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CORRESPONDENT BANKING AND INSIDER LOANS AFTER THE FINANCIAL INSTITUTIONS REGULATORY AND INTEREST RATE CONTROL ACT OF 1978

A series of major bank failures from 1973 to 1976,[1] caused primarily by insider abuses,[2] demonstrated the need for reform of the nation's financial regulatory apparatus.[3] The abuses generally involved banks'

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[1] *See* H.R. REP. No. 1383, 95th Cong., 2d Sess. 7, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 9273, 9279 [hereinafter cited as H.R. REP. No. 1383 and hereinafter paginated to U.S. CODE CONG. & AD. NEWS]. The United States National Bank of San Diego failed in 1973 as a result of massive insider abuses. *Id.* at 9280. The bank's chief executive officer drained over 400 million dollars of bank assets in the form of loans for use in his other enterprises. *Id.* Federal officials, although aware of the abuses for eleven years prior to the bank's failure, neglected to prevent the improvident loans. *Id.* at 9281. Subsequently, several other major banks collapsed due to insider abuses. *Id. See generally* note 10 *infra.*

[2] The label of "insider" applies to persons exercising influence over bank policies regardless of employment titles and compensation, or recorded ownership in bank stock. *See* 12 U.S.C. §§ 375a, 375b, 1972(2)(Supp. II 1978). *See* text accompanying note 9 *infra.*

[3] Bank regulation is accomplished through three federal bank supervisory agencies: the Comptroller of the Currency who is responsible for administration of national banks; the Federal Reserve Board which formulates monetary policy and regulates all banks which are member of the Federal Reserve System; and the Federal Deposit Insurance Corporation (FDIC) which provides protection for depositors of both member banks of the Federal Reserve System and insured nonmember banks through insurance and supervisory functions. *See* Note, *The Federal Bank Commission Act: A Proposal to Consolidate The Federal Banking Agencies,* 25 CLEV. ST. L. REV. 475, 475 n.4 (1976) [hereinafter cited as *Proposal to Consolidate*]. The three administrative agencies evolved at different times in response to various economic needs and have been criticized for lack of coordination and inability to insure safe commercial banking. *See id.* at 477, 494.

Until 1863 all banks were state chartered with the exception of two short-lived national banks in the early 19th century. *Id.* at 477. Congress established a national banking system by passing the National Currency Act of 1863, which authorized chartering of national bank associations and the corresponding issuance of national bank notes. Act of Feb. 25, 1863, 12 Stat. 665; *see Proposal to Consolidate, supra,* at 477. The Currency Act vested supervisory powers over the banking association in the Currency Bureau of the Treasury Department, headed by the Comptroller of the Currency. *Id.* In 1864, Congress superseded the Currency Act with the National Bank Act, which established the modern framework for bank regulation. Act of June 3, 1864, ch. 106, 13 Stat. 99; *Proposal to Consolidate, supra* at 477. In 1913, Congress enacted the Federal Reserve Act (FRA) in response to the financial panic of 1907. *Id.* The FRA coordinates individual banks and created Federal Reserve Banks to act as depositaries and fiscal agents of the government. *See* Englehart, *Bank Supervision in Historical Perspective,* 34 BUS. LAW. 1659, 1670-71 (1979) [hereinafter cited as *Supervision*]. The FRA also defines the powers and duties of the Board of Governors of the Federal Reserve System and requires that the Board examine the financial condition of the system's state-chartered member banks. *See* Buchalter and Allen, *Bank Insider Abuses: When does the Ax Fall?,* 96 BANKING L.J. 804, 805 (1979) [hereinafter cited as *Insider Abuses*]. The Federal Deposit Insurance Act of 1933, enacted in response to the stock market crash of 1929 and subsequent bank failures in the 1930's, created the FDIC to insure the deposits of

dealings with large shareholders and the extension of preferential loans to insiders of other banks which maintained correspondent accounts[4] with

national banks, members of the federal reserve system, and qualifying state banks. *See* 12 U.S.C. §§ 1811, 1814 (1976); *Proposal to Consolidate, supra* at 477.

The banking system in the United States consists of four bank classes which determine which agency or agencies may regulate a specific bank. *Id.* at 476. National banks, chartered under federal law, 12 U.S.C. §§ 21-28 (1976), are supervised primarily by the Comptroller of the Currency. *See* 12 U.S.C. § 222 (1976); *Proposal To Consolidate, supra* at 476. Nevertheless, national banks are also subject to regulation by the Federal Reserve Board by reason of mandatory membership in the Federal Reserve System, and to regulation by the FDIC. 12 U.S.C. §§ 222-23 (1976); *Proposal To Consolidate, supra* at 476. Additionally, all national banks must be insured by the FDIC. 12 U.S.C. §§ 282, 501a (1976). The other three bank classes consist of state-chartered banks, which are subject to regulation by the state banking authority exercising jurisdiction over the bank charter. *Proposal To Consolidate, supra* at 476. Voluntary members of the Federal Reserve System comprise the first class of state-chartered banks. These banks are subject to regulation by the Federal Reserve Board and by the FDIC. 12 U.S.C. § 321 (1976). The second class of state banks consists of those insured by the FDIC, but which are not members of the Federal Reserve System. These insured, nonmember banks, are subject to regulation by the FDIC. *Id.* § 1820(b) (1976). The third group of state banks are those which are neither insured by the FDIC nor members of the Federal Reserve System. Members of this third group are only subject to state regulation. *See Proposal To Consolidate, supra* at 476-77. Although Congress considered proposals to create a combined federal banking agency exercising the consolidated regulatory powers of the existing three regulatory agencies, no composite agency has yet been created. *See id.* at 494.

[4] A correspondent account is a non-interest bearing demand deposit account maintained by Bank A with Bank B for the purpose of compensating Bank B for services rendered to Bank A. 12 C.F.R. § 214.21(d) (1979). The necessity for the correspondent banking system stems from the fact that approximately 9,000 banks in the United States are not members of the Federal Reserve System and, therefore, do not have direct access to the check clearing and payment mechanisms of that system. *See The Safe Banking Act of 1977: Hearing on H.R. 9086 Before the Subcomm. on Financial Institutions Supervision, Regulations, and Insurance of the House Comm. on Banking, Finance and Urban Affairs,* 95th Cong., 1st Sess. 943-44 (1978) (statement of Quinton Thompson, Regional Director, FDIC) [hereinafter cited as *Hearings on H.R. 9086*]. Because most state laws require that certain amounts of bank reserve be in cash or due from other banks, many nonmember banks keep their reserves in the larger member banks in interest-free checking accounts. *Id.* at 944. In exchange for these reserves, the larger bank provides services for the nonmember bank. These services include check clearing, data processing, advice on loans and investments, and purchase and sale of securities. *Id.* Since the federal reserve system does not perform all of these services, member banks also use larger banks as correspondents and must keep excess reserves to obtain the services. *Id.* Compensation of the bank providing the services (correspondent bank) by the bank purchasing the services (respondent bank) is not on a strict fee basis by which a charge for each particular service may be itemized. *Id.* at 944, 956. Critics of the correspondent banking sytem in this country note that the compensating balances which act as payment for the services provided are divorced from the actual services, and therefore make a determination of the cost of each service provided impossible. *Id.* at 956 (statement of Martin Myers). Until stockholders know how much of a correspondent account is necessary for the services provided by correspondent banks and the expenses are itemized, correspondent accounts will remain subject to abuse. *Id.* at 947 (statement of Mr. Pickett). The potential financial damage due to abuse of correspondent accounts is great because of the large deposits in the accounts. A respondent bank typically maintains with a major correspondent bank an account which fluctuates from $800,000 to $1,800,000, and which rarely falls below $700,000. *Id.* at 377 (statement of Mr. Cleveland).

the lending institution.[5] In 1977, the "Bert Lance affair"[6] again focused public attention on insider banking transactions and added significant impetus to the banking reform movement.[7] Congress responded to the problem of insider abuses by passing the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (the Act or FIRICA),[8] which

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[5] *See* H.R. REP. No. 1383, *supra* note 1, at 9282, 9285.

[6] In 1974, T. Bertram Lance staged an unsuccessful primary campaign for the Georgia Democratic gubernatorial position. During the campaign Lance served first as president, and later as chairman of the Calhoun First National Bank [Calhoun]. *See* Hearings on H.R. 9086, *supra* note 4, at 30. In 1975 Lance and several associates acquired controlling interest in the National Bank of Georgia [NBG], of which Lance subsequently became President. *See id.* at 30 [letter from Robert Bloom, acting Comptroller of the Currency].

During a regularly scheduled examination of the Calhoun Bank in 1975, examiners discovered that the bank permitted the "Lance for Governor Campaign" to overdraw its account in 1974. *See id.* at 10. An investigation by the Comptroller of the Currency, however, established that no violation of banking law occurred. *See id.* Nevertheless, in 1975, the Securities Exchange Commission filed a complaint alleging that NGB, Calhoun, and Lance engaged in a course of business which included financial irregularities and unsafe banking practices. *See* SEC v. The National Bank of Georgia, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,402 (N.D. Ga. 1976). The complaint maintained that loans from Calhoun to Lance and certain of his relatives, friends and associates were made on preferential terms without adequate consideration of the burrowers' credit worthiness. *Id.*

With respect to loans by Calhoun to several of his relatives, the SEC alleged that Lance prepared and signed the names of certain relatives to financial statements which overstated the relatives' net worth. *Id.* An investigation by the Comptroller revealed that the checking accounts of 9 relatives showed overdrafts from 1972 to 1975. *See Hearings* on H.R. 9086, *supra* note 4, at 12 [remarks of Donald Tarleton, Regional Administrator Office of Comptroller of Currency]. The total amount of the overdrafts once reached $450,000. *Id.* The Comptroller's report also noted that the Calhoun Bank permitted officers, directors, some employees, and their families to overdraw their accounts and did not charge interest for periods during which the accounts were overdrawn. *Id.* Other evidence indicated that Lance, as president of NGB, used correspondent bank relationships to secure personal loans for himself. In the same month that Citizens and Southern Bank increased loans from $335,000 to $935,000 to Lance, his campaign committee, and companies in which he was a principal, NGB added over $1,700,000 to their account with Citizens and Southern. *See id.* at 247. Thereafter the loan to Lance and his associates interests climbed to over $1 million and the average deposite NBG kept with Citizens and Southern increased to amounts ranging from $2 million to $4 million.

Lance did not contest the SEC complaint, instead signing a consent agreement promising to perform or refrain from certain activities. Among other provisions of the consent agreement, Lance agreed not to overdraft any checking account except to the extent available to offer bank customers and not to obtain a loan from any bank in connection with any campaign by him for political office. *See* SEC v. The National Bank of Georgia, ¶ 96,402.

[7] *See* H.R. REP. No. 1383, *supra* note 1, at 9283-84. Although the Lance affair received much media coverage, the effect of the affair should not be overemphasized. Changes in bank insider regulations are attributable primarily to investigations regarding major bank failures in the 1970's. *Id* at 9279-81; *see* note 1 *supra*.

[8] Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-639, 92 Stat. 3641 (codified in scattered sections of 12 U.S.C. (Supp. II 1978)). In 1977, the House Subcommittee on Financial Institutions, Supervision, Regulation and Insurance held extensive hearings on the proposed Safe Banking Act of 1977. *See Hearings on H.R. 9086, supra* note 4. As a result of these hearings and a committee markup, the House Committee on Banking, Finance, and Urban Affairs introduced the Financial Institutions Regu-

became effective on March 11, 1979.

The Act curbs insider abuses by expansively defining "insiders" to include individuals exercising actual influence over bank policies[9] and by creating stricter enforcement powers for the federal regulatory agencies.[10] The insider prohibitions of FIRICA restrict loans from banks to insiders of the lending bank,[11] and regulate loans from banks to insiders of correspondent institutions.[12] Title I of the Act,[13] codified in part at sections

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latory Act of 1978 to the House of Representatives. H.R. REP. No. 1383, *supra* note 1, at 9275. The House joined the bill with the Interest Rate Control Act under consideration in the Senate, approved the combined legislation on October 11, 1978, and concurred in the Senate amendments on October 15, 1978. *See id.*

[9] *See* 12 U.S.C. §§ 375a, 375b, 1972(2) (Supp. II 1978); note 2 *supra*. Depending on the specific prohibition, directors, executive officers, principal shareholders, affiliates, and certain members of political or campaign committees are considered insiders. Directors include paid and unpaid directors of banks, directors of bank holding companies, and directors of any subsidiary of a bank holding company. 12 C.F.R. § 215.2(c) (1979). Executive officers are non-directors who have authority to participate in major policy-making functions of a bank or company without regard to such officer's title or salary. *Id.* § 215.2(d) (1979). Executive officers of affiliate companies are also considered executive officers of the bank unless the boards of both the affiliate and the bank resolve to exclude the affiliate's executive officer from participation in bank policy-making. Principal shareholders include persons or companies which directly or indirectly own, control, or have the power to vote a certain percentage of a bank's voting securities. 12 C.F.R. § 215.2(j) (1979).

[10] FIRICA authorizes the three banking agencies, *see* note 3 *supra*, to impose daily civil money penalties against institutions and insiders violating the Act, grants the agencies improved cease and desist authority, and empowers the agencies with improved provisions for removing and suspending insiders who violate the Act's prohibitions. *See* H.R. REP. No. 1383, *supra* note 1, at 9289. Civil fines, a new tool of the regulatory agencies, add needed flexibility to the regulatory apparatus. Prior to the enactment of FIRICA, regulatory agencies often either ignored violations or imposed cease and desist orders. *See id.* Cease and desist orders, however, were often considered too severe for the criticized action, and legislators believed that the threat of daily civil money penalties would serve to deter violations of the Act without involving undue harshness. Further, under prior law, the banking agencies could issue cease and desist orders only against institutions. Orders directed at an entire institution, however, can be inappropriate where a single insider engages in prohibited activities. *See id.* at 9290. In the event that the daily management of a bank is controlled by a single stockholder or other insider, a cease and desist order against the bank itself may unjustly discredit the institution's reputation if the condemned practices are the sole responsibility of the controlling insider. *See id.* Accordingly, FIRICA provides for issuance of cease and desist orders against individual violators of the Act. Finally, the new statute presents a less burdensome test for instituting removal or suspension proceedings against an individual violating the Act. Before passage of FIRICA, an insider could be removed from his bank-related position by the regulatory agencies only upon a showing that the insider engaged in unsafe practices adversely affecting the institution and that the alleged unsafe practices involved personal dishonesty. *See* H.R. REP. No. 1383, *supra* at 9290. The new FIRICA provisions authorize removal when an insider demonstrates personal dishonesty or evidences disregard for the soundness of the financial institution. 12 U.S.C. § 1818(e)(2) (Supp. II 1978). In addition to the sanctions of fines, removal, and cease and desist orders, the enforcement provisions of the Act allow for a hearing and review of the enforcing agency's actions. *Id.* § 1818(h)(1) (Supp. II 1978).

[11] *See* 12 U.S.C. §§ 375a, 375b (1976 & Supp. II 1978).

[12] *See* 12 U.S.C. § 1972(2)(A)-(D) (Supp. II 1978).

[13] *See* Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L.

375a and 375b of title 12 of the United States Code,[14] regulates loans to insiders of the lending institution. Section 375a prohibits member banks of the Federal Reserve System[15] (member banks) from extending credit[16] to their own executive officers[17] unless expressly authorized by the statute.[18] Section 375a also requires a prompt report to the bank's board of directors of all loans made by the bank to its executive officers, and expressly forbids banks from extending preferential treatment[19] to their own executive officers.

Regardless of the terms of the loan, section 375a authorizes only certain extensions of credit to executive officers. Authorization is extended to personal home mortgages not exceeding $60,000 which are secured by first liens,[20] loans to finance the education of officers' children in out-

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No. 95-630, 92 Stat. 3641 (codifies in scattered sections of 12 U.S.C. (Supp. II 1978)). Title I of the Act, entitled Supervisory Authority Over Depository Institutions, generally sets out prohibitions, penalties, and hearing and notice procedures for regulating various depository institutions.

[14] 12 U.S.C §§ 375a & 375b (1976 & Supp. II 1978).

[15] The term "member bank of the Federal Reserve System" refers to any banking institution which belongs to the Federal Reserve System, but does not include domestic branches of foreign banks. 12 C.F.R. § 215.2(g) (1979).

[16] For the purposes of § 375a, an extention of credit is a loan or any other type of credit. 12 C.F.R. § 215.3(a) (1979). The term "extension of credit" does not, however, include such things as advances against accrued compensation or preauthorized loans of up to $5,000 which also are available to general bank customers. *Id.* § 215.3(b)(1), (5) (1979).

[17] *See* 12 C.F.R. § 215.2(d) (1979); note 9 *supra.* The term "executive officer" includes the chairman of the board, the president, all vice-presidents, the cashier, the secretary, and the treasurer of a bank unless the bank resolves to exclude such officer from non-directorial policymaking and the officer actually abides by the resolution. *See* 12 C.F.R. § 215.2(d) (1979).

[18] 12 U.S.C. § 375a(1) (Supp. II 1978); *see* text accompanying notes 19-22 *infra.*

[19] 12 U.S.C. § 375a(1)(A), (B) (Supp. II 1978). An extension of credit is preferential if the bank is unauthorized to make such a credit extension to borrowers other than bank officers or if the terms of the loans are more favorable to the bank's officers than the terms accorded other borrowers. *Id.*

[20] *Id.* § 375a(2) (Supp. II 1978). A bank's board of directors specifically must approve all home mortgage loans to the bank's executive officers before extending the loan. *Id.* As a further condition on the loan, the mortgage must be secured for a "dwelling which is expected, after the making of the loan, to be owned by the officer and used by him as his residence . . . " *Id.* § 375a(2)(A). The statutory language of § 375a does not, however, establish whether the expectation of the dwelling's use and ownership is to be held by the board of directors authorizing the loan or by the borrowing officer. Also, the placement of the phrase "after the making of the loan" implies that the expectation of the dwelling's use is to continue after the loan is granted. Such construction would require an unreasonable and continuing expectation of the officer's ownership and use of the dwelling. A construction embodying the more probable intent of the draftsmen would read "the mortgage must be secured for a dwelling which is expected to be owned by the officer and used by him as his residence after the loan is granted." In addition, banks may not extend mortgage loans to an executive officer when the bank has any other outstanding mortgage loans to the same officer. *Id.* § 375a(2)(B). This restriction on mortgage loans applies regardless of the respective loan amounts. Thus, even though the permissible amount of a single mortgage loan is $60,000, if the bank has an outstanding mortgage loan to an officer, the bank is unauthorized to grant the officer a second loan even if the two loans total less than $60,000.

standing aggregate amounts not exceeding $20,000,[21] general purpose loans not exceeding the aggregate amount of $10,000,[22] and extensions of credit in maximum amounts of $10,000 to partnerships controlled singly or jointly by bank officers.[23] Further, if an executive officer of one bank becomes indebted to another bank in amounts exceeding those extendable by his employer bank, the officer must report all such excessive loans to the board of directors of his employer bank.[24] The report is important to the employer bank since any loan by the employer bank to one of its executive officers is payable upon demand when the officer becomes indebted to other banks in an aggregate amount exceeding the credit extendable by the employer bank under section 375a.[25] Although section 375a only applies to executive officers of banks,[26] section 375b applies to both executive officers and other bank insiders.[27]

Subsection (1) of section 375b prohibits extensions of credit by member banks to their own executive officers,[28] to persons owning, controlling, or having the power to vote at least ten percent of any outstanding voting stock in the bank,[29] to companies[30] controlled by such officers and per-

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[21] 12 U.S.C. § 375a(3) (Supp. II 1978). Unlike mortgage loans, *see* note 20 *supra*, executive officers may have several loans outstanding from their employer bank to finance their children's educations so long as the total loan outstanding does not exceed $20,000. Section 375a does not define "education" and does not limit the term to tuition or any other specific educational use. See 12 U.S.C. 375a(3) (Supp. II 1978).

[22] 12 U.S.C. 375a(4) (Supp. II 1978). The loans allowed under 375a(4) are permitted in addition to those specifically authorized under § 375a(2) and (3) for mortgages and education of executive officers' children. Indeed, the amount extended for a loan under any provision of § 375a(2)-(4) does not affect the amounts extendable to officers under any other provision of § 375a(2)-(4). Thus, an educational loan extended to an executive officer under § 375a(3) would not affect the amount extendable to the same officer for a home mortgage under § 375a(2).

[23] 12 U.S.C. § 375a(5) (Supp. II 1978). Except for the $10,000 general purpose loan extendable to executive officers under § 375a(4), *see* text accompanying note 22 *supra*, banks may not extend credit to partnerships in which executive officers of the bank, individually or jointly, maintain a majority interest. Further, for the purposes of § 375a(4), any loans made to such a partnership are credited against the amounts extendable to each executive officer who belongs to that partnership. 12 U.S.C. § 375a(5) (Supp. II 1978).

[24] 12 U.S.C. § 375a(1)(D) (Supp. II 1978).

[25] *Id.* Only loans made by banks other than the executive officer's employer bank must be aggregated under § 375(a)(1)(D). Therefore, loans from employer banks to their own executive officers are not aggregated with loans from other banks to the same officers.

[26] *See* 12 U.S.C. § 375a (Supp. II 1978).

[27] *See id.* § 375b (Supp. II 1978); text accompanying notes 28-32.

[28] 12 U.S.C. § 375b(1) (Supp. II 1978). The definition of "executive officer" under § 375b is the same as under § 375a. *Id.* § 375b(6)(F); *see* 12 C.F.R. § 215.1(g), 2(d) (1979); note 9 *supra*.

[29] 12 U.S.C. § 375b(1) (Supp. II 1978). In the case of a bank located in a municipality of less than 30,000 persons, the prohibition of loans to bank shareholders is effective only when the shareholder owns, controls, or has the power to vote at least 18% of the bank's voting stock. *Id.* Congress included this exception for banks in towns of less than 30,000 persons to facilitate infusion of capital into banks located in areas where capital is in short supply. H.R. REP. No. 1383, *supra* note 1, at 9284. Although the concept of "control" in regard to bank stock is not defined, "control" is defined in relation to control of companies. *See* note

sons,[31] and to political committees which benefit or are controlled by such officers or persons,[32] where the aggregate outstanding amount exceeds the limit imposed by section 84 of title 12 of the United States Code.[33] Section 84 prohibits the total obligations of any person, partnership, or corporation to a bank from exceeding ten percent of the bank's unimpaired surplus fund.[34]

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31 *infra*. As originally proposed to Congress in the Safe Banking Act of 1977, § 375b(1) would apply to holders of only 5% of a bank's stock. *See Hearings on H.R. 9086, supra* note 4, at 1885 (statement of American Banking Assoc.). The effect of prohibiting loans to 5% shareholders, however, was potentially devastating to small banks because in the originally proposed Safe Banking Act 5% shareholders were limited to borrowing 5% of a bank's assets, whereas non-insiders could continue to borrow up to 10% of the bank's assets. *See id.* at 1885. Thus, prosperous individuals in communities with banks having minimal assets would be uninterested in investing in more than 5% of a bank's stock since any investment over 5% by such individual would cut the line of credit extendable to that individual and his business enterprise from 10% to 5% of the bank's assets. *Id.* at 1886.

[30] For the purpose of § 375b, "company" means any form of business entity or trust, except for any insured bank or any corporation in which the majority of shares is owned by the federal or state government. 12 U.S.C. § 375b(6)(B) (Supp. II 1978).

[31] *Id.* § 375b(1). A person is considered to control a company if he directly or indirectly owns, controls, or can vote at least 25% of any voting securities in the company, controls the election of a majority of the company's board of directors, or has the power to control the policymaking functions of the company. *Id.* § 375b(5)(A)-(C). Further, a person is presumed to control a company if that person is an executive officer or director of the company and also directly or indirectly controls more than 10% of the company's voting stock. 12 C.F.R. § 215.2(b)(2)(i) (1979). The same presumption also applies if a person controls a greater percentage of the same class of securities. *Id.* § 215.2(b)(2)(ii) (1979). A person to whom the presumption of control applies may rebut the presumption by satisfying the cognizant regulatory agency that he does not maintain such control. *Id.* § 215.2(b)(4).

[32] 12 U.S.C. § 375b(2) (Supp. 1978). A political campaign or committee "benefits" a bank insider when the organization's funds or services "benefit" that person. *Id.* No further explanation of either "benefit from" or "control of" a political organization is given by the statute, nor does the statute define political "committee" or "campaign". Therefore, banks must use extreme caution when extending loans to political organizations and must require bank insiders to acknowledge political affiliations with any prospective organizational borrower.

Some guidance for interpreting the benefit concept might be gained, however, by examining the "Bert Lance for Governor" campaign. In 1974 T. Bertram Lance staged an unsuccessful campaign for the Georgia Democratic gubernatorial nomination. *Hearings on H.R. 9086, supra* note 4, at 30 (statement of John P. Sherry, Attorney, Enforcement & Compliance Section, Office of the Comptroller of the Currency). During the campaign (May 1973-December 1974), Lance was President and subsequently Chairman of the Board of the Calhoun First National Bank. From October 1973 through August 1974 the bank advanced its own money to pay certain bills incurred by the Lance Campaign Committee. *Id.* Congressional concern that Lance transferred the Calhoun First National Bank into a personal political machine, *see id.* at 38, might serve to restrict the concept of "benefits from" a political organization to include only those persons who seek election. Thus, a campaign worker might not be considered to benefit from a campaign committee even if compensated for his services.

[33] 12 U.S.C. § 84 (1976 & Supp. II 1978).

[34] *Id.* Section 84 does not define either "paid-in unimpaired capital stock" or "unimpaired surplus fund." Paid in capital, however, is that amount of consideration actually received by a corporation for the issuance of shares in the corporation. *See* H. HENN,

Where the aggregate amount of the loans exceeds $25,000, subsection (2) of section 375b prohibits credit extensions to the same individuals and enterprises affected by the provisions of subsection (1).[35] An exception to the $25,000 limit is permitted, however, if a majority of the entire board of directors of the lending bank approves the additional credit prior to extending the loan.[36] The extra amounts extendable by the board of directors are nevertheless limited to ten percent of the bank's assets as provided in sections 375b(1) and 84.[37] Additionally, subsection (2) of section 375b, unlike subsection (1), applies to bank directors[38] and their business and political enterprises. Thus, although subsection (2) initially appears to have a wider scope than subsection (1) because directors are not subject to the limitations of subsection (1), directors appear able to procure loans exceeding ten percent of the bank's assets. Since section 84 applies to all persons and their enterprises,[39] however, even directors are prohibited from borrowing more than ten percent of the bank's assets despite the absence of such a prohibition in section 375b(1).

Regardless of the scope of subsections 375b(1) and (2), member banks are also forbidden to extend credit to executive officers, directors, principal shareholders, and the enterprises of such insiders unless the loans are on substantially the same terms as those prevailing for "comparable transactions" with other customers and do not involve abnormal risk of repayment or other "unfavorable features."[40] Although Congress intended

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LAW OF CORPORATIONS § 126 (2d ed. 1970). Capital is considered unimpaired when dividends are not paid out of the capital fund. *See id.* § 320, at 651. Paid-in surplus generally means amounts contributed for shares in excess of the stated capital. *See id.* § 319, at 636 n.6.

[35] 12 U.S.C. § 84 (1976 & Supp. II 1978).

[36] *Id.* No interested party may participate in the board of directors' vote to grant or deny a loan from a lending bank to a bank insider. *Id.* Additionally, since a majority of the entire board of directors must approve the loan and interested parties cannot participate in the approval process, if half of the members of the board are "interested" parties regarding a specific loan application, no approving majority exists and the bank may not lend over $25,000.

[37] *See* 12 U.S.C. §§ 84, 375b(1) (1976 & Supp. II 1978); text accompanying notes 28-34 *supra.*

[38] 12 U.S.C. § 375b(2) (Supp. II 1978). Section 375b defines "directors" as persons who are directors of any bank holding company of which their own bank is a subsidiary, or who are directors of any other subsidiary of the same holding company. *Id.* § 375b(5)(D) (Supp. II 1978). "Director" of a member bank includes even those directors who do not receive compensation, but does not include any advisory director who is not elected by the bank shareholders, is unauthorized to vote on matters before the board of directors, and who provides only general policy advice to the board. 12 C.F.R. § 214.2(c) (1979). The exclusion of nonelected, nonpolicymaking directors (outside directors) from the effect of § 375b stems from congressional concern that inclusion of such directors in the prohibitions of § 375b could hamper banks' efforts to procure effective advice. *See Hearings on H.R. 9086, supra* note 4, at 137. Outside directors often are good customers of the bank which they serve, and application of loan restrictions to these outside directors would deter their willingness to act as advisors. *See id.*

[39] *See* 12 U.S.C. § 84 (1976 & Supp. II 1978). Section 84, however, applies only to national banking associations. *Id.; see* note 3 *supra.*

[40] 12 U.S.C. § 375b(3) (Supp. II 1978). The terms "comparable transaction" and "un-

the prohibition on loans which are not on substantially the same terms as "comparable transactions" to prevent preferential loans,[41] the statute's language is a model of imprecision.[42] Further, in many instances the complexity of a transaction is so unique that comparable business settlements do not exist.[43]

For the purpose of establishing the aggregate amount of outstanding loans to insiders and their enterprises under section 375b, the Act broadly defines controlling interests in companies to include those groups indirectly controlled by bank insiders.[44] FIRICA does not limit the restrictions to incorporated organizations, but rather defines "company" to include most business enterprises.[45] By extending the credit limitations to business enterprises generally, the Act prevents bank insiders from using commercial organizations to obtain loans which the insiders could not legally procure in their individual capacities.[46] A gap exists, however, in FIRICA's definitional language. The Act prohibits loans not only to companies controlled by insiders, but also to political or campaign committees which benefit or are controlled by insiders.[47] Although control of a company is defined by section 375b,[48] benefit from or control of a political or campaign committee is not defined anywhere in the Act.[49] Until implementing regulations issuable by the federal regulatory agencies fill this gap, lending institutions risk violating the Act whenever they extend credit to political organizations of which bank insiders are members.

The final prohibition of section 375b forbids member banks from paying overdrafts on the accounts[50] of the bank's executive officers or directors, but excludes the bank's principal stockholders from the overdraft

favorable features" are not defined by § 375b or any implementing regulations. *See* text accompanying notes 42 & 43 *infra.*

[41] *See* Bell & Oliver, *Correspondent Bank Loans After the Financial Institutions Regulatory and Interest Rate Control Act of 1978,* 34 Bus. Law. 1347, 1353 (1979) [hereinafter cited as *Correspondent Bank Loans*].

[42] *See id.;* note 40 *supra.* For purposes of bank compliance with the Act, the definition of nonpreferential loans may cause serious problems. Although the regulatory agencies undoubtedly view the "catch-all" prohibition of loans demonstrating "unfavorable features" as a flexible tool of enforcement, the statute's language does not afford a lending bank any guidance as to the propriety of specific loans. *Correspondent Bank Loans, supra* note 41, at 1353.

[43] Guenter, *The Lance Legacy—Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978,* 96 Banking L.J. 292, 298 (1979) [hereinafter cited as *Lance Legacy*].

[44] 12 U.S.C. § 375b(5) (Supp. II 1978); *see* note 31 *supra.*

[45] 12 U.S.C. § 375b(6)(B) (Supp. II 1978); *see* note 30 *supra.*

[46] *See generally Lance Legacy, supra* note 43, at 297.

[47] *See* 12 U.S.C. § 375b(2) (Supp. II 1978); note 32 *supra.*

[48] *See* note 31 *supra.*

[49] *See* note 32 *supra.*

[50] The term "pay an overdraft on an account" means payment by a member bank of an amount for an account holder in excess of the funds the account holder has on deposit. 12 U.S.C. § 375b(6)(G) (Supp. II 1978).

payment restriction.[51] Overdrafts in the form of preauthorized extensions of credit[52] are exempt from the Act's prohibitions.[53] Thus, executive officers and directors nevertheless may take advantage of tied accounts[54] and other automatic credit procedures available to general customers of the bank.

Congress extended restrictions similar to those of sections 375a and 375b to all banks maintaining correspondent accounts with other banks, thereby fully implementing insider restrictions on banks and their executive officers, directors, and shareholders. Congressional belief that insiders could receive preferential loans from other banks by controlling distribution of correspondent banking business resulted in promulgation of Title VIII of the Act.[55] Title VIII, entitled "Correspondent Accounts," is codified in title 12 of the United States Code at section 1972(2).[56] The essential purpose of Title VIII is to prevent banks[57] which maintain correspondent balances (respondent banks)[58] with other banks (correspondent banks)[59] from extending credit[60] on preferential terms[61] to one an-

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[51] 12 U.S.C. § 375b(4) (Supp. II 1978).

[52] A preauthorized extension of credit is a written, preauthorized, interest-bearing loan specifying a method of repayment or a written, preauthorized transfer of funds from another account of the account holder at the bank. *Id.* § 375b(6)(G) (Supp. II 1978).

[53] *Id.*

[54] Tied accounts are related accounts between which transfers of funds are permitted. *See* note 52 *supra.*

[55] *See* note 6 *supra.* Congressional investigators reviewing the proposed Safe Banking Act of 1977 focused upon Lance's alleged misuse of his position as a bank insider to obtain personal loans from correspondent banks, compensating the lending institution by placement of a correspondent balance. *See id.*

[56] 12 U.S.C. § 1972(2) (Supp. II 1978).

[57] For the purposes of § 1972(2), "bank" has the meaning given that word by 12 U.S.C. § 1841(c), and includes branches of foreign banks and lending institutions controlled by a foreign bank or foreign bank holding company. *See* 12 U.S.C. § 1971 (1976); 12 C.F.R. § 215.21(a) (1979). The definition of "bank" used in §§ 1971 and 1841(c) differs from the one used in §§ 375a and 375b insofar as the § 1971 version includes branches of foreign banks. *See* 12 U.S.C. § 1841(c) (1976); note 15 *supra.*

[58] *See Hearings on H.R. 9086, supra* note 4, at 964. *But cf. Correspondent Bank Loans, supra* note 41, at 1349-50 (defining bank at which correspondent account maintained as "depository bank" and defining depositing bank as "correspondent bank").

[59] *See Hearings on H.R. 9086, supra* note 4, at 964. A correspondent bank is a bank which maintains correspondent accounts for a member bank which, during a calendar year, exceed a daily average balance during that year of $100,000 or .5% of such member bank's total deposits, whichever is less. 12 C.F.R. § 215.21(d) (1979). Although § 1972(2) has been criticized for not defining "correspondent accounts", *see Lance Legacy, supra* note 43, at 297-98, the regulations promulgated under § 1972(2) now clearly define the term as an account maintained by a bank with another bank for the deposit or placement of funds. 12 C.F.R. § 214.21(c) (1979).

[60] "Extension of credit" under § 1972(2) is defined by reference to 12 U.S.C. § 371(c) (1976). Section 371, only describes transactions which are included under the label "extension of credit" and does not conclusively define the term. Section 371 provides that for "the purposes of this section, (1) the terms 'extension of credit' and 'extensions of credit' shall be deemed to include (A) any purchase of securities, other assets or obligations under repurchase agreements, and (B) the discount of promissory notes, bills of exchange, conditional

other's executive officers, directors, and principal shareholders.[62] The opportunity for abuse by insiders of correspondent accounts arises in determining the appropriate level of a correspondent balance.[63] An insider of a respondent bank might open an account in the name of his bank at another institution and in return receive a personal preferential loan from the correspondent bank. The correspondent account is thus used as compensation for the preferential loan.[64]

Section 1972 lists four prohibitions designed to prevent abuse of correspondent accounts.[65] These restrictions forbid extensions of credit by both correspondent and respondent banks to any insider of the other bank on preferential terms or with abnormal risk of repayment.[66] Additionally, no respondent bank may open an account with a correspondent bank if either bank has outstanding preferential loans to insiders of the other bank.[67] These restrictions serve to limit two different types of potential abuse of correspondent accounts. Two of the four prohibitions prevent respondent banks from maintaining inordinately large accounts for correspondent banks to compensate the correspondent bank for extending preferential treatment to respondent bank insiders.[68] The remaining two prohibitions prevent correspondent banks from accepting disproportionately low balances from respondent banks in order to compensate respondent banks for extending preferential credit treatment to

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sales contracts, or similar paper . . . " 12 U.S.C. § 371(c) (1976). Taken literally, § 1972(2) would limit only repurchase arrangements and discount transactions, but Congress probably intended the restriction to extend to direct loans as well. *See Lance Legacy, supra* note 43, at 296.

[61] The language of § 1972(2) which describes the elements of preferential loans is identical to the language used in § 375b and thus suffers from the same shortcomings. *See* 12 U.S.C. §§ 375b(3), 1972(2)(A)-(D) (Supp. II 1978); text accompanying notes 41-43 *supra.*

[62] "Executive officer" is accorded the same meaning under § 1972(2) as under § 375a. 12 U.S.C. § 1972(2)(E) (Supp. II 1978); *see* note 9 *supra.* "Principal shareholder" is defined by the regulations promulgated under §§ 375a, b, *see* 12 C.F.R. § 215.10(2), .21(e) (1979), as a person who owns or controls 10% of a bank's voting securities. 12 C.F.R. § 215.10(2) (1979).

[63] *See Correspondent Bank Loans, supra* note 41, at 1349.

[64] *Id.*

[65] *See* 12 U.S.C. § 1972(2)(A)-(D) (Supp. II 1978). Subsection (2)(A) prohibits correspondent banks from extending credit, except on a nonpreferential basis, to executive officers, directors, and ten % shareholders of respondent banks. Subsection (2)(B) prohibits respondent banks from opening correspondent accounts with correspondent banks if the correspondent bank has a preferential loan outstanding to executive officers, directors, or ten % shareholders of the respondent bank. Subsection (2)(C) prohibits respondent banks from extending preferential credit to executive officers, directors, and ten % shareholders of correspondent banks. Subsection (2)(D) prohibits respondent banks which have outstanding loans to executive officers, directors, or ten % shareholders of correspondent banks from opening a correspondent account of the correspondent bank unless all such outstanding loans are nonpreferential. *Id.; see Correspondent Bank Loans, supra* note 41, at 1351.

[66] 12 U.S.C. § 1972(2)(A), (C) (Supp. II 1978); note 65 *supra.*

[67] 12 U.S.C. § 1972(2)(B), (D) (Supp. II 1978); note 65 *supra.*

[68] *See* 12 U.S.C. § 1972(2)(A) & (B) (Supp. II 1978); *Correspondent Bank Loans, supra* note 41, at 1351-52; note 4 *supra.*

insiders of the correspondent bank.[69] These prohibitions apply regardless of whether the size of the correspondent account is justified by the volume of business transacted between the banks. The statute does not consider if a connection exists between a correspondent account and loans extended by one bank of that correspondent relationship to insiders of the other related bank.[70] Enforcement of a statute which would apply only where the correspondent account acted as compensation for preferential loans would, however, present a formidable task. Congress therefore wisely chose an absolute ban on preferential loans where banks are linked by correspondent accounts.[71] Nevertheless, the Act does not ban preferential loans from one bank to insiders of another where the respective institutions do not share a correspondent relationship.[72]

FIRICA's disclosure requirements are crucial to enforcement of Title VIII of the Act.[73] Section 1972(a)(G)(i)[74] requires that each executive officer and each recorded stockholder controlling ten percent of voting bank stock[75] make a written report to the board of directors of their own bank describing any loans received from a correspondent bank maintaining an account in the name of the insider's institution.[76] Each insured bank is then required to accumulate the reports filed pursuant to the reporting requirement and forward the reports to the appropriate regulatory agency.[77] Additionally, each insured bank must list all of their executive officers and recorded shareholders who obtain credit from banks sharing a correspondent relationship with the reporting institution and must also list the aggregate amount of such credit extended to each executive officer and shareholder of record.[78]

The reporting requirements of Title VIII are not, however, properly designed to enforce the statute fully. Although section 1972(2) prohibits preferential loans from banks in a correspondent relationship to insiders of banks sharing in that relationship, the disclosure requirements apply

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[69] See 12 U.S.C. § 1972(2)(C) & (D) (Supp. II 1978); *Correspondent Bank Loans, supra* note 41, at 1352; note 63 *supra*. Whether potential for abuse exists in cases where a correspondent bank accepts an inordinately low correspondent balance from a depositing (respondent) bank in order to compensate the depositing bank for extending preferential loan to insiders of the correspondent bank is uncertain. *Id.*

[70] *See Correspondent Bank Loans, supra* note 41, at 1352.

[71] *Id.*

[72] *See* 12 U.S.C. § 1972(2)(A)-(D) (Supp. II 1978).

[73] *See* 12 U.S.C. § 1972(2)(G) (Supp. II 1978).

[74] *Id.* § 1972(a)(G)(1) (Supp. II 1978).

[75] The term "ten percent stockholder of record," as used in the disclosure sections, is defined as 10% shareholder, who is also recorded as a shareholder of any bank stock. 12 U.S.C. § 1972(G)(i) (Supp. II 1978). The individual need not, however, be the record holder of 10% of the bank stock. *See Bank Insider Abuses, supra* note 3 at 811 n.30. Therefore, disclosure requirements of § 1972(2) apply to record share owners controlling at least 10% of the bank stock, even though the shareholder is not a record holder of a full 10% interest.

[76] 12 U.S.C. § 1972(2)(G)(i) (Supp. II 1978).

[77] *Id.* § 1972(2)(G)(iii) (Supp. II 1978); *see* note 3 *supra*.

[78] *Id.* § 1972(2)(G)(iii) (Supp. II 1978).

only to the respondent bank.[79] Secondly, the reporting regulations do not apply to bank directors even though Title VIII includes directors within the insider category for purposes of the prohibitions in section 1972.[80]

Not only are the reporting requirements deficient, but testimony in congressional hearings criticized the prohibitions of both Titles I and VIII for failure to restrict loans from banks to the family members of bank insiders.[81] During the hearings, various spokesmen expressed concern that the prohibitory effects of FIRICA on loans from banks to bank insiders would be circumvented if family members of bank insiders obtained loans unavailable to the insider and then allowed the related bank insider to enjoy the benefits of the loans.[82]

Compliance with Title VIII will be difficult due to the administrative bookkeeping generated by the reporting requirements and the uncertainty regarding the definition of a preferential loan. Accordingly, banks should clarify internal policy to all banks insiders and standardize methods of discovering correspondent bank-related loans.[83] Organization of bookkeeping procedures should include notification to all insiders of the bank's correspondent relationships so that insiders might avoid even the appearance of preferential loans to and from insiders of correspondently related banks.[84] A simple way to reduce both the bookkeeping load and the possibility that a loan violates section 1972(2) is for banks to eliminate nonessential correspondent relationships.[85]

The Act requires that each bank executive officer and ten percent shareholder annually disclose to his board of directors all loans to him or to his affiliates from banks maintaining a correspondent account in the name of the insider's bank.[86] Both the form and timing of this report, however, are left open. The timing of insiders' reports to their respective board of governors will be dictated by the deadline required of banks for filing their annual Title IX report[87] to the appropriate regulatory agencies. Thus, to permit time to prepare disclosures, banks must require their insiders to file Title VIII disclosures sufficiently in advance of the due date for bank's Title IX report.[88]

Since the Act prohibits respondent banks from opening correspondent accounts with correspondent banks if the correspondent bank has ex-

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[79] *See Correspondent Bank Loans, supra* note 41, at 1355.

[80] *See id.*

[81] *See Hearings on H.R. 9086, supra* note 4, at 101, 131, 139 & 414.

[82] *See id.*

[83] *See Correspondent Bank Loans, supra* note 41, at 1355-56.

[84] *Id.* at 1355.

[85] *Id.* at 1356.

[86] 12 U.S.C. § 1972(2)(G)(i) (Supp. II 1978); *see* text accompanying notes 75-76 *supra.*

[87] 12 U.S.C. §§ 1817(k)(1), 1972(G)(ii)-(iii) (Supp. II 1978). Although no date is set for the required filing of a bank's report of correspondent loan activity, presumably regulatory agencies will set a date by which a bank must submit its report to the appropriate banking agency. *See Correspondent Bank Loans, supra* note 41, at 1356.

[88] *Correspondent Bank Loans, supra* note 41, at 1356.

tended preferential credit to an insider of the respondent bank,[89] respondent banks should survey their insiders to determine that no preferential loans from a correspondent bank exist. If a preferential loan is discovered, bank management has two options. It can forego the correspondent relationship or persuade the insider with the preferential loan to pay off the loan or modify its terms so as to eliminate any element of preference.[90]

Since the Act also prohibits respondent banks from opening correspondent accounts at other banks when the respondent bank has extended preferential credit to insiders of the correspondent bank,[91] management of the respondent bank should request a list of correspondent bank insiders. The list should be examined to determine whether the respondent bank has any outstanding preferential loans to correspondent bank insiders.

Recent events have altered the legality of preferential loans extended within correspondent banking relationships. Because of Title VIII of the new Act and the high profile of the Lance case, regulators will likely become increasingly attentive to correspondent relationships in their bank examinations. Further, by extending loan prohibitions to an expanded category of "insiders", Title I of the Act serves to prevent bank failures caused by banks overextending credit to persons exercising control over bank policy.

ROBERT G. MCLUSKY

[89] *See* 12 U.S.C. § 1972(2)(B) (Supp. II 1978).

[90] *See Correspondent Bank Loans, supra* note 41 at 1357.

[91] *See* 12 U.S.C. § 1972(2)(D) (Supp. II 1978); *Correspondent Bank Loans, supra* note 41, at 1357. *But cf. id.* (claiming that § 1972 prevents correspondent banks from accepting correspondent accounts when the respondent bank has extended preferential credit to its own insiders).