Decision of the
Supervision Appeals Review Committee

Case No. 2012-01

I. Summary of Findings.

After consideration of the timely filed written submissions of the parties, the record of the case, and following the May 1, 2012 deliberative meeting of this Committee, we have denied *** (the Bank's) appeal. For the reasons set forth in this decision, the Committee upholds as fully supported, the conclusion of the Director of FDIC's Division of Risk Management Supervision ("RMS," the "Director") that the *** loan meets the terms of the Loss classification definition established by the FDIC's *Risk Manual of Examination Policies*. Further, the Committee determines that the Bank's 2009 acquisition and retention of real estate located in the *** subdivision is both an unauthorized equity investment, and an investment of a type not permissible for a national bank under the National Bank Act. Accordingly, the investment constitutes an apparent violation of Part 362 (Activities of Insured State Banks) of the FDIC Rules and Regulations that implements section 24 of the Federal Deposit Insurance Act, which generally prohibits state banks from undertaking activities not permitted national banks.

II. Background.

A. Introduction.

*** (the "Bank") is a $*** million state-chartered nonmember bank with headquarters and four additional offices located in City, State. Originally opened for business in ***, the Bank is wholly owned by *** ("Holding Company"), a one-bank holding company. President, Chief Executive Officer, and Chairman of the Board *** (A) has been CEO of the Bank since ***. The A family owns ** percent of the Holding Company's stock. The Bank's **-member Board is largely controlled by CEO A and includes ** other family members.

On October 26, 2010, the Bank timely filed a Request for Review (the "Request") with the Director relating to specific findings of the ***, 2011 Report of Examination ("ROE," the "Joint Examination") conducted by the FDIC and the ** State Department of Financial Institutions ("XDFI"). Identifying the overall condition of the Bank as critically deficient, the Joint Examination noted that asset quality had deteriorated substantially, with adversely classified items amounting to 253 percent of total capital and approximately 21 percent of total assets. Further, the Bank was operating at a significant loss caused by high funding costs, high levels of non-earning assets, and a failure to provide adequate reserves for loans and other real estate owned ("OREO"). Capital was determined to be inadequate, given the high-risk profile and significant losses that posed a threat to the viability of the Bank. The Joint Examination resulted in CAMELS of 555544/5.[1] In its Request, the Bank disputed certain material supervisory determinations (the "Determinations") outlined in the ROE, including its component ratings. Additionally, the Request disputed the citation of apparent violations of Part 362 of the FDIC's Rules and Regulations related to the acquisition from *** Bank, City, State. ("Bank Y") of properties in the ***subdivision (the "Bank Y Properties," or "Bank Y Lots"). Finally, the Bank objected to the ROE classification of six assets, including the *** (the "Loan"). (The Bank's Request also disputed certain other findings in the Joint Examination, some of which were upheld and some modified, none of which are at issue in this appeal.)

In response to the Bank's Request, on January 13, 2012, the Director largely affirmed the Division's earlier findings. The Director concurred with and affirmed the component ratings, pointing out that each of these findings was adequately supported in the ROE and representative of the Bank's risk profile. Additionally, the Director upheld the Loss classification for the Loan based on information available to the examiners at the time of the Joint Examination. Finally, the Director concurred with the Region's Determinations regarding the apparent violations of Part 362 of the FDIC's Rules and Regulations ("Part 362"). Accordingly, the Director concluded that since the Bank had failed to file for permission to continue to hold the Bank Y Properties and since the investment was of a type not permitted by a national bank, the ROE citation was appropriate. On February 7, 2012, the Bank timely appealed the Director's decision on the issues surrounding the Loan and the Bank Y Lots.

B. Summary of the Parties' Contentions.

The Bank challenges the $2.5 million Loss classification for the Loan, a $3 million construction loan intended for renovation of a commercial building and development and operation of a movie theater on the premises. The Bank argues that it holds a perfected security position in the leasehold interest and, under the terms of the lease (the "Lease"), it was entitled to a grant of general intangibles in support of the Loan. The Bank thus asserts that it had valuable rights in the Lease – rights that RMS has improperly refused to acknowledge as having any value until a lien on those assets was filed. The filing of the lien occurred after the closing of the Joint Examination in 2011.

The Bank also rejects the RMS determination that the Bank acquisition and holding of real estate purchased from Bank Y and the Bank's failure to file a divestiture plan for that property constitutes an apparent violation of Part 362. The Bank's principal contention is that because Part 362 does not apply to investments acquired in connection with debts previously contracted ("DPC") where the Bank does not hold the property for speculation, Part 362 has no application in this case. According to the Bank, the Bank Y Lots were related to OREO it had already acquired by foreclosure in

[1] **C**apital of 5; **A**sset Quality of 5; **M**anagement 5; **E**arnings 5; **L**iquidity 4; **S**ensitivity to Market Risk 4; Composite Rating 5.

2009 (the "X Lots," or "X Properties"), located in the same ***subdivision, priced in the same "high-end" market, and with similar amenities. The Bank argues that Bank Y had threatened to "dump" the Bank Y Lots, which would have "damaged [the Bank] with dramatic short-term losses[.]" Accordingly, the Bank Y Lots, rather than purchased and held for speculation, were purchased specifically to maintain and protect the value of the Bank's other *** subdivision real estate – the X Lots (the Bank's DPC). Finally, the Bank dismisses RMS's reliance on an early Supreme Court case as misplaced: the case, the Bank asserts, is outdated *dicta* construing long-since repealed statutory provisions.

RMS, in reply to the Bank's Loan position, notes that the Bank, in defending the Loan, wholly ignores the fact that there was no operating cash flow to support the Loan. The lack of operating cash flow was the principal reason for the Loss classification, and the Joint Examination expressly stated as much. The enforceability of the Bank's security agreement is suspect and had not been established as of the close of the record of this case. And, the Bank's valuation of the leasehold interest at $4.1 million is unsupportable, based as it is on an appraisal assumption that the theater was generating market levels of rent – an assumption not borne out by the facts: not only was the theater not producing market rents, it was shuttered.

With respect to the Bank Y Lots, RMS disputes the Bank's assertion that the Bank acquired the Bank Y Lots in connection with DPC because the Bank Y Lots are part of *** subdivision, as are the X Lots: the Bank Y Lots do not serve as security for the Bank's X Lots, and any suggestion on the part of the Bank that the purchase of the Bank Y Lots would somehow bolster the value of the X Lots is a suggestion not supported by any record evidence – either that the X Lots would decline in value or that the Bank Y Lots would somehow rehabilitate the X Lots if they had declined. RMS contends that the purchase was not executed for any purpose a bank may legally make or hold such a direct investment in real estate under section 24 of the FDI Act. Finally, RMS notes, the *Union Bank* Supreme Court case, though early, remains good law and is regularly cited by the OCC in support of the proposition at issue is this case.

In accordance with the *Guidelines for Appeals of Material Supervisory Determinations* ("*Guidelines*"),[2] the Committee reviews for consistency with the policies, practices, and mission of the FDIC, and the reasonableness of, and support for, the positions of the parties. The Committee granted the Bank's request to appear at the Committee's May 1, 2012 deliberative meeting. Under the *Guidelines*, the burden of proof on all matters at issue rests with the institution. The scope of the Committee's review is limited to the facts and circumstances existing at the time of the Report of Examination. No consideration has been given to facts or circumstances that developed after that period.

III. Analysis.

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[2] The *Guidelines* are set out at 77 Fed. Reg. 17,055 (March 23, 2012).

A. The Loan.

, LLC, was organized to acquire and develop a movie theater on ***, an historic area in City, State. The limited liability company is owned by the(B) Trust, ***(C), ***, Inc., and two other members who own less than two percent of the concern apiece.

The Loan was originated in April 2007 for $3 million as a construction loan for the acquisition and development of the theater. ***, LLC, leased the building from *** ("the Landlord"), with Loan funds to provide for leasehold improvements and theater equipment. The theater opened for business in April 2008; the Loan was renewed in April 2009 for one year and renewed again in April 2010, to mature in April 25, 2011. Under the terms of the Loan, ***, LLC, was obligated to pay monthly interest, repayment funds to be generated by cash flow from the theater operation. The Loan was collateralized by an unrecorded security agreement on business assets and guaranteed by Principals B, C and D.

The 25-year term lease (the "Lease") provided for annual rental starting at $215,423 plus 5% of gross sales, rising to $278,281 in the sixth year, with subsequent annual rental increases tied to the Consumer Price Index. The Lease also provided for an annual advertising assessment. Taxes, insurance, and utilities were to be paid by the landlord and reimbursed by Principal B, which was to pay its own maintenance. The Lease specifically granted B the right to encumber its interest in the Lease for a loan up to $3 million to fund construction of tenant improvements.

B opened the theater in 2008, had continuous operating losses, and closed it in 2010. The theater remained closed and the building vacant from that time through the Examination period. During the Examination, Guarantor D paid $500,000 on the Loan, with $25,000 in cash and proceeds from a loan from the Bank for $475,000, using as collateral a second lien on his residence. At the time of the Joint Examination, Loan interest payments were 157 days past due and on nonaccrual as of February 28, 2011; B was not making payments to the Landlord; and the theater was closed. Following Guarantor D's cash infusion, the Bank released him from the Loan. Guarantor C did not provide funds. The examiners classified the remaining balance of $2.5 million as a Loss.

The Bank's Position. The Bank rejects the ROE $2.5 million Loss classification, stating that a Substandard classification on the remaining balance is appropriate. The Bank argues that it has an enforceable security interest in the leasehold interest and that the Loan was not in default under City, State law as of the Examination Period. In support of these contentions, the Bank cites two attorney opinions and an appraisal valuation.

Relying on the opinion of Attorney *** (E), the Bank contends that the Bank's existing security agreement on general intangibles provides sufficient collateral in the leasehold estate, including the Lease and the projection and other equipment. Under the terms of that agreement, Principal B is prohibited from transferring any theater assets, by sale, without the consent of the Bank. Further, should a prospective buyer of the theater want to receive marketable title to furniture, fixtures, and equipment, Attorney E reasons:

> [A]rrangements satisfactory to the bank will have to be made to discharge the bank's indebtedness. Typically, this would involve either a payoff or an assumption of the indebtedness by the buyer at the close of escrow.

Noting both the opinion of Attorney *** (F) and the terms of the Lease between B and the Landlord, the Bank maintains that B assigned the Bank its interest in the Lease as security for the Loan. Accordingly, the validity of the lien was established, not by the 2011 UCC filing but by the terms of the Lease itself. Thus, the Bank has a leasehold estate and an interest in the theater to the extent of its $3 million Loan, which grants B assignment rights with respect to the Lease, to that amount. Moreover, the Bank's security agreement for the Loan broadly grants the Bank a security interest in all general intangibles.

Attorney F also opines that the Landlord/Lease is valid until a notice of default has been issued, the notice has been challenged, and the Lease has been invalidated by an appropriate trier of fact such as a judge or an arbitrator. None of these events has occurred. The landlord had not declared a default as of the time of the Joint Examination, and, as of March 24, 2011, no payments were due for 90 days. The Bank adds that mere nonpayment of rent does not invalidate a lease.

Finally, the Bank relies on the February 2011 appraisal review of a December 2010 appraisal by the *** Group (the "*** Group Appraisal"), which valued the leasehold at $4.1 million, later amended to $3.88 million. The Bank alleges that the review appraiser upheld the value opinion as of February 2011 as "adequately supported and reasonable."

RMS's Position. RMS argues that the ROE classified the Loan as a $2.5 million Loss "due to the lack of operating cash flow . . ." Also cited were the financial strength of the guarantor, the unsupported value of the leasehold interest that is contractually in default, and the fact that workout strategies were based on conjecture and unsupported premises.

First and foremost, the Bank has no response to the closing and shuttering of the theater, the ongoing monthly lease delinquencies, or the lack of any possible source of repayment for the Loan. The fact remains, argues RMS, that the Bank has not identified a single viable repayment source – from the borrower, the guarantor, by collateral liquidation, or by any other avenue or method. Under the Loan terms, monthly interest payments were to be generated by cash flow from the theater's operation, and yet the theater had continuing operating losses nearly from the start.

Further, the enforceability of the Bank's security agreement was not established as of the close of the Examination. The Bank offers two opinions stating that the Bank's security agreement on general intangibles serves as collateral for the Loan. But neither opinion rebuts the ROE finding that the Bank had failed to perfect the lien by the close of the Joint Examination in 2011. Under the SARC *Guidelines*, SARC review is to be limited to the facts and circumstances as they existed at the close of the Joint Examination.[3]

Notwithstanding the Bank's lien position, the Bank's valuation of the leasehold interest at $4.1 million (or at $3.88 million) is unsupportable. The initial appraiser assumed a market value based on the operation of a theater in a high-end locale that attracts more than 2 million visitors each year. However, under the initial appraiser's assumptions, the theater had not gone dark, and full monthly rent obligations were being met. The appraiser stated that he had visited the site, although at the time it was closed and generating no rent. The review appraiser, on the other hand, cautioned:

> It is my recommendation that this report be amended to include the author's opinion of the "as-is"[4] [market] value of the leasehold interest in this property. This [market] value opinion must take into consideration the market's perception of the risks and benefits of purchasing the leasehold position at the present date. If the operation of the theater does not generate sufficient income to pay all expenses [including contract rent] and attractive entrepreneurial incentive, the value of the leasehold interest could be as little as $0.

Following the review appraiser's cautionary statement, the initial appraiser provided an amended version of his report showing the "as-is" market value of the leasehold estate was $3,882,000.

Given the facts of the case – the operational failures, the structure of the Loan with the leasehold interest serving as the primary collateral, RMS urges that the Bank could not maintain the Loan's continued performance (*i.e.*, as a bankable asset) following B's default on both the Loan and rent due the Landlord. Whether or not the lien on B's leasehold interest is enforceable, the record clearly and rightfully reflects, RMS argues, that the Loan was classified Loss because it lacked a viable source of payment. According to the FDIC's *Risk Manual of Examination Policies*, a loan is classified as a Loss when it is considered uncollectible as a practical matter:

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[3] *See Guidelines for Appeals of Material Supervisory Determinations*, Section M: SARC review will be limited to the facts and circumstances as they existed prior to, or at the time the material supervisory determination was made, even if later discovered, and no consideration will be given to any facts or circumstances that occur or corrective action taken after the determination was made.

[4] *"As is" market value* is defined as "the estimate of market value of real property in its current physical condition, use, and zoning." *Interagency Appraisal Evaluation Guidelines* most recently issued December 2, 2010 by the OCC, the Federal Reserve Board, the FDIC, the National Credit Union Administration, and the Office of Thrift Supervision.

> Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

The Loan fits the description of a Loss – the Bank is unable to suggest any path by which any reasonable recovery is possible.

B. The Bank Y Lot Acquisitions.

1. Statutory and Regulatory Background.

Section 5137 of the Revised Statutes of the United States (12 U.S.C. § 29) provides that a national bank is authorized to purchase, hold, or convey real estate *only* for four specific purposes, (1) as necessary for its accommodation in transacting its business; (2) as mortgaged to it as security for DPC; (3) as conveyed to it in satisfaction of DPC; and (4) as purchased to secure debts due it. The third purpose is at issue in this case: Rev. Stat. § 5137 (Third) ("such as shall be conveyed to it in satisfaction of DPC contracted in the course of its dealings").

Section 24 of the FDIC Act limits the activities and equity investments (including real estate activities and investments) of state-chartered banks to those that are *permissible for national banks* [under Rev. Stat. section 5137], unless the FDIC has determined that the activity would pose no significant risk to the Deposit Insurance Fund (the "DIF") and the bank is in compliance with applicable capital standards. 12 U.S.C. § 1831a(a).

Section 24 is implemented by Part 362, which provides guidance to state banks for interpreting provisions concerning permissible real estate investments. "Regulations, official circulars, bulletins, orders or written interpretations issued by the OCC are all sources for determining what activities or investments are permissible for national banks . . ." 12 C.F.R. § 362.1(a).

To interpret how the requirements of Rev. Stat. section 5137 (12 U.S.C. § 29) are applied to real estate acquired as DPC, reference is made to OCC's regulations on the holding of OREO (12 C.F.R. § 34) and various OCC interpretive rulings. Section 34.86(a) provides a three-part test for determining when a national bank may make additional advances to complete OREO that is a development project if the advances:

> (1) Are reasonably calculated to reduce any shortfall between the parcel's market value and the bank's recorded investment amount;
> (2) Are not made for the purpose of speculation in real estate; and

(3) Are consistent with safe and sound banking practices.

But in addition to the OCC body of law developed around the permissibility of a national bank's real estate activities, reference must also be made to section 24 of the FDI Act, which is implemented by Part 362 for additional authority. Part 362 specifically excludes from the general prohibitions referenced above, those real estate activities regarding –

(1) acquisition of interest in real estate used for the conduct of a bank's business;
(2) activities conducted as agent for a customer, in a brokerage, custodial, advisory, or administrative capacity; or
(3) equity investments acquired in connection with debts previously contracted (DPC) if the insured state bank does not hold the property for speculation and takes only such actions as would be permissible for a national bank's DPC.

12 C.F.R. § 362.1(b)(1) – (3).

For any other real estate activity, a bank must comply with Part 362, under which an insured state bank that meets applicable capital standards must *apply for and receive the FDIC's prior written consent*, which is given only if the FDIC determines that the activity poses no significant risk to the DIF. 12 C.F.R. § 362.3(b)(2).

Applications for consent are to be filed in accordance with 12 C.F.R. § 303.121. Approvals may be made subject to any conditions or restrictions found by the FDIC to be necessary to protect the DIF, and to prevent unsafe or unsound banking practices. Among application requirements, a bank must provide (1) a description of the activity and the manner in which it will be conducted; (2) the amount of the bank's existing or proposed direct or indirect investment, as well as calculations sufficient to indicate compliance with any specific capital ratio or investment percentage limitation detailed in subpart A of Part 362; (3) a copy of the business plan regarding the activity; (4) a description of the bank's policy and practice with regard to any anticipated involvement in the activity by a director, executive officer or principal shareholder of the bank; (5) a citation to the state statutory or regulatory authority for the conduct of the activity; (6) a description of the bank's expertise in the activity; and (7) a copy of any necessary order of approval from the appropriate state regulatory authority.

2. Factual Background.

The *** subdivision, established in 2005, is a ****-acre, gated community in *** County consisting of *** large lots. The Bank was one of several banks to make loans to the X developer. Following the developer's bankruptcy, the Bank repossessed four X lots as DPC and subsequently discovered that additional X lots were held by Bank Y, were in the same high-end price range, and had virtually identical amenities as those lots recently taken by the Bank as DPC. The five Bank Y Lots were offered at prices that the Bank characterizes as "well below established appraisals" for the *** subdivision. The five lots the Bank purchased from Bank Y were not related to any other loan or participation, and the Bank did not hold any interest in any of the lots before the purchase.

The Bank's Position. The Bank argues that when it learned that eight Bank Y Lots held as OREO were being offered in the same subdivision as its X DPC Lots and that the Bank Y Lots were in the same high-end price range with similar amenities, it prudently agreed to acquire the lots. The Bank Y Lots were being "dumped" by Bank Y, which was, according to the Bank, "experiencing severe financial difficulties," and the effect of that dumping "at prices well below established appraisals" would have "seriously undermined [the Bank's] ongoing effort to preserve capital" and would have endangered the value of the Bank's X Lots.

The Bank dismisses RMS reliance on *Union National Bank v. Matthews,* 98 U.S. 621 (1878) ("*Union Bank*") arguing that the Court's admonition against banks embarking on hazardous real estate speculations and the necessity of bank capital flowing in the daily channels of commerce rather than accumulating in property holdings were merely *dicta*, not necessary to the Court's holding. The true holding of *Union Bank* was simply that banks may make real estate loans, foreclose on loans and purchase security for loans at foreclosure. Further, the statutes construed by the Court have long since been repealed.

The Bank goes on to assert that the Bank Y Lots were connected with the OREO lots that the Bank had already acquired through foreclosure (the X Lots). The connectivity of the X Lots to the Bank Y Lots lies in their similarities in price range and amenities as well as their proximity to the X Lots (the Bank Y Lots were within the same subdivision and included some lots that were adjacent to certain of the X (DPC) Lots). Further, the X Lots had no access to county roads. The Bank Y Lots could provide that access, thus stabilizing the value of the X Lots. This connectivity with the X Properties, the Bank argues, confers DPC status on the Bank Y Lots. "Dumping" of the Bank Y Lots would have resulted in "dramatic short-term losses" to the X Lots. Accordingly, because buying up the Bank Y Properties would be reasonably calculated to reduce any shortfall between the market price of the X Lots and the Bank's investment in those lots, the Bank contends it was not engaged in speculation and was not unreasonably encumbering its capital but simply preserving the value of its X Lots.

Continuing, the Bank reasons that there can be no serious contention that the Bank Y Lots were held for speculation, noting that the files for each of the lots (to which the FDIC was given full access) clearly demonstrate that there was an ongoing effort by the Bank to market and sell all of the lots held as OREO in the *** subdivision. Because the acquisition of the Bank Y Lots was motivated by a desire to protect the value of the X Lots, the Bank Y Lots acquisition was reasonably related to the conduct of the Bank's business – a precipitous drop in the value of some or all of the Bank's OREO lots could have substantially impaired the Bank's capital.

Finally, the Bank asserts that **State law is consistent with the Bank's position. A violation of **State law would be dependent upon a finding that the Bank's acquisition of the Bank Y Lots was an impermissible investment in real estate and not "otherwise reasonably related" to the conduct of the Bank's business. **State. Fin. Code § **** (". . . or which is reasonably related to the conduct of its business"); *see also* (b) ("such as may be conveyed to it in satisfaction in whole or in part of debts previously contracted in the course of its business"). Since the acquisition was made to protect the value of the DPC X Lots, it was reasonably related to the Bank's business and therefore not a violation of **State law.

RMS's Position. RMS believes that the Bank's argument that the Bank acquired the Bank Y Lots because they were contiguous to its *** subdivision Lots acquired by the Bank for DPC, with similar amenities, unreasonably stretches the definition of what a bank can do in connection with real estate acquired for DPC. Under Part 34 of the OCC regulations DPC means "real estate (including capitalized and operating leases) acquired by a national bank through any means in full or partial satisfaction of a debt previously contracted." 12 C.F.R. § 34.81(b). In no sense were the Bank Y Lots acquired in satisfaction of the debt contracted with respect to the X Properties.

RMS brings to the attention of the Committee a 1992 OCC Interpretive Letter in which the OCC held that the inclusion of non-DPC assets in a DPC pool is similar to spending additional funds on an individual DPC asset to enhance the bank's recovery. The OCC went on to indicate that such funds may be spent to improve or complete an asset to bring it to salable condition or to purchase an adjacent property to protect the bank's interest in its DPC property. *OCC Interpretive Lette*r 634 (1992). Nevertheless, even if this interpretation were to apply, such a situation would still require the timely filing (before the purchases were executed) of an application with the appropriate Federal banking agency ("AFBA") and would require a safety and soundness review (including the effect on the DIF) and the imposition of appropriate conditions around the acquisition of the new property.

But the Bank never properly filed for the FDIC's prior written consent under section 362.3 of the regulations to make the Bank Y purchases. As a result, the FDIC never was able to make a judgment, based on a full and careful study of the proposed plan before the purchase of the Bank Y Lots, whether the purchase posed a threat to the health of the institution or to the DIF. Because the Bank failed to comply with section 362.3(b) of the regulations, the FDIC had no notice of the purchase and the Bank executed the purchase despite its deficient capital position at the time the purchase was completed.

RMS disputes the Bank's contention that the Bank was not engaged in speculation. Its examiners define real estate speculation as the purchase or preparation of real estate, or the production of real estate assets without an agreement with an end-user to purchase the property from a party that purchases, prepares, or produces a real estate asset. Such an acquisition of real property is likely to increase the risk profile of a bank. The Bank's Bank Y purchase did exactly that.

Further, RMS points out that, far from representing outdated *dicta* construing long-repealed statutory provisions, the *Union Bank* case is good law cited regularly for the proposition at issue in this case – to prevent banks from engaging in risky speculation. The case is regularly cited by the OCC, the regulator for national banks, and by federal courts, including the Supreme Court. Additionally, Rev. Stat. section 5137, which the Supreme Court construes in *Union Bank*, is the official codification of the law, derived from the Act of June 3, 1864, c106, 13 Stat. 107.[5]

In *Union Bank*, a national bank was enjoined by a lower court from foreclosing on a deed of trust that was assigned to it, the lower court noting that such an assignment was an impermissible real estate transaction. In *Union Bank*, the Supreme Court discussed the purpose of the real estate restrictions under Rev. Stat. section 5137 (12 U.S.C. § 29). The restrictions, which continue to be regularly relied upon, were intended to (1) keep the capital of banks flowing in the daily channels of commerce; (2) deter banks from embarking on hazardous real estate speculations; and (3) prevent the accumulation of large masses of property in their hands to be held in perpetuity. *See also Central National Bank in Chicago v. Fleetwood Realty Corp*., 441 N.E.2d 1244 (Ill. App. Ct. 1982) (holding that section 29 [Rev. Stat. section 5137] limitations on national banks investing in real estate are designed to protect bank depositors and stockholders from risky investments); *State of North Dakota v. Liberty National Bank and Trust*, 427 N.W.2d 307 (N.D. 1988) (the purpose of section 29 [Rev. Stat. section 5137] real estate restrictions was to prevent banks from becoming extensive and monopolistic holders of real estate).

The *Union Bank* principles, RMS urges, were established to prevent banks from unsafe and unsound speculation in real estate. The acquisition of real property is likely to increase the potential risk profile of a bank due to the non-earning nature of undeveloped real estate and the fact that the value of OREO is not realized until final disposition of the property. The Bank's acquisition of the Bank Y Lots, RMS argues, is speculation, and a bank may not undertake such risk if it is not properly authorized by the required filing under 12 C.F.R. § 362.3(b)(2).

RMS additionally rejects the Bank's argument that the Bank was essentially being forced to purchase the Bank Y Lots because the "dumping," would lower the value of the X Lots, thereby imperiling the Bank's capital position. The argument ignores both the risk inherent in the purchase and the imperative that the Bank seek permission of the FDIC to make such a purchase. Moreover, though examiners had access to the Bank's files, as the Bank argues, the files reveal no analyses of, or justification for, the purchase. Similarly, there is no evidence of Board discussion of the purchase – no minutes documenting a balanced presentation, analysis, or exchange of

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[5] The Revised Statutes of the United States was the codification of the Acts of Congress, undertaken by Congress as the first official codification, approved June 22, 1874, for the laws in effect as of December 1, 1873. The Revised Statutes were enacted as positive law.

ideas on the part of the Board in support of the purchase. There are no reports on the properties, real estate analyses comparing the properties and discussing the market. There is no pre-purchase study showing potential buyers or evidence of other bidding. Other investors own contiguous lots to the X Properties, and yet neither the Bank's nor the Bank's Board of Directors' records reveal any evidence that the properties of other investors had declined in value. Similarly, there were no pre-purchase reports showing access to county roads for either the X Lots or the Bank Y Lots.

Taking these facts together, the advances for the purchase of the Bank Y Lots were not calculated under section 34.86 of the regulations to demonstrate the likely financial benefit that would be realized by the Bank if it were to purchase the X Lots. Moreover, the Bank clearly made no showing that the project was consistent with safe and sound banking practices as would have been required by the regulations.

Finally, with respect to the Bank's argument that **State law supports the Bank's position, RMS notes that, pursuant to section Q of the SARC *Guidelines*, RMS notified XDFI of the Bank's Request for Review, provided them a copy, and solicited XDFI's views on the merits of the Request. The Bank has been advised by XDFI that its purchase of the Bank Y Lots is a violation of **State Fin. Code § **** [currently codified at **State Fin. Code § ****, which requires prior application to, and approval from, the Commissioner for real estate acquisitions.

In response to the Request for Review filed by the Bank, the **State Deputy Commissioner informed the Region:

> [T]he findings and determinations in the ROE are firmly based on fact and are well supported. Appellant's arguments were found to be unpersuasive; therefore, the 2011 examination findings should be sustained.

A copy of the Bank's appeal was also provided to the **State Commissioner on or about February 9, 2012, in compliance with section Q of the *Guidelines*. In response, the Deputy Commissioner confirmed the XDFI continues to believe the Bank Y Bank transaction violated **State law, as cited in the ROE.

IV. The Committee's Findings.

A. The Loan.

The unrebutted fact that stands out with respect to the Loan is that there is no viable source of repayment for the Loan. Under the Loan terms, repayment was to be generated by cash flow from the theater receipts, and yet the theater never operated at a profit. At the time of the Examination, Loan interest payments were 157 days past due and on nonaccrual as of February 28, 2011. B was not making payments to the landlord. One guarantor paid $500,000 down on the Loan (which was accounted for in the Loss classification), but the second guarantor provided no funds.

The value of the leasehold is not credible at either $4.1 million or $3.88 million. The appraisal is based on the assumptions that the theater was up and running and current in its rent. Neither assumption is accurate. The theater was closed and shuttered, apparently even when the initial appraiser visited the property. The review appraiser cautioned of the necessity of using the "as is" market value, which is required to take into consideration the market's perception of the risks and benefits of purchasing the leasehold interest. Accordingly, the review appraiser opined that the value could be as little as $0 if the theater did not generate income, which it did not.

Additionally, the Bank's reference to subleasing to another theater operator is not credible, either. Because the leasehold serves as the primary collateral, B's default on both the Loan and the rental payments to the landlord undermines the value of the Lease. As of the Examination date, the Bank had not exercised its collateral position by repossession, presumably because of the specialized use of the property and the Lease delinquencies. Any revenues from subletting would be due the landlord.

The Committee cannot take note of the 2011 UCC filing with respect to the lien, but, even if it were to do so, lien perfection would be of little help in the face of repayment sources and the value of the collateral. The Committee finds that the Loan is uncollectible and of such little value that its continuance as a bankable asset is not warranted, and, under the FDIC's *Risk Manual of Examination Policies*, such a loan is classified as a Loss.

B. The Bank Y Lot Acquisitions.

We find the acquisition and holding of the Bank Y Lots by the Bank as both unauthorized and improper. The Bank argues that its purchase of the Bank Y Lots was a prudent one. The situation, as the Bank describes it in its papers, was precarious: the threat of property being "dumped," undercutting the value of the Bank's X Lots and undermining its own efforts to preserve capital; the property offered by a bank that, as the Bank describes it, had "severe financial problems." But the Bank, by its own account, viewed the situation as offering it an opportunity to bolster its holdings and shore up its capital position. The Committee takes the Bank at its word that the Bank *believed* that making the purchases would constitute "prudent steps gauged to protect the true value of all the Bank's lots in the *** subdivision, and to preserve the Bank's capital." Nevertheless, on the record as this Committee reads it, the conclusion is inescapable that no facts support the assertion that they were, in fact, prudent steps. Rather, the Bank went forward on a major transaction with little or no forethought, no study, no Board discussion, and without regard to regulatory and statutory prerequisites for such an investment.

The statutory and regulatory background for the acquisition and holding of property is both complex and exacting, precisely because of the dangers inherent in regulated financial institutions engaging in real estate investment. That background has been set out in this opinion. The FDI Act limits the activities and equity investments of insured state banks to those that are permissible for national banks *unless the FDIC has determined that the activity would pose no significant risk to the DIF and the bank is in compliance with capital standards.* Under the regulations, that determination by the FDIC is to be made after a detailed and comprehensive filing by the bank under section 303.121 of the regulations in which the bank is required to provide full disclosure of the transaction or transactions, the Bank's business plan, including details of the proposed investment, the policy the investment would serve, and the expertise the bank brings to making and managing the investment. The Bank did not comply with that obligation. Thus, the FDIC was frustrated in its obligation to ensure that the Bank "undertake only safe and sound activities and investments that do not present significant risks to the DIF . . . ."

But not only did the Bank choose not to file under section 362.3(b)(2) of the FDIC's regulations for authority to make the Bank Y Lots purchases, the Bank's Board of Directors apparently never considered the purchase, or at least the Board's minutes reflect no such discussion. The record before the Committee is unrebutted that there was no analysis of, or justification for, the purchase. Despite the Bank's argument that "dumping" the Bank Y Properties would have de-valued the X Properties, the record reveals no studies taking on that issue. To the contrary, we have been shown no evidence of comparable values of any of the properties. As RMS points out, the Bank has adduced no pre-purchase analyses showing potential buyers or evidence of other bidding. We are forced to conclude that there are no such analyses and that the Board never compared properties nor discussed the market – either the general market or the *** subdivision market. We find the purchase of the Bank Y Properties to be an unauthorized and impermissible venture.

With respect to the access issue, the evidence presented at the Committee Meeting is of course beyond the close of the record of this case. But just as important, no pre-purchase analysis on the access to county roads for either the X Lots or the Bank Y Lots was submitted to the FDIC prior to the Bank's purchase of the properties.

We also address *OCC Interpretive Lette*r 634 (1992), the case brought to our attention by RMS. In that case, the OCC determined that funds may be spent to improve or complete an asset to bring it to a salable condition or even to buy an adjacent property to protect the bank's interest in its DPC property. But OCC's approval of a national bank's acquisition of adjacent property could only take place conditioned on an appropriate application by the bank, which would include (and did in the case of *IL 634*) a full record outlining the history of the investment, the bank's goals and plan to achieve those goals, complete disclosure of the transaction and its structure, understandings and conditions attached to the transaction, as well as a safety and soundness review and appropriate conditions placed on the transaction by the OCC. As noted, the Bank never filed an application for the purchase of the Bank Y Properties and has had deficient capital and composite ratings for the last two Examinations.

The Bank raised for the first time at the Committee's May 1 meeting the case of *** ("Bank Z"), a state member bank regulated by the Federal Reserve Board ("FRB").

Bank Z had purchased X lots from Bank Y at the same time that the Bank purchased its X Lots, also from Bank Y. The Bank argued that Bank Z had not been criticized by the FRB. The Committee, as is its practice in following its *Guidelines*, will not consider arguments advanced for the first time following the closing of the case record. In any event, whatever the facts surrounding Bank Z's X purchases, they would not be dispositive of the supervisory determinations made in this case.

Finally, the Committee rejects the Bank's dismissal of *Union Bank* as an outdated anachronism. The case stands for bedrock regulatory principles governing banking – limitations on real estate investing intended to protect both depositors and stockholders and to prevent banks from unsafe and unsound speculation in real estate. These principles have been codified, regularly relied upon, and followed by federal and state courts since 1873.

*C. **State Law.*

With respect to the citation of **State authority, the Committee does not intend to make any findings on such law but notes the response of the state's Deputy Commissioner to the Bank's Request for Review filed by the Bank:

> [T]he findings and determinations in the ROE are firmly based on fact and are well supported. Appellant's arguments were found to be unpersuasive; therefore, the 2011 examination findings should be sustained.

Additionally, by letter dated *** **, 2011, the XDFI Senior Counsel informed the Bank that the violation of **State Financial Code *** in the ROE was "properly noted," and the Bank should have filed an application to acquire the lots.

RMS informs us that a copy of the Bank's appeal was provided to the State Commissioner on or about February 9, 2012. In response to the appeal, the **State Deputy Commissioner confirmed to the Region that the XDFI continues to believe that the Bank Y transaction was completed in violation of the **State. Fin. Code, as cited in the ROE. The CDFI did not offer any additional or revised opinion on the loan Loss classification.

V. Conclusion.

For the foregoing reasons, the Bank's appeal is denied as set forth in this opinion. Specifically, this Committee affirms the conclusions of the Director and finds that (1) the Loss classification of the Loan is attributable to the lack of any collateral value and, lacking any viable source of support, the Loan is of such little value that its continuance as a bankable asset is not warranted; and (2) the acquisition of the Bank Y Lots represents a prohibited equity investment, acquired under no exception allowed by the National Bank Act or its implementing rules and guidelines, and because the Bank has failed to file for authority to acquire and continue to hold the Bank Y Lots under section 303.121 of the FDIC's Rules and Regulations, as required by section 362.3(b)(2) of those regulations, a violation of Part 362 is appropriately cited.

Upon receipt of the Committee's decision the Bank is directed:

1. To make a charge through its Allowance for Loan and Lease Losses in the amount of $2.0 million to reflect the Loss classification assigned to the Loan; and
2. To correct within a reasonable period, the violation of Part 362 cited in the Report of Examination. Such corrective measures should include the filing of a plan with the Region for the Bank to divest of the Bank Y Properties purchased from Bank Y in 2009.

This decision is considered a final supervisory decision by the FDIC.

By direction of the Supervision Appeals Review Committee of the FDIC, on June 19, 2012.

Valerie J. Best
Assistant Executive Secretary