that are subsidiaries of the bank;
9. Financial subsidiaries of the bank;
10. Companies, in which 15% or more of the equity capital is held under merchant banking or insurance company investment authority for financial holding companies (“FHCs”), unless the FHC can establish that it does not control the company or can meet certain specific exemptions. (If an FHC does not control a private equity fund, it is not deemed to control companies held by such fund for purposes of Regulation W.);
11. Any partnership for which the bank or its affiliate serves as a general partner or causes any director, officer, or employee of the bank or its affiliate to serve as a general partner;
12. Subsidiaries of the preceding “affiliates;” and
13. A “catch-all” provision for companies that are determined by the Federal Reserve Board or the bank’s primary federal regulator to have a relationship with the bank or its affiliate such that covered transactions may have a detrimental effect on the bank.

***Exempt Affiliates.*** Regulation W specifically excludes from the definition of “affiliate” the following:

1. Companies that are subsidiaries of the bank, unless the company is (i) a depository institution, (ii) a financial subsidiary, (iii) directly controlled by either one or more affiliates (other than depository institution affiliates) of the bank, or a shareholder that controls the bank or a group of shareholders that together control the bank, or (iv) an employee stock option plan, trust or similar organization that exists for the benefit of shareholders, partners, members, or employees of the bank or any of its affiliates;
2. Companies engaged solely in holding bank premises;
3. Companies engaged solely in conducting a safe deposit business;
4. Companies engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and

5. Companies where control results from the exercise of rights arising out of a bona fide debt previously contracted, subject to permissible holding periods.

***What constitutes a “Covered Transaction” under section 23A?*** The restrictions, limitations and requirements of section 23A, as implemented in Regulation W, do not apply to every transaction that a bank may have with an affiliate. Regulation W only applies section 23A to certain “covered transactions” between a bank and an affiliate. “Covered transactions” are generally designed to capture transactions where a bank may be exposed to an affiliate’s credit or investment risk. A “covered transaction” under section 23A includes:

1. A bank’s “extension of credit” to an affiliate, which includes, without limitation:
  - a. The making or renewal of a loan;
  - b. The granting of a line of credit;
  - c. The extending of credit in any manner whatsoever, including on an intraday basis;
  - d. An advance to an affiliate by means of an overdraft, cash item, or otherwise;
  - e. A sale of Federal funds to an affiliate;
  - f. A lease that is the functional equivalent of an extension of credit to an affiliate;
  - g. An acquisition by purchase, discount, exchange or otherwise of a note or other obligation of an affiliate, including commercial paper or other debt securities issued by an affiliate;
  - h. Any increase in the amount of, extension of the maturity of, or adjustment to the interest rate term or other material term of, an extension of credit to an affiliate; and
  - i. Any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent).
2. A bank’s purchase of, or investment in, a security issued by the affiliate;
3. A bank’s purchase of an asset from the affiliate, including an asset subject to recourse or an agreement to repurchase, except purchases of real or personal property that the Federal Reserve Board may exempt by order or regulation;
4. A bank’s acceptance of a security issued by an affiliate as collateral for an extension of credit to any person or company; and
5. A bank’s issuance of a guarantee, acceptance or letter of credit, including an endorsement or standby letter of credit, on behalf of the affiliate, a confirmation of a letter of credit issued by the affiliate, and a cross-affiliate netting arrangement.

**Restrictions under section 23A.** When a bank proposes to enter into a covered transaction with an affiliate, the following restrictions, limitations or requirements under section 23A apply to the transaction pursuant to Regulation W:

1. **Limitations on Maximum Amount of Covered Transactions.** A bank may not enter into a covered transaction with an affiliate if it would cause the bank:
  - a. To have outstanding an aggregate amount of covered transactions with such affiliate (other than a financial subsidiary of the bank) in excess of 10% of the bank's capital stock and surplus; or
  - b. To have outstanding an aggregate amount of covered transactions with all affiliates in excess of 20% of the bank's capital stock and surplus.
2. **Safety and Soundness Requirement.** A bank may not engage in any covered transaction, including an exempt transaction under Regulation W, unless the transaction is on terms and conditions that are consistent with safe and sound banking practices.
3. **Collateral Requirements.** A bank's "credit transactions" with an affiliate must be secured by collateral having a market value equal to at least:
  - a. 100% of the amount of the transaction, if the collateral is:
    - i. Obligations of the United States or its agencies;
    - ii. Obligations fully guaranteed by the United States or its agencies as to principal and interest;
    - iii. Notes, drafts, bills of exchange or bankers' acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or
    - iv. A segregated, earmarked deposit account with the bank that is for the sole purpose of securing credit transactions between the bank and its affiliates and is identified as such.
  - b. 110% of the amount of the transaction, if the collateral is obligations of any State or political subdivision of any State.
  - c. 120% of the amount of the transaction, if the collateral is other debt instruments, including loans and other receivables.
  - d. 130% of the amount of the transaction, if the collateral is stock, leases, or other real or personal property.

Please note that a "credit transaction" with an affiliate refers to: (i) an extension of credit, (ii) an issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the affiliate and a confirmation of a letter of credit issued by the affiliate, and (iii) a cross-affiliate netting arrangement.

A bank must have a perfected, first priority security interest in any collateral required by Regulation W or, in computing the required coverage, must deduct from the value of collateral obtained the lesser of (i) the amount of any security interest senior to that of the bank, or (ii) the amount of any credit secured by the collateral that is senior to that of the bank.

The following types of collateral are “ineligible”, i.e., cannot be used for collateral purposes under Regulation W: (i) low-quality assets, (ii) securities issued by an affiliate, (iii) equity securities and debt securities issued by the bank that represent regulatory capital of the bank, (iv) intangible assets, unless specifically approved by the Federal Reserve Board, and (v) guarantees, letters of credit and similar instruments.

4. **Low-Quality Assets Prohibition.** Subject to certain limited exemptions, a bank cannot purchase a low-quality asset from an affiliate unless, pursuant to an independent credit evaluation, the bank had committed itself to purchase the asset before it was acquired by the affiliate.

***Exemptions from the Quantitative Limits and Collateral Requirements of section 23A.*** The following covered transactions are exempt from the quantitative limits and the collateral requirements of section 23A, but are still subject to the safety and soundness requirement of 12 C.F.R. § 223.13 and the low-quality asset prohibition of 12 C.F.R. § 223.15:

1. Parent institution/subsidiary institution transactions.
2. Transactions between the bank and a depository institution owned by the same holding company.
3. Certain loan purchases from an affiliated depository institution on a nonrecourse basis.
4. Internal corporate reorganizations.

***Exemptions from the Quantitative Limits, Collateral Requirements and the Low-Quality Asset Prohibition of Section 23A.*** The following covered transactions are exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition of section 23A, but are still subject to the safety and soundness requirement of 12 C.F.R. § 223.13:

1. Making correspondent banking deposits.
2. Giving credit for uncollected items.
3. Transactions secured by cash or U.S. government securities.
4. Purchasing securities of a servicing affiliate.
5. Purchasing certain liquid assets.
6. Purchasing certain marketable securities from a securities affiliate.
7. Purchasing municipal securities from a securities affiliate.
8. Purchasing an extension of credit that was originated by the bank and sold to the affiliate subject to a repurchase agreement.
9. Asset purchases by a newly formed bank.
10. Transactions approved under the Bank Merger Act.

11. Purchasing an extension of credit from an affiliate on a nonrecourse basis.
12. Intraday extension of credit to an affiliate.
13. Riskless principal transactions.
14. Additional Exemptions. A bank may request an exemption not otherwise provided in Regulation W by submitting a written request to the Federal Reserve Board.

***What constitutes a “Covered Transaction” under section 23B?*** Section 23B generally applies to any transaction covered by section 23A, unless the transaction is exempt under certain provisions of section 23A. However, section 23B also covers a broader group of transactions that may not involve any explicit credit or investment risk to an affiliate but which could nonetheless result in abuse of the affiliate relationship to the detriment of the bank. Specifically, section 23B also includes within its scope of covered transactions:

1. The sale of a security or other asset to an affiliate, including an asset subject to a repurchase agreement.
2. The payment of money or the furnishing of a service to an affiliate under contract, lease, or otherwise.
3. Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person.
4. Any transaction or series of transactions with a nonaffiliate, if an affiliate (a) has a financial interest in the nonaffiliate, or (b) is a participant in the transaction or series of transactions.

***Restrictions and Prohibitions under section 23B.*** Section 23B includes a number of specific restrictions or prohibitions intended to prevent conflicts of interest, including, without limitation, the following:

1. **Market Terms Requirement.** The bank’s covered transactions must be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with or involving nonaffiliates. In the absence of comparable transactions, a bank’s covered transactions must be on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliates.
2. **Prohibited Fiduciary Purchases.** The bank may not purchase as fiduciary any security or other asset from any affiliate unless the purchase is permitted:
  - a. Under the instrument creating the fiduciary relationship;
  - b. By court order; or
  - c. By law of the jurisdiction governing the fiduciary relationship.

3. **Prohibited Purchases of Securities Underwritten by an Affiliate.** The bank, whether acting as principal or fiduciary, may not knowingly purchase or otherwise acquire any security during the existence of any underwriting or selling syndicate if an affiliate is a principal underwriter of that security. However, this prohibition does not apply if a majority of the directors of the bank approved the purchase before the security was initially offered for sale to the public based on a determination that the purchase was a sound investment for the bank, or for the person on whose behalf the bank was acting as fiduciary.
4. **Prohibited Advertisements or Agreements.** The bank and its affiliates may not publish any advertisement or enter into any agreement stating or suggesting that the bank will in any way be responsible for the obligations of its affiliates. However, this prohibition does not apply to the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate, confirming a letter of credit issued by an affiliate, or entering into a cross-affiliate netting arrangement that complies with the quantitative limits and collateral requirements of section 23A, and is otherwise permissible under Regulation W.

### C. **Lending Limit Rules - 12 C.F.R. Part 32**

**Purpose Underlying the Lending Limit Rules.** The OCC Lending Limit Rules, promulgated pursuant to 12 U.S.C. § 84, prohibit a national bank from making certain loans in excess of set limits to particular individuals. The Lending Limit Rules are intended to protect the safety and soundness of national banks by preventing excessive loans to one person, or to related persons that are financially dependent, and to promote diversification of loans and equitable access to banking services. They are viewed as an important safeguard against undue concentration of credit risk in the national banking system.

**Applicability of the OCC Lending Limit Rules.** Pursuant to 12 CFR § 560.93(c), the OTS has made the OCC's Lending Limit Rules and interpretive rules applicable to savings associations. The lending limit provisions of the Texas Finance Code regulating loans to one borrower by a state savings bank do not expressly provide that the OCC Lending Limit Rules are applicable; however, the latter are indirectly incorporated. Section 94.001 of the Texas Finance Code provides that loans to one borrower by a state savings bank are limited to the same extent as a savings association is limited under the Home Owners' Loan Act. The Home Owners' Loan Act, in turn, provides that 12 U.S.C. § 84 is applicable to savings associations in the same manner and to the same extent as it applies to national banks. Thus, generally, the OCC Lending Limit Rules promulgated pursuant to the authority set forth under 12 U.S.C. § 84 are applicable to Texas state savings banks. Although the Texas Administrative Code does not expressly incorporate the OCC Lending Limit Rules, the general lending limits applicable to Texas state banks pursuant to the Texas Administrative Code are not significantly different from those set forth under the OCC Lending Limit Rules. For example, while the OCC Lending Limit Rules limit a national bank's total outstanding loans and extensions of credit to one borrower to 15% of the bank's capital and surplus, plus an additional 10% of the bank's capital and surplus (provided the amount that exceeds the 15% threshold is fully secured by readily marketable collateral), the Texas Administrative Code limits such amounts to 25% of the lesser of the state bank's capital and certified surplus or the bank's total equity capital.

**Restrictions.** A national bank's total outstanding loans and extensions of credit to one borrower may not exceed 15% of the bank's capital and surplus, plus an additional 10% of the bank's capital and surplus, if the amount that exceeds the bank's 15% general limit is fully secured by readily marketable collateral. These limitations are referred to as the "combined general limit." "Readily marketable

collateral” is defined to mean financial instruments and bullion that are salable under ordinary market conditions with reasonable promptness at a fair market value determined by quotations.

***What Constitutes a Loan or Extension of Credit under to the Lending Limit Rules?*** Under Section 32.2(k) of the Lending Limit Rules, a loan or extension of credit refers to a bank’s direct or indirect advance of funds to or on behalf of a borrower based on an obligation of the borrower to repay the funds or repayable from specific property pledged by or on behalf of the borrower, and specifically includes the following:

1. A contractual commitment to advance funds;
2. A maker or endorser’s obligation arising from a bank’s discount of commercial paper;
3. A bank’s purchase of securities subject to an agreement that the seller will purchase the securities at the end of a stated period (but not including a bank’s purchase of Type I securities subject to a repurchase agreement);
4. A bank’s purchase of third-party paper subject to an agreement that the seller will repurchase the paper upon default at the end of a stated period;
5. An overdraft, but not an intraday overdraft for which payment is received before the close of business of the bank that makes the funds available;
6. The sale of Federal funds with a maturity of more than one business day; and
7. Loans or extensions of credit that have been charged off on the books of the bank in whole or in part, unless the loan or extension of credit is unenforceable by reason of discharge in bankruptcy, expiration of the statute of limitations or judicial decision, or for other reasons, provided there are records to demonstrate those reasons.

***Exceptions and Exemptions from the Combined General Limit.*** Certain loans and extensions of credit are subject to special lending limits, which generally exceed the loan amount allowed under the bank’s combined general limit. For example, loans secured by bills of lading or warehouse receipts covering readily marketable staples, loans and extensions of credit that arise from the discount of installment consumer paper, loans secured by documents covering livestock, and loans secured by dairy cattle are all examples of loans and extensions of credit subject to special lending limits. When loans and extensions of credit qualify for more than one special lending limit, the special limits are cumulative.

However, certain loans and extensions of credit are exempt from the combined general limit, including, without limitation:

1. Loans arising from the discount of commercial or business paper;
2. Bankers’ acceptances;
3. Loans secured by U.S. obligations;
4. Loans to or guaranteed by a Federal agency;
5. Loans to or guaranteed by general obligations of a State or political subdivision;

6. Loans secured by segregated deposit accounts;
7. Loans to financial institutions with the approval of the Comptroller of the Currency (“OCC”);
8. Loans to the Student Loan Marketing Association;
9. Loans to industrial development authorities; and
10. Loans to leasing companies.

### III. ATTRIBUTION RULES & DISTINCTIONS AMONG THE REGULATIONS

#### A. Regulation O

Under Regulation O, an extension of credit will be 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 evasion of the restrictions of Regulation O through the use of nominee borrowers.

However, an exception to this attribution rule occurs, and consequently an extension of credit will not be attributed to an insider, under the following circumstance:

- The proceeds of the extension of credit are used in a bona fide transaction to acquire property, goods, or services from the insider, and
- The extension of credit is arm’s length, i.e., on substantially the same terms as those prevailing at the time for comparable transactions with other persons, does not involve more than the normal risk of repayment, and does not present other unfavorable terms.

#### B. Regulation W

***Attribution under section 23A.*** Pursuant to section 23A, a bank must treat any of its transactions with any person as a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate, subject to certain exemptions. This “attribution rule” was included in section 23A to prevent a bank from evading the restrictions in the section by using intermediaries and to limit the exposure that a bank has to customers of affiliates of the bank. The following circumstances are exemptions to this attribution rule:

1. ***Certain Agency Transactions.*** An extension of credit by the bank to a nonaffiliate that uses the proceeds to purchase an asset from an affiliate that is acting exclusively as an agent or broker in the transaction, and the asset purchased by the nonaffiliate is not issued, underwritten, or sold as principal by any affiliate of the bank. However, if an affiliate retains a portion of the proceeds from any such transaction as an agency fee or brokerage commission, the exemption from the quantitative limits and collateral requirements of section 23A does not apply, unless the fee or commission meets the market terms requirement of 12 C.F.R. § 223.51.
2. ***Certain Riskless Principal Transactions.*** An extension of credit by the bank to a nonaffiliate that uses the proceeds to purchase a security through a securities affiliate that is acting exclusively as a riskless principal in the transaction, provided the security is not

issued, underwritten or sold as principal by any affiliate of the bank and any mark-up meets the market terms requirement of 12 C.F.R. § 223.51. (Please note that these transactions are still subject to the safety and soundness requirement, the market terms requirement and certain other provisions of Regulation W.)

3. ***Preexisting Lines of Credit.*** An extension of credit by the bank to a nonaffiliate that uses the proceeds to purchase a security from or through a securities affiliate, if made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit not established for such purpose.
4. ***General Purpose Credit Card Transactions.*** An extension of credit by the bank to a nonaffiliate that uses the proceeds to purchase a product or service from an affiliate, if made pursuant to, and consistent with any conditions imposed in, a general purpose credit card issued by the bank to the nonaffiliate.

***Attribution under section 23B.*** Pursuant to section 23B, any transaction by the bank with any 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. However, unlike section 23A, there are no listed exemptions to this attribution rule.

### **C. Lending Limit Rules**

Under the Lending Limit Rules, a loan or extension of credit will be attributed to another person when either (i) the proceeds of the loan or extension of credit are to be used for the “direct benefit” of the other person, or (ii) a “common enterprise” exists between the borrower and the other person.

***Direct Benefit Test.*** Under the direct benefit test, the proceeds of a loan or extension of credit will be deemed to be for the “direct benefit” of another person, and thus attributed to the other person, when the proceeds, or assets purchased with the proceeds, are transferred to another person, other than in a bona fide arm’s length transaction where the proceeds are used to acquire property, goods, or services.

***Common Enterprise Test.*** A common enterprise will be found to exist, and loans or extensions of credit to separate borrowers will be aggregated, under each of the following circumstances:

1. When the expected source of repayment is the same for each borrower AND neither borrower has another source of income from which the loan or extension of credit may be fully repaid;
2. When loans or extensions of credit are made to borrowers who are related directly or indirectly through common control, AND substantial financial interdependence exists between or among the borrowers. Substantial financial interdependence occurs when 50% or more of one borrower’s gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other borrower. Note that both the common control as well as the substantial financial interdependence prongs must be present in order for a “common enterprise” to exist;
3. When separate persons borrow from a bank to acquire a business enterprise of which those same borrowers will own more than 50% of the voting interests. Note that the separate creditworthiness of individual borrowers does not bar the finding of a common enterprise when their separate loan proceeds are used in the acquisition of a business; or

4. When the facts and circumstances of a particular transaction support that conclusion, as determined by the OCC. Past OCC rulings and interpretations reveal that a very strong evidentiary record based upon a number of factors must exist before a common enterprise will be found to exist solely on the basis of the facts and circumstances. Instances in which the facts and circumstances test will apply where the other direct benefit and common enterprise tests do not will be rare. In various interpretive letters, the OCC has considered the following facts and circumstances to be relevant to a common enterprise determination: (a) engaging in supporting lines of business; (b) interchange of goods and services; (c) common ownership of assets; (d) common management; (e) use of common facilities; (f) commingling of assets and liabilities; (g) closely related business activities; (h) similarity in structure, financing and holding; (i) use of same business address; (j) centralized cash management program; (k) likelihood that a financially troubled member of the group would receive financial aid from other members of the group; (l) family relationships among the borrowers; and (m) pledging of assets to support another's loans.

***Special Attribution Rules.*** The Lending Limit Rules also contain special attribution rules applicable to corporate groups, partnerships, joint ventures, associations, members of such entities, and foreign governments, agencies and instrumentalities.

#### **D. Important Distinction Among the Regulations**

The “transfer” test and “tangible economic benefit” test of Regulation O are substantially the same as the “direct benefit” test found in the Lending Limit Rules. Under each of these tests, a loan will be attributed to another person where the proceeds are transferred to the other person, unless the proceeds are used in a bona fide arm's length transaction to acquire property, goods, or services. Unlike the attribution concepts under Regulation O and the Lending Limit Rules, there is no exception under Regulation W's attribution rule for transactions that are on an arms-length basis and for consideration.

In the Implementing Release for Regulation W, the Federal Reserve explained the underlying reason for this discrepancy as follows:

“The Board ... does not believe that a Regulation O-like exemption, for transactions by a member bank with a third party the proceeds of which are used by the third party in a bona fide transaction to acquire goods or services from an affiliate of the member bank, would be appropriate in the context of section 23A. Regulations O's exemption meshes well into that rule's underlying statutory scheme because sections 22(g) and 22(h) of the Federal Reserve Act do not generally cover asset purchases from an insider; section 23A on the other hand, generally does restrict asset purchases from an affiliate. Moreover, Regulation O's exemption reflects an underlying policy concern not to discourage qualified business owners from serving as management officials of banks. This sort of concern is not present in the section 23A context.”

### **IV. ATTRIBUTION RULES IN THE CONTEXT OF A GENERAL PARTNER**

#### **A. Lending Limit Rules**

Pursuant to the Lending Limit Rules, loans or extensions of credit to a partnership, joint venture, or association are deemed to be loans or extensions of credit to each member of the partnership, joint venture, or association. However, this special attribution rule does not apply to limited partners in limited partnerships or to members of joint ventures or associations if the partners or members, by the terms of the partnership or membership agreement, are not held generally liable for the debts or actions of the

partnership, joint venture, or association, and those provisions are valid under applicable law. In light of the central premise of partnership law that each general partner in a partnership is jointly and severally liable for all liabilities of the partnership, loans to a partnership will normally be attributed to its general partner(s).

Attempts to limit a general partner's liability contractually will not prevent aggregation of loans for lending limit purposes. The OCC has been very clear that a bank may not alter the manner in which aggregate indebtedness is calculated with respect to partnership and joint venture loans merely by contractually agreeing to specific limitations on the partners' individual liabilities for the loans. The exception for limited liability only applies where a partner's or member's obligations are curtailed pursuant to a partnership or joint venture agreement, not where such curtailment arises pursuant to a loan contract.

## **B. Regulation O**

An unpublished FRB Interpretive Letter, dated May 10, 1985, demonstrates how the Federal Reserve has responded to an attribution issue in the context of an individual owning both an interest in a limited partnership and an interest in that limited partnership's general partner. The Interpretive Letter deals with a situation where a majority shareholder of Bank A, an individual who also serves on the bank's board of directors ("Mr. X"), owns 49% of the shares of a Michigan corporation (the "MI GP"). The remaining 51% of the shares of the MI GP are owned or controlled by another individual. The MI GP is the only general partner of the limited partnership ("MI LP") organized under the Michigan limited partnership laws. (Please refer to Exhibit D.)

In the Interpretive Letter, because Mr. X owns 49% of the MI GP's voting stock, he is deemed to "control" the MI GP for purposes of Regulation O. According to the Federal Reserve, the MI GP, in turn, has "the power to exercise a controlling influence over the management or policies" of the MI LP, within the meaning of Regulation O. Michigan limited partnership law makes it clear that the general partners and not the limited partners control the business of a limited partnership.

The Federal Reserve reasoned that since, under Michigan law, a general partner has actual control of a limited partnership, it necessarily has a controlling influence over the management and policies of that limited partnership. Because Mr. X controls MI GP and MI GP has a controlling influence over the MI LP, the MI LP is a related interest of Mr. X. Accordingly, any extension of credit by Bank A to the MI LP is subject to the restrictions and limitations of Regulation O.

## **C. Regulation W**

Regulation W provides that a partnership will be considered an "affiliate" of the bank if (i) the bank or any affiliate of the bank serves as a general partner of the partnership, or (ii) the bank or an affiliate of the bank causes any director, officer, or employee of the bank or affiliate to serve as a general partner of the partnership.

Although partnerships for which the bank serves as a general partner are generally considered to be affiliates, such partnerships typically will be excluded from the definition of affiliate as subsidiaries of their parent bank. The Federal Reserve traditionally has considered the general partner interest in a limited partnership to be a separate class of voting securities of the partnership. Accordingly, a limited partnership would be considered an operating subsidiary of a member bank (that is, a subsidiary of a member bank that is not a section 23A affiliate of the bank) in the typical circumstances where the bank owns or controls more than 25% of the general partner interests in the partnership and the partnership is not a financial subsidiary of the bank.

## V. ISSUES RELATED TO “CONTROL” & DISTINCTIONS AMONG THE REGULATIONS

### A. Definition of “Control”

#### 1. Regulation O

Because Regulation O defines an “insider” to include an executive officer, director, or principal shareholder, and includes any related interest of such a person, it is important to recognize what constitutes a “related interest.” Under Regulation O, a “related interest” of a person includes: (i) a company that is controlled by that person; or (ii) a political or campaign committee that is controlled by that person or the funds or services of which will benefit that person. Therefore, in order to determine what constitutes a “related interest,” and, thus, an “insider,” understanding when control will be deemed to exist is essential.

Regulation O defines “control” of a company or bank to mean that a person directly or indirectly, or acting through or in concert with one or more persons:

1. Owns, controls, or has the power to vote 25% or more of any class of voting securities of the company or bank;
2. Controls in any manner the election of a majority of the directors of the company or bank; or
3. Has the power to exercise a controlling influence over the management or policies of the company or bank.

#### 2. Regulation W

In determining whether an entity is a bank “affiliate” pursuant to Regulation W, the concept of control is relevant. As discussed previously, an “affiliate” is defined to include, among other things, (i) parent companies (any company that controls the bank), (ii) companies under common control by a parent company, and (iii) companies under other forms of common control with the bank (for example, a company controlled by a trust for the benefit of shareholders that also control the bank). Regulation W defines “control” to be generally consistent with concepts used in Regulation Y implementing the Bank Holding Company Act. “Control” by a company or shareholder over another company is defined to mean that the company or shareholder:

1. Owns, controls or has the power to vote 25% or more of any class of voting securities of the other company;
2. Controls in any manner the election of a majority of the directors, trustees or general partners (or individuals exercising similar functions) of the other company; or
3. Exercises a controlling influence over the management or policies of the other company, as determined by the Federal Reserve Board after notice and an opportunity for hearing.

Note that the third prong of Regulation W's definition of control differs from that found in Regulation O and the Lending Limit Rules in that the company or shareholder must "exercise a controlling influence" rather than "[have] the power to exercise a controlling influence." Furthermore, Regulation W's third prong requires that the Federal Reserve Board make such a determination after notice and an opportunity for hearing.

Regulation W also provides that ownership or control of shares in a fiduciary capacity does not constitute control, unless the shares are held by a company controlled by a trust for the benefit of shareholders that also control the bank or any company that controls the bank, or if the company owning or controlling the shares is a business trust. Furthermore, a company or shareholder that owns or controls options, warrants or other instruments that are convertible or exercisable, at the option of the holder or owner, into securities is deemed to control the securities unless information is presented to the Federal Reserve Board rebutting such presumption of control. Finally, if a company or shareholder owns or controls 25% or more of the equity capital of another company, a rebuttable presumption of control is established.

### **3. Lending Limit Rules**

In determining when a loan or extension of credit will be attributed to another person pursuant to the Lending Limit Rules, the concept of control is also relevant. As discussed earlier, under the Lending Limit Rules, a loan or extension of credit will be attributed to another person when either (i) the proceeds of the loan or extension of credit are to be used for the "direct benefit" of the other person, or (ii) a "common enterprise" exists between the borrower and the other person. One circumstance where a "common enterprise" will be deemed to exist occurs when loans or extensions of credit are made to borrowers who are related directly or indirectly through common control, and substantial financial interdependence exists between or among the borrowers.

Pursuant to the Lending Limit Rules, control is presumed to exist when a person directly or indirectly, or acting through or together with one or more persons:

1. Owns, controls, or has the power to vote 25% or more of any class of voting securities of another person;
2. Controls, in any manner, the election of a majority of the directors, trustees, or other persons exercising similar functions of another person; or
3. Has the power to exercise a controlling influence over the management or policies of another person.

#### **B. What Constitutes a Controlling Influence Over the Management or Policies of an Entity?**

##### **1. Regulation O**

Regulation O specifically addresses this issue using a rebuttable presumption of control. Under Regulation O, a person is presumed to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank under the following two circumstances:

1. The person is an executive officer or director of the company or bank, and directly or indirectly owns, controls, or has the power to vote more than 10% of any class of voting securities of the company or bank.

2. The person directly or indirectly owns, controls, or has the power to vote more than 10% of any class of voting securities of the company or bank, and no other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

Note that an individual is not considered to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank solely by virtue of the individual's position as an officer or director of the company or bank.

According to an unpublished FRB Interpretive Letter, dated May 10, 1985, the "controlling influence" standard of Regulation O is derived from Regulation Y, and indirectly, from the Bank Holding Company Act. In applying those provisions, the Federal Reserve has recognized that "a controlling influence embraces pressures and influences, at times subtle, by which a company may be capable of influencing or controlling the affairs of another company."

## **2. Regulation W**

There is virtually no interpretive letter, regulatory issuance, or other legal precedent in publicly available literature interpreting in an enlightening manner the meaning of "exercising a controlling influence over the management or policies of" an entity. Mr. Mark Van Der Weide of the Federal Reserve, and one of the two authors of Regulation W, confirmed to a colleague of mine that there is virtually no Federal Reserve precedent interpreting the controlling influence prong of the definition of "control" because the Federal Reserve has rarely used its authority to hold a hearing to determine whether control existed under the controlling influence prong in a particular situation. Mr. Van Der Weide commented that the Federal Reserve typically does not consider control to exist in instances where the first two prongs for determining control are not satisfied. As a result, the Federal Reserve rarely looks to the controlling influence prong, except in situations where the facts of the relationship between a bank and another entity indicate manifest abuse. Mr. Van Der Weide expressed his view that the standard for determining control under the controlling influence prong is a significantly higher standard than that for determining control under Regulation Y. Regulation Y specifically sets forth certain rebuttable presumptions of control.

The FDIC has asserted authority to make a control determination under the controlling influence prong with respect to banks that it supervises. There are several FDIC enforcement actions in which the controlling influence prong was considered, as well as a federal court of appeals case reviewing the FDIC's decisions in one of these enforcement actions. Although the FDIC's interpretations of the controlling influence prong are not binding on the Federal Reserve, they are instructive in that they appear consistent with the approach that Mr. Van Der Weide indicated the Federal Reserve would take in applying the controlling influence prong. That is, the situations in which the FDIC has deemed control to exist involved individuals who had a significantly great deal of influence over the entities in question and individuals whose actions suggested (at best) a willful disregard of laws and of safety and soundness considerations.

Factors in the FDIC interpretations and the court case that demonstrated this greater degree of control, or indicated disregard for laws and safety and soundness considerations, included:

1. The control person effectively holding additional shares of the entity in question through family members, "straw men" or close business associates;
2. The control person personally funding the entity's operations;

3. The control person's office address being the same as the entity's address;
4. The control person exercising unilateral power to make important entity decisions such as hiring of key financial personnel, or to run critical entity functions such as directing payment of accounts payable and disposition of inventory;
5. The control person representing himself to be, and having a general reputation in the community as being, "in charge" of the entity; and
6. The granting of loans to the entity from the commonly controlled bank on terms unfavorable to the bank or unreasonably favorable to the entity.

### **3. Lending Limit Rules**

In determining what constitutes a controlling influence over the management or policies of an entity, the OCC has taken a case-by case approach after examination of all the facts. Interpretive letters reveal that the OCC has focused on certain factors, including, without limitation: (i) significant managerial control, (ii) the existence of management contracts, (iii) familial relationships which give rise to a controlling influence over the management or policies of another person, and (iv) in the context of a trust, provisions of the trust agreement and the entity's ability to influence the trustees' management or administration of the trust.

## **VI. GUARANTEES & DISTINCTIONS AMONG THE REGULATIONS**

### **A. Regulation O**

An "extension of credit" is defined under Regulation O to include, among other things, any transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever. This provision has been interpreted to include loan guarantees. Accordingly, a loan guaranteed by an insider will fall under the scope of Regulation O as an "extension of credit."

However, under Regulation O, an endorsement or guarantee for the protection of a bank of any loan or other asset previously acquired by the bank in good faith does not constitute an extension of credit. For instance, the Federal Reserve has previously stated that a bank's executive officer or principal shareholder would be permitted to provide a guarantee on a loan made by the bank to an unrelated person where the credit has deteriorated without being subject to Regulation O's restrictions.

The Federal Reserve explains that in order to avoid double counting of extensions of credit to a bank official and the related interests of the bank official, an endorsement or guarantee by a bank official of an extension of credit to a related interest of the bank official (or vice-versa) will be considered a single extension of credit in the amount of the direct obligation of the related interest for the purpose of Regulation O's lending limitations.

### **B. Regulation W**

A "covered transaction" is defined under Regulation W to include the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the

affiliate, a confirmation of a letter of credit issued by the affiliate, and a cross-affiliate netting arrangement.

*Cross-Affiliate Netting Arrangement.* A “cross-affiliate netting arrangement” refers to an arrangement among a bank, one or more affiliates of the bank, and one or more nonaffiliates of the bank in which:

1. A nonaffiliate is permitted to deduct any obligations of the affiliate of the bank to the nonaffiliate when settling the nonaffiliate’s obligations to the bank; or
2. The bank is permitted or required to add any obligations of its affiliate to a nonaffiliate when determining the bank’s obligations to the nonaffiliate.

Cross-affiliate netting arrangements expose a bank to the credit risk of its affiliates because the bank may become liable for the obligations of its affiliates. According to the Federal Reserve, because the exposure of a bank to an affiliate in such an arrangement resembles closely the exposure of a bank when it issues a guarantee on behalf of an affiliate, Regulation W explicitly includes such arrangements in the definition of covered transaction.

*Keepwell Agreements.* In a keepwell agreement between the bank and an affiliate, the bank typically commits to maintain the capital levels or solvency of the affiliate. According to the Federal Reserve, the credit risk incurred by the bank in entering into such a keepwell agreement is similar to the credit risk incurred by a bank in connection with issuing a guarantee on behalf of an affiliate. As a consequence, keepwell agreements generally should be treated as guarantees for purposes of section 23A and, if unlimited in amount, would be prohibited by the quantitative limits of section 23A.

### **C. Lending Limit Rules**

Guarantees are not included in the definition of “extension of credit” in the Lending Limit Rules. The Lending Limit Rules do not consider a loan on which someone signs as guarantor as having been made to the guarantor unless that person is deemed to be a borrower under the “direct benefit” or “common enterprise” attribution tests. Hence, the existence of a guaranty does not require attribution of other loans to the guarantor, but does suggest that the common enterprise and direct benefit tests be carefully considered.

## **VII. CURRENT TOPIC RELATING TO THE LENDING LIMIT RULES – NON-CONFORMING LOANS DUE TO COLLATERAL SHORTFALLS**

On December 23, 2003, federal officials announced the first case of Mad Cow disease in a dairy cow located in the state of Washington. Due to the public perception of the issue, along with the almost immediate ban on imports of U.S. beef by other countries, live cattle prices and futures prices for cattle dropped in the range of 20 to 30 percent. In light of this situation, the OCC has received inquiries from bankers requesting guidance on legal lending limit compliance for loans where a decline in the collateral value of cattle that secures those loans has led to temporary collateral shortfalls for purposes of the legal lending limit calculations and whether such shortfalls may fall within the scope of the “extraordinary circumstances” provision of 12 C.F.R. § 32.6(c).

Under the Lending Limit Rules, a loan is treated as nonconforming if the loan is no longer in conformity with the bank’s lending limit because collateral securing the loan to satisfy the requirements of a lending limit exception has declined in value. A bank is required to bring such a nonconforming loan into conformity with the bank’s lending limit within 30 calendar days, except when judicial proceedings,

regulatory actions or other extraordinary circumstances beyond the bank's control prevent the bank from taking action.

In a recent OCC Advisory Letter, the OCC stated that the decline in market value of live cattle has been a systemic phenomenon and is not the result of action by a particular bank or borrower. As a result, the OCC is advising its examiners to treat collateral shortfalls that arise from the Mad Cow disease announcement as an "extraordinary circumstance" beyond the bank's control for purposes of the nonconforming loan provisions of the Lending Limit Rules for the next 180 days, until July 21, 2004. However, this interpretation only applies to monies already advanced on existing loans and does not apply to any new advances under existing facilities or new loans.