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National Bank Lending Limits and the Attribution Rules Of 12 U.S.C. S 84 Congress and the Comptroller Cover the Bases

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NATIONAL BANK LENDING LIMITS AND THE ATTRIBUTION
 RULES OF 12 U.S.C. § 84
 CONGRESS AND THE COMPTROLLER COVER THE BASES

Donald E. Frechette*

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INTRODUCTION

In 1863, Congress placed the first statutory limit on the amount of money that any one person, company or firm could borrow from a national bank.¹ Although no enduring evidence has survived which might indicate Congress' intent in enacting the original statute, its progeny, 12 U.S.C. § 84, can be said to express two objectives. First, by limiting the amount of money a single individual can borrow, Congress intends to increase availability of banking services to the public. Congress apparently rationalizes that national banks are chartered for the good of the general populace, not a chosen few. Second, by encouraging national banks to make loans to a broad array of individuals and entities, the significance of each loan to the bank's financial health is reduced. Thus, diversification of bank loan portfolios serves the interests of safety and soundness of each institution and the banking industry.²

1. Section 47 of the statute, commonly referred to as the Currency Act (12 Stat. 665, *et seq.*) provided as follows:

And be it further enacted, That the total liabilities of any person, or of any company or firm, (including in the liabilities of a company or firm the liabilities of the several members thereof) to any association, including liabilities as acceptor of bona fide bills of exchange, payable out of the state where the association is located, shall at no time exceed one third; exclusive of liabilities as acceptor, one fifth; and exclusive of liabilities on such bills of exchange, one tenth part of the amount of the capital stock of such association actually paid in.

Currency Act, § 47, 12 Stat. 665, *et seq.* (1863)(Current version at 12 USC § 84 (1989)).

2. Both of these concepts were clearly articulated by one of the architects of the present statute, Representative McFadden, who stated:

[T]his is the most important section of the National Bank Act. It regulates the amount that a national bank may lend to one individual, firm, or corporation. The theory of this section is that the funds of a national bank should be loaned for the use and benefit of the business men of the community who furnish the deposits out of which such loans are made. The section is intended to prevent one individual, or a relatively small group, from borrowing an unduly large amount of the bank's deposits for the use of the particular business enterprises in which they are engaged. It is intended to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different lines of business.

One of the notable achievements of Congress's initial foray into the field of lending limits was the adoption of what has come to be known as a rule of attribution. Attribution requires that a loan which is made to an individual or entity may, under certain circumstances, also be considered as a loan to a third party which is separate and legally distinct from the recipient of the actual funds. Thus, both direct and attributable lendings must be considered for lending limit purposes. Under the original statute, for example, when a national bank considered lending to a company or firm, any outstanding loans to the entity's various individual members would be aggregated with direct loans outstanding to the company or firm in order to determine whether the intended transaction would violate the bank's lending limit.³ This early and, admittedly, imprecise attribution rule prevented circumvention of lending restrictions through the creation of corporate shells or other artificial identities. The attribution requirements of the original statute functioned much like the modern statute by preventing concentration of the bank's resources among a small cadre of borrowers, and by spreading risk.

Over the last 125 years, the lending limit statute of 1863 has been amended extensively.⁴ Regulations promulgated under a broad

68 Cong. Rec. H5817 (1927) (Statement of McFadden, Chairman of the House Banking Committee).

Representative McFadden's statement of purpose has been adopted by the OCC in both its regulations and its rulings. See, e.g., 12 C.F.R. § 32.1(b); Letter of Byrd, Assistant Director, Legal Advisory Services Division, No. 184, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,265 (April 2, 1981); Letter of Oda, Senior Attorney, Legal Advisory Services Division, No. 292, [1984-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,462 (June 20, 1984).

This rationale has also been articulated by the courts. See, e.g., *Corsicana National Bank of Corsicana v. Johnson*, 251 U.S. 68, 83 (1919) (The statutory limit is a special safeguard designed by Congress for the very purpose among others of preventing undue reliance upon the financial standing of borrowers); *Valente v. Dennis*, 437 F. Supp. 783, 786 (E.D. Pa. 1977) (citing *O'Hare v. Second National Bank*, 77 Pa. 96, 102-103 (1874)) (regulations were designed to prevent banks from lending too much of their money to one person).

3. See *supra*, note 1.

4. The statutory history of the original statute, which was derived from Act June 3, 1864, c.106, § 29, 13 Stat. 108 is designated the National Bank Act by 12 U.S.C. § 38, is summarized as follows:

R.S. § 5200; June 22, 1906, c. 3516, 34 Stat. 451; Sept 24, 1918, c. 176, § 6, 40 Stat. 967; Oct. 22, 1919, c. 79, § 1, 41 Stat. 269; Feb. 25, 1927, c. 191, § 10, 44 Stat. 1229; May 20, 1933, c. 35, § 1, 48 Stat. 73; June 16, 1933, c. 89, § 26(a), 48 Stat. 191; Aug. 23, 1935, c. 614, Title III, § 321(b), 49 Stat. 713; June 11, 1942, c. 404, § 8, 56 Stat. 356; July 22, 1937, c. 517, §15(a), as added Aug. 14, 1946, c. 964, § 5, 60 Stat. 1079, and Aug. 25, 1958, P.L. 85-748, § 1(c), 72 Stat. 841; Sept. 9, 1959, P.L. 86-251, § 3, 73 Stat. 488; Sept. 28, 1962, P.L. 87-723, § 4(c)(4), 76 Stat. 672; May 25, 1967, P.L. 90-19, § 27(b), 81 Stat. 29; June 23, 1972, P.L. 92-318, Title I, Part D, § 133(c)(2), 86 Stat. 269.

statutory grant of authority, expanded and strengthened the attribution rules.⁵ In response, bank directors, officers, customers and their respective counsel have contrived new artifices to avoid the reach of the rules. Their principal (and formidable) adversary in this endeavor is the Office of the Comptroller of the Currency ("OCC").⁶ Expressly empowered in 1918 to promulgate rules and regulations concerning lending limits,⁷ the OCC is charged with interpretation and enforcement of 12 U.S.C. § 84. However, the OCC's daunting regulatory power is not attributable to a rigid and unyielding statutory mechanism. Rather, the OCC wields control by way of a complex and comprehensive regulatory framework.

This article examines the provisions of 12 U.S.C. § 84, and its regulatory counterpart, 12 C.F.R. § 32.1, et seq. Part I generally describes the statute and its application. Part II examines current attribution rules, considering OCC regulations and interpretive rulings, as well as existing case law. Finally, Part III examines statutory liability of bank personnel who are found to have violated the provisions of Section 84.

I. THE STATUTE

When analyzing various statutory components of federal bank regulation, the reader must attend carefully to the virtually plenary authority assumed by OCC in enlarging the scope of the statute beyond its language through regulatory enhancement. Such recognition reveals that the statute's influence cannot be determined merely by examining its terms. The real meaning and power of Section 84 is defined by and resides with the OCC. Acting pursuant to Congress's grant of authority to administer and carry out the purposes of Section 84, the OCC has effectively formed and held the first line of defense for the statute.

The current version of the statute became effective on April 14, 1983 with passage of the Garn-St. Germain Depository Institutions Act of 1982.⁸ The statute has four major components:

5. See 12 C.F.R. § 32.1 et seq. (1991). These regulations promulgated by the Office of the Comptroller of the Currency, serve to further refine the statute's terms, clarify the circumstances under which the statute's exceptions will be available and describe the tests that will be employed to determine whether a loan that is ostensibly made to one individual should be attributed to the account of another in order to determine lending limit compliance.

6. For a brief, yet interesting commentary on such efforts, see Letter of Byrd, Assistant Director, Legal Advisory Services Division, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,011 (Aug. 12, 1977) (In any area where bankers and bank counsel have shown as much ingenuity as they have in the application of lending limits, it is impossible to cover all possible fact situations in generalized interpretive rulings).

7. Act Sept. 24, 1918, c. 176, §6, 40 Stat. 967.

8. Act Oct. 15, 1982, P.L. 97-320, Title IV, Part A, § 401(a), 96 Stat. 1508.

Subsections (a)(1) and (a)(2) contain broad prohibitions which, subject to certain exceptions, create the outer boundaries of permissible lending. Subsections (b)(1) and (b)(2) contain definitional provisions. Exceptions to the restrictions set forth in subsections (a)(1) and (a)(2) are described by subsections (c)(1-10). Finally, subsections (d)(1) and (d)(2) empower the OCC to promulgate rules and regulations concerning implementation and interpretation of the statute.

A. Subsections (a)(1) and (a)(2); Limitations on Lending

Provisions defining basic lending limits are found at 12 U.S.C. § 84(a)(1) and (a)(2):

(a)(1) The total loans and extensions of credit by a national banking association to a person outstanding at one time and not fully secured, as determined in a manner consistent with paragraph (2) of this subsection, by collateral having a market value of at least equal to the amount of the loan or extension of credit shall not exceed 15 per centum of the unimpaired capital and unimpaired surplus of the association.

(a)(2) The total loans and extensions of credit by a national banking association to a person outstanding at one time and fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the funds outstanding shall not exceed 10 per centum of the unimpaired capital and unimpaired surplus of the association. This limitation shall be separate from and in addition to the limitation contained in paragraph (1) of this subsection.

Subsections (a)(1) and (a)(2) impose two closely related, though separate, constraints on bank lending. The first prohibits loans or extensions of credit by a national bank to a single person in excess of 15 percent of the bank's unimpaired capital and unimpaired surplus unless the loans or extensions are fully secured by readily marketable collateral.⁹ The second limit, separate and

9. 12 C.F.R. § 32.2(c) establishes that the terms unimpaired capital and unimpaired surplus are equivalent to the terms capital and surplus defined at 12 C.F.R. § 3.100. See, 12 C.F.R. § 32.2(c) (1991).

distinct from the 15 percent ceiling, caps the aggregate amount that a national bank can lend to one person on a secured or unsecured basis. In addition, a national bank may loan an additional 10 percent of its capital and surplus (in excess of the 15 percent ceiling) to a single person provided the additional loan is fully secured by readily marketable collateral.¹⁰ When considered together, these two fundamental restrictions generally permit a national bank to lend up to 15 percent of its capital and surplus to any single person, whether the loan is secured or unsecured. Moreover, the bank can make additional loans to the same person, up to an additional 10 percent of its capital and surplus, provided the additional loans are fully secured by the types of readily marketable collateral described by the statute.

The OCC considers readily marketable collateral to include bullion or financial instruments of a type that are capable of being sold under ordinary circumstances with reasonable promptness at a value determined by "quotation based upon actual transactions on an auction or a similar available daily buy and ask price market."¹¹ Accordingly, stocks, bonds, commercial paper, negotiable certificates of deposit, and money market mutual fund

12 C.F.R. § 3.100(a) states that capital shall include the amount of common stock outstanding and unimpaired plus the amount of perpetual preferred stock outstanding and unimpaired. 12 C.F.R. § 3.100(b) (1991). Similarly, 12 C.F.R. § 3.100(c) defines surplus as the sum of paragraphs (c)(1), (2), (3) and (4) of that section which provide:

(1) Capital surplus; undivided profits; reserves for contingencies and other capital reserves (excluding accrued dividends on perpetual and limited life preferred stock); net worth certificates issued pursuant to 12 U.S.C. 1823(i); minority interests in consolidated subsidiaries; and allowances for loan and lease losses; minus intangible assets;

(2) Purchased money servicing rights;

(3) Mandatory convertible debt to the extent of 20% of the sum of paragraphs (a) and (c)(1) and (2) of this section;

(4) Other mandatory convertible debt, limited life preferred stock and subordinated notes and debentures to the extent set forth [at 12 C.F.R. § 3.100(f)(2)].

10. Although 12 U.S.C. § 84(a)(2) states that the loan will be in compliance only if readily marketable collateral is posted with respect to the amount of the funds outstanding, a careful reading of the statute clearly reveals that only the additional 10% loan must be secured in the manner specified. The reader's particular attention is drawn to the language at the conclusion of Section 84(a)(2) which provides that the limitation in that paragraph is separate from and in addition to the limitation described in Section 84(a)(1). 12 U.S.C. § 84(a)(2) (1991). Further, 12 C.F.R. § 32.4(b) clearly establishes that the collateral requirement only applies with respect to the loan or extension of credit based upon the Section 84(a)(2) limitation, not upon all outstanding loans or extensions of credit.

11. 12 C.F.R. § 32.4(c) (1991).

shares in which a bank may perfect a security interest would be acceptable collateral.¹² In contrast, real estate, accounts receivable, equipment, art-work, boats, and non-negotiable securities fail to satisfy the definition.

In an effort to promote ongoing statutory compliance, the OCC mandates that national banks institute and maintain monitoring procedures which ensure that each loan is, at all times, appropriately collateralized.¹³ If collateral value drops to the extent that it is no longer sufficient to fully secure the portion of a loan made pursuant to subsection (a)(2), and if the general 15 percent loan limitation of subsection (a)(1) is exceeded, the errant loan must, within five (5) business days, be brought into conformance.¹⁴ In practice, this requires the loan's principal balance to be reduced or an additional security interest in acceptable collateral to be granted to the lending bank. However, if during the interim, the bank's capital position improves sufficiently that the loan could then be made without violating the above limitations, no further correction would be required.

B. Subsections (b)(1) and (b)(2); Definitions

The definitional provisions of the statute have far-reaching effects. Through expansive definitions of "person" and "loans or extensions of credit", Congress demonstrated its intent to regulate all manner and form of indebtedness owing to a national bank by any individual or entity.

"Person[s]" who are subject to the statute are defined at 12 U.S.C. § 84(b)(2) as follows:

[T]he term "person" shall include an individual, sole proprietorship, partnership, joint venture, association, trust, estate, business trust, corporation, sovereign government or agency, instrumentality, or political subdivision thereof, or any similar entity or organization.

12. *Id.* Financial instruments which are posted as security pursuant to this section may be denominated in foreign currencies as long as they are freely convertible to U.S. Dollars. If the collateral is so denominated and payable in currency other than that of the loan or the extension of credit that it secures, the bank must have procedures in place to require that the collateral be revalued on at least a monthly basis, using appropriate foreign exchange rates, in addition to being repriced at current market value. 12 C.F.R. § 32.4(e) (1991).

13. 12 C.F.R. § 32.4(d) (1991).

14. 12 C.F.R. § 32.4(f) (1991).

This definition encompasses virtually any legal entity or structure.¹⁵ Moreover, the statute's reference to "similar" types of entities, when coupled with the OCC's interpretative powers, assures that any form of legal structure will, unless specifically excepted by the OCC, be subject to the provisions of Section 84.

Loans and extensions of credit are defined at 12 U.S.C. § 84(b)(1):

[T]he term loans and extensions of credit shall include all direct or indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of the person and, to the extent specified by the Comptroller of the Currency, such terms shall also include any liability of a national banking association to advance funds to or on behalf of a person pursuant to a contractual commitment[.]

Accordingly, a loan or extension of credit can arise whenever a person is, directly or indirectly, obligated to repay money to a national bank. In simpler times, such an obligation took the form of a pre-printed promissory note. However, many modern transactions have attributes of a loan, but (as discussed below) may be denominated using other terminology. In determining whether or not a given transaction constitutes a "loan or extension of credit" governed by the statute, the principal inquiry is whether or not funds have been advanced in exchange for an obligation to repay.

The most notable example of a loan hybrid is the repurchase agreement. In one form of repurchase agreement, an individual "sells" certain securities to a lending institution for a prearranged period of time. At the time of "sale", the individual contractually binds himself to repurchase the securities at a specific future time for an amount equal to the original sales price plus a "service charge" which, by no mere coincidence, equals the amount of interest which would otherwise have accrued on the funds advanced. Additionally, the repurchase agreement requires that the original "seller" repurchase the securities at their sales price, irrespective of any diminution in their value. This requirement removes any risk stemming from fluctuations in the value of the collateral. Accordingly, the only remaining exposure is the credit risk which is common to all loans.

15. 12 C.F.R. § 32.2)(b) completely incorporates the statutory definition of persons. However, it also adds not-for-profit corporations to the list of entities included in the definition. *Id.*

Courts examining repurchase agreements in other contexts have not been dissuaded from characterizing such transactions as loans.¹⁶ Although the parties may be labeled "buyer" and "seller", money is advanced in return for a contractual obligation that the original amount be repaid with the addition of a sum which represents interest. It is hardly surprising that some repurchase agreements have been considered to be loans by the OCC for Section 84 purposes.¹⁷

16. See, e.g., *In re Braswell Government Securities Corp.*, 648 F.2d 321, 324 n.5 (5th Cir. 1981) (finding that repurchase agreements are, for securities purposes, short-term collateralized loans); *Union Planters National Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir. 1970) (finding that, for purposes of federal tax consequences, repurchase agreements constitute loans); *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970) (repurchase agreements are loans, not purchases and sales, for purposes of federal tax law); *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980) (characterizing repurchase agreements in a securities context as short-term collateralized loans). See also, *United States v. Erickson*, 601 F.2d 296, 300 n.4 (7th Cir. 1979), cert. den'd. 442 U.S. 979 (1979) (repurchase agreements are in substance a secured loan); *Erlich-Bober & Co. v. University of Houston*, 49 N.Y. 2d 574, 577, 404 N.E. 2d 726, 728, 427 N.Y.S. 2d 604, 606 (1980) (repurchase agreements are in essence a loan transaction). But see, *Matter of Bevill, Bressler & Schulman Asset Management Corporation*, 67 B.R. 557, 597-598 (D.N.J. 1986) (repurchase agreements are to be construed in accordance with the intent of the parties and, in the subject case, were determined to be contracts for the purchase and sale of goods, not loan agreements); *City of Harrisburg v. Bradford Trust Company*, 621 F. Supp. 463, 469-470 (M.D. Pa. 1985) (for purposes of the anti-fraud provisions of the 1933 and 1934 Securities Acts, repurchase agreements are securities); *SEC v. Gomez*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,013 (S.D. Fla. 1985) (repurchase agreements are securities under the anti-fraud provisions of the 1933 and 1934 Securities Acts); *In re Financial Corp.*, 1 B.R. 522 (W.D. Mo. 1979), aff'd. sub. nom., *Financial Corp. v. Occidental Petroleum Corp.*, 634 F.2d 404 (8th Cir. 1980) (while a repurchase agreement may have many attributes of a secured loan, the intention of the parties to effectuate a security interest is lacking); *Gilmore v. State Board of Administration of Florida*, 382 So.2d 861 (Fla. 3d D.C.A. 1980) (repurchase agreement is not collateralized loan since the buyer had the right to sell the original securities at any time after acquiring them without accountability for the sale proceeds, subject only to an obligation to offer like securities for repurchase by the original seller under the term specified in the agreement).

17. 12 C.F.R. § 32.103 provides as follows:

Section 32.103 Purchase of Securities Subject to Repurchase Agreement.

(a) The purchase of "Type I Securities," as defined in 12 C.F.R. 1.3(c), subject to an agreement that the seller will repurchase at the end of a stated period is not a "loan or extension of credit" for purposes of this part.

(b) The purchase of other types of securities subject to an agreement that the seller will repurchase at the end of a stated period is regarded as a loan from the purchasing bank to the seller and not as an obligation of the underlying obligor of the security.

A "Type I security" means a security which a bank may deal in, underwrite, purchase and sell for its own account without limitation. These include obligations of the United States, general obligations of any state or any

Another transactional structure which is similar to a loan is a personal property lease. Under a personal property lease, an individual "rents" a piece of property such as a car, a boat or computer from a bank. The rent that is paid over the course of the lease is equivalent to the value of the property plus an additional amount (which may be labelled in any number of ways) roughly equivalent to the interest payable for loan financing of the purchase.

Personal property leases can be either closed or open-ended. In an open-ended lease, the transaction is structured in such a way that, at the conclusion of the term, the property: (1) has no remaining value; (2) must be purchased by the lessee; or (3) has a remaining book value sufficiently less than its projected market value to assure that the lessor sustains no loss on disposition of rental property. Thus, the lessor bears no risk associated with fluctuation in the value of the collateral. The lessor's sole risks are those present in any ordinary loan transaction (i.e. pricing and nonperformance risk).

In contrast to an open-ended lease, a close-ended lease does not obligate the lessee to purchase the rental property or otherwise assure its continued value. Accordingly, the lessee is exposed not only to ordinary credit risks, but also to risks associated with changes in the value of the security during the course of the lease.

The OCC originally took the position that personal property leases did not constitute loans for purposes of Section 84. Former 12 C.F.R. § 7.3400¹⁸ provided:

A national bank may become the owner or lessor of personal property acquired upon the specific request and for the use of a customer and may incur such additional obligations as may be incident to becoming an owner and lessor of such property. *Lease transactions do not result in obligations for the purpose of 12 U.S.C. § 84.* [Emphasis added].

political subdivision thereof and other obligations listed in § 7 of 12 U.S.C. § 24. Examples of type I securities set forth in § 7 include, but are not limited to, obligations of the Washington Metropolitan Area Transit Authority, obligations issued under authority of the Federal Farm Loan Act and securities of the Student Loan Marketing Association among others. See Letter of Byrd, Assistant Director, Legal Advisory Services Division, [1979-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,284 (July 7, 1981).

18. 12 C.F.R. § 7.3400 was substantially revised by 44 Fed. Reg. 22393 (1979).

In *M&M Leasing Corporation v. Seattle-First National Bank*,¹⁹ several motor vehicle leasing agencies, dissatisfied with the OCC's position on personal property leases, brought suit to combat the intrusion of national banks into the leasing business. The agencies sought a determination that personal property leasing constituted an *ultra vires* act for a national bank. The district court analyzed the distinction between open-end and closed-end leases and determined that the open-end leases were, in fact, loans. Accordingly, open-end leases constituted valid activities on the part of national banks. However, the court reasoned that close-end leases, because of speculative components concerning the residual value of the collateral, posed risks which were beyond the appropriate bounds of the banking business.²⁰ Therefore, banks could not lawfully engage in the creation or servicing of close-end leases.

On appeal, the 9th Circuit agreed that the open-end personal property leases are loans. As such, they can properly be undertaken by national banks. However, the appellate court modified the lower court's ruling concerning closed-end leases. It found that close-end leases are appropriate "when, in the light of all relevant circumstances, the transactions constitute the loan of

19. *M & M Leasing v. Seattle First Nat'l Bank*, 391 F. Supp. 1290 (W.D. Wash. 1975), *aff'd in part and rev'd in part*, 563 F.2d 1377 (9th Cir. 1977).

20. *Id.* at 1295. Specifically, the court stated:

In my opinion, the open-end motor vehicle lease, which is the usual form, is merely a variation in the traditional manner of extending credit and is the functional equivalent of a loan of personal security. Specifically, the open-end lease differs only insignificantly from a conditional sales contract with a final balloon payment. The lease customer assumes all of the burdens and risks of ownership of the automobile. The bank, during the lease term, is repaid the cost of the vehicle together with the cost of financing the transaction out of a combination of rentals and guaranteed residual payment, and sometimes tax benefits also. The bank is promised a pre-established financial return, with only the usual risks inherent in any credit transaction.

*The closed-end vehicle lease, on the other hand, is not functionally equivalent to a loan because the lessee does not guarantee the residual value of the car. The risk of downward fluctuation in that value falls on the bank; this fact sets the closed-end vehicle lease apart from an ordinary loan. A closed-end lease is equivalent to a loan only if written for a term which exhausts the usable life of the leased property so that the bank does not rely on any residual value in its calculation of its expected financial return. Closed end vehicle leases do not meet this criterion. [Emphasis added]. *Id.**

money secured by the properties leased."²¹ The "bright line" traced by the district court was blurred by the appellate court's "totality of the circumstances" test. Therefore, not all closed-end leases constituted improper banking activity. Instead, the appellate court found that a closed-end lease was permissible if residual value of rental property upon termination of the lease was not expected to contribute substantially to the bank's recovery of its advances plus interest.²²

In analyzing a personal property lease, it is important to note that the substance of the transaction warrants the conclusion that there has been an indirect advance of funds in exchange for a repayment obligation. This is, of course, the essence of a "loan or extension of credit" pursuant to 12 U.S.C. § 84. The transaction appears to be no more than a promissory note with a prearranged stream of payments. Only one feature distinguishes a personal property lease from most bank lending transactions: in a loan, a bank would maintain a security interest in the collateral, while the customer holds title to the property. However, in a lease, the bank maintains both ownership of the property and the right to repossess it in the event of a default by the renter. Despite this distinction, the transaction represents a repayment obligation for principal and interest. Accordingly, it is appropriately subject to the statute's limitations.

21. *M & M Leasing*, 563 F.2d at 1381.

22. *Id.* The appellate court stated:

Finally, our holding manifestly is not intended to authorize leases which imposed significant financial risks on national banks more onerous than those incident to loans. Therefore, it is necessary that the lessor bank look primarily to the obligations of the lessee for the entire return of its advances. It is the lessee's creditworthiness, not primarily the market value of the property, to which the bank must look for its return. No banker, however, ignores the borrower's collateral; nor must he when the loan is cast in lease form. Our point, put differently, is that a lease, which from its inception inevitably must be repeated or extended to enable the bank to recover its advances plus profit, is not a "loan of money on personal security." Such leases indicate a rental business, not the business of banking. To engage in the business of renting personal property would permit the assumption of risks not permitted national banks. *An impermissible assumption of risks is not indicated, however, by an open-end lease, in which the bank's entire advance is guaranteed by the lessee, or a closed-end lease, in which the residual value of the leased property at the expiration of the lease contributes unsubstantially to the bank's recovery of its advances plus interest. [Emphasis added]. Id. at 1382.*

Another type of transaction closely analogous to a "loan" is the discounting of commercial paper. When a bank "discounts" paper, it purchases the paper for less than its face value. The difference between the face value and the amount actually paid for the paper is the "discount". This amount is typically thought to represent prepaid interest and service charges incurred in connection with the transaction. The seller of the paper can transfer it to the bank on either a recourse or a non-recourse basis. If the paper is negotiated on a recourse basis, the seller must satisfy the paper in the event of default by the drawer. In such a case, a loan has been made; there has been a transfer of funds in exchange for a repayment obligation. However, if the paper is transferred without recourse, whether direct or indirect, no loan has been made, since the seller has incurred no express or implied repayment obligation. Instead, the original maker of the paper becomes the bank's borrower.²³

In view of statutory language proscribing "indirect" advances of funds, bank overdrafts have also been found to constitute transactions within the purview of 12 U.S.C. § 84.²⁴ This view holds whether the overdraft is prearranged or not.²⁵ The OCC merely focuses on the fact that the money has been exchanged contemporaneously with the creation of an implied repayment obligation.

Renewals of existing obligations may also, in certain cases, constitute loans or extensions of credit. Although renewal of an existing loan which has become excessive because of a decline in the bank's capital position does not violate the statute, such a holding is primarily based upon the rationale that "no new money

23. These conclusions are compelled by the terms of 12 C.F.R. § 32.104 which states:

Where a bank purchases third-party paper subject to an agreement that the seller will repurchase the paper upon default or at the end of a stated period after default, the seller's obligation to repurchase is subject to 12 U.S.C. § 84 and is measured by the total unpaid balance of the paper owned by the bank less any applicable dealer reserves. Where seller's obligation to repurchase is limited, the seller's total loans or extensions of credit, for the purpose of 12 U.S.C. § 84 are measured by the total amount of paper the seller may ultimately be obligated to repurchase. Where no more than an agreed percentage of the purchase price is retained by the bank and credited to the reserve to be held as a form of collateral security, but the bank has no direct or indirect recourse to the seller, the loans or extensions of credit do not constitute loans or extensions of credit to the seller subject to the limitations of § 84.

The reader should note, however, that certain of the exceptions of § 84 may be relevant to the consideration of this issue. Specifically, the reader's attention is drawn to exceptions 1 and 8 of 12 U.S.C. § 84(c).

24. 12 C.F.R. § 32.105 (1991). See also, *McCormick v. King*, 241 F. 737 (9th cir. 1917), *aff'd*. 250 U.S. 504 (1919).

25. 12 C.F.R. § 32.105 (1991).

leaves the bank's vaults."²⁶ However, if a new loan includes both principal and interest from discounted prior loans which exceeded statutory limits, a violation has occurred. In such a case, the prepaid interest amount is, in effect, being advanced. Whenever "new money" is advanced by the bank, a new loan occurs. Therefore, statutory compliance must be examined at that time.²⁷

The second way in which a loan or extension of credit can be created is through a contractual commitment by the bank to advance funds.²⁸ Such commitments usually occur in one of three ways: (1)

26. *Payne v Ostrus*, 50 F.2d 1039 (8th Cir. 1931). Finding a renewal not to be violative of the statute, the Court wrote:

In the absence of exceptional circumstances and a course of conduct pointing unavoidably to a deliberate purpose to evade the law and to extend unwarranted lines of credit, we do not think the taking of renewal notes falls within the inhibition of the letter and spirit of the statute. No new money leaves the bank's vaults. . . . It does not appear that the bank was damaged by the taking of these renewal and interest notes, nor is it shown that the original notes were collectible or that the interest could have been paid by the makers. Furthermore, the best interests of banks often demand that notes should be renewed, and that, on occasion, collections should not be pressed. *Id.* at 1041;

See also, Letter of Byrd, Assistant Director, Legal Advisory Services Division, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,039 (Sept. 30, 1977).

27. *Atherton v. Anderson*, 86 F.2d 518 (6th Cir. 1936) *rev'd. on other grounds sub nom. Anderson v. Atherton*, 302 U.S. 643 (1937). In *Atherton*, the subject bank advanced interest on a renewal note. The obligation which was the subject of the renewal note had a prepaid interest component. The renewal note was in an amount in excess of that permitted by the statute. Finding the loan excessive, the Court held that loans may not become excessive by the mere running of time and the inclusion of interest with principal is insufficient to constitute the loan being excessive for no new money leaves the bank's vaults. However, when interest is incorporated with the original note and a renewal note is issued, the total indebtedness of a borrower increases so that the entirely new loan is in excess of that which the bank is permitted by law to loan to the borrower. Under such circumstances the new loan violates the statute because new money does leave the bank's vaults. *Id.* at 533, 534.

28. 12 C.F.R. § 32.2(d) defines a "contractual commitment to advance funds" as follows:

(d)(1) . . . an obligation to make payments (directly or indirectly) to a third party contingent upon default by the bank's customer in the performance of an obligation under the terms of that customer's contract with the third party or upon some other stated condition; or
 (2) an obligation to guarantee or stand as surety for the benefit of a third party. . . .; or
 (3) a qualifying commitment to lend (as defined at paragraph (f) of this section). The term includes, but is not limited to, standby letters of credit (as defined in paragraph (e) of this section), guarantees, puts or

by an obligation undertaken by the bank to make payments, directly or indirectly, to a third party upon the occurrence of a stated condition or upon default of the bank's customer under the terms of a contract with that third party; (2) pursuant to a guaranty obligating given by a bank to act as surety for the benefit of a third party; and (3) in accordance with the terms and conditions set forth in a "commitment letter" evidencing the bank's future obligation to make a loan.

A bank's obligation to make third-party payments typically arises through the issuance of a standby letter of credit. A standby letter of credit is defined in 12 C.F.R. § 32.2(e) as follows:

A "standby letter of credit" is any letter of credit or similar arrangement, however named or described, which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party, or (2) to make payment on account of any indebtedness undertaken by the account party, or (3) to make payment on account of any default by the account party in the performance of an obligation.

Standby letters of credit function as security documents. For example, a letter of credit may be posted as collateral in connection with a promissory note. The letter might also be used to provide indemnity against failure of some future performance. Real estate developers often post letters of credit with municipalities or other government agencies in order to provide irrevocable assurance of their financial ability in connection with required site improvements.

When a bank issues a standby letter of credit, the bank is at risk from the time that the letter of credit is issued. The risk does not abate until the letter either expires or until the underlying conditions requiring its issuance have been satisfied. Therefore, the bank incurs a credit risk simply by issuing the letter of credit, regardless of whether it is ever called upon by

other similar arrangements.

For the purposes of this part, undisbursed loan funds and loan commitments not yet drawn upon which are not qualifying commitments to lend, or which are not otherwise equivalent to a contractual commitment to advance funds as defined are not considered a contractual commitment to advance funds. This definition also does not include commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer, which do not guarantee payment of a money obligation, and which do not provide for payment in the event of default by the account party.

the beneficiary to perform according to its terms. Under these circumstances, the OCC has determined that 12 U.S.C. § 84 must be applied from the moment that the letter of credit is issued. Therefore, the issuance of a letter of credit is viewed as the inception of an extension of credit.²⁹ If the letter is subsequently extended or renewed, the time of the extension or renewal may be considered to be the inception of a new extension of credit.³⁰

Guaranties and other arrangements, whereby a bank agrees to answer for the debt of another, represent another class of extensions of credit.³¹ Much the same as above, the bank undertakes a future and contingent obligation to advance money for the benefit of an obligor in exchange for the obligor's promise to repay. Again, since credit risk is incurred by issuing the future promise to pay, it is not necessary that repayment actually be demanded in order for the transaction to be subject to the limitations of Section 84.³²

A binding written commitment to lend is also viewed as a contractual obligation to advance funds.³³ Although the OCC has not provided any guidance in this area, the law of contracts would presumably determine whether or not the commitment is "binding". In other words, the commitment would have to be supported by consideration; be sufficiently definite so as to be enforceable; and all necessary preconditions would have to have been satisfied.

Since a written commitment to lend is necessarily a future obligation, an interesting question arises as to when lending limit compliance should be determined: at the time of the issuance of the commitment or, upon funding? For example, on January 1, 1991, Bank's capital and surplus is \$10,000,000 and its unsecured lending limit is equal to 15 percent of that amount, or \$1,500,000. Later the same day, Customer, who already owes \$1,000,000 in unsecured loans, obtains a commitment from Bank for additional unsecured loans in the amount of \$500,000. Following issuance of the commitment, Bank's capital and surplus declines to \$9,000,000,

29. 12 C.F.R. § 32.2(d)(1) (1991).

30. Letter of Corey, Attorney No. 477, [1989-1990 Transfer Binder], Fed. Banking L. Rep. (CCH) ¶ 83,027 (Jan. 11, 1989). (At the expiration of a standby letter of credit, the risk is extinguished. Accordingly, renewing the letter renews the risk and compliance should be examined at that time. A different rule applies to "evergreen" letters, however. Such letters of credit give the beneficiary the right to call the letter if it is not renewed. Accordingly, the failure to extend such a letter of credit may actually increase, not decrease, the risk to the bank. Renewals of "evergreen" letters are not, therefore, considered new extensions of credit).

31. 12 C.F.R. § 32.2(d)(2) (1991).

32. *Id.*

33. 12 C.F.R. § 32.2(d)(3) (1991); 12 C.F.R. § 32.2(f) (1991).

reducing Bank's lending limit to \$1,350,000. Can Bank advance under the commitment letter, or will such a loan result in a lending limit violation?

The OCC takes the position that a "snapshot" of the Bank's position on the date of commitment is sufficient to establish lending limit compliance as long as the commitment and all other outstanding loans (or commitments) to Customer were within Bank's lending limit on the date of the subject commitment.³⁴ In such a case, if a decline in the lending limit occurs, funding of the loan would not violate Section 84 since the extensions of credit were legal at the time of execution. Instead, the excessive portion of the loan would be viewed as "non-conforming".³⁵ If Customer sought to renew the loan, Bank would be required to utilize its best efforts to bring the loan back into conformance. This could be accomplished through, for example, partial repayment or by obtaining participation of another lending institution.³⁶

On the other hand, if the commitment, combined with Customer's other loans, exceeded Bank's lending limit at the time the commitment was issued, the commitment would not be deemed a loan until funded. Therefore, the legality of the subsequent loan would be examined at the time of funding.³⁷ Accordingly, if Bank's lending limit had declined, the protective leeway permitted by the non-conforming rule would be unavailable and the extension of credit would be deemed unlawful.

This scheme appears to make sense in that it protects extensions which were proper when committed but does not protect extensions which were excessive at their inception. However, the rule appears logically flawed in another context: unless the commitment provides otherwise, the borrower can demand performance by the bank, even if regulation prohibits the bank from funding all or part of the loan. If the bank refuses to perform, it could be answerable in damages for breaching its contractual commitment to make the loan.³⁸ The bank could be faced with a choice between

34. 12 C.F.R. § 32.2(f) (1991). If these conditions are satisfied, the commitment is deemed a qualifying commitment.

35. Department of the Treasury, Comptroller of the Currency 56 Fed. Reg. 37272 (Aug. 6, 1991), reprinted at Fed. Banking L. Rep. (CCR) ¶ 88,561 (1991).

36. *Id.*

37. *Id.*

38. See, National Farmers Organization, Inc. v. The Kingsley Bank, 731 F.2d 1464 (10th Cir. 1984) (Lending limit statutes are designed to proscribe bank, not borrower, conduct. Accordingly, borrowers, without notice of a lending limit violation, may enforce their contract.); Bank Itec N.V. v. J. Henry Schroder Bank & Trust Company, 612 F. Supp. 134 (S.D.N.Y. 1985) (State and federal courts have universally applied a single guiding principle: one without knowledge of a statutory lending limit violation can enforce an obligation which violates that limit.); See also First American National Bank v. Alcorn, Inc., 361 So. 2d 481 (Miss. 1978) (Letter of credit beneficiary who was unaware of lending limit

disbursing the loan in violation of its lending limit, or breaching its contract with the borrower and incurring damages which may exceed the amount of the loan.

It would appear more appropriate to determine lending limit compliance on the date of the commitment and retain the rule of non-conformance. The date of commitment is the date on which the obligation and consequent credit risk are incurred. In this manner, national banks and their directors could be spared the choice between honoring a contract and incurring the wrath of the OCC, or incurring civil liability for breaching the contract. Their new alternatives would be simple and straightforward; lend or don't lend based upon present facts, not future projections or occurrences. Commitments that were lawful when made would not be affected by a reduction in the bank's lending limit.³⁹

violation could enforce maker's obligation under the letter of credit.); *Bank of College View v. Nelson*, 106 Neb. 129, 183 N.W. 100 (1921) (Innocent borrower can enforce bank's promise to lend a sum in excess of legal lending limit.); *Labor Discount Center, Inc. v. State Bank and Trust Company*, 526 S.W. 2d 407 (Mo. Ct. App. 1975) (Absent knowledge of a given bank's loan limits, a borrower should be able to hold a bank liable for breach of a contract to make a loan).

39. Recent rule revisions by the OCC have, in the opinion of the author, exacerbated this situation. Formerly, if a bank's lending limit was \$5 million and the bank had issued a binding written loan commitment in that amount to a customer, any further loan or extension of credit would have violated the bank's lending limit. This is because the commitment would be considered a loan or extension of credit on the date issued since it was within the bank's lending limit. See Former 12 C.F.R. §32.2(d) as revised by 56 Fed. Reg. 37272 (August 6, 1991), and recodified at 12 C.F.R. §§32.2(d)(3) and 32.2(f). Presently, if a bank entered into a \$456 million commitment with a customer, it would be free to advance cash to that customer up to its \$5 million lending limit. *Id.* This result is justified by the fact that the commitment is not considered as an extension of credit when made. The bank's sole exposure (other than a potential "safety and soundness" argument) is the possibility of a breach of contract claim should it be unable to subsequently fund the excessive commitment.

Instead of adopting a conservative approach that measures lending limit compliance on the date that the binding contract to lend is entered into, the OCC now allows actual loans to be made up to the amount of the bank's lending limit whether or not the commitment was within the limitation when entered into. 12 C.F.R. §32.2(f) (1991). In other words, using the above-described example, both customers would be permitted to go to the bank and obtain loans for up to \$5 million even though they already had, respectively, \$5 million and \$456 million unadvanced loan commitments outstanding. *Id.* The OCC does require that the unfunded loan commitment be disqualified, for Section 84 purposes, for each dollar actually advanced. *Id.* Yet, this approach still ignores that fact that the commitment is a contractual undertaking for breach of which the bank will be answerable in damages. Given this level of regulatory permissiveness, diligent bankers would be well advised to insert a precondition into their loan commitments that relieves them of the obligation to fund if to do so would violate Section 84. Alternatively, bankers who advance funds which, when combined with outstanding commitments, would exceed Section 84 limits should give serious consideration to obtaining contractual releases of their pre-existing obligations.

The word "obligation" within the definition of "loans or extensions of credit" also has particular significance. An "obligation" represents a legally enforceable duty. Accordingly, the discharge of a loan in bankruptcy, or its unenforceability at law (as, for example, by passage of the applicable statute of limitations), remove such loans from the reach of the statute.⁴⁰ However, a loan which is charged off in whole or in part by the bank does not necessarily represent an extinguished obligation since the bank's accounting practice does not make the loan any less enforceable. Therefore, charged off loan balances may be fully considered in calculating lending limit compliance.⁴¹

C. Subsections (c)(1-10); Statutory Exceptions

Most of the statutes's exceptions are absolute, allowing unlimited extensions of credit. However, certain of the exceptions merely create specific lending limits particular to instances where they are present and distinct from the broad parameters previously described. Each exception is separately discussed below.

1. Recourse Commercial Paper

12 U.S.C. § 84(c)(1) provides:

Loans or extensions of credit arising from the discount of commercial paper or business paper evidencing an obligation to the person negotiating it with recourse shall not be subject to any limitation based upon capital or surplus.

This exception allows for unlimited extensions of credit by a bank in discounting negotiable paper which has been used to finance the purchase of commodities which are the subject of certain domestic or export transactions. The commodities must be either for resale, fabrication of a product, or any other business purpose which may reasonably be expected to provide funds for payment of the paper.⁴²

Generally, such paper must bear the full recourse endorsement of its owner.⁴³ However, if the notes are generated in connection with the discounting of paper utilized in an export transaction, they may be non-recourse or limited recourse (including those covered by separate agreement for limited recourse) as long as they are transferred in conjunction with an assignment of appropriate

40. 12 C.F.R. § 32.106 (1991).

41. *Id.*

42. 12 C.F.R. § 32.6(a)(2) (1991).

43. *Id.*

insurance covering political, credit and transfer risks associated with the paper.⁴⁴ In such cases, the insurance is deemed to represent a satisfactory substitute for the recourse endorsement.⁴⁵

The rationale for this exception is that the discounted paper is created in connection with the sale of a commodity which, in turn, serves as a source of repayment.⁴⁶ For example, the discounting of agricultural sales paper created in connection with the sale of farm machinery to farmers is entitled to the exception. Reasoning that this machinery will be used to produce crops which, in turn, provide a source of repayment, the OCC stated:

[The exception] is applicable to negotiated paper, bearing the full recourse endorsement of an actual owner, given by a farmer in payment of the purchase price of farm machinery, the use of which may reasonably be expected to provide funds for the payment of the paper upon its maturity. *This means that it must appear reasonable, not only to the farmer but to the banker or a disinterested third person, that the machinery will improve production to the extent that the machinery may be said to pay for itself within the term of the paper.*⁴⁷ [Emphasis added]

The requirement of the OCC that the machinery must pay for itself during the term of the paper is consistent with extending exceptions to financing for items which establish their own repayment source. This exception is founded upon the notion that the paper is effectively backed by commodities which can be viewed as a source of repayment. It should be noted that, if the item purchased with the paper becomes obsolete prior to the generation of commodities sufficient to pay for its purchase, the underlying rationale has been defeated and the exception becomes unavailable for continued use.

The OCC has taken the position that the source-of-repayment rationale mandates that any default with respect to payment on the paper, whether of principal or interest, vitiates the justification for the grant of unlimited credit.⁴⁸ If such a default occurs, there must have been an insufficient basis for believing that the

44. *Id.*

45. Comptroller of the Currency Letter, [1961-1963 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 93,653 (Jan 21, 1963); Comptroller of the Currency Letter, [1961-1963 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 93,645 (Dec. 14, 1962).

46. 12 C.F.R. § 32.6(a)(3) (1991).

47. Comptroller of the Currency Letter, [1961-1963 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 93,680 (Feb. 1, 1963).

48. 12 C.F.R. § 32.6(a)(3) (1991).

commodity financed would generate enough funds to make payments on the paper. Such a default would not make the subject loan retroactively violate the statute. However, it would require the paper to be taken into consideration to determine lending limit compliance with regard to subsequent renewals, extensions or additional loans to the same borrower.⁴⁹

At first, this exception appears to defy both of the statute's stated intentions. Theoretically, one person could "tap out" an institution based upon paper generated in connection with a single line of business. Accordingly, risk diversification and benefit spreading would be ill-served. However, the mechanics of discounting warrant a conclusion that, except in the most unusual cases, many persons in a plethora of business enterprises are served by this provision with little erosion of the statute's goals. Sellers of commercial paper are, for their own protection, prone to risk diversification, as are discounters. Moreover, if it were shown that the seller of the paper was merely acting as a "pass-through" agent for a single maker, such a pattern of transactions would be discovered and the exception disallowed under the direct benefit and common enterprise tests hereinafter described.

2. Bankers' Acceptances⁵⁰

12 U.S.C. § 84(c)(2) provides:

The purchase of bankers' acceptances of the kind described in Section 13 of the Federal Reserve Act [12 U.S.C. §§ 82, 342-346, 347c, 372] and issued by other banks shall not be subject to any limitations based on capital and surplus.

Purchase of bankers' acceptances of the type described at 12 U.S.C. § 372 and § 373⁵¹ is not subject to the lending limitations of Section 84. These statutes establish separate limitations on the acceptance of "eligible" drafts by a national bank. Such limitations are beyond the scope of this article. However, drafts

49. *Id.*

50. A banker's acceptance is nothing more than a time draft that has been finally accepted by a bank for payment. BLACK'S LAW DICTIONARY 133 (5th ed. 1979). The act of acceptance is the functional equivalent of a guaranty by the accepting bank to honor the draft when it is presented. U.C.C. § 3-410 (1989). As such, the accepting bank has substituted its credit for that of the original maker of the instrument.

51. 12 U.S.C. § 373 applies to drafts or bills that are drawn by banks in foreign countries or dependencies of the United States for purposes of dollar exchanges. An examination of the interfacing between 12 U.S.C. § 84, 12 U.S.C. § 372 and 12 U.S.C. § 373 is beyond the scope of this Article. Accordingly, the interaction between 12 U.S.C. § 84 and 12 U.S.C. § 372 alone will be examined.

which are "ineligible" (i.e. not of the type described at 12 U.S.C. § 372 and § 373) are subject to lending limits set forth in 12 U.S.C. § 84.

The "eligible drafts" exception to 12 U.S.C. § 84 is based upon that fact that eligible bankers' acceptances are marketable securities backed by the credit of issuing financial institutions which are regulated pursuant to 12 U.S.C. § 372. However, in these troubled economic times, the rationale underlying this exception may prove no stronger than the weakest bank permitted to issue bankers' acceptances. Although the demands of commercial custom may require this exception, it can no longer be unequivocally stated that all commercial banks which create bankers' acceptances represent unquestionable sources for the repayment of the funds represented by the acceptances.

As previously stated, 12 U.S.C. § 84 and 12 U.S.C. § 372 create different limits with respect to bankers' acceptances, depending upon the nature of the acceptance, and the identities of the acceptor and the holder.⁵² A banker's acceptance is never simultaneously subject to both sections. Nor is the bank free to choose which limitation should apply.⁵³

In determining the applicable lending limit, the first inquiry to be made is whether the acceptance is "eligible" or "ineligible". This determination is governed by the provisions of 12 U.S.C. § 372 which, in the pertinent part, provides:

Any member bank and any Federal or State branch or agency of a foreign bank subject to reserve requirements . . . of the International Banking Act . . ., may accept drafts or bills of exchange drawn upon it having not more than six months sight to run, exclusive of days of grace -

(i) which grow out of transactions involving the importation or exportation of goods;

(ii) which grow out of transactions involving the domestic shipment of goods; or

(iii) which are secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples.

52. Letter of Byrd, Assistant Director, Legal Advisory Services Division, No. 131, [1979-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,212 (Dec. 17, 1979).

53. *Id.*

If a banker's acceptance meets all of the requirements set forth in 12 U.S.C. § 372, it is considered to be an "eligible" acceptance. If it does not meet those requirements, it is "ineligible".

When a bank accepts is an eligible draft, the limitations contained in 12 U.S.C. § 372 are exclusively applicable. In such cases, 12 U.S.C. § 84 lending limits are pre-empted. Accordingly, a national bank may not create eligible acceptances in excess of its 12 U.S.C. § 372 limit, even though the bank's 12 U.S.C. § 84 limitations would not be met.⁵⁴

However, if the bank then discounts its own eligible acceptance a different result occurs. Such transactions are not subject to 12 U.S.C. § 372. Instead, 12 U.S.C. § 84 represents the sole applicable lending limit. This is because, after discounting, the acceptances are considered to be a loan to the bank's customer.⁵⁵ The bank has given cash in exchange for the instrument and a promise to pay if it is subsequently dishonored. If these acceptances are later resold or further discounted, 12 U.S.C. § 84 will no longer govern. Instead, the amounts must be included in the bank's 12 U.S.C. § 372 limitation.⁵⁶

The purchase of eligible acceptances issued by other banks is not subject to the provisions of either Section 372 or Section 84. This is because 12 U.S.C. § 372 only applies to the actual act of acceptance and 12 U.S.C. § 84(c)(2) specifically exempts the purchase of eligible bankers' acceptances from the general lending limitations of that statute.⁵⁷

Most situations are greatly simplified if an acceptance is determined to be "ineligible". If so, Section 372 cannot be applied. Accordingly Section 84 will represent the sole lending limitation.⁵⁸

The following example illustrates the application of these rules. If Customer presents a draft to First Bank for acceptance, First Bank would initially determine whether or not the draft has been issued in connection with any types of transactions described by 12 U.S.C. § 372. If this initial inquiry were answered in the affirmative, the draft would be considered "eligible" and limitations set forth in Section 372 should be consulted. If the answer were no, the draft would be ineligible. In such a case, the

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

act of acceptance would be considered a loan or extension of credit subject to the lending limits of Section 84.

Assuming First Bank has accepted an "eligible" draft, if Customer were to ask First Bank to discount that draft, Section 372 would no longer apply. Instead, Section 84 would govern. The Section 84 exception for bankers' acceptances would be unavailable since it applies only to acceptances issued by third party banks other than the discounting institution. However, if Customer were to take the eligible acceptance to Second Bank for discounting, Second Bank would not be subject to Section 372, but could benefit from Section 84 exception. As such, no limitations would apply. The same result would occur if, subsequently, First Bank were to discount the eligible acceptance of Second Bank. In such a case, First bank would no longer consider the acceptance as a loan to Customer. Instead, the transaction would be subject solely to the limitations expressed in Section 372.

If the acceptance created by First bank is "ineligible", any transaction discounting it for Customer's benefit would be viewed as a loan subject to Section 84. Hence, the above exception would not be available. Moreover, if First Bank were to discount its own ineligible acceptance and later discount the ineligible acceptance to Second bank, Second Bank's discounting would be considered to represent a loan to First Bank subject to Section 84.⁵⁹

Commercial realities lead to the conclusion that the exception furthers both of Section 84's statutory intentions. Bankers' acceptances are business instruments created in connection with many sorts of transactions. It is doubtless that circumstances could arise which might appear to frustrate the intention of the statute. However, a more realistic view is that the exception furthers commerce and trade. Congress could reasonably be believed to have determined that the goals of risk diversification and benefit spreading would be fostered by the exception.

3. Loans Secured by Bills of Lading or Warehouse Receipts Covering Readily Marketable Staples

12 U.S.C. § 84(c)(3) states as follows:

Loans and extensions of credit secured by bills of lading, warehouse receipts, or similar documents transferring or securing title to readily marketable staples shall be subject to a limitation of 35 percent of capital and surplus in addition to the general limitations if the market value of the staples

59. *Id.*

securing each additional loan or extension of credit at all times equals or exceeds 115 percent of the outstanding amount of such loan or extension of credit. The staple shall be fully covered by insurance whenever it is customary to insure such staples.

This exception allows national banks to lend up to 35 percent of their capital and surplus if such loans are secured by bills of lading, warehouse receipts or other documents of title issued in connection with readily marketable staples. This exception operates in conjunction with general limitations set forth in Section 84(a)(1) and (a)(2).⁶⁰

The rationale behind this exception is apparent. Like the rationales for other exceptions discussed above, the staples themselves provide a source of repayment. They must be nonperishable and must be covered by insurance when this is the custom.⁶¹ Further, acceptable nonperishable staples may not be held for more than 10 months, while refrigerated or frozen nonperishables may not be held for more than six months.⁶²

The market value of all staples must, at all times, equal or exceed 115 percent of the outstanding loan amount.⁶³ For that reason, the OCC has defined a "readily marketable staple" as an item of commerce, agriculture or industry which is characteristically the subject of dealings in a ready market with frequent price quotations.⁶⁴ This would include such commodities as wheat and other grains, cotton, wool, and basic metals such as tin, lead and copper.⁶⁵ The market for a staple must be one in which the price can be easily and definitely ascertained, and which

60. 12 C.F.R. § 32.6(c)(2) (1991).

61. 12 C.F.R. § 32.6(c)(3) (1991). It is important to note, however, that refrigerated or frozen staples are considered to be non-perishable. *Id.*

62. 12 C.F.R. § 32.6(c)(5)(i), (ii) (1991).

63. While the language of this exception certainly seems to require that the entire loan be secured by the staples, the OCC has previously ruled that this is not the case. Rather, only that portion of the loan over and above the general 15% limitation of § 84(a)(1), for which there is no collateral requirement, and the collateralized 10% limitation of § 84(a)(2), must be secured in accordance with this exception.

Letter of Byrd, No. 185, [1981-82 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,266 (Mar. 11, 1981). (This opinion was issued prior to the dual limitations of Section 84(a)(1) and (a)(2) at a time when a single ten percent lending limit applied. However, its reasoning appears equally applicable to the modern day two-tier general prohibitions of ten and fifteen percent).

64. 12 C.F.R. § 32.6(c)(3) (1991).

65. *Id.*

allows easy sale and realization of the staple without material sacrifice of its collateral value.⁶⁶

Documentation securing the loan must provide the bank with control of the commodity and the right to immediate possession.⁶⁷ This requirement enables the institution to immediately obtain possession in order to sell the collateral without protracted litigation. Shipping documents, warehouse receipts, bills of lading and other such documents which evidence title satisfy the OCC's objective to maintain a right to immediate possession.⁶⁸

Under this exception, risk is limited by collateral requirements. However, through use of this exception, a single borrower can receive loans which total up to 60 percent of a single institution's capital and surplus since the exception allows borrowings over and above general limitations set forth in Section 84(a)(1) and (a)(2). This exception would appear to raise serious questions regarding the extent to which legislative concerns about risk diversification and benefit spreading have been advanced.

4. Loans Secured by U.S. Obligations

An absolute exception to lending limits is provided in 12 U.S.C. § 84(c)(4):

Loans or extensions of credit secured by bonds, notes, certificates of indebtedness, or Treasury bills of the United States or by other such obligations fully guaranteed as to principal and interest by the United States shall not be subject to any limitation based on capital or surplus.

This exception draws its justification from the accepted proposition that obligations of the United States of America expose a lending institution to no credit risk. Nonetheless, since one borrower could borrow all of a bank's available funds through this exception, benefit spreading is inhibited.

The exception is founded upon the full faith and credit of the United States Government. If the particular obligation in question is not supported by the full faith and credit of the United States, it does not qualify for the exception.⁶⁹ Following this principal, the OCC has determined that Federal National Mortgage Association

66. *Id.*

67. 12 C.F.R. § 32.6(c)(6) (1991).

68. *Id.* § 32.6(c)(6).

69. Letter of Oda, No. 285, [1983-84 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,449 (Apr. 30, 1984).

Guaranteed Mortgage-Backed Securities are fully subject to the provisions of 12 U.S.C. § 84, while Government National Mortgage Association pass-through securities are not. The OCC's position was crisply stated as follows:

. . . The FNMA Guaranty constitutes an obligation solely by FNMA and is not backed by the full faith and credit of the United States. [Citation omitted].

While FNMA enjoys certain privileges of government sponsorship [citation omitted], it is not a wholly-owned corporation of the United States[.] . . . [T]he FNMA Guaranteed Mortgage-Backed Security is an obligation of FNMA, it is not a direct obligation of the United States, nor is it backed by the full faith and credit of the United States. A loan secured by FNMA GMBS's therefore, would not fall within the §84(c)(4) exception. . . .

[Government National Mortgage Association or] GNMA pass-through securities are covered by the § 84(c)(4) exception. GNMA pass-throughs give rise a general obligation of the United States. [Citation omitted.] To the extent that the GNMA fully guarantees payment of principal and interest on securities, therefore, they are covered by the exemption. Payment is fully guaranteed when it is to be made regardless of whether the principal and interest are actually collected⁷⁰ [Emphasis added]

The OCC is also quick to point out that if the market value of the pledged collateral declines so that the loan is no longer in conformance with this exception, and if the statute's general 15 percent limitation is exceeded, the loan must be brought into conformance within five business days.⁷¹

5. Loans to or Guaranteed by a Federal Agency

12 U.S.C. § 84(c)(5) provides:

Loans or extensions of credit to or secured by unconditional takeout commitments or guarantees of any department, agency bureau, board, commission or establishment of the

70. *Id.*

71. 12 C.F.R. § 32.6(d)(3) (1991).

United States or any Corporation wholly owned directly or indirectly by the United States shall not be subject to any limitation based on capital and surplus.

Like the exception above for obligations backed by the full faith and credit of the United States government, this exception is grounded in the presumed absence of credit risk associated with federal government obligations. The absolute nature of the exception suggests Congress was unconcerned that benefit spreading would not be enhanced by the exception.

However, the OCC's respect for federal agencies is not limitless. Agency commitments and guarantees must be payable in cash or cash equivalent within 60 days after a demand for payment is made.⁷² Although the guaranty or commitment must be unconditional, minimal procedural requirements, such as notification of default, may be acceptable.⁷³

Although this exception is technically distinguishable from the preceding exception for full faith and credit obligations of the United States, the practical distinction is negligible. Pursuant to this exception, the OCC has determined that loans insured by the Farmers Home Administration,⁷⁴ the Small Business Administration⁷⁵ and the Commodity Credit Corporation⁷⁶ are exempt from the limitation of Section 84.

If the government is not fully liable for the loan, or if the guaranteeing entity is not a legal subdivision of the government or a wholly-owned corporation, the exception is not applicable. For example, in denying the exception to Federal National Mortgage Association guaranteed Mortgage-backed securities, the OCC stated:

Loans secured by FNMA GMBS's also are not exempt under 12 U.S.C. § 84(c)(5). The paragraph exempts from any lending limit a loan secured by guaranties or unconditional takeover commitments of the United States or a wholly-owned corporation of the United States. FNMA is not a wholly-owned corporation of the United States; it is a Government-sponsored

72. 12 C.F.R. § 32.6(e)(3) (1991).

73. 12 C.F.R. § 32.6(e)(4) (1991).

74. COMPTROLLER OF THE CURRENCY REGULATION INTERPRETATIONS, NATIONAL BANKING REVIEW, Volume II, No. 4 (June 1965).

75. Letter of Shockey, Chief Counsel, No. 141, [1979-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,222 (May 19, 1980).

76. Letter of Byrd, Assistant Director, Legal Advisory Services Division, No. 59, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,134 (Oct. 2, 1978).

privately held corporation. Furthermore, § 84(c)(5) does not apply because FNMA does not guarantee the obligation of the borrower/pledgor to the bank. The FNMA guaranty covers only the obligation of the issuer to pay principal and interest as they come due. Exception § 84(c)(5) is inapplicable, therefore, because the collateral is guaranteed, not the loan itself, and because FNMA is not a wholly-owned corporation of the United States.⁷⁷

6. Loans Secured by Segregated Deposit Accounts

12 U.S.C. § 84(c)(6) provides:

Loans or extensions of credit secured by a segregated deposit account in the lending bank shall not be subject to any limitation based on capital and surplus.

If a loan is secured by a deposit account in which the bank has a perfected security interest, no lending limitation applies. The risk associated with such a loan is minimized by the availability of immediate cash repayment. In such a case, risk diversification is unnecessary for security. Congressional concern for spreading benefits was apparently not paramount in this case.

In order to assure that the circumstances surrounding a loan continue to justify the rationale for the exception, banks must establish internal procedures which prevent the release of the security.⁷⁸ The bank must also have a validly perfected security interest under applicable state law.⁷⁹ Although the deposit need not be denominated in U.S. dollars, it must be freely convertible and must be revalued at least monthly to ensure that the loan remains fully secured.⁸⁰ If the value of a foreign currency deposit declines sufficiently so that the loan is no longer fully secured, and if the general 15 percent limitation is exceeded, the loan must be brought into conformance within five business days. The only exception to this rule would be if judicial or regulatory proceedings or other extraordinary events frustrate efforts to comply.⁸¹

7. OCC Approved Loans to Financial Institutions

77. See *supra*, note 69.

78. 12 C.F.R. § 32.6(f)(3) (1991).

79. 12 C.F.R. § 32.6(f)(2) (1991).

80. 12 C.F.R. § 32.6(f)(4) (1991).

81. *Id.*

Commonly known as the "emergency" exception, 12 U.S.C. § 84(c)(7) provides:

Loans or extensions of credit to any financial institution or to any receiver, conservator, superintendent of banks, or other agent in charge of the business and property of such financial institution, when such loans or extensions of credit are approved by the Comptroller of the Currency, shall not be subject to any limitation based on capital and surplus.

This exception applies only in extraordinary circumstances where a national bank is called upon by the OCC to provide credit to any other commercial bank, savings bank, savings and loan association, credit union or trust company.⁸²

8. Discount of Installment Consumer Paper

12 U.S.C. § 84(c)(8) provides:

(A) Loans and extensions of credit arising from the discount of negotiable installment consumer paper which carries a full recourse endorsement or unconditional guaranty by the person transferring the paper shall be subject under this section to a maximum limitation equal to 25 percent of such capital and surplus, notwithstanding the collateral requirements set forth in [12 U.S.C. § 84(a)(2)].

(B) If the bank's files or the knowledge of its officers of the financial condition of each maker of such consumer paper is reasonably adequate, and an officer of the bank designated for that purpose by the board of directors of the bank certifies in writing that the bank is relying primarily upon the responsibility of each maker for payment of such loans or extensions of credit and not any full or partial recourse endorsement or guaranty by the transferor, the limitations of this section as to the loans or extensions of credit of each such maker shall be the sole applicable loan limitation.

82. 12 C.F.R. § 32.6(g)(2) (1991).

This exception permits loans or extensions of credit which arise from discounting negotiable or non-negotiable installment consumer paper to be made to a maximum of 10 percent of capital and surplus in excess of the 15 percent limitation set forth by 12 U.S.C. § 84(a)(1). Although this exception addresses a different form of collateral than required by § 84(a)(2), the exception caps the total loans to the affected customer at 25 percent of capital surplus.⁸³

The paper in question must be unconditionally guaranteed or subject to full recourse endorsement.⁸⁴ In certain cases, the paper may be considered as a loan or extension of credit to the maker, rather than to the seller of the paper. This may occur if two qualifications are met: first, based on the bank's files or its officer's knowledge, the bank must be able to demonstrate that each maker is financially able to make good on the loan. Second, a bank officer who is designated by the bank's board of directors must certify in writing that the bank relies primarily upon the maker for repayment, rather than upon the guaranty or endorsement of the transferor. If these qualifications can be met, the loan is subject only to the lending limits of the maker of the paper, not its transferor.⁸⁵

For example, ABC Auto sells cars to Customers. Each Customer pays ABC Auto with a signed installment note. ABC Auto discounts the notes to Bank on a recourse basis. Pursuant to this exception, Bank may extend credit to ABC Auto based on the discounting for up to 10 percent of its capital and surplus in addition to the standard 15 percent limitation of Section 84(a)(1). If evidence were to show that ABC Auto and Bank agreed only to discount paper from customers whose credit was pre-approved by Bank, and if Bank maintains appropriate records, the discounting would not be considered as an extension of credit to ABC Auto. Rather, Bank would be considered to have made a loan to each individual customer.

An interesting aspect of this exception is the expansive use of the term "consumer". Many other statutory schemes define consumer obligations as those which involve personal, household or family purchases.⁸⁶ In this case, however, 12 C.F.R. § 32.6(h)(3) provides:

83. 12 C.F.R. § 32.6(h)(2) clearly establishes that this exception is not in addition to the limitations established by 12 U.S.C. § 84(a)(2).

84. 12 C.F.R. § 32.6(h)(2) (1991). The unconditional guaranty is permitted to be in the form of a repurchase agreement or a separate guaranty agreement.

85. 12 C.F.R. § 32.6(h)(5) (1991).

86. See, e.g., 15 U.S.C. § 1602(h) (1991) (defining a consumer transaction as one in which the party . . . is a natural person, and the money, property or services which are the subject of the transaction are primarily for personal, family or household purposes.)

For purposes of this [exception], "consumer" means the user of any products, commodities, goods, or services, whether leased or purchased, and does not include any person who purchases products or commodities for the purpose of resale or for fabrication into goods for sale.

Unlike more commonly used definitions, this definition of "consumer" turns on whether or not the commodity is consumed by its original purchaser or purchased for resale or as a component for some larger good. Based upon this distinction, paper generated in connection with the sale of farm chemicals to supply dealers has been found not to meet the definition. Consequently, ordinary lending limits apply.⁸⁷ However, as part of the same ruling, the OCC determined that paper generated in connection with the direct sale of the same chemicals to farmers would qualify for the exemption because the farmers were the ultimate consumers of the chemicals.⁸⁸

9. Loans Secured by Livestock or Dairy Cattle

There are actually two exceptions from the statute's general lending limitations set forth at 12 U.S.C. § 84(c)(9). That section provides:

(A) Loans and extensions of credit secured by shipping documents or instruments transferring or securing title covering livestock or giving a lien on livestock when the market value of the livestock securing the obligation is not at any time less than 115 percent of the face

87. Letter of Byrd, Assistant Director, Legal Advisory Services Division, No. 114, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,189 (July 18, 1979); See also, Comptroller of the Currency Letter, February 1, 1963, *supra* note 47, (Paper arising out of sale to farmers of agricultural machinery may qualify for exception); Comptroller of the Currency Letter, [1960-1966 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 93,681 (Feb 1, 1963). (Lease paper issued in connection with lease of cars and trucks to a business is entitled to exception); Rulings of the Comptroller of the Currency, National Banking Review, Vol. 3, No. 4, [1960-1966 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 94,460 (June 1966) (Full recourse installment notes discounted by a heavy equipment and machinery dealer to a bank for discount are eligible for the exception; Full recourse purchase money mortgages are "consumer paper" within the meaning of the exception); Rulings of the Comptroller of the Currency, National Banking Review, Vol. 4, No. 1, [1960-1966 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 94,532 (September 1966) (Loan participation backed by an unconditional guaranty with respect to loans made in connection with the sale of aircraft to foreign commercial air carriers may qualify as consumer paper; The equipment was purchased for business use, not resale).

88. Letter of Byrd, Assistant Director, Legal Advisory Services Division, No. 114, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,189 (July 18, 1979).

amount of the note covered, shall be subject under this section, notwithstanding the collateral requirements set forth in [12 U.S.C. § 84(a)(2)], to a maximum limitation equal to 25 percent of such capital and surplus.

(B) Loans and extensions of credit which arise from the discount by dealers in dairy cattle of paper given in payment for dairy cattle, which paper carries a full recourse endorsement or unconditional guaranty of the seller and which are secured by the cattle being sold, shall be subject under this section, notwithstanding the collateral requirements set forth in [12 U.S.C. § 84(a)(2)], to a limitation of 25 percent of such capital and surplus.

Under the first exception, national banks can make loans or extend credit up to a maximum of 10 percent of capital and surplus (in addition to the standard 15 percent limitation set forth in Section 84(a)(1)) when: (1) the note evidencing the loan is secured by shipping, title or security documents on livestock, and (2) the market value of the livestock is, at all times, equal to at least 115 percent of the face amount of the loan.⁸⁹ The rationale for this exception is that collateral can be readily liquidated. Therefore, the bank's risk is minimized. Accordingly, the value of the collateral is paramount. The OCC requires banks to maintain annually updated inspection and appraisal reports on file.⁹⁰

The second exception permits loans or extensions of credit up to a maximum of 10 percent of capital and surplus (in addition to § 84(a)(1)'s 15 percent limitation) if the loan arises from the discounting of dealer purchase paper. The paper must be secured by the cattle sold, and must be unconditionally guaranteed by or subject to the full recourse endorsement of its seller.⁹¹

These two exceptions are mutually exclusive. Therefore, a national bank may make two separate loans to the same person, each secured by one of the two types of collateral described above.

89. Again, although the language of this statutory exception suggests otherwise, it would seem logical that the only portion of the loan which must be collateralized by the livestock is that portion which exceeds the general 15% limitation set forth in Section 84(a)(1). See *supra*, note 63. The reader's attention is drawn to the fact, however, that the exception refers to 115% of the face amount of the note covered. This language certainly presents a less compelling case for the foregoing interpretation.

90. 12 C.F.R. § 32.6(i)(1)(ii) (1991).

91. 12 C.F.R. § 32.6(i)(2)(ii) (1991).

Each loan would be subject to a 10 percent capital and surplus limitation in addition to the 15 percent limitation of § 84(a)(1).⁹²

10. Student Loan Marketing Association Loans

12 U.S.C. § 84(c)(10) provides:

Loans or extensions of credit to the Student Loan Marketing Association shall not be subject to any limitation based on capital and surplus.

The Student Loan Marketing Association, like FNMA,⁹³ is not a wholly-owned corporation of the United States and does not enjoy full faith and credit backing. However, Congress apparently decided that social benefits derived from its activities outweigh any risk of harm that could result from the exception. Since student loans are made to many individuals, benefit spreading and risk diversification appear to have been served.

II. COMBINING OF LOANS TO SEPARATE BORROWERS

Although OCC regulations provide guidance in interpreting the statute's general limitations and specific exceptions, they principally focus on identifying circumstances in which "a loan putatively made to a person shall . . . be attributed to another person."⁹⁴ These *per se* attribution rules apply in cases involving loans to partnerships and corporations. However, even loans which are not prohibited *per se* may run afoul of the "direct benefit" and/or the "common enterprise" tests. Each of these rules of attribution is examined below.

A. The Direct Benefit Test

A loan or extension of credit to one person will be attributed to another person if the proceeds of the loan are used for the direct benefit of the other person.⁹⁵

The decision whether a given series of loans must be combined under the direct benefit test is necessarily fact-specific. This should not imply that the issue is complicated or obtuse, however. Simply stated, the determination turns on the actual, as opposed to the stated beneficiary of the loan.

92. 12 C.F.R. § 32.6(i)(3) (1991).

93. See *supra*, notes 69, 70, 71 and accompanying text.

94. 12 U.S.C. § 84(d)(2) (1991).

95. 12 C.F.R. § 32.5(a)(1)(i) (1991).

In *DelJunco v. Conover*,⁹⁶ the OCC sought to combine three loans ostensibly made to different persons. The first loan had been made to Lewis, the President of Fame Furniture Co., Inc. ("Fame"). The second loan was made to Fame itself. The third was made to Ware, Fame's Treasurer. At an OCC hearing, the bank and its directors admitted they knew that the Lewis loan proceeds were used for Fame's benefit. It was further determined that the Ware loan was obtained to fund an overdraft in Fame's checking account. The bank's loan officer knew that the loan proceeds were going to go through Mr. Ware to Fame. Specific discussions regarding lending limits had taken place between Ware, Lewis and the bank's officers. Finally, it was shown that the Ware proceeds were deposited directly to Fame's checking account by the bank. Employing the direct benefit test, the OCC determined that aggregation of those loans was appropriate. The Ninth Circuit agreed. The loans had really been obtained for Fame's benefit, notwithstanding the fact that they were putatively made to other seemingly unrelated individuals.⁹⁷

A common instance where the direct benefit test may be appropriate arises if an individual borrows funds to purchase an equity interest in a business. In such a case, a loan is made to the individual who uses the funds to purchase stock or a partnership interest. The OCC has repeatedly determined that if loan proceeds are used to purchase an interest in an entity a benefit has been conferred upon the entity. Therefore, the loan must be attributed to the entity which was purchased.⁹⁸ Obviously, when considering successively smaller ownership positions, a point must be reached when any benefit to the business entity becomes sufficiently attenuated that it is unreasonable to require attribution. For example, loan proceeds might be used to purchase only one share of General Motors stock. In such an instance, the OCC would surely exercise its prerogative to find that no direct benefit was received.⁹⁹

96. 683 F.2d 1338 (9th Cir. 1982).

97. See also, *Anderson v. Ahers*, 7 F. Supp. 924 (W.D. Ky. 1934) (loans made to firm's employees for benefit of corporation attributed); *National Bank of Corsicana v. Johnson*, 251 U.S. 68 (1919); *First National Bank of Lincolnwood v. Keller*, 318 F. Supp. 339, 343 (N.D. Ill. 1970) (loans to employees or shareholders which are, in reality, loans to their corporation, are properly attributable).

98. Letter of Byrd, Assistant Director, Legal Advisory Services Division, No. 15, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,090 (Jan. 28, 1978) (loan to individual to purchase one-third interest in corporation attributed to corporation). See also, Letter of Byrd, Assistant Director, Legal Advisory Services Division, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,039 (September 30, 1977) (borrowing to purchase limited partnerships; Ruling based upon "common enterprise" theory); Letter of Byrd, Assistant Director, Legal Advisory Services Division, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,011 (Aug. 12, 1977) (loans passed through to a general partnership are attributed to such entity by virtue of "common enterprise").

99. *Id.*

A more difficult fact pattern occurs when A borrows money for the express purpose of repaying a bona fide debt of ABC Corp. In this case, one commentator has opined that the determination will turn on whether A could have repaid ABC Corp. without the bank loan. If A could have afforded the expense, combination would be inappropriate since ABC Corp. derived no benefit that could not have been obtained directly from A. However, if A would have been unable to pay ABC Corp., then ABC Corp. directly benefitted from use of the loan proceeds. Therefore, aggregation would be appropriate.¹⁰⁰

B. The "Common Enterprise" Tests

The common enterprise tests also turn upon a factual assessment of the circumstances surrounding the transaction in question.¹⁰¹ A common enterprise will generally be found to exist if any of the following circumstances are present:

(i) The expected source of repayment is the same for each of the individual borrowers; or

(ii) The loans are made to persons who are related through common control and the persons are engaged in interdependent businesses or significant financial interdependence between them is present; or

(iii) Separate individuals borrow in order to acquire a business enterprise in which they will own greater than 50 percent of the voting securities.¹⁰²

1. Common Repayment Source

Since one of the accepted purposes of the statute is to encourage risk diversification, loans to separate persons must be considered in combination when those persons will look to a single source for repayment of the loans. If that source of repayment is impaired, both loans would be affected.

Consider the following: XYZ Widget Company ("XYZ") is a national manufacturing corporation. As part of its distribution chain, XYZ owns warehouses located throughout the United States. For business reasons apart from lending limit concerns, XYZ's warehouses located in each state are owned by separate subsidiaries. Accordingly, warehouses in North Carolina are owned

100. William B. Glidden, *National Bank Lending Limits and the Comptroller's Regs.: A Clarification*, 101 *BANKING L.J.* 430, 432 (July-August, 1984).

101. 12 C.F.R. § 32.5(a)(2)(i) (1991).

102. 12 C.F.R. § 32.5(a)(2)(ii-iv) (1991).

by "XYZ North Carolina" while warehouses in Maryland are owned by "XYZ Maryland". XYZ owns one hundred percent of each subsidiary. Except for owning the warehouses in which XYZ stores its goods, each subsidiary conducts no other business.

In such a case, loans or extensions of credit to XYZ would also be attributed to each subsidiary corporation.¹⁰³ Moreover, loans to any subsidiary would be attributable to all of the other subsidiaries and to XYZ corporation.¹⁰⁴ This is because XYZ and its subsidiaries each have only the resources of XYZ to repay its debts. Therefore, in order to minimize risk, such loans must be aggregated for lending limit purposes. Benefit spreading is fostered by the restriction since it discourages any one individual or entity from misusing corporate instrumentalities to borrow more than his reasonable share of any institution's available loan funds.

2. Common Control

Two persons may be found to engage in a common enterprise if they are related through common control and are either engaged in independent businesses or substantial financial interdependence exists between them. Substantial financial interdependence exists *per se*, "when 50 percent or more of one person's gross receipts or gross expenditures (on an annual basis) are derived from transactions with one or more persons related through common control" ¹⁰⁵

Circumstances under which common control is presumed to exist include:

- (a) One or more persons acting in concert directly or indirectly own, control, or have power to vote 25 percent or more of any class of voting securities or another person; or
- (b) One or more persons acting in concert control, in any manner, the election of a majority of the directors, trustees, or other

103. 12 C.F.R. § 32.5(a)(2)(ii) (1991); Cf. 12 C.F.R. § 32.5(b)(2) (1991).

104. 12 C.F.R. § 32.5(a)(2)(ii) (1991).

105. 12 C.F.R. § 32.5(a)(2)(iii) (1991). See also, Letter of Firtzgerald, Chief Counsel, No. 352, [1984-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,522 (Sept. 23, 1985) (reversing a long-standing rule which interpreted the *per se* test as requiring that where several entities are under common control and one of several entities derives its gross receipt or expenditures from transactions with the others, the gross receipts or expenditures would be added together to determine whether they amounted to fifty percent or more, and stating a new rule as being triggered only when one entity derives the full fifty percent of its gross receipts or expenditures from transactions with another entity under common control).

persons exercising similar functions of another person; or

(c) Any other circumstances exist which indicate that one or more persons acting in concert directly or indirectly exercise a controlling influence over the management or policies of another person.¹⁰⁶

For example, consider the following: A is an individual owning one hundred per cent of the stock of ABC, Inc. ("ABC"), a corporation engaged in the retail sales of shoes. ABC, in turn, owns seventy five per cent of XYZ, Inc. ("XYZ"), a shoe wholesaling corporation. XYZ wholesales to many other retailers, but ABC accounts for twenty five per cent of XYZ's annual revenues. The activities of XYZ generate twenty five per cent of ABC's total annual revenues. An additional ten per cent is attributable to its ABC's retail shoe sales.

XYZ has two wholly-owned subsidiaries: Soles, Inc. ("Soles") and Heels, Inc. ("Heels"). Both corporations are manufacturing entities named for their products. Soles sells ninety per cent of its product to XYZ and these sales generate ninety per cent of its annual revenues. Heels, sells twenty five per cent of its product to XYZ thereby generating twenty five per cent of its revenues.

In addition, XYZ owns ten per cent of Realty, Inc. ("Realty"), a corporation engaged in the ownership of local real estate. Realty's properties generate positive cash flow. Thus, Realty stands on its own without support from its various shareholders. XYZ's revenue from Realty amounts to one to two per cent of its total revenues. Realty's other owners are located outside the geographic area. In order to assure the proper administration of the corporation's affairs, a voting trust has been established, vesting majority control in XYZ.

ABC also owns one hundred per cent of Aloha, Inc. ("Aloha"), a regional travel agency. In recent years, ABC revenues derived from travel-related activities have substantially exceeded those obtained through shoe manufacturing, wholesaling and retailing. ABC currently derives sixty five per cent of its annual revenues from Aloha's activities.

As a result of A's extensive business dealings, his relationship with his children, Gary and Flo, has suffered. In order to compensate for this loss, when each reached the age of majority, A set each sibling up in his or her own business with \$100,000 of A's personal funds. As a condition for the gift, A required each child to promise to follow A's wishes in running his

106. 12 C.F.R. § 32.5(a)(2)(v)(A-C) (1991).

or her business until A was satisfied that they could succeed on their own.

A's son Gary became president of Gary's Gloves, Inc. ("Gary"), a corporation devoted to the manufacture and sale of fine hardware. Unfortunately, Gary's business faltered. He was forced to borrow money from his father on an annual basis. Gary borrowed so heavily that it is doubtful that the business can survive without A's continued contributions:

On the other hand, Flo, A's other child, prospered. She opened Flo's Florist, Inc. ("Flo"), a corporation that specialized in floral wedding decorations. After A's initial capital contribution, Flo's business was able to operate on a stand-alone basis. Flo continued to adhere strictly to her father's wishes with respect to the operation of the business.

Shortly after Gary and Flo opened their respective businesses, they each purchased a fifty per cent ownership share in Rental, Inc. ("Rental"). Rental's sole function was to own and operate the building occupied by Flo and Gary. It had no other assets. Its sole revenues consisted of rental payments made by Gary and Flo.

Although the foregoing fact pattern is complex, A's "financial empire" will illustrate all of the common control/common enterprise rules of attribution.

A common enterprise exists between A and ABC since A controls more than twenty five per cent of the voting securities of ABC. Since he derives all of his income from ABC, A can be viewed as substantially financially dependent upon ABC's activities. A *per se* common enterprise exists because A derives more than fifty percent of his annual gross receipts from the activities of ABC.

A common enterprise exists between ABC and Aloha. Aloha is wholly-owned by ABC. Substantial financial interdependence exists between the two entities since Aloha is responsible for sixty five per cent of ABC's annual revenues, satisfying the requirements of the fifty per cent *per se* rule.

The relationship between ABC and XYZ is another example of a common enterprise, but for different reasons. ABC owns seventy five per cent of XYZ, thereby establishing common control. However, XYZ is not responsible for fifty per cent or more of ABC's annual revenues. As such, substantial financial interdependence does not exist on a *per se* basis. However, ABC and XYZ engage in interdependent businesses. Therefore, a common enterprise can still be said to exist between ABC and XYZ.

Soles and Heels are both related to XYZ by common control. They are wholly-owned subsidiaries. It is not necessary to apply the percentage of revenue test to Soles and Heels because both

companies engage in interdependent businesses with XYZ owing to their supply relationship. Because of this, a common enterprise exists.

XYZ and Realty are not a common enterprise. Although control may be readily exerted by the voting trust, Realty and XYZ are not financially dependent upon each other, nor are they engaged in supporting lines of business.

A's relationship with his childrens' corporations illustrates A's *de facto* control of both Gary and Flo. However, while a common enterprise exists between A and Gary, the same cannot be said of the relationship between A and Flo. In the former instance, substantial financial interdependence exists between A and Gary. In the latter instance, neither financial interdependence nor businesses interdependence exist between A and Flo.

Finally, common enterprises exist between Gary and Rental, and also between Flo and Rental. These common enterprises exist because Rental is entirely dependent on Gary and Flo for its livelihood.

It must be remembered that the attribution rules are structured to recognize the concept of compounding. In other words, if D's loans are attributed to C, and if C's loans are attributed to B, then D's loans are attributable to B.¹⁰⁷ The "step-ladder" approach necessarily means that loans between seemingly far-removed entities may be attributed to each other as if the parties were related. For example, as the application of the attribution rules to A's empire discloses, a loan to Heels can be attributed to A. The progression is as follows: Heels' loan is attributed to XYZ. The "XYZ" loan is then attributed to A. This compounding rule reaches down the ladder, as well as up. In other words, since Heels' loans are attributable to A, and since a common enterprise exists between A and Gary, Heels' loans may also be attributed to Gary. Moreover, since Gary's loans are attributable to Rental, and Rental's loans are attributable to Flo, Gary's and, thus A's and Heels' loans are attributable to Flo.¹⁰⁸

107. Recognition of this doctrine is not specifically articulated in either the statute or the regulations. It is a sensible requirement and necessarily implied in that its absence would allow easy avoidance of the statute merely by "layering" a sufficient number of entities. Undoubtedly, the OCC's broad interpretation powers will be used to analyze each case on its particular facts. *Cf. Hughes v. Reed*, 46 F.2d 435, 442 (10th Cir. 1939).

108. When examined, the result makes perfect sense. A practical example of its application is demonstrated by analyzing what would happen if financial disaster were to befall Flo. Under our example, she would arguably be unable to support the activity of Rental. This would affect Gary. Together, Gary and Flo would turn to A for support. A's ability to contribute capital to ABC could be endangered, thus affecting ABC's ability to support and maintain its business relationship with XYZ. XYZ, having been affected in its relationship with ABC might curtail its activities with Heels. Thus, in the final analysis, Heels'

Only Realty escapes unscathed because no common enterprise exists between it and any other person. It is, therefore, insulated from the compounding effect.

3. Majority Acquisition

The majority acquisition test requires attribution among persons who borrow in order to acquire more than fifty percent of the voting securities of a business enterprise.¹⁰⁹ Such a conclusion is compelled by common sense. Where the express purpose of a loan to two or more individuals is to assist them in creating a controlling interest in a business that will, of necessity, create financial interdependence among all members of the group, the common enterprise test is satisfied.

C. Loans to Partnerships

A loan to a general partnership is considered as a loan to each general partner of the partnership.¹¹⁰ For example, assume that Bank has made a loan of \$1,000,000 to the ABC partnership. If Bank's lending limit is \$1,000,000, Bank is not permitted to make any further loans to ABC Partnership. Bank also may not make additional loans to the individual partners of ABC Partnership because of the partnership attribution rules.

The reason for this attribution rule is that each general partner could be called upon to satisfy ABC's loan in its entirety.¹¹¹ Since any partner of ABC partnership could be compelled to pay the loan personally, the OCC reasons that risk diversification and benefit-spreading motivations of 12 U.S.C. § 84 are best served by requiring attribution.

A more interesting scenario will arise if Bank makes a non-recourse loan to ABC Partnership. Since the OCC's rationale in the partnership cases stems from the common law liability of individual partners, it would appear that limiting such liability would defeat the purpose of the rule. However, the OCC has ruled that the adoption of such a position would "[encourage] banks to exclude

loan has been affected by Flo's misfortune. Again, the OCC will, undoubtedly, utilized its discretion to determine the extent to which any particular fact pattern represents a realistic model for application of the rule and the extent to which compounding will be employed.

109. 12 C.F.R. § 32.5(a)(2)(iv) (1991).

110. 12 C.F.R. § 32.5(c)(1) (1991). A joint venture is, for Section 84 purposes, treated like a partnership and loans to the venture are considered loans to the venturers. Letter of Byrd, Assistant Director, Legal Advisory Services Division, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,018 (Aug. 29, 1977).

111. Joint and several tort liability is the essence of a partnership at common law. See, e.g., *Weaver v. Marcus*, 165 F.2d 862 (4th Cir. 1948). See also, UNIFORM PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1969).

borrowers from personal liability in situations where banking prudence, and thus the intent of section 84, clearly counsel otherwise."¹¹² The OCC has further reasoned that neither of the statutes' underlying purposes would be served by such a rule. Investment risk would actually be increased, and the same borrowers would have access to additional loans from the same bank.¹¹³ Thus, making a loan to a general partnership on a non-recourse basis has no impact on the application of the partnership attribution rules.

Although closely related to non-recourse general partnership loans, loans to limited partnerships have received more favorable treatment from OCC. A loan to a limited partnership is not automatically required to be attributed to each of the limited partners.¹¹⁴ Although the liability of the limited partners is essentially equivalent to the liability of a non-recourse general partner, the OCC justifies this distinction by the fact that limited partnerships generally contemplate that the limited partners will not participate in management.¹¹⁵ Since a limited partner is not directing the activities of the partnership, his status is similar to that of a shareholder. Therefore, attribution would be inappropriate. If however, limited partners engage in conduct with respect to each other or the partnership which satisfies the direct benefit or common enterprise test, attribution may be required.¹¹⁶ For example, if a limited partner were to borrow to fund his purchase of an interest in the limited

112. Letter of Byrd, Assistant Director, Legal Advisory Services Division, No. 164 [1979-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,245; See also, Letter of Fitzgerald, Director, Legal Advisory Services Division, No. 149 [1979-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,230 (May 28, 1980) (Contractual Liability of a partner is not the focus of Section 84); Letter of Kane, District Counsel, Central District, No. 88-3, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,043 (March 29, 1988).

113. *Id.*

114. 12 C.F.R. § 32.5(c)(3) (1991). See also, Letter of Byrd, Assistant Director, Legal Advisory Services Division, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,039 (Sept. 30, 1977); Letter of Kane, District Counsel, Central District, No. 88-3, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,043 (March 29, 1988); Letter of Byrd, Assistant Director, Legal Advisory Services Division, No. 126, [1979-1980 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,207 (Nov. 8, 1979); Letter of Kane, District Counsel, Central District, No. 88-1 [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,207 (March 9, 1988).

115. Letter of Byrd, Assistant Director, Legal Advisory Services Division, No. 126, [1979-1980 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,207 (Nov. 8, 1979).

116. Letter of Kane, District Counsel, Central District, No. 88-1, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,041 (March 9, 1988); Letter of Byrd, Assistant Director, Legal Advisory Services Division, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,039 (Sept. 30, 1977); Letter of Byrd, Assistant Director, Legal Advisory Services Division, No. 126, 2 [1979-1980 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,207 (Nov. 8, 1979).

partnership, attribution of the partner's loans would be warranted.¹¹⁷

Under certain circumstances, loans to individual partners may be attributable to the partnership. This could arise if the OCC determines that requirements of the direct benefit and/or either of the common enterprise tests have been met.¹¹⁸ In addition, loans to one partner may be attributable to another partner if it can be shown that any of the tests have been satisfied by the relationship between the partners.¹¹⁹ If it can be shown that a loan was made to a partner in order to fund his purchase of a partnership interest, that person's loan will automatically be attributable to the partnership.¹²⁰ Consider, for example, the following. X, Y and Z combine to form the XYZ partnership. X and Y borrow from First bank to the extent of their individual lending limits. Thereafter each lends the cash to the partnership. Z has an outstanding personal obligation to First Bank which is unrelated to the XYZ partnership. Z's obligation is sufficient to exhaust First bank's legal lending limit as to Z. According to these facts, serious lending limit violations appear to have occurred.

It is clear that the loans to X and Y will be cross-attributed because of their involvement in a common enterprise. Since X and Y have each reached their individual lending limits, the attribution of another loan to them will cause a violation. Further, each of the loans will be attributed to the partnership. This is because XYZ partnership has received the direct benefit of the loan proceeds. Because the loans to X and Y have already reached the bank's limit, the attribution of both loans to the partnership will cause another lending limit violation. Finally, the attribution of the X and Y loans to the partnership will be considered as loans to each of the other partners. Therefore, for lending limit purposes, the outstanding debt of Z includes not only his original personal loan, but the loans to X and Y as well, resulting in an additional lending limit violation.¹²¹

D. Loans to Corporations

117. See *supra*, note 114, Letter of Byrd, No. 126 (Nov. 8, 1979 and Sept. 30, 1977).

118. *Id.*

119. 12 C.F.R. § 32.5(c)(2) (1991).

120. *Id.*

121. While this result may be harsh as it relates to Z, the reader is reminded to focus upon the underlying purposes of Section 84. See also, Letter of Byrd, Assistant Director, Legal Advisory Services Division, [1978-1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,011 (Sept. 30, 1977) (citing *Mills v. Riggle*, 83 Kan. 703, 112 P. 617 (1911) for the proposition that, under certain circumstances, a partnership can be called upon to satisfy the debts of its individual partners.)

In contrast to prior regulations,¹²² current OCC policy does not require the automatic combination of loans made to a corporation with loans to the majority-owned subsidiaries of the corporation.¹²³ Similarly, loans to various subsidiaries of the same corporation need not be combined with each other.¹²⁴ Rather, such combinations are warranted only when it is determined that one of the "common enterprise" tests has been satisfied between the subsidiaries.¹²⁵ Notwithstanding this, loans by national banks to a single corporate group may not exceed fifty per cent of the bank's capital and unimpaired surplus.¹²⁶ A corporate group is defined to include a corporation and all of its subsidiaries.¹²⁷

E. Accommodation Parties

A drawer, endorser or guarantor is not considered to have received a loan or extension of credit for § 84 purposes unless that person receives any portion or direct benefit of the proceeds

122. See, former 12 C.F.R. § 7.1310(c) (1991), which provided as follows:

General Rules.

(1) Obligations of a parent corporation shall be combined with obligations of all subsidiary corporations in which the parent owns or controls a majority interest.

(2) If the Parent corporation is not borrowing, obligations of subsidiary corporations are generally not combined except in the following situations:

(i) Bank is looking to a single source for repayment of the loan.

(ii) One or more loans is [sic] for the accommodation of the parent corporation or other subsidiary.

(iii) The borrowing corporations are not separate concerns in reality but merely departments or divisions of a single enterprise.

(3) Obligations of a corporation must be combined with any other extension of credit the proceeds of which are used for the benefit of the corporation.

123. 12 C.F.R. § 32.5(b)(2) (1991).

124. *Id.*

125. *Id.* It is peculiar that the OCC's regulations do not specifically require attribution among corporations if the "direct benefit" test is satisfied. The reader is, however, reminded that a corporation is a "person" within the meaning of §84(b)(2). Accordingly, the OCC could convincingly maintain that the "direct benefit" test remains available by inference since it applies to any "person." *Id.*

126. *Id.*

127. *Id.*

or unless that person is engaged in a common enterprise, as determined by 12 C.F.R. § 32.5(a)(1), with the primary obligor.¹²⁸

III. STATUTORY LIABILITY FOR NON-COMPLIANCE

Prior to passage of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA")¹²⁹, bank directors were liable for engaging in excessive lending only if: (1) they knowingly participated in or assented to the extensions of credit,¹³⁰ or (2) if they deliberately refrained from investigating despite information which placed them on notice of the existence of a potential violation.¹³¹ Mere negligence was generally held to be insufficient to support a claim of violation.¹³² However, the mere absence of improper motive was not viewed as a viable defense.¹³³

The provisions of FIRREA created a new three-tiered approach to civil violations of the National Bank Act ("Act"), including § 84. Each tier provides increasingly severe penalties meant to address progressively more egregious conduct.

Tier one is embodied at 12 U.S.C. § 93(b)(1), which provides:

First Tier. Any national banking association which, and any institution-affiliated party . . . with respect to such association who, violates any provision of [the Act] . . . or any regulation issued pursuant thereto, shall forfeit and pay a civil penalty of not more than \$5,000 for each day during which such violation continues.

First-tier violations are viewed as least significant by regulators. Despite this, it is notable that the scienter

128. 12 C.F.R. § 32.101. The OCC has held that, despite the language of 12 C.F.R. § 32.101 which mandates attribution if the accommodation party receives any benefit, the test that is actually employed is whether any "substantial benefit" has been obtained. Letter of Oda, Senior Attorney, Legal Advisory Services Division, No. 291, [1984 -1987 Transfer Binder] (CCH) ¶ 85,461 (May 4, 1984).

129. Public Law, 101-647 (1989).

130. *Atherton v. Anderson*, 86 F.2d 518, 527 (6th Cir. 1936) *rev'd on other grounds sub non*, *Anderson v. Atherton*, 302 U.S. 643 (1937); *Payne v. Ostrus*, 50 F.2d 1039, 1041 (6th Cir. 1931); *First Nat'l Bank of Fairbanks v. Noyes*, 257 F. 593, 599 - 600 (9th Cir. 1919), *McRoberts v. Spaulding*, 32 F.2d 315, 318 (S.D.Iw. 1929); *McQueen v. First Nat'l Bank Mesa City, Az.*, 283 P. 273, 276 (Az. 1929).

131. *Atherton*, *supra* note 131; *White v. Thomas*, 37 F.2d 452, 454 (9th Cir. 1929); *McQueen*, *supra* note 130.

132. *Atherton*, *supra* note 131; *Payne*, *supra* note 130; *First Nat'l Bank of Fairbanks*, *supra* note 130.

133. *McRoberts*, *supra* note 130.

requirement previously contained in 12 U.S.C. § 93 has been removed. Accordingly, even unintentional violations of the act are now sufficient to warrant the imposition of civil penalties.

The second layer of offensive conduct is described at 12 U.S.C. § 93(b)(2) which provides:

Second Tier. Notwithstanding Paragraph (1), any national banking association which, and any institution-affiliated party . . . with respect to such association who, commits any violation described in Paragraph (1) which --

- (A)(i) commits any violation described in [12 U.S.C. § 93(b)(1)];
- (ii) recklessly engages in an unsafe or unsound practice in conducting the affairs of such association; or
- (iii) breaches and fiduciary duty; and
- (B) which violation, practice or breach
 - (i) is part of a pattern of misconduct;
 - (ii) causes or is likely to cause more than minimal loss to such association; or
 - (iii) results in pecuniary gain or other benefit to such party,

shall forfeit and pay a civil penalty of not more than \$25,000 for each day during which such violation, practice or breach continues.

While tier one violations can be inadvertent in nature and result in only minimal loss to the affected institution, tier two violations reflect Congress' intent to punish those activities which: (1) are part of a pattern of misconduct; (2) result in significant loss to the institution; or (3) result in a pecuniary gain to the party responsible for the violation. Like tier one violations, violations of tier two may be established without proving intent, but the presence of aggravating factors tend to suggest the possibility of intentional conduct.

Third tier violations occur when a person knowingly engages in proscribed conduct and knowingly or recklessly causes a substantial loss to the institution or the accrual of a substantial pecuniary gain for his own benefit. 12 U.S.C. § 93(b)(3) provides:

Third Tier. Notwithstanding Paragraph (1) and (2), any national banking association which, and any institution-affiliated party . . . with respect to such association who --

(A) Knowingly

- (i) commits any violation described in Paragraph (1);
- (ii) engages in any unsafe or unsound practice in conducting the affairs of such association; or
- (iii) breaches any fiduciary duty; and

(B) Knowingly or recklessly causes a substantial loss to such association or a substantial pecuniary gain or other benefit to such party by reason of such violation, practice or breach, shall forfeit and pay a civil penalty [in the case of any person other than the national banking association, an amount to not exceed \$1,000,000, and in the case of a national banking association, an amount not to exceed the lesser of \$1,000,000 or 1 percent of the total assets of such association.]¹³⁴

In addition to civil penalties, 12 U.S.C. § 93 provides that bank officials who knowingly violate § 84 can be held liable for damages sustained as a consequence of their actions. The OCC has broad power to fashion remedies in furtherance of such damage claims. For example, in *DeJunco* the OCC examined the following loan sequence:

<u>Loan Date</u>	<u>Borrower</u>	<u>Amount</u>	<u>Lending Limit</u>	<u>Excess</u>
1/19/79	Lewis	\$225,000		
5/9/79	Fame	<u>225,000</u>		

134. Although presenting the potential for substantial penalties, the Act also allows for the mitigation of those penalties in view of the following factors.

- a. The size of financial resources and good faith of the insured depository institution or other person charged;
- b. The gravity of the violation;
- c. The history of previous violations;
- d. Such other matters as justice may require.

12 U.S.C. § 93(b)(5); 12 U.S.C. § 1818(i)(2)(G)(i-iv).

		SUBTOTAL	\$450,000	\$272,866	\$177,134
6/11/79	Ware		<u>125,00</u>		
		TOTAL	\$575,000	\$277,108	\$297,892

Following a determination by the OCC that combination of the above loans was warranted, consideration turned to the extent of director liability. The OCC found that the measure of liability was \$350,000. This represented the total of all loans (\$575,000) less the legal Lewis loan of \$225,000.¹³⁵ Further, the OCC determined that none of that liability could be reduced until the legal loan was repaid. The directors, on the other hand, sought to apply monies received first to the improper facilities, then to the legal loan.

In finding that the director's efforts to give primacy to collecting the illegal loans were invalid, the Ninth Circuit stated:

135. See, *First Nat'l Bank of Lincolnwood v. Keller*, 318 F. Supp. 339, 347 (N.D. Ill. 1970) (Penalty properly assessed as the difference between greatest amount of combined obligations and amount of outstanding legal loan amounts before illegal loans were made).

See also, *Corsicana Nat'l Bank of Corsicana v. Johnson*, 251 U.S. 68 (1919), (distinguished in *Lincolnwood*, supra) wherein the Court dealt with two \$15,000 loans which were made simultaneously and at a time when the bank's lending limit was \$20,000. After combining the loans as a result of a common enterprise finding, the court determined that the damages were properly set at the full \$30,000, stating:

We assume that if, in good faith and in the ordinary course of business, defendant had made a loan of \$20,000 to [the obligors], and if while this loan remained unpaid he had afterwards and as a separate transaction unlawfully loaned them an additional \$10,000 in excess of the limit. The damage largely attributable to his violation of the limiting provisions would have been \$10,000. But that is not this case. According to the evidence, the \$30,000, less discount, was paid out by the bank as a single payment; and, if the jury found it to have been loaned in excess of the statutory limit . . . it must be upon the ground that it was a single transaction. That being so it would follow that the entire amount disbursed by the bank was disbursed in violation of the law. The cause of action against a director knowingly participating in or assenting to such excessive loan would be complete at that moment, and entire; there would be no legal presumption that the borrowers would have accepted a loan within the limit, if their application for the excessive loan had been refused; nor that a director who in fact violated his duty as defined by law would be mindful of it, have loaned them even \$20,000 Hence the entire excessive loan would have to be the basis for computing the damages of the bank. *Id.* at 87-88.

In the instant case, the purpose underlying 12 U.S.C. § 84--protection of a bank's assets--will be furthered if the Directors are not allowed to extinguish their liability until the legal Lewis loan, which is unsecured, is fully repaid. The policy of protecting bank assets would be frustrated if the Directors were allowed to make, as they did, an unsecured but legal loan to the borrower, then to use or agree to the use of, the borrower's assets to secure further credit extensions that are illegal. Such a procedure would permit the Directors to protect themselves fully against any exposure resulting from the illegal loans while substantially increasing the risk that the bank would be unable to recover the amount of its legal loan. The fiduciary responsibility of the Directors of the bank precludes them from protecting themselves against liability at the bank's expense. The security arrangement was in derogation of that responsibility. Thus, the Directors may not use borrower's assets to extinguish their own liability to the bank. Here, the Directors ignored the recommendation of the Comptroller and the bank president's advice that the first loan to be paid off should be that of . . . Lewis and not Fame . . ., since the stockholders might claim that this loan was paid to limit the liability of Directors. The Comptroller's remedy is appropriate, because any other remedy could create a conflict between the Bank and its Directors.

In light of the Comptroller's broad discretion to fashion an appropriate remedy, we conclude that the remedy selected was lawful. It serves to protect the banks assets, to insure that the Directors fulfill their fiduciary duty, and to prevent the Directors from insuring themselves against liability for their wrongful act at the Bank's expense.¹³⁶ [Emphasis added].

After supporting the OCC's determination of the order of loan recovery, the Court went even further. The OCC had assessed collection expenses and attorney's fees incurred by the bank in the calculation of the Directors' damages. Citing the "[d]eference .

136. *DelJunco v. Conover*, 682 F.2d 1338, 1343.

. . . due to the [OCC's] interpretation of the law under which [it] operates", the Court found the assessment valid. The Court pointed out that 12 U.S.C. § 1818(b)(1) allows the OCC to take affirmative action to correct conditions that result from a director's violation of banking laws:

Obviously the [OCC] has interpreted the Bank's collection expenses and attorney's fees paid on behalf of the Directors as "conditions resulting" from the violation of 12 U.S.C. § 84.

The Directors argue that the collection expenses are not a condition resulting from the violation of the law: There is no evidence that but for these loans being excessive they would not have become delinquent. That argument is meritless. If the Directors have acted within the law, the excess loans would never have been made, and the problem of collection would never have arisen.¹³⁷

IV CONCLUSION

To a large degree, lending limit compliance is simple common sense. Armed with knowledge of the statutory purposes of § 84 - risk diversification and benefit spreading, the alert banker can develop an intuitive awareness of lending limit concerns. However, problems lay in wait among the intricacies of our increasingly complex financial environment. Potential borrowers often do business with several bankers within the same institution, and those same borrowers are often associated with numerous and varied entities which may each be involved with a different bank officer. In the final analysis, the gathering and maintenance of accurate borrower profiles is essential. The responsible officer must make it normal business procedure to keep up-to-date records detailing:

- The name of each and every entity, be it partnership, corporation or otherwise, in which a borrower is involved;
- The extent and nature of the borrower's involvement with the entities with which he is associated, both in financial and management capacities;
- The business in which these entities are engaged;
- The degree to which borrowing entities are interdependent;

137. *Id.*

- The name of each other shareholder (in closely held corporations), partner, officer or director of such entities;
- The amount of any loans outstanding to any such entities;
- The amount of any loans outstanding to any shareholders (of closely held corporations), partners, officers or directors of such entities;
- Whether the borrower's family has outstanding loans with the institution and the extent to which such family members are involved in such entities;
- The exact use to which the loan funds will be put;
- The nature of the collateral securing the loan or extension of credit including, where applicable, its manner and date of valuation; and
- The source of repayment.

Through the use of such information, a bank officer can minimize potential for engaging in violations of lending limits. Further, if such a violation occurs, absent any aggravating factors, the availability of the above records would substantially assist in establishing the inadvertent nature of the violation and the good faith of the institution. As a result, statutory penalties may be effectively minimized.