community BANKER

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Welcome to the latest issue of the COMMUNITY BANKER.

The COMMUNITY BANKER is prepared by attorneys at Olson & Burns P.C. to provide information pertaining to legal developments affecting the field of banking. In order to accomplish this objective, we welcome any comments our readers have regarding the content and format of this publication. Please address your comments to:

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The attorneys at Olson & Burns represent a wide range of clients in the financial and commercial areas. Our attorneys represent more than 30 banks throughout North Dakota.

ENSURING COMPLIANCE IN COMMERCIAL AND AGRICULTURAL LENDING

Recent examinations show that some banks continue to struggle in ensuring compliance with consumer compliance-related rules that apply to commercial and agricultural credit transactions. This result is not necessarily surprising. On the one hand, the applicable rules generally cut across various business lines and products, thus requiring broader compliance strategies. But on the other hand, commercial and agricultural lending functions usually operate independently, outside the normal compliance-heavy consumer loan areas. Also, commercial and agricultural lenders may have less knowledge of applicable consumer compliance rules than a bank's consumer and residential real estate lenders.

To help reduce the chance of potential violations, this article will provide a brief overview of the more significant compliance rules that apply to commercial and agricultural loans and strategies for ensuring compliance in these loan areas.

Regulation B—Equal Credit Opportunity Act. Many of Regulation B's provisions apply to commercial and agricultural loan transactions, including the general prohibition against discrimination based on a prohibited basis in any aspect of a credit transaction. Regulation B also prohibits banks from requiring a spouse or another

individual to sign on a loan if the applicant applies and qualifies individually for the loan. Requiring a spouse to sign a loan in these circumstances can lead to possible marital status discrimination.

We have seen some recent violations of the spousal signature rules, so we will provide additional detail on these rules. *(A March 2012 article in Banking in the Ninth includes additional information regarding Regulation B's spousal signature requirements.)* The regulation implements these requirements by requiring that for joint loans, the bank must establish at application that the borrowers intended to apply jointly. Most applications for consumer-purpose loans include information that satisfies this joint intent requirement. However, many banks do not obtain applications for commercial and agricultural transactions, which means that they must establish and document joint intent differently. A joint financial statement is not sufficient for establishing joint intent. Thus, banks should adopt consistent practices for commercial and agricultural lenders to establish joint intent at application, such as documenting in the loan file the applicants' intent to apply jointly or requiring the borrowers to sign documentation at application noting their intent to apply jointly. Training commercial and agricultural lenders on spousal signature requirements is critical for helping ensure compliance with these rules and protecting against possible marital status discrimination concerns.

The adverse action notice requirements of Regulation B also apply to commercial and agricultural loan applications; however, the rules differ somewhat from the consumer loan requirements. *(Business credit, as defined in Regulation B section 1002.2(g), includes extensions of credit primarily for business or commercial purposes, including agricultural purposes. The definition has a few narrow exceptions described in section 1002.3(a)-(d).)* The bank should adopt standardized practices and train commercial and agricultural lenders to help ensure compliance with the adverse action requirements for commercial and agricultural credit applications.

- Business and agricultural borrowers with $1 million or less in gross annual revenues: Generally, the bank must provide these borrowers the same information it must provide consumer loan borrowers under similar timing rules. *(See Regulation B section 1002.9.)* The primary difference is that the bank may provide the information orally or in writing.

- Business and agricultural credit applicants with more than $1 million in gross annual revenues: The bank must notify applicants of the action taken, in writing or orally, within a reasonable time after application. It must provide a written statement of the reasons for adverse action and the ECOA notice if the applicant makes a written request for the reasons within 60 days of the creditor's notification.

Regulation H—Flood Disaster Protection Act. The flood insurance provisions of Regulation H apply to certain commercial and agricultural real estate loans. Banks must obtain a flood determination on most loans secured by improved real property or a mobile home, regardless of the loan's purpose. The bank must notify the borrowers in advance and obtain adequate flood insurance coverage for any of these loans located in special flood hazard areas (SFHA) prior to making, increasing, extending or renewing the loan. *(See Regulation H section 208.25.)* Controls for helping ensure that the bank obtains flood insurance when appropriate and in the proper amount include the following:

- Adopting processes to ensure lending staff does not close these loan transactions before adequate flood insurance is in place.

- Centralizing flood insurance responsibilities with certain staff members to help build expertise with the flood insurance rules.

- Monitoring flood insurance loans centrally, if possible, to help ensure that flood insurance policies remain in place and that the bank force places flood insurance when required, and

- Testing loans secured by properties in SFHAs periodically to confirm compliance with flood-related rules.

Additional regulatory requirements. A 2015 Consumer Compliance Outlook article includes a discussion on additional compliance-related requirements for commercial transactions.

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FDIC Targets Board Responsibilities

By Tom Hinkel, Compliance Guru

"A topic is at times of such significant interest to bankers and examiners that it warrants a special issue…" Whenever something from a regulatory body begins this way all bankers should take notice, and the latest Special Corporate Governance Edition from the FDIC is no exception. In fact the Guru did a little research and the last time the FDIC released a Special Edition of its Supervisory Insights was the Foreclosure Edition in 2011, which was a post-mortem on the banking crisis.

So all bankers would be well advised to review this latest publication, but particularly community bankers. In fact the full title is: **A Community Bank Director's Guide to Corporate Governance: 21st Century Reflections on the FDIC Pocket Guide for Directors**. The emphasis on community banks and bankers is intentional, and the release states right up front that:

> "Community banks play a vital role in the nation's economy and local communities, and a bank's management – including its directors and senior management – is perhaps the single most important element in the successful operation of a bank."

Although the FDIC states that this does not constitute new guidance (the original Pocket Guide was issued almost 30 years ago, but the basics haven't really changed), the fact that they chose this topic and this time to release a special issue indicates that this is almost certainly going to be an area of increased focus for examiners going forward.

If there is one common theme that resonates from this issue it is that directors are expected to play a more active role in the day-to-day affairs of their institutions, and NOT be simply a "rubber stamp" for management. This sums it up pretty well:

> "…a director's responsibility to oversee the conduct of the bank's business necessitates using independent judgment and providing a credible challenge. This entails engaging in robust discussions with senior management and perhaps challenging recommendations at times, rather than simply deferring to their decisions."

I've talked about this concept of "credible challenge" before, which also appears several times in the recent FFIEC Management Handbook, and is defined as "being actively engaged, asking thoughtful questions, and exercising independent judgment." In order to do that, directors need access to accurate, timely and relevant information. Board reports, once very high-level, should now include sufficient detail to allow members to comprehend (and if necessary, challenge) management decisions.

*Tom Hinkel, **FDIC Targets Board Responsibilities**, safesystems.com, complianceguru.com Reprinted with permission from the author.*

WHAT DIRECTORS SHOULD REVIEW

●**The Publication:**

A COMMUNITY BANK DIRECTOR'S GUIDE TO CORPORATE GOVERNANCE:
21ST CENTURY REFLECTIONS ON THE FDIC POCKET GUIDE FOR DIRECTORS

● **What It's About:**

This Special Corporate Governance Edition for community banks offers commentary on the FDIC's classic Pocket Guide for Directors and other guidance related to corporate governance and strategic planning. The issue highlights key governance concepts, roles, and responsibilities of directors and senior management, and discusses how FDIC examiners evaluate governance at community banks. A list of resources, with links to regulations, guidance and training materials, is included to help community bank directors fulfill their duties.

●**Where to Find the Applicable FDIC Publications:**

Supervisory Insights, *Special Corporate Governance Edition*, April 2016
https://www.fdic.gov/regulations/examinations/supervisory/insights/sise16/SI_SE2016.pdf

Pocket Guide for Directors (Last Updated 12/13/2007)
https://www.fdic.gov/regulations/resources/director/pocket/index.html

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AN INTRODUCTION TO ADEQUATE PROTECTION

A secured creditor is entitled to "adequate protection" of its "interest in property" of the debtor's estate in several circumstances: **(a)** for "cause" in the context of the automatic stay (§ 362(d)(1)); **(b)** in the context of the trustee's sale, use, or lease of collateral (§ 363(e)); and **(c)** in the context of priming liens - the trustee's borrowing of funds secured by collateral that is already encumbered (§ 364(d)). "Trustee" herein means a chapter 7 trustee, a chapter 11 trustee, or a debtor-in-possession under chapter 11.

The Purpose of Adequate Protection: Adequate protection is meant to compensate the secured creditor for any decrease or diminution in value of the collateral during the bankruptcy case. 11 U.S.C. § 361. The lack of adequate protection for a secured creditor's interest in property is "cause" or, in layman's terms, "a good reason" for lifting the automatic stay. The lift of the stay, including the reason that the collateral is not adequately protected from diminution, allows the secured creditor to pursue its remedies under state law, such as foreclosure and sale of the collateral.

A secured creditor is entitled to adequate protection for its interest in property of the debtor that is "used, sold, or leased, or proposed to be used, sold, or leased, by the trustee . . ." 11 U.S.C. § 363(e). For example, when a debtor in possession uses the tractor subject to a security interest, the lender is entitled to adequate protection against any reduction in the value during that use.

A business debtor obtains greater access to liquidity while depriving secured creditors of certain remedies, such as any right to immediate foreclosure, which is barred by the automatic stay. The rights of other creditors are also affected in that a debtor's access to or use, sale, lease, or pledge of the collateral may afford them a better chance at a higher recovery. At the same time, a secured creditor is entitled to adequate protection of the value of its interests in collateral, in particular where debtors utilize liquidity enhancements like using cash collateral or borrowing money using already-encumbered property as security.

Post-petition, a debtor can obtain credit secured by a senior or equal lien on encumbered estate property with court approval and after notice and a hearing only if: **(1)** the debtor is unable to obtain credit otherwise, and **(2)** the interest of the creditor to be primed is adequately protected. 11 U.S.C. § 364(d). Generally, "adequate protection" requires that a secured lender receive compensation or something of value during the pendency of the bankruptcy case to protect it against the diminution or erosion in value through depreciation, dissipation, or any other cause, including the dollar value of the priming debtor-in-possession loan. Adequate protection can take many forms, including, but not limited to, periodic cash payments, post-petition security interests a/k/a replacement liens, liens in unencumbered property, or an "equity cushion" (the amount by which the secured lender is oversecured). Whether a court will or will not permit a debtor to obtain a priming lien is fact-specific and depends on different considerations, such as whether the creditor is over- or under-secured, whether the creditor has a blanket lien (no other unencumbered assets to pledge), and other factors.

The trustee or debtor in possession bear the burden of proving that the secured creditor's interest in property is adequately protected. 11 U.S.C. §§ 362(g)(2), 363(p)(1), and 364(d)(2). Further, if adequate protection *fails* and the secured creditor is not compensated for the diminution in the value of the collateral, the secured creditor is entitled to an administrative claim to be paid in full before almost all other administrative claims. 11 U.S.C. § 507(b).

Categories of Adequate Protection: What constitutes adequate protection is a question of fact to be determined on a case-by-case basis. 11 U.S.C. § 361 sets out a non-exclusive list of forms of adequate protection:

> **a.** requiring the debtor to make a cash payment or periodic cash payments to the extent that the automatic stay or the use, sale or lease of property results in a decrease in the value of the creditor's interest in the property (11 U.S.C. § 361(1));
>
> **b.** providing to the secured creditor an additional or replacement lien to the extent that the automatic stay or the use, sale or lease of property results in a decrease in the value of the creditor's interest in the property 11 U.S.C. § 361(2); and
>
> **c.** granting other relief (other than entitling the creditor to compensation allowable as an administrative claim) so that the creditor will realize the "indubitable equivalent" of the creditor's interest in the property. 11 U.S.C. § 361(3)

"Indubitable equivalent" in § 361(3) has been interpreted by a number of courts to require that adequate protection be "completely compensatory" or nearly so. It has also been expressed as providing a creditor whose collateral position is compromised "with the same level of protection it would have had" if the action

threatening the creditor's security interest had not occurred. In re Fontainebleau Las Vegas Holdings, LLC, 434 B.R. 716, 748–49 (S.D. Fla. 2010).

The court may require multiple forms of adequate protection. For example, if cash flow from business operations cannot keep up with overhead or tax obligations of real property collateral, any equity cushion would diminish and eventually no longer offer adequate protection. Some combination of an equity cushion, periodic payments, additional liens, and a good prospect of reorganization may serve as adequate protection in cases where one form alone may not.

Determination of Value: Essential to the consideration of adequate protection is the determination of value of the secured creditor's interest in the property and the diminution of that value during the case. The courts has discretion as to the method of valuation, which should examine all relevant facts, including the value of the collateral, the likelihood of depreciation or appreciation, the operational performance of the debtor, and the prospects for a successful reorganization. Unfortunately, valuation disputes lead to expensive litigation. In smaller commercial real property bankruptcy cases where litigation costs would take a toll on the parties, debtor and creditor have a greater incentive to avoid expensive valuation litigation and to agree on a rough approximation of adequate protection as monthly payments.

Replacement Liens as Adequate Protection: Replacement liens are listed under 11 U.S.C. § 361(2) as possible adequate protection. Some pre-petition security interests in property acquired post-petition are cut off under 11.S.C. § 552(a), even if the security agreement would otherwise validly cover after-acquired property under state law. Accordingly, a debtor operating company may offer adequate protection in the form of replacement liens in inventory and accounts receivable acquired post-petition. In that way, the secured creditor that lost its right to such liens by the operation of § 522(a) receives compensation for diminution of its collateral. Of course, creditors are less than thrilled that the "benefit" they receive is something they were entitled to anyway under their loan documents.

What, If Any, Amount of Equity Cushion May Ensure Adequate Protection: Generally, the debtor's equity cushion in collateral is the value of the collateral measured against the amount of the creditor's secured claim. Courts also consider whether the equity cushion is eroding from interest accrual and other costs; generally, a declining equity cushion is an indicator that additional adequate protection may be required. An equity cushion is the classic form of protection for a secured debt, and the determination whether the equity cushion in collateral is sufficient is made on a case-by-case basis.

Take Heart: Many, if not most, lenders will at sometime in his or her career sit looking at a Chapter 11 or Chapter 12 bankruptcy petition. That lender may then get a whirlwind lesson in adequate protection, sufficiency, adequacy, equity cushions, replacement liens, and "indubitable equivalent." Take a deep breath and hang on. A customer's bankruptcy case is a turbulent ride, but you *will* land safely.

DISCLAIMER

The COMMUNITY BANKER is designed to share ideas and developments related to the field of banking. It is not intended as legal advice and nothing in the COMMUNITY BANKER should be relied upon as legal advice in any particular matter. If legal advice or other expert assistance is needed, the services of competent, professional counsel should be sought.