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Bank Lender Tie-In Prohibitions "Caveat Commodator"

Introduction

The recent uncertainty in the financial markets, as well as the general increase in the tightening of the credit market and the need to fashion more creative financing arrangements has caused a greater likelihood that certain practices may run afoul of the prohibitions on bank tying under the Bank Holding Company Act Amendments of 1970 (12 U.S.C. §1972) ("Act"). Generally speaking, banks are able to combine traditional banking products, but as these financing packages become more creative, there is a need to be mindful of how certain practices may run afoul of the Act.

Background

Prior to the enactment of the anti-tying provisions of the Act, the leading case pertaining to tying arrangements involving credit was *Fortner Enterprises, Inc. v. United States Steel Corp., et al* (394 U.S. 495 (1969). The U.S. Supreme Court held that an illegal tying arrangement could be found to exist if a customer was required to take a "tied product," as a condition of being allowed to purchase the "tying product." The Court ruled that credit could not be used by U.S. Steel (or, for that matter, any lender) to illegally tie other products and demonstrated that the extension of credit would be viewed by the court as a "product."

Even though the *Fortner* decision demonstrated that treble damages and injunctive relief could be obtained under the Sherman Act where anticompetitive tying involving credit was shown to exist, Congress recognized that the antitrust enforcement capabilities of the Justice Department and Federal Trade Commission were limited. Furthermore, the Sherman and Clayton Acts did not adequately protect borrowers from being required to accept unwanted tied products as a condition to receiving loans issued by banks.

Therefore, in 1970, Congress enacted Section 106 of the Act, which was specifically designed to apply to and remedy such bank misconduct and to provide a bank specific tying prohibition to help "provide specific statutory assurance that the use of the economic power of a bank will not lead to a lessening of competition or unfair competitive practices" (S. Rep. No. 91-1084, at 16 (Aug. 10, 1970)).

Statutory Overview

The Act is a federal statute that permits bank customers to seek civil damages when one transaction is conditioned on the customer's willingness to complete a second transaction with the same institution (*United States vs. Beuttenmuller*, 29 F. 3d 973 n. 8 (5th Cir. 1994)). However, while courts could still find Sherman Act violations for tying arrangements involving credit, with treble damages as a remedy, it is unlikely any such finding contrary to the Federal Reserve System's regulatory powers would prevail.

The anti-tying provisions are set forth within Section 106 of the Act, which provides that:

> "a bank shall not in any manner extend credit or furnish any service, or fix or vary the consideration for any credit or service on the condition or requirements that among other things: (A) the customer obtain some additional credit, property, or service from such bank *other than* a loan, discount, deposit, or trust service or those related to or usually provided in connection with a loan, discount, deposit or trust service; (B) the customer obtain or provide some additional credit, property, or service from a bank holding company of such bank or from any subsidiary of such bank holding company; or (C) the customer not obtain some other credit, property or service from a competitor of such bank, a bank holding company of such bank or any subsidiary, other than as a condition or requirement reasonably imposed in a credit transaction to assure the soundness of the credit."

Institutions Subject to the Act

Section 106 applies, by its terms, to any depository institution that meets the definition of "bank," as defined in Section 2(c) of the Bank Holding Company Act ("BHC Act"), including a grandfathered "nonbank bank" that is controlled by a company under Section 4(f) of the BHC Act. The statute also applies to any depository institution that is described in Section 2(c)(2)(D), (F), (G), (H), (I) or (J)

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of the BHC Act and, thus, excluded from the definition of "bank" under the BHC Act. As a result, virtually every type of institution, including savings institutions, that is chartered as a bank, including every "insured bank" (as defined in Section 3 of the Federal Deposit Insurance Act), is subject to Section 106. This is true whether or not the covered depository institution is owned or controlled by a bank holding company registered under the BHC Act.

Section 106 also applies to any U.S. branch, agency, or commercial lending company of a foreign bank (as those terms are defined in Section 8 of the International Banking Act). In addition, although affiliates of a bank generally are not subject to Section 106, the BHC Act specifically provides that an affiliate of an institution controlled pursuant to Section 4(f) or described in Section 2(c)(2)(D), (F), (G), (H), (I) or (J) of the BHC Act is subject to the anti-tying prohibitions of Section 106 in connection with any transaction involving the products of both the affiliate and the institution as if the affiliate were a bank and the institution were an affiliate.

Section 106 also applies to most, but not all, subsidiaries of banks. In particular, Section 106 applies to all subsidiaries of a bank, other than a financial subsidiary, in exactly the same manner as the statute applies to the bank itself. A financial subsidiary of a national bank or a state member bank, however, is treated as an affiliate of the bank, and not as a subsidiary of the bank, for purposes of the statute.

Regulatory Guidance and Case Law

There are both statutory and regulatory exceptions to the general prohibitions of Section 106 of the Act. Section 106 itself, as quoted above, specifically allows a bank to condition both the availability and price of any bank product on the requirement that the customer obtain a "traditional bank product" (such as a "loan, discount, deposit, or trust service").

In addition to the explicit exception for a "traditional bank product" found in the Act, the Board of Governors of the Federal Reserve System ("FRB") has utilized the authority granted to it by the Act to grant regulatory exceptions to the tying restrictions prohibited under Section 106 of the Act. These exceptions are set forth in §225.7 of Regulation Y (12 CFR 225.7) and allow a bank to restrict the availability and vary the price of any product if the customer:

(i) Also obtains a "traditional bank product," as defined in the Act, from the bank or any affiliate of the bank;
(ii) Provides a product to the bank or any affiliate of the bank and such product is "related to and usually provided in connection with" the bank product;
(iii) Refrains from obtaining a tied product from a competitor of the bank or a competitor of an affiliate of the bank if that condition is reasonably imposed by the bank in a credit transaction to ensure the soundness of the credit (the "exclusive dealing exception");
(iv) Is not obliged, in any combined-balance discount packages, to purchase non-traditional products in order to obtain the discount; or
(v) Is a "foreign person," as defined in the Act.

Several facts are important in determining whether the traditional bank product exception applies in a given situation. The FRB, on August 25, 2003, proposed an interpretation and supervisory guidance (the "FRB Interpretation") of the anti-tying restrictions of Section 106 of the Act. The proposed FRB Interpretation clarified that traditional bank products include, among other things, the following:

(i) All types of extension of credit, including loans and lines of credit;
(ii) Letters of credit and financial guarantees;
(iii) Credit derivatives where the bank or affiliate is the seller of credit protection;
(iv) All forms of deposit accounts;
(v) Safe deposit box services;
(vi) Escrow services;
(vii) Payment and settlement services;
(viii) Payroll services;
(ix) Cash management services;
(x) Discretionary asset management services provided as a fiduciary; and
(xi) Custody services.

In response to criticism received by the FRB from banks and other lending institutions, the proposed FRB Interpretation was never officially adopted. In particular, the sentiment expressed by such banks and lending institutions was that banking is a dynamic business and that the regulatory proposals were overly restrictive and that by specifically stating what was a "traditional bank product," it left the door open for potential plaintiffs to make the argument that everything that was not specifically listed in the regulations would not fall under this exception. This argument was compelling to the FRB in that it recognized that traditional banking practices are evolutionary and that any attempt to define the terms "traditional bank product" would be limiting and detrimental to the lending markets as a whole. Recognizing that the financial world at the time the proposed FRB Interpretation was issued was different from the one that existed when Section 106 was enacted, the FRB was willing to leave it up to the courts to review the facts and circumstances surrounding a particular credit arrangement in order to determine if there were any violations of anti-tying restrictions.

Although never officially adopted, the FRB Interpretation does provide some guidance on how the FRB views the anti-tying provisions of the Act and subsequent interpretations have demonstrated that the FRB has exercised its authority to grant exemptions in a manner that supports the legality of arrangements in which customers have a meaningful choice.

For example, in its 1994 Fleet order (*Fleet Financial Group*, 80 Fed. Res. Bull. 1134 (1994)), the FRB granted an exemption from Section 106 for Fleet's combined balance discount program and found that the program was not "coercive, anticompetitive, or otherwise inconsistent with the purposes of Section 106." Subsequently, the FRB has repeatedly issued guidance reaffirming the permissibility of relationship-based conditions in which customers, because of meaningful choice to select traditional bank products in order to obtain discounts, have not been coerced into accepting non-traditional bank product. *See, e.g. Citibank* (combined balance program permissible

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because it "offers meaningful choice to customers" and "would not directly or indirectly cause customers to use non-traditional products." (*Citibank, N.A.*, FRB Interp. Ltr., at 3 (Dec. 6, 1996)); and *NationsBank* (because of customer's ability to obtain banking services without obtaining non-traditional bank products, proposed discount arrangement "does not raise the concerns about coercion and anti-competitiveness that Section 106 was intended to address." (NationsBank Corp., 1997 WL 1138814, at 3 (F.R.B. Sept. 19, 1997).

Case law that is relevant to relationship banking also supports the notion that unlawful tying cannot exist if customers have a choice of whether to obtain the tied product. For example, in *Stefiuk v. First Union National Bank of Florida* (61 F. Supp. 2d. 1294 (S.D. Fl. 1999), aff'd 207 F.3d 664 (11th Cir. 2000)), the plaintiff argued that the bank engaged in an unlawful tie when it conditioned free check cashing on his opening a bank account, even though he could also avoid check cashing fees by obtaining a check cashing card. In addition to observing that the bank's practices were likely permitted by the traditional bank products exception, the court held that there was no tie because the plaintiff was not forced to get the tied product – opening an account.

A similar result was reached in *Integon Life Ins. Corp. v. Browning* (989 F.2d 1143 (11th Cir. 1993)), in which the court held that an unlawful tie occurs only when the plaintiff is, in fact, forced to buy the tied product to obtain the tying product. Where customers have the option of obtaining the tying product by selecting a traditional bank product or a non-traditional bank product, no such coercion is present.

As illustrated above, courts have found that coercion is an essential element in determining whether an illegal tie-in exists. The case law supports the view that Section 106 was intended as additional protection for small businesses and consumers who would be more likely to be subject to such types of coercion (*See, e.g.*, *Dibidale*, 916 F.2d 300 (small building business being required to use bank's choice of general contractor in order to obtain a construction loan would be a violation of Section 106)); *see also, Sharkey v. Security Bank & Trust Co.*, 651 F. Supp.1231 (bank's requirement that customer purchase real estate from the bank as a condition to obtaining a loan was a violation of Section 106).

Conclusion

In today's current financial and credit market conditions, there may be temptation by both lenders and borrowers to engage in creative financing arrangements in order to originate new loans or to keep existing loans current and free from default. However, despite this increased pressure on financial institutions to provide creative financing arrangements during a time of uncertainty and because of skeptical attitudes towards lending institutions, banks need to be sure that their operations do not run afoul of the anti-tying prohibitions of the Act. At the same time, borrowers should be mindful of conditions to obtaining credit proposed by lenders and be aware of the statutory and regulatory protections available to them to ensure fair dealing and competitive practices.

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