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Regulation O—Rebutting a Presumption of Control

Carleton Goss*

Compliance with the insider lending limitations of Regulation O can be a challenge for banks, especially for community banks. Banks may be able to rebut the presumption of control of businesses in which the insider owns between 10 and 25 percent. This article discusses the rebuttal procedure, examples of how the regulators have applied this procedure, and factors that might be persuasive in concluding that the presumption of control should be rebutted.

Compliance with the insider lending limitations of Regulation O can be a challenge for banks, especially for community banks whose directors and executives have equity interests in companies in the community that the bank serves. This is because the definitions of "insider" and "control" are broad—an insider can include businesses in which the director or executive owns as little as 10 percent. Notwithstanding these broad definitions, banks may be able to obtain regulatory relief under a rarely used procedure to rebut the presumption of control of businesses in which the insider owns between 10 and 25 percent. If granted, such loans would then be exempt from the requirements of Regulation O because they would not be considered loans to "insiders." This article discusses the rebuttal procedure, examples of how the regulators have applied this procedure, and factors that might be persuasive in concluding that the presumption of control should be rebutted.

WHO IS AN "INSIDER"?

Regulation O defines the term "insider" to mean "an executive officer, director, or principal shareholder and includes any related interest of such a person."[1] A "principal shareholder" is an individual or company that owns 10 percent or more of the voting stock of a bank or bank affiliate.[2] "Related interests" means a company that is "controlled" by an insider.[3]

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[1] 12 C.F.R. § 215.2(h).

[2] *See* 12 C.F.R. § 215.2(m)(1).

[3] *See* 12 C.F.R. § 215.2(n)(1).

The definition of control is complicated. According to 12 C.F.R. § 215.2(c),

> Control of a company or bank means that a person directly or indirectly, or acting through or in concert with one or more persons:
>
> (i) Owns, controls, or has the power to vote 25 percent or more of any class of voting securities of the company or bank;
>
> (ii) Controls in any manner the election of a majority of the directors of the company or bank; or
>
> (iii) Has the power to exercise a controlling influence over the management or policies of the company or bank.

Furthermore, a person is presumed to have control, including the power to exercise a controlling influence over the management or policies, of a company or bank if:

(i) The person is:

(A) An executive officer or director of the company or bank; and

(B) Directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; or

(ii)

(A) The person directly or indirectly owns, controls, or has the power to vote more than 10 percent of any class of voting securities of the company or bank; and

(B) No other person owns, controls, or has the power to vote a greater percentage of that class of voting securities.

In other words, a company is a related interest of an insider if the insider's interest in the company meets at least one of the three prongs for control. Regulation O commonly applies to loans made by a bank to companies that are related interests of insiders.

Additionally, there is a two-prong rebuttable presumption of control test. Under this test there is a rebuttal presumption of control if the insider's interest in the company meets either of the two prongs. The *first* prong creates a rebuttable presumption of control where the insider is either a director or officer of a company *and* owns more than 10 percent of the voting stock of the company. The *second* prong creates a rebuttable presumption of control where the insider owns more than 10 percent of the voting stock of the company *and* no other person owns a greater percentage of the voting shares of the company. If the insider's interest in the company meets at least one of these two prongs, then there exists a rebuttable presumption that the insider controls the company. If the presumption is not rebutted, then the entity is a related interest of the insider and any loans to that company must conform with Regulation O. If the presumption is rebutted, then loans to that company will not be covered by Regulation O.

A presumption of control can be rebutted by submitting to the bank's primary federal regulator written materials that, in the regulator's judgment, demonstrate an absence of control.[4] Unfortunately, there is only one publicly available response to a request for determination of an absence of control under Regulation O.

FDIC ADVISORY OPINION 80-13

Federal Deposit Insurance Corporation ("FDIC") Advisory Opinion 80-13 (July 1, 1980) is the sole publicly available response to a request for determination of an absence of control under Regulation O (the "Opinion").[5] According to the Opinion, the bank submitted seven facts in support of the conclusion that the corporation and borrower in question should not be considered to be controlled by the bank's president. Those facts were as follows:

1) The president was one of seven persons who own equally the stock of the corporation (approximately 14.3 percent each);
2) Each stockholder served on the board of directors of the corporation;
3) The president was not and never has been an officer of the corporation and resided in a city different from that of the corporation's office;
4) Another shareholder was a director and treasurer of the corporation, was responsible for the daily management of the business, and was asserted to be the person who controlled the corporation in fact;
5) The corporation's loan at the bank was guaranteed by the three shareholders of the corporation who originally organized it and the president was not a member of this organization group;
6) No formal or informal understandings exist among the directors as to which directors, if any, shall be "active" or "passive" or which directors shall control the corporation's affairs;
7) The loan in question was a renewal of a loan that had been made by the bank before the president became a shareholder of the corporation. He personally had no direct part in making the credit decisions

[4] 12 C.F.R. § 215.2(c)(4).

[5] https://www.fdic.gov/regulations/laws/rules/4000-610.html#fdic400080-13.

involving the corporation, and his equity contribution to the corporation was not tied to the loans in any manner.

Despite these facts, the FDIC concluded that control had not been rebutted. In defending its conclusion, the FDIC provided the following reasons:

- "[w]here equal shareholders (each owning more than ten percent of the stock of the corporation) are each a director as well, it is . . . very difficult to demonstrate that the control presumption should not be operative;"
- "[i]n order to rebut the presumption it would be necessary to demonstrate that some individual other than the bank insider exercises actual control;"
- "[t]here is nothing in the By-laws or Articles of Incorporation to identify such an individual. Nor is there any evidence of an agreement among several of the directors to vote in the same manner (i.e., to create a control block) or any voting pattern that would imply that one or more individuals exercise such a degree of influence over the others so that he or she (they) can be identified as a controlling influence;" and
- "[e]ven though [another] (shareholder, director, and treasurer of the corporation) may be responsible for routine, day-to-day operations of the corporation and is authorized by the board of directors to execute certain leases on behalf of the corporation, he cannot be said to control the management or policies of the corporation to the exclusion of the remaining shareholders/directors as he is still responsible to the board."

The takeaway from this public guidance is that companies that are seeking to borrow from a community bank and who are owned, at least 10 percent, by an insider of the community bank should consider adopting provisions in their organizational documents making it clear that some individual (or individuals) other than the insider exercises actual control, especially if that insider happens to be a director or officer of the company. Alternatively, the bank director could resign their post as a director or officer of the prospective borrower.

NONPUBLIC REBUTTAL OF CONTROL

We are aware of at least one instance in which a community bank was successful in rebutting the presumption of control under Regulation O. In that case, the regulator found that the presumption of control was rebutted with respect to (i) a trust established by a director of the bank's holding company ("Trust") that held equity interests in two prospective borrowers and (ii) a company owned equally by six shareholders, one of whom was a director of the bank.

The Trust's holdings included over 10 percent of the bank's holding company as well as over 10 percent of two companies that were seeking to borrow money from the bank. No other shareholder owned a larger percentage of the two prospective borrowers so the Trust was presumed to control the two prospective borrowers. The director of the bank's holding company was the grantor and settlor of the Trust, but was not the trustee, and had relinquished all voting rights associated with the equity investments of the Trust. The Trust, also, did not participate actively in the operations, management, or oversight of the two prospective borrowers. The Trust was domiciled in Alaska, all administrative functions of the Trust occurred in Alaska, and the two prospective borrowers conducted all of their business in the Midwest. The trustee did not attend shareholder meetings and traditionally voted the shares of the trust as directed by management of the respective two companies. The regulator found that these facts successfully rebutted the presumption of control. The takeaway is that parties may have more success in convincing a regulator that the presumption of control should be rebutted where the insider's equity holdings are held passively through a property structured trust.

As part of the same request, the regulator found that control was rebutted with respect to a bank director that owned an equal one-sixth interest in a prospective borrower. The director was not a director or officer of the prospective borrower, so the director could not exercise control over the company in that manner. The request also argued by analogy that control should be rebutted because the indicia of control identified in the Federal Reserve's policy on equity investments in banks and bank holding company[6] were not present: specifically, the director's total equity interest was less than 25 percent and the director did not consult with the officers of the prospective borrower on the operation of the company. The regulator agreed that control was rebutted. The takeaway is that the Federal Reserve's policy on equity investments may be persuasive in convincing a regulator that control should be rebutted under Regulation O.

CONCLUSION

Banks are justifiably concerned about compliance with Regulation O and avoiding even the appearance of insiders' impermissibly benefitting from their position. To that end, banks should maintain and regularly update a list of individuals and entities that would be considered "insiders" for purposes of Regulation O. However, if an insider owns between 10 and 25 percent of the

[6] https://www.federalreserve.gov/bcreg20080922b1.pdf.

voting interests of a company (and the insider is also an officer or director of the company or no other shareholder owns a greater percentage of the company than the insider), that company may not be considered a related interest of the insider if the bank's primary regulator agrees that the presumption of the control should be rebutted. Banks that wish to lend to such companies should consult with an attorney and draft a request to their primary federal regulator to find that the presumption of control should be rebutted under Regulation O.