The Commonwealth of Massachusetts

Office of the Commissioner of Banks
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Boston, Massachusetts 02110

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GOVERNOR

THOMAS J. CURRY
COMMISSIONER

December 31, 2001

Robert C. Buckley, Esq.
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Dear Mr. Buckley:

This letter is in response to your correspondence dated June 14, 2001 and July 25, 2001 to the Division of Banks (the "Division") on behalf of Lawrence Savings Bank, (the "Bank"), North Andover, Massachusetts relative to a recent examination conducted by the Federal Deposit Insurance Corporation ("FDIC"). The FDIC, in their examination report, aggregated under the loans to one borrower provisions of General Laws chapter 167E, section 14, subsection A, the guaranty on a participation credit by Windham Equity Company ("Windham"). The Bank does not agree with such action. Your letter states that the FDIC indicated to Bank management that the determination by the Division would control the ultimate outcome in this matter. This matter was also the subject of a meeting at the offices of the Division on July 19, 2001 between you and other representatives of the Bank and staff of the Division.

The relevant facts as set forth in your letters are:

- The Bank is a participant in a loan arrangement originated by Southern New Hampshire Bank and Trust Company ("SNHB"). The SNHB loan arrangement is an automobile dealer floor plan financing pool spread over approximately 800 individual dealer accounts.

- The dealer floor financing pool is serviced by Lease and Rental Management Corp. ("LRMC"). LRMC is a wholly-owned subsidiary of Windham.

- Windham guaranties LRMC's performance obligation pursuant to a servicing agreement. Such guaranty extends to the full performance of the payment obligations to the Bank.

- Fifty-two percent of Windham is owned by William DeLuca, Jr. and Mr. DeLuca's four children each own twelve percent of Windham. Mr. DeLuca, and entities controlled by him, have no existing loan arrangements with the Bank.

- The Bank's participation in the SNHB loan is to a maximum of 50%, but not to exceed in the aggregate $25 million. The Bank reserves the right to object to any individual dealership financings and undertakes its own independent credit review regarding its agreement to participate in any advance.

- The Bank's present legal lending limit at the time of examination was approximately $5.3 million under subsection A of section 14 of chapter 167E of the General Laws ("Section 14"). During the pending of this matter the Bank restructured its capital stock. That restructuring was approved by the Division on July 31, 2001. As a result of that transaction the Bank's lending limit was doubled from 10% to 20% of its capital stock, surplus and undivided profits.

- The current outstanding principal balance of the Bank's participation in the SNHB loan arrangement is $6,587,000.

Under said Section 14, a Massachusetts bank in stock form is limited to the amount it can extend to one borrower. The key phrase, as noted in your letter, under this section is "obligations to one borrower." You state that your research indicates that there is no controlling interpretation of the Division relative to this section dealing with the facts presented. Accordingly, you argue that there is no definitive mechanism to determine whether a guarantor or endorser of the type of floor plan financing arrangement presented would be a "borrower" under Section 14. Therefore, your understanding of the Division's position is that a determination as to whether the amount of any guarantor's obligation should be aggregated for purposes of compliance with Section 14 would therefor be made on a case by case basis by the examiners during an examination after consideration of all the relevant facts and consideration of the public policy objectives of Section 14. In focusing on public policy objectives, you state that the contingent liabilities of Windham as guarantor should not be aggregated and should not constitute a violation of Section 14 since under the financing arrangement there are 800 individual account borrowers. The contingent liability of Windham is therefor broadly disbursed and the likelihood that there would be any claim of any significance on Windham is remote. Moreover, you state that the individual floor plan loans are secured by collateral that would have a market value that is most likely equal to or in excess of the approximate amount of the loan obligations. Accordingly, you believe that public policy obligations of Section 14 are preserved.

The Division has had a consistent position on the treatment on guaranties in the calculation of loans to one borrower. It includes guaranties in that calculation. That position is grounded in concerns for the safety and soundness of an institution rather than general public policy theories. The FDIC is aware of the Division's position on the inclusion of guaranties in the calculation of the aggregate limit.

However, the Division has given extensive internal consideration and review to the unique issues raised by the particular transaction raised in the examination. The provisions of section 14 of chapter 167E governing loans to one borrower are general and therefore broadly interpreted by the Division. The totality of the facts presented by the Bank as well as the ambiguity of the statute have resulted in this extended review by the Division. Other ongoing events are consistent with the Division's additional review of the restrictions of the loan to one borrower statue.

Currently pending before the Massachusetts Legislature are two bills, Senate 10 and House 11, which would completely rewrite chapter 167E of the General Laws. House 11 is a recommendation of the Division. The legislation seek to modernize the statute by eliminating the numerous classes of loans and other restrictive provisions. Both bills also seek to bring additional clarity to the loans to one borrower law. The pending legislation does not affect the Division's ability to interpret the existing law and to understand how other regulatory agencies aggregate loans to one borrower and treat guaranties.

Although the Division broadly interprets the loan to one borrower statute as noted above, it has written few rulings, outside of confidential examinations, on that law. It has not written before on the facts presented here. This response will provide necessary clarification of the Division's general rule on guaranties.

In order to trigger the provisions of said section 14 there must be a borrower. Under the Division's general interpretation of that statute, a guaranty of a loan made the individual or entity a borrower and the related extension of credit would be aggregated to the guarantor's outstanding loan balance for the purposes of section 14. Absent the Division's general rule on guaranties under the facts presented neither Windham nor LRMC may be a borrower.

Based on the information provided by the Bank, Windham and its wholly-owned subsidiary, Lease and Rental Management Corp. ("LRMC"), operate outside of the lending function. SNHB and the Bank underwrite the lines of credit directly to each of the various automobile dealers. Upon the sale of an automobile, the dealer submits the proceeds to its local financial institution, which, in turn, wire transfers the funds to LRMC. LMRC then forwards the funds to SNHB and the Bank for payment towards the line of credit. As a facilitator of wholesale financing, LRMC does not involve itself in any aspect of the retail transaction between the automobile dealership and the purchaser of the automobile, as this financing is transacted independent of LRMC. Moreover,

LRMC plays no role in the origination process or underwriting decision. Windham guaranties the performance of LRMC as the service provider.

The limitation on the amount one individual or entity may borrow from a bank in Section 14 is one of the most significant regulatory tools for safety and soundness purposes in the General Laws. The Office of the Comptroller of the Currency (the "OCC") lending limits regulation is consistent with that purpose and so states in its purpose clause. It also makes reference to the regulations preventing excessive loans to one person or related persons that are financially dependent as well as to promote diversification of loans and equitable access to banking services. It is appropriate for the Division to look to see how a similar issue would be addressed under comparable regulations of the OCC which have the same regulatory purposes of Section 14.[1]

In general the provisions of the OCC governing loans to one borrower are extensive and set out in regulation at 12 CFR Part 32. Those regulations do not contain the blanket inclusion of a guaranty in calculating the legal lending limit as does the Division. The threshold issue remains as to whether a person or entity is a borrower. The OCC regulations define a borrower in two ways.

The first part of the definition of a borrower is straightforward and includes a person named as a borrower or debtor in a loan or extension of credit. The definition then goes on to include any other person, including a drawer, endorser or guarantor, who is deemed to be a borrower under the "direct benefit" or the "common enterprise" tests. Both of those tests are set out in 12 CFR 32.5. That provision of the regulations sets out combination rules for attributing loans or extensions of credit to a borrower to another person so that that person is also deemed a borrower.

The direct benefit test requires attribution to another person when the proceeds, or assets purchased with the proceeds, are transferred to that person other than in a bona fide arm's length transaction. The common enterprise test has several prongs requiring attribution including, but not limited to, when the source of repayment is the same for each person, there is common control, as well as if the OCC determines based upon the facts of a particular transaction that a common enterprise does exist.

Staff of the Division have reviewed the regulations and discussed these definitions and tests directly with the OCC. The facts of this pending matter were also discussed for analyses under the OCC regulations.

Using the above-cited OCC regulations as a guide, the facts of this pending matter are analyzed as follows. It is clear that neither Windham nor LRMC are borrowers since they are not named as a borrower or debtor. The facts then need to be reviewed under the

[1] The Division also notes that the New Hampshire Banking Department which regulates SNHB reviewed SNHB's transactions in conjunction with regulations of the OCC. SNHB was not cited as being in violation of New Hampshire law governing loans to one borrower.

two alternative tests for attribution. Under the direct benefit test the two entities are not deemed borrowers since the proceeds of the loan or the assets purchased by the proceeds are not transferred to either Windham or LRMC. Similarly, none of the several distinct prongs of the common enterprise test result in Windham or LRMC being determined to be a borrower.

The Division believes the analysis provided herein is a better approach to determining whether a guaranty is to be included in the calculation of loans to one borrower. The Division's general position on including guaranties though clear for aggregation purposes is far too broad. Accordingly, with this letter the Division clarifies its position on guaranties. A guaranty will be calculated against the legal lending limit if it falls within the direct benefit or common enterprise tests set out in 12 CFR Part 32.

This clarification on the aggregation of a guaranty by the Division does not restrict the review responsibilities of examiners. The Division's position that the limited language in Section 14 stands for the authority to review and attribute loans to another person remains. The clarification is to provide additional guidance by referring to established tests by another bank regulatory agency on a comparable statute. It must be noted that within one of those tests, the one on common enterprise, there is a provision referenced herein, which allows the regulator to determine based on the facts and circumstances presented that a loan should be attributed to another person. If there is evidence available to an examiner that a transaction has been structured to conceal the real interests, benefits or facts, then the Division as the OCC does, reserves the right to examine the underlying facts of a transaction on a case by case basis to determine if a common enterprise exists.[2]

In conclusion, the Division has clarified its position on guaranties automatically being calculated against the legal lending limit. Such clarification was made after extensive review of the facts presented relative to the Bank's participation in an automobile dealer floor financing pool. The facts were presented in two filings with and a meeting at the Division. They were also discussed in several telephone discussions. Additionally, the transaction was discussed with another state bank regulatory agency with jurisdiction over a bank involved in the transaction. That agency's reliance on regulations of the OCC on lending limits resulted in the review and discussion of those regulations by the Division with the OCC. Several internal meetings involving policy, supervision and legal personnel were held.
Based on this extended review, the Division would not calculate the indemnification and guaranty of LMRC and Windham against the lending limit for each of those entities.

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[2] Paragraphs (a) to (c) inclusive of 12 CFR Part 32.5 setting out certain combination rules for determining lending limits are attached hereto as an appendix.

The analysis provided herein is strictly from a legal viewpoint. It is separate and distinct from an analysis that could be based on the financial supervision principles of safety and soundness. The two views should not be confused. The fact that a transaction may be legal does not exempt it from criticism on financial supervision principals. Criticisms of bank management could focus on concentrations with one borrower, within one industry or issues of credit quality among others.

Therefore the Bank, must realize that such transactions remain subject to review and comment by examiners during the course of regularly scheduled examinations. Compliance with the loans to one borrower statute are addressed herein. However, similar transactions may also raise issues of concentrations in lending as well as unsafe and unsound banking practices. Depending on the totality of the particular facts, the Bank could be subject to criticism in a Report of Examination.

Very truly yours,

Thomas J. Curry
Commissioner of Banks

cc. Patrick J. Rohan, Regional Director
Federal Deposit Insurance Corporation

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Appendix
Office of the Comptroller of the Currency
Rules and Regulations
12 CFR 32.5

§32.5 Combination rules.

(a) *General rule.* Loans or extensions of credit to one borrower will be attributed to another person and each person will be deemed a borrower

(1) When proceeds of a loan or extension of credit are to be used for the direct benefit of the other person, to the extent of the proceeds so used; or

(2) When a common enterprise is deemed to exist between the persons.

(b) *Direct benefit.* The proceeds of a loan or extension of credit to a borrower will be deemed to be used for the direct benefit of another person and will be attributed to the other person when the proceeds, or assets purchased with the proceeds, are transferred to another person, other than in a *bona fide* arm's length transaction where the proceeds are used to acquire property, goods, or services.

(c) *Common enterprise.* A common enterprise will be deemed to exist and loans to separate borrowers will be aggregated:

(1) When the expected source of repayment for each loan or extension of credit is the same for each borrower and neither borrower has another source of income from which the loan (together with the borrower's other obligations) may be fully repaid. An employer will not be treated as a source of repayment under this paragraph because of wages and salaries paid to an employee, unless the standards of paragraph (c)(2) of this section are met;

(2) When loans or extensions of credit are made

(i) To borrowers who are related directly or indirectly though common control, including where one borrower is directly or indirectly controlled by another borrower; and

(ii) Substantial financial interdependence exists between or among the borrowers. Substantial financial interdependence is deemed to exist when 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other borrower. Gross receipts and expenditures include gross revenues/expenses, intercompany loans, dividends, capital contributions, and similar receipts or payments;

(3) When separate persons borrow from a bank to acquire a business enterprise of which those borrowers will own more than 50 percent of the voting securities or voting interests, in which case a common enterprise is deemed to exist between the borrowers for purposes of combining the acquisition loans; or

(4) When the OCC determines, based upon an evaluation of the facts and circumstances of particular transactions that a common enterprise exists.