

LEWIS RICE *Bank Law Update*

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New Rule Permits S-Corp Participation in Capital Purchase Program

Pursuant to the Emergency Economic Stabilization Act of 2008, the U.S. Department of Treasury has provided capital to banking organizations under the Capital Purchase Program (CPP) by purchasing senior perpetual preferred stock from such entities. Under the CPP, banks have been allowed to issue perpetual preferred stock to the Treasury that is senior to their common stock and has an equal right to payment as their existing preferred stock (CPP Preferred Stock). CPP Preferred Stock is designed with attractive features such as an initial dividend rate of five percent per annum that increases to nine percent per annum after five years, to encourage banking organizations to replace it with private capital. Certain restrictions on the issuance of CPP Preferred Stock apply, including the requirement that the aggregate amount issued by an organization be between one and three percent of the organization's risk-weighted assets, but not greater than \$25 billion.

Until recently, S-Corp and mutual bank holding companies (S-Corp BHCs) were unable to receive capital through the issuance of CCP Preferred Stock due to Internal Revenue Code regulations and structural constraints. On June 1, 2009 the Federal Reserve Board (the Board) issued an interim final rule amending Regulation Y to permit S-Corp BHCs to participate in the CPP. Because S-Corp BHCs may not issue multiple classes of equity securities, they have been unable to issue CPP Preferred Stock.

Continued on page 2

Supreme Court Decision Refines OCC Interpretation of the National Bank Act

On June 29, 2009, the U.S. Supreme Court addressed issues of federal preemption regarding the enforcement of state laws against national banks in a decision that initially was perceived as a major victory for state regulators against the Office of the Comptroller of the Currency (OCC). However, the court's decision in *Cuomo v. The Clearing House Association* is not as sweeping as first thought and may ultimately have little practical effect on national banks.

In 2005 the Attorney General of New York sent letters requesting certain non-public information "in lieu of a subpoena" to several national banks alleging they had violated New York's fair lending laws. In response, the OCC and the Clearing House Association, a banking trade group, sought an injunction claiming that the OCC's regulation under the National Bank Act (NBA) prohibited this type of state activity against national banks. The U.S. District Court for the Southern District of New York entered an injunction in favor of the OCC, and the U.S. Court of Appeals for the Second Circuit affirmed the injunction. The New York Attorney General appealed the Second Circuit's ruling to the Supreme Court, where the Court partially reversed the Second Circuit's ruling.

The opinion in this case initially seemed unusual. Federal courts have generally struck down the states' attempts to regulate national banks. Second, in a 5-4 decision, the majority was comprised of Justices that do not often support the same opinions. For example, Justice Scalia authored the Majority Opinion, from which Justice Thomas dissented.

The NBA generally exempts national banks from the state exercise of "visitorial powers." The OCC adopted additional regulations stating, among other things, that "[s]tate officials may not exercise visitorial powers with respect to national banks, such as conducting examinations; inspecting or requiring the production of books or records of national banks; or prosecuting enforcement actions." The Attorney General maintained that, rather than exercising "visitorial powers," New York sought information for the purpose of enforcing its own fair lending laws, and that the OCC's regulation exceeded its authority under the NBA. Thus, the Supreme Court addressed whether the OCC had authority to promulgate a rule that precluded the enforcement of state fair lending laws by state officials against national banks.

Describing traditional visitorial powers as those involving the oversight of corporate affairs, the court stated that the OCC's regulation was reasonable to the extent that it interpreted the NBA to preclude states from examining, inspecting or requiring the production of books or records of national banks. In contrast, according to the court, it was unreasonable for the OCC to prevent the states from "prosecuting enforcement actions." Citing a long line of cases, the court held that if a state statute that purports to regulate banks has not been substantively preempted by federal law, then the power of enforcement lies with the state rather than the federal government. Unlike the NBA, which only exempted national banks from the exercise of visitorial powers, the court found that the OCC's regulation purported to prevent states from enforcing even non-preempted laws against national banks.

Continued on page 4

New Rule Permits S-Corp ... continued from page 1

The Final Rule permits an eligible S-Corp BHC to issue subordinated debt securities to the Treasury in order to receive capital. Similar to the CPP Preferred Stock, these subordinated securities are senior to an S-Corp BHC's common stock but are generally subordinate to depositor and creditor claims. Also like the CPP Preferred Stock, the subordinated securities will have features designed to increase their attractiveness to generally sound S-Corp banking organizations, such as an initial interest rate of 7.7 percent per annum, increasing to 13.8 percent after five years. Further, an issuing S-Corp BHC may defer interest payable on the subordinated securities for up to 20 quarters without defaulting.

The Final Rule also permits an S-Corp BHC to include the full amount of subordinated debt securities it issues to Treasury in its tier 1 capital, even if it exceeds the traditional limit of 25% of the company's total tier 1 capital placed on restricted core capital elements. However, the 25% limit still applies to restricted core capital elements other than the subordinated debt securities, and careful analysis of the Final Rule is necessary to ensure an S-Corp BHC's compliance in this regard. Like CPP Preferred Stock, an S-Corp BHC's aggregate amount of subordinated securities issued to the Treasury must be between one percent and the lesser of \$25 billion and three percent of the company's risk-weighted assets.

Small S-Corp BHCs are also permitted a special exception under the Final Rule. The Final Rule amends the Small Bank Holding Policy Statement to allow an S-Corp BHC with less than \$500 million in consolidated assets to exclude subordinated securities they issue to the Treasury completely from their debt. This has the practical effect of allowing small S-Corp BHCs to participate in the CPP by issuing subordinated securities without exceeding their debt-to-ratio standard to a degree prohibitive of their ability to pay dividends.

By allowing S-Corp BHCs to receive capital by issuing subordinated debt securities to the Treasury and to count such securities in their tier 1 capital, the Final Rule enhances the attractiveness of S-Corp status for Bank Holding Companies under current economic conditions. The full text of the interim final rule is available online at <http://edocket.access.gpo.gov/2009/E9-12626.htm>. All public comments are available at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

◆ David W. Brown • dbrown@lewisrice.com • 314-444-1341 (Jay Piatt, Saint Louis University School of Law, contributed to this article)

Regulation Z Amendment Imposes Additional Disclosure Requirements

On May 19, 2009, the Federal Reserve Board published a final rule amending Regulation Z to conform with changes made to the Truth in Lending Act (TILA). This rule increases waiting periods designed to delay the consummation date of mortgage loans and adopts stricter standards for creditors.

Previously, Regulation Z early disclosure requirements only applied to mortgage loans that were subject to the Real Estate Settlement Procedures Act (RESPA), and were for the purchase or initial construction of a consumer's principal dwelling. The final rule extends Regulation Z coverage to mortgage transactions that are secured by other dwellings, such as a second home, and requires creditors to provide early disclosures within three business days after receiving the consumer's written application. Disclosures must also be delivered or mailed seven business days before consummation.

Under the final rule, until after a consumer receives the early disclosure, creditors are barred from charging fees other than a fee to obtain a credit report. Other fees may be charged within three business days after the disclosure has been mailed, or any time after delivery if the disclosure was delivered in person. All early disclosures must also contain the statement, "You are not required to complete this agreement merely because you have received these disclosures or signed a loan application."

If the APR stated in an early disclosure changes more than 1/8th of one percent prior to consummation, the creditor must redisclose the APR and other changed terms. The final rule requires creditors to wait an additional three business days after the amended disclosure is received by the consumer before consummation can occur. This additional waiting period cannot be used to shorten the original seven business day waiting period.

Consumers may waive or shorten either or both the seven and three day waiting periods if the consumer determines an extension of credit is needed to meet a bona fide personal financial emergency. To waive or shorten either of the waiting periods, among other things, a consumer must prepare a handwritten statement that: (i) details the specific emergency, (ii) makes a request to waive or shorten a waiting period, (iii) and has been signed by each consumer that will be legally obligated and entitled to receive a disclosure.

The final rule became effective on July 30, 2009, and can be found at <http://edocket.access.gpo.gov/2009/pdf/E9-11567.pdf>.

◆ Samuel A. Yoffie • syoffie@lewisrice.com • 314-444-7618
(Brady McAninch, Southern Illinois University School of Law, contributed to this article)

Inadequate Notice May Give Borrowers Three Year Rescission Period

If a consumer borrower uses his or her own principal residence to secure a loan, the Truth in Lending Act (TILA) gives the borrower three days to reconsider and cancel the deal, for any reason, without penalty. If a lender provides inadequate TILA notice, the borrower's rescission period may be statutorily extended from three days to three years. On March 20, 2009, the Eighth Circuit Court of Appeals held that a failure to strictly follow TILA requirements could result in such an extension. The court's decision in *Rand Corporation v. Moua* illustrates why lenders must adhere closely to TILA's rules to avoid such a scenario.

Under TILA, the three-day rescission period ends on midnight of the third business day after each of the three following events occur: (i) the bank provides the borrower a TILA disclosure form containing certain information about the credit contract, (ii) the bank provides two copies of a TILA notice explaining the right to rescind, and (iii) the borrower signs the contract. Once the three-day rescission period begins, activity relating to the contract *cannot* take place. This means that the lender may not deliver money to the borrower until the three-day period has passed.

Occasionally the waiting period will be problematic for borrowers due to a "bona fide financial emergency," such as damage to a home from a storm. Due to this concern, TILA allows borrowers suffering from financial emergencies to waive the right to a three-day rescission period so they may immediately receive the funds. To waive the waiting period, a lender must adhere to a process for providing notice consistent with TILA requirements. While often utilized in practice, using contradictory documents to waive the rescission period is ineffective and can prove costly to banks.

In *Rand*, borrowers that had such a bona fide financial emergency sought to waive the three-day rescission period.

At closing on April 22, 2005, the borrowers signed a document informing them of the three-day right to rescission. In an attempt to waive the three-day rescission period, the borrowers executed a document, also dated April 22, 2005, which stated that three days had passed and claimed to acknowledge the end of the rescission period. Finding that the notice was insufficient, the Eighth Circuit stated that requiring borrowers to sign contradictory statements that are demonstrably false is a "paradigm for confusion." As a result, the court held that the lender had violated TILA and the borrowers were entitled to a three-year rescission period.

Lenders who work with consumer loans secured by the borrower's principal residence can prevent a similar result by implementing a comprehensive procedure for delivering TILA notice. First, lenders should always provide a TILA disclosure form. This document must include information about the credit contract, such as the annual percentage rate, finance charge, amount financed, and the payment schedule. Second, lenders should provide two copies of a TILA notice explaining the three-day rescission period. Finally, lenders should make certain that the borrower signs the contract and all of the notice documents after review.

In order to successfully waive the rescission period, a borrower must provide a personalized written statement describing the cause for emergency and waiving the right to rescind. This statement should be in the borrower's own words and not be coerced by the lender. Additionally, this statement must be signed and dated by every person sharing in ownership of the home. Lenders should never have the borrower sign a contradictory form. Whether or not the borrower is actually confused, the lender may be subjected to the extended rescission period because of inconsistent documentation.

Lenders should ensure that all procedures comply with the appropriate statutes in order to successfully mitigate the risk of an extended rescission period. By enacting protective procedures and avoiding contradictory documents, a lender's chances of successfully managing this risk are greatly increased.

The full text of *Rand Corporation v. Moua* is available online at: <http://caselaw.lp.findlaw.com/data2/circs/8th/072544p.pdf>

◆ Alfred J. Ludwig • aludwig@lewisrice.com • 314-444-7605
(Alex Wessler, University of Illinois College of Law, contributed to this article)

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Lewis Rice Bank Law Update

Supreme Court Decision Refines OCC ... continued from page 1

Moving to the substance of the Attorney General's case, the Court found that the Attorney General's information-seeking activities were not the enforcement of state law but were more akin to the exercise of supervisory power, which is legitimately preempted by the NBA. Thus, while vacating the injunction insofar as it prohibited the Attorney General from enforcing any state laws, the Court affirmed the injunction prohibiting the Attorney General from seeking non-public information.

Initial commentary on the decision predicted that it would open the floodgates of litigation as state attorneys general sought to enforce a variety of non-preempted laws. However, the holding of the case is so narrow that the decision may prove to have little practical effect. The crux of the case is that states can bring lawsuits against national banks to enforce those state laws not preempted by the NBA. However, the states cannot issue subpoenas or other requests for information they need in order to file those lawsuits in the first place, as such exercise of "visitorial powers" remains barred by the OCC regulations under the NBA. In order to enforce a law, states would need to file lawsuits with information obtained independent of the banks themselves through public information, piggybacking federal investigations, etc. Thus, Cuomo is not the major victory for state attorneys general that many commentators initially proclaimed, but is something much more limited.

The lasting importance of *Cuomo v. The Clearing House Association* is still unclear and may remain so for quite some time. National banks should continue to monitor their interactions with state regulators who may insist that the case grants them more power than it really does. For now, though, it seems as if the initial importance of the case is somewhat premature.

The full text of *Cuomo v. The Clearing House Association* is available online at:

<http://www.supremecourtus.gov/opinions/08pdf/08-453.pdf>

◆ Leonard J. Essig • lessig@lewisrice.com • 314-444-7651

(John Steffens, University of Missouri-Columbia School of Law, contributed to this article)

LRF Financial Institutions Group

Please direct any inquiries to:
Thomas C. Erb, Chairman
314 444 7613

Tom W. Zook, Vice Chairman
314 444 7671

Lewis Rice Bank Law Update

Managing Editors:

Gregory R. Beekman	314 444 7684
John C. Bodnar	314 444 7761
William M. Bolster	314 444 7850
David W. Brown	314 444 1341

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St. Louis
500 North Broadway
Suite 2000
St. Louis, Missouri 63102
314 444 7600

Kansas City, Missouri
Overland Park, Kansas
Belleville, Illinois
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