Message from the Chair

This edition of the Banking Law Committee Journal includes five articles on a wide range of topics. Gabriel Rosenberg and Jeremy Girton of Davis Polk & Wardwell LLP have contributed a thought-provoking article on questions about the prioritization and coordination of permissive rulemakings pursuant to the Dodd-Frank Act. Laurence Smith of Wolff & Samson PC has provided a piece that questions a procedural convention underlying many commercial loan sales today: the refusal by the lender to sell the loan at a discount to the borrower or its affiliate some or all of whose principals are the same as the principals of the borrower. In addition, Gerald Comizio and Amanda Jabour of Paul Hastings LLP have written an article that details the potential legal challenges that could arise out of President Obama's recess appointment of Richard Cordray as Director of the CFPB. Grappling with the meaning of "good faith" for purposes UCC Article 4A -- particularly in the area of E-Banking? Mark Wilson and Jeremy Kerman of Kerns, Frost & Pearlman LLC explain how recent case law suggests that the FFIEC Handbook on E-Banking could provide significant insight. And last, but not least, HMH Consulting's Charles Morgan and James Hess explain the key issues counsel should consider before managing Bank Owned Life Insurance pursuant to the arrangement set forth in Private Letter Ruling 201152014.

William F Kroener III
Chair, Banking Law Committee

Featured Articles

Beyond "Shall": Dodd-Frank's Permissive Rulemakings
By Gabriel D. Rosenberg and Jeremy R. Girton, Davis Polk & Wardwell LLP

The burden on regulatory agencies to complete the hundreds of rulemakings required by the Dodd-Frank Act has garnered a great deal of well-warranted attention. Much less discussed, however, are the 198 places in the Act that authorize, but do not require, regulatory action. These "permissive rulemakings" raise key questions about the prioritization and coordination of rulemaking. These provisions and related controversy are the focus of this paper.

Required vs. Permissive Rulemakings

Dodd-Frank's 848 pages only begin to outline the multiple regulatory regimes it puts into place. The Act contains 243 provisions that specifically require U.S. financial regulators to adopt final rules - counting each regulator separately, this amounts to roughly 400 rulemaking requirements. Of these 400 requirements, 286 have specified deadlines, mainly within the first two years after Dodd-Frank's enactment. The Act further requires 87 studies to be conducted, some repeated annually. As Jonathan Macey of Yale Law School recently noted: "Laws classically provide people with rules. Dodd-Frank is not directed at people. It is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies."
**Loan Sales: Should the Borrower be Permitted to Bid?**
*By Laurence M. Smith, Wolff & Samson PC*

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**Cordray's Recess Appointment: Future Legal Challenges**
*By V. Gerard Comizio, Fried, Frank, Harris, Shriver & Jacobson LLP and Amanda M. Jabour, Paul Hastings LLP*

On January 4, 2012, President Obama appointed Richard Cordray as director of the Consumer Financial Protection Bureau ("CFPB"), pursuant to the President's constitutional recess appointment powers. The Recess Appointments Clause, Article II, Section 2, of the U.S. Constitution provides in part that "[t]he President shall have power to fill up all Vacancies that may happen during the Recess of the Senate, by granting Commissions which shall expire at the End of their next Session."

Cordray's appointment has raised questions about the constitutionality of the President's actions for a number of reasons. Partially because the appointment of a CFPB director has been politically charged, challenges to Cordray's appointment are likely. These potential legal challenges include, but are not limited to, challenges to both new regulations and enforcement actions against nonbank lenders. As a result, the legal issues surrounding the appointment have significant implications for all institutions regulated by the CFPB.

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**What Is Good Faith? Subjective and Objective Standards for Banks Accepting Payment Orders**
*By Mark E. Wilson and Jeremy D. Kerman, Kerns, Frost & Pearlman, LLC*

The Uniform Commercial Code ("UCC") contains several provisions incorporating the concept of "good faith." But what exactly does "good faith" mean? The Code originally defined "good faith" as "honesty in fact in the conduct or transaction concerned." See UCC § 1-201(19) (2006). While many in the banking industry are familiar with this subjective, "pure heart and empty head" standard, banking lawyers may be surprised to learn that the current uniform text imposes an objective standard as well as the traditional subjective one. This dual, subjective-objective standard of good faith applies to funds transfers under Article 4A of the UCC. The Federal Financial Institution Examination Council ("FFIEC") has established guidelines that may assist financial institutions in meeting the objective component of the good faith standard with regard to funds transfers, especially with regard to Internet schemes such as "phishing" frauds.

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**Bank Owned Life Insurance (BOLI) and PLR 201152014©: An Innovative Arrangement Poses Numerous Issues**
*By Charles C. Morgan and James L. Hess, HMH Consulting, LLC*

*Private Letter Ruling 201152014* (the "PLR") describes a novel approach to managing Bank Owned Life Insurance ("BOLI"). This article outlines the most...
significant issues that counsel should call to the attention of bank management should they be considering participation in this untested arrangement.

The stated purpose of the transaction described in the PLR is to provide banks with a more effective, centralized way to manage BOLI and, where appropriate, either negotiate the terms of new replacement life insurance policies or renegotiate the terms of existing BOLI. Probably of at least equal importance, the conclusions in the PLR bless the arrangement as a structure that eliminates the income tax impediments to updating BOLI plans that otherwise would effectively prevent a bank from purchasing replacement life insurance coverage or renegotiating the terms of existing BOLI.

One of the unfortunate problems with updating BOLI plans is that doing so could cause the bank to lose interest deductions on its debt. The PLR concludes that the transaction, as structured, does successfully eliminate the risk that banks holding minority interests in the LLC will lose those interest deductions but it does not address many other concerns to which the proposed transaction may give rise.
Beyond “Shall”: Dodd-Frank’s Permissive Rulemakings

Gabriel D. Rosenberg and Jeremy R. Girton
Davis Polk & Wardwell LLP

The burden on regulatory agencies to complete the hundreds of rulemakings required by the Dodd-Frank Act has garnered a great deal of well-warranted attention. Much less discussed, however, are the 198 places in the Act that authorize, but do not require, regulatory action. These “permissive rulemakings” raise key questions about the prioritization and coordination of rulemaking. These provisions and related controversy are the focus of this paper.

Required vs. Permissive Rulemakings

Dodd-Frank’s 848 pages only begin to outline the multiple regulatory regimes it puts into place. The Act contains 243 provisions that specifically require U.S. financial regulators to adopt final rules – counting each regulator separately, this amounts to roughly 400 rulemaking requirements. Of these 400 requirements, 286 have specified deadlines, mainly within the first two years after Dodd-Frank’s enactment. The Act further requires 87 studies to be conducted, some repeated annually. As Jonathan Macey of Yale Law School recently noted: “Laws classically provide people with rules. Dodd-Frank is not directed at people. It is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies.”

The Dodd-Frank Act also includes 198 provisions permitting, rather than requiring, regulators to adopt rules. In a typical example, a section of the Act could say that the Federal Reserve “may issue” a rule on a specific topic, rather than state that it “shall issue” a rule on that topic. Only about 3% of such “permissive rulemakings” have a specified statutory deadline for completion. Not

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1 Gabriel D. Rosenberg is an Associate and Jeremy R. Girton is a Legal Assistant in the Financial Institutions Group of Davis Polk & Wardwell LLP, New York, New York. The views expressed in this article are entirely those of the authors and do not reflect the opinions of Davis Polk & Wardwell LLP or any of its clients. The authors thank Margaret Tahyar, Colleen Hobson, Alexander Charap and Dana Seesel for comments.

2 Rulemaking data are derived from the Davis Polk Regulatory Tracker. The number of actual legislative rules issued under the Dodd-Frank Act may vary tremendously, as rulemaking requirements are combined or divided into actual rules. Rulemaking requirements are counted separately for each applicable regulator, regardless of whether regulators are required to coordinate rulemaking, to appropriately illustrate the administrative burden on regulatory agencies.

3 Too Big Not to Fail, THE ECONOMIST, Feb. 18, 2012.

4 While, as we have stated elsewhere, counting rulemaking requirements under Dodd-Frank is difficult, counting permissive rulemakings is even more complicated and, as a result, our numbers should be seen as illustrative. See Davis Polk, Dodd-Frank Progress Report 15 (March 2012), available at www.davispolk.com/dodd-frank. We also do not address in this paper cases where regulators, in the course of implementing Dodd-Frank, choose to issue rules that are not explicitly permitted by the Act but are authorized under existing statutes.
surprisingly, the five regulators with the most required rulemakings under the Dodd-Frank Act are also those with the most permissive rulemakings. According to our analysis, the SEC has the largest percentage of rulemaking grants under the Dodd-Frank Act (24.5% of required, 25.25% of permissive), followed by the Federal Reserve (16.5%, 14.65%), CFTC (16%, 19.70%), FDIC (11.5%, 5.05%) and CFPB (8.5%, 20.71%).

Permissive rulemakings under Dodd-Frank fall into one of three categories. The first set of permissive rulemakings consists of those that complement required rulemakings. For example, under Section 165, the Federal Reserve is required to issue rules prescribing enhanced prudential standards for all bank holding companies with more than $50 billion in assets and nonbank financial companies designated for heightened supervision (collectively, “SIFIs”).\(^5\) Sections 115(b) and 165(g) of the Dodd-Frank Act, however, permit the Federal Reserve to additionally establish short-term debt limits for SIFIs. In the recently released Proposed Rule on Enhanced Prudential Standards, meant to meet the rulemaking requirement, the Federal Reserve requested comment on

whether to use this permissive rulemaking authority – whether short-term debt limits should be considered as a replacement for, or in addition to, the Liquidity Coverage Ratio and Net Stable Funding Ratio, elements required as part of the global Basel III reforms approved in December 2010.6

The second set contains permissive rulemakings predicated on the results of a required study. For example, Section 1028 of the Dodd-Frank Act permits the CFPB, after conducting a required study, to issue rules restricting mandatory pre-dispute arbitration agreements for consumer financial products or services if it finds doing so would be “in the public interest and for the protection of consumers.”7 So far, the CFPB has not sought comment on the required study but has released a prototype for a simplified credit card agreement that does not include a mandatory arbitration clause.8 Similarly, Section 913(g) of the Dodd-Frank Act amends the Securities Exchange Act to permit the SEC to establish a fiduciary duty for brokers and dealers, but it also independently gives the SEC the ability to “promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.”9 In January 2011, the SEC staff released a study that recommended implementing a uniform fiduciary standard but did not discuss whether the SEC should use its separate authority to, for example, prohibit specific compensation schemes.10

The third set of permissive rulemakings is composed of those that exist independently of either a study or required rulemaking. In most cases, these provisions give the regulator specific discretion to designate or exempt a type of entity or category of transaction. For example, Section 941 of Dodd-Frank amends the definition of “asset-backed security” under the Securities Exchange Act and permits the SEC, by rule, to designate additional types of securities as falling under the definition.11 A similar example is Section 721, which permits

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7 Dodd-Frank Act § 1028.
8 See CFPB Prototype Credit Card Agreement, available at http://www.consumerfinance.gov/credit-cards/nowbeforeyouowe/ (accessed 2/7/2012). The prototype notes that “this is not a model form, and use is not mandatory,” and does indicate that the lack of an arbitration clause represents a view of the CFPB.
9 Dodd-Frank Act § 913(g), amending Securities Exchange Act Section 15(k)-(l) (15 U.S.C. 78o(k)-(l)).
the Secretary of the Treasury to exempt foreign exchange swaps and forwards from the definition of “swap” under the Commodity Exchange Act.12

The Challenge and Controversy of Permissive Rulemaking

Permissive rulemakings have started to, and will likely continue to, serve as flash points for one of the main challenges for regulators implementing the Dodd-Frank Act – balancing (1) the Act’s specific requirements and congressional intent, (2) the overall goal of creating holistic and practical regulations and (3) the constraints of limited resources.

The first question regulators must address is whether required rulemakings must be completed before permissive rulemakings are undertaken. Many required rulemakings have specific deadlines and conditions attached to them, whereas most permissive rulemakings do not. Where purely permissive rulemaking has been exercised, regulators have elicited attention and often criticism. At a CFTC meeting in December 2010, Commissioner Bart Chilton criticized the commission for focusing on permissive rulemakings rather than the Act’s required rulemaking on swaps position limits, due the following month.13

If congressionally mandated rulemakings are to take priority, however, the question arises of how to treat permissive rulemakings needed to complement those required rulemakings as part of holistic regulatory regimes. In several cases, regulators have found it necessary to implement permissive rulemakings in advance of, or in concert with, more high-profile required rulemakings in order to create workable regulatory regimes. For example, when working to comply with Dodd-Frank’s mandate in Section 1075 that the Federal Reserve issue final rules restricting debit card interchange fees, the Board issued rules that addressed three permissive rulemaking provisions in addition to the four required rulemaking provisions. Nowhere has this approach been more evident than in the implementation of over-the-counter derivatives reforms under Title VII of Dodd-Frank, through which the CFTC and SEC are charged with crafting a new regulatory regime for swaps and security-based swaps. To date, 20 of the 60 permissive rulemaking grants under this title have been used, more than anywhere else in the Act.

Finally, and particularly relevant in the current climate, is the question of the use of limited regulatory resources. At the same December 2010 CFTC meeting at which Commissioner Bart Chilton criticized prioritizing permissive rulemaking over required rulemaking, Commissioner Jill Sommers criticized the

12 See Dodd-Frank Act § 721(a)(21), amending Commodity Exchange Act § 1a(47) (7 U.S.C. 1a(47)).
13 See Bart Chilton, Commissioner, CFTC, Opening Statement at CFTC Meeting: Sixth Series of Proposed Rulemakings Under the Dodd-Frank Act (Dec. 1, 2010).
Rosenberg and Girton Beyond “Shall”: Dodd-Frank’s Permissive Rulemakings

CFTC’s rulemaking priorities on resources grounds: “[A] number of the regulations that we have already considered, and a number of regulations that we are considering today, are not required by Dodd-Frank. Commission staff has spent months and months drafting proposed regulations that are purely voluntary, all the while with the Commission expressing grave concern about our level of resources...This has been a mistake, and in my view, an unwise use of our limited staff resources.”

Conclusion

Ultimately, prioritization of required vs. permissive rulemakings along these three dimensions will be decided by the regulators. The controversy will likely amplify as the most critical required rulemakings are finalized and regulators are left to prioritize secondary required rulemakings against key permissive rulemakings needed to fill remaining gaps in the new Dodd-Frank regulatory structure. The new and controversial CFPB, which has 41 permissive rulemaking grants in addition to its 43 required rulemakings, may well be the center of the debate. Due to a wide range of factors, including the number of influential permissive rulemaking provisions in the Act, the relatively loose parameters given to regulators to implement them, the continuing debate over the proper interpretation of Congressional priorities and continued budgetary constraints on regulators, we expect that permissive rulemakings will attract increased attention in the coming months and years.

Loan Sales: Should the Borrower be Permitted to Bid?

By: Laurence M. Smith

Following the collapse of Lehman Brothers, many commercial mortgage lenders have sold more loans than they have originated. Escalating vacancy rates and a precipitous decline in property values are among the causes of the defaults which have led to the loan sales. Rather than examine causal factors, this article explores a procedural phenomenon underlying many loan sales: the refusal by the lender to sell the loan at a discount to the borrower or its affiliate some or all of whose principals are the same as the principals of the borrower. Why?

A precise understanding of the relevant facts will help focus the analysis. The asset class in question is a commercial mortgage loan which is owned and serviced by one lender, is fully disbursed and is in default. Moreover, the commercial real estate collateralizing the loan has appraised recently at a value far below the outstanding principal balance of the loan. To complete the picture, the loan is non-recourse, so the lender cannot look to the outside assets of the borrower or its principals as a source of repayment, and this is the only loan on which the lender has exposure to the borrower; thus, there are no concerns about how the administration or disposition of one loan may affect other loans to the same or an affiliated entity. Foreclosure proceedings have been commenced, but the backlog of actions in the state in which the mortgaged property is located renders foreclosure a costly, protracted and generally unappealing option. The lender therefore elects to pursue, on a parallel track, the sale of the mortgage loan.

Should the lender consider selling the loan to the borrower? In the author's experience, a lender's reaction to this question ranges from reluctance to peremptory dismissal, often borne of an institutional bias against allowing a borrower to purchase its own loan. The reasons proffered for the lender's position include the “sanctity of contract” argument. That is, the borrower and its principals originally bargained for a non-recourse loan, with the full understanding that if the loan was not repaid in full in a timely manner, the borrower would lose the property; the borrower, therefore, should not be permitted to retain ownership if the lender will not receive payment in full. In contrast to repaying a loan at a discount, which results in cancellation of indebtedness income to the borrower,² the purchase of a loan by an affiliate of the borrower may, with careful tax planning, enable the borrower to delay or avert completely the recognition of

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¹ The author is a member of the law firm of Wolff & Samson PC and co-chair of the firm’s corporate and securities department. Mr. Smith would like to acknowledge the contributions of his tax partner, Sean Aylward, in the preparation of this article.

² See Section 61(a)(12) of the Internal Revenue Code of 1986, as amended (the “Code”), which includes income from the discharge of indebtedness as an element of gross income. However, pursuant to Code Section 108 a taxpayer may, under certain circumstances, be able to avoid the recognition of income. Further, the impact of forgiveness of indebtedness income may be mitigated pursuant to provisions of the American Recovery and Reinvestment Act of 2009. A detailed discussion of these tax issues is beyond the scope of this article.
cancellation of indebtedness income. Among the tax rules that have to be satisfied in order to avoid cancellation of indebtedness income to the borrower are (i) the borrower and the purchaser cannot be “related parties” which, for purposes of this article and subject to detailed attribution rules, means that the purchaser cannot own more than 50 percent of the borrower, and the same person or entity cannot, directly or indirectly, own more than 50 percent of both the borrower and the purchaser\(^3\) and (ii) the underlying debt cannot be “significantly modified.”\(^4\) Likewise, the affiliate who purchases the mortgage loan at a discount may reap significant benefits, such as receipt of amortization payments that far exceed the amount paid for the loan. Allowing the borrower and its principals to profit from the very default that compelled the sale of the loan at a discount is anathema to most lenders. Further, lenders are wary that a borrower who believes it can purchase its loan at a discount may be motivated to present a more dismal picture to the lender—regarding environmental issues, the prospect of attracting new tenants to fill vacancies or the magnitude of other problems associated with the mortgaged property—than a borrower who understands that anything less than full payment equates to a loss of the property; even more Machiavellian, a borrower may be tempted to default on its loan as the first step of a plan designed to culminate in the purchase of the loan by an affiliate of the borrower. Lastly, lenders are aware that confidentiality obligations are difficult to police and enforce, so allowing a defaulting borrower to purchase its loan may have unwanted, precedential consequences when the lender negotiates with other, unrelated borrowers.

There are, however, countervailing factors which a lender may want to consider when marketing a mortgage loan for sale. Commercial real estate owners are invested, literally and figuratively, in the success of each project they undertake. Having a property wrested from them through foreclosure results in a loss of the time and equity invested in the property, as well as reputational damage; most successful business people do not like to admit that they made a mistake, and their desire to avoid defeat may impel them to place an inflated value on a property when bidding for the mortgage loan. Moreover, the borrower likely knows more about the property and the true extent of its problems than will an independent investor who may be afforded two weeks of due diligence prior to bidding on the mortgage loan; if the risk of the unknown is less, the discount sought by the prospective investor may be proportionately less. Perhaps most significant, if the purchaser of the loan is an affiliate of the borrower, there is no need to endure the foreclosure process in order to obtain title to the property; here, again, an element of uncertainty—which might otherwise depress the amount that an investor is willing to bid—is eliminated. If an affiliate of the borrower buys the loan, the lender can demand as one of the closing deliveries an unconditional release from the borrower, an added modicum of comfort that is not available if the loan is sold to an outside investor. In a similar vein, the lender’s representations and warranties in the loan sale agreement will be especially Spartan if the purchaser is an affiliate of the borrower, and the loan sale agreement need not provide for a due diligence “out”. Finally, a lender should be

\(^3\) See Code Section 108(e)(4) and Treas. Reg. 1.108-2.

\(^4\) See Code Section 108(e)(10) and Treas. Reg. 1.1001-3.
mindful that, in a competitive bidding situation, allowing an affiliate of the borrower to submit a bid may serve to increase the amount realized by the lender, even if the borrower’s affiliate is not the successful bidder.

The decision of whether to allow an affiliate of the borrower to bid for or purchase a defaulted mortgage loan requires a careful analysis of all relevant facts. Cogent arguments can be made in support of either result. The author does not believe that, under all circumstances, a borrower or its affiliate should be invited to bid. However, a per se rule prohibiting a borrower or its affiliate from purchasing a defaulted mortgage loan may frustrate the goal of maximizing the lender’s ultimate recovery.
Cordray’s Recess Appointment: Future Legal Challenges

By V. Gerard Comizio and Amanda M. Jabour*

Introduction

On January 4, 2012, President Obama appointed Richard Cordray as director of the Consumer Financial Protection Bureau (“CFPB”), pursuant to the President’s constitutional recess appointment powers. The Recess Appointments Clause, Article II, Section 2, of the U.S. Constitution provides in part that “[t]he President shall have power to fill up all Vacancies that may happen during the Recess of the Senate, by granting Commissions which shall expire at the End of their next Session.”

Cordray’s appointment has raised questions about the constitutionality of the President’s actions for a number of reasons. Partially because the appointment of a CFPB director has been politically charged, challenges to Cordray’s appointment are likely.¹ These potential legal challenges include, but are not limited to, challenges to both new regulations and enforcement actions against nonbank lenders.² As a result, the legal issues surrounding the appointment have significant implications for all institutions regulated by the CFPB.

The role of the CFPB

Now that the CFPB has a director, the bureau has broad authority to change the regulatory landscape for financial institutions. For example, pursuant to the Dodd-Frank Act ("Dodd-Frank"), once a CFPB director is in place, the bureau has authority to take on a more expansive regulatory role, primarily direct regulation of nonbank firms, as well as enforcing abusive acts and practices rules.³

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¹ A Department of Justice legal opinion regarding the recess appointment states, “The question is a novel one, and the substantial arguments on each side create some litigation risk for such appointments.” See Memorandum Opinion for the Counsel to the President, from Virginia A. Seitz, Assistant Attorney General, “Lawfulness of Recess Appointments During a Recess of the Senate Notwithstanding Periodic Pro Forma Sessions,” (Jan. 6, 2012) (hereafter “Department of Justice Opinion”).

² At the same time, President Obama also used his recess appointment power to appoint three members of the National Labor Relations Board (“NLRB”). Cases have already been brought to challenge those appointments as unconstitutional, and presumably the outcome of these cases could indicate the potential for success for future challenges to Cordray’s appointment. Republican senators have indicated that they will join an amicus curiae brief in one of the cases – depending on the content of the brief, this could signal their willingness (or unwillingness) to challenge Cordray’s appointment. See Seung Min Kim, “Republicans join challenge of recess appointments,” Politico.com (Feb. 13, 2012).

Cordray, who testified before a House Oversight Committee subcommittee on January 24, has signaled his intention to aggressively regulate nonbank financial institutions in a manner similar to how banks are regulated.  However, the questions that have been raised regarding the constitutionality of his appointment could potentially undermine any actions the CFPB takes under his directorship. As discussed in further detail below, if Cordray’s appointment is deemed to be invalid, then many of the actions taken by the CFPB under his leadership could, in turn, be called into question and become the subject of separate legal challenges.

Questions regarding the constitutionality of Richard Cordray’s recess appointment

The primary issue concerning Cordray’s appointment is whether President Obama had the authority to make the recess appointment pursuant to the Recess Appointment Clause. The asserted purpose of the Recess Appointments Clause is to enable the President to keep the government fully staffed when the Senate is not “in session for the appointment of officers.” Although the general understanding of the scope of the recess appointment power has changed over time, Presidents since George Washington have made recess appointments. In determining the President’s authority, the foundational issue is whether the Senate was at recess, as required by the Constitution. When the Senate is not at recess, the President does not have the authority to make recess appointments. In the case of Mr. Cordray’s appointment, whether a proper recess existed requires resolution of two questions: (i) did the House consent to the Senate recess as required by Article I, Section 5 of the Constitution, and (ii) if the Senate was at recess, did the pro forma sessions interrupt the recess? A third issue is whether, regardless of whether a proper recess existed, a recess appointment is a valid means of appointing a CFPB director, as required by Dodd-Frank.

A. Did the House consent to the Senate recess?

Before the Senate adjourned for the 2011 holiday break on December 17, 2011, it passed a resolution providing in part that the Senate “adjourn and convene for pro forma sessions only, with no business conducted... and that following each pro forma session the Senate adjourn until the following

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However, Article I, Section 5 of the Constitution states that neither house of Congress may adjourn for more than three days without the consent of the other house.\footnote{U.S. Const. art. I, § 5.} It is undisputed that the House did not consent to the Senate recess at the end of the year, and without consent the Senate cannot constitutionally recess. Republicans and others opposing Cordray’s appointment point to this as the crux of the issue: the Senate was not - and could not have been - in recess during the December 2011- January 2012 holiday season. The Administration, arguing that the provision cannot trump the Recess Appointments Clause,\footnote{See Charlie Savage, “Justice Department Defends Obama’s Recess Appointments,” \textit{The New York Times} (Jan. 12, 2012).} maintains that the unanimous consent of the Senate is sufficient to send the Senate into a valid recess.\footnote{Press Gaggle by Secretary Jay Carney, discussion with press corps aboard Air Force One (Jan. 4, 2012).} In the past, both houses of Congress have conducted pro forma sessions in order to comply with the consent requirement in Article I, § 5.\footnote{See Department of Justice Opinion, \textit{supra} n. 1, at 3.}

B. Did the pro forma sessions interrupt the Senate recess?

The Administration and Republican Senators have generally assumed the Senate was at recess and instead have focused their dispute on a separate legal issue: whether the pro forma sessions conducted by individual senators were sufficient to interrupt the recess. The December 17th resolution made clear that the Senate was to remain in session, although no business was to be conducted.\footnote{Although no business was supposed to be conducted, on December 23, Senator Harry Reid did conduct some business regarding the payroll tax holiday extension. See John P. Elwood, “Recess Appointment of Richard Cordray Despite Pro Forma Sessions,” \textit{The Volokh Conspiracy} (Jan. 4, 2012).}

The obvious purpose of such pro forma sessions, which have been used by Republicans and Democrats alike,\footnote{See Henry B. Hogue, “Recess Appointments: Frequently Asked Questions,” Congressional Research Service at 1 (Jan. 9, 2012).} is to prevent the President from making recess appointments. Under pro forma procedure, a member of the Senate “gavels in,” brings the house to order, and gavels out without
conducting any business. The question is whether the sessions, which typically last less than one minute, interrupt the Senate’s recess for the purpose of the Recess Appointments Clause.

The answer to the legal issue is unclear: unsurprisingly, Democrats generally argue “no,” and Republicans generally argue “yes.” Both sides point to persuasive authority in support of their positions.

The Obama Administration has referred to the pro forma sessions as a political “gimmick,” and White House Counsel Kathryn Ruemmler has concluded that they do not interrupt the recess. The argument is that pro forma sessions are a mere formality and do not interrupt a recess of the Senate, in part because they do not allow the Senate to conduct any business. In a 1905 report, the Senate Judiciary Committee recognized that a “Recess of the Senate” occurs when it cannot “participate as a body in making appointments” and that a recess must be “actual, not something fictitious.” The pro forma sessions, by contrast, have no substance, and apparently their sole purpose is to prevent the President from using his appointment power. Concluding that such sessions interrupt the recess would thus undermine the separation of powers because the Senate could unilaterally frustrate the exercise of the President’s power.

The Department of Justice has reached the same conclusion, apparently advising the President of its views before Cordray’s appointment. According to a DOJ legal brief addressing the issue, “The Senate could remove the basis for the President’s exercise of his recess appointment authority by remaining continuously in session and being available to receive and act on nominations, but it cannot do so by providing for pro forma sessions at which no business is to be conducted.”

Republicans and others opposing the President’s recess appointment argue that pro forma sessions are sufficient to interrupt the Senate recess. Their argument turns on the timing of the appointment: in the past thirty years, no President has used a recess appointment during a recess of less than 10 days. The Constitution does not specify the length of time the Senate must be in recess

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19 Id. (citing to Department of Justice Opinion, supra n. 1).
before the President may make a recess appointment. Presidents generally do not exercise recess appointment power where Congress is at recess for less than 10 days; however, a Department of Justice brief from 1993 implied that the President may make a recess appointment during a recess of longer than three days.\(^{21}\) Yet, the pro forma sessions at issue occurred every three days. The Republican argument, therefore, is that President Obama acted outside his constitutional authority in appointing Cordray during that three day period.

There are several other arguments against the Administration’s position. First, the Senate has validly employed pro forma sessions in other contexts, such as “to satisfy the Twentieth Amendment’s direction that in the absence of legislation providing otherwise, Congress must convene on January 3.”\(^{22}\) Second, one could argue that the Executive Branch is bound by the Senate’s own understanding of whether the pro forma sessions validly interrupt the recess.\(^{23}\) The Department of Justice has countered these arguments by determining that while Congress can set rules governing its internal operations, it may not ignore its constitutional restraints.\(^{24}\)

C. Is the appointment of the Director valid pursuant to the Dodd-Frank Act?

A separate legal issue is whether a recess appointment has the same force as a Senate confirmation as required by the Dodd-Frank Act. The statutory language of the Dodd-Frank Act requires that “the Director shall be appointed by the President, by and with the advice and consent of the Senate.” (Emphasis added).\(^{25}\) Because Cordray’s appointment was not with the advice and consent of the Senate, it is unclear whether it fulfills the statutory requirement. Moreover, it would be difficult, given the factual positions it has already staked out, for the Administration to argue that the Senate provided the consent that the Dodd-Frank Act requires.

On the other hand, many other statutes requiring appointments have similar language.\(^{26}\) The Constitution itself provides that the President “shall nominate, and by and with the Advice and


\(^{22}\) See John Elwood, “OLC Opinion on Pro Forma Sessions and Appointments Published,” The Volokh Conspiracy (Jan. 12, 2012).

\(^{23}\) Id.

\(^{24}\) Id.


\(^{26}\) See, e.g., 28 U.S.C. § 133(a) (appointment of judges to federal district courts); 31 U.S.C. § 301 (appointment of Secretary of the Treasury); 22 U.S.C. § 2651a (organization of Department of State);
Consent of the Senate” appoint certain government officials, but that has not precluded presidents from making recess appointments without Senate consent. Such language has not served as a barrier to recess appointments in the past, and arguably does not raise a novel issue in the context of Cordray’s appointment.

Nevertheless, the question of whether proper Senate consent was given to the Cordray appointment may prove to be a central issue in the event Cordray’s appointment becomes the subject of legal challenges.

**Potential political and legal consequences**

Cordray’s appointment has caused backlash on Capitol Hill and in the financial industry, and will likely lead to one or more potential consequences. On Capitol Hill, Republican senators could filibuster all presidential appointments until President Obama rescinds the recess appointments. Senators could also stall the President’s legislative agenda or refuse to approve his budget requests. Such actions would add to the legislative gridlock that has become the status quo, and the implications for the CFPB are unclear because eventually Congress and the Administration would need to reach an agreement on CFPB leadership.

It is likely that there will be litigation challenging the CFPB’s actions and enforcement, particularly in light of the current lawsuits challenging President Obama’s appointments to the NLRB. Anyone filing a lawsuit would need to have standing, but challenges could potentially be brought by members of Congress, entities regulated by CFPB, or industry trade groups. An interested trade group could bring suit in the near future, or litigation could come in the form of individual entities challenging specific actions.

The increasingly likely outcome seems to be that firms targeted by CFPB regulation (i.e., nonbank financial institutions such as mortgage servicers and payday lenders), who would likely have standing, will file lawsuits challenging the constitutionality of Cordray’s appointment and potentially

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27 U.S. Const. art. II, § 2.

28 For example, President Bill Clinton made 139 recess appointments; President George W. Bush made 171. See Hogue, “Recess Appointments,” supra n. 13, at 1. See also Fisher, supra n. 5.

29 See discussion, supra n. 2. However, litigation challenging Cordray’s appointment may be delayed pending the outcome of the NLRB cases.
rendering invalid any CFPB actions under his directorship.\textsuperscript{30} Specifically, if the CFPB issues a regulation or enforcement order that depends on the authority of Cordray as director, a firm subject to such order or regulation could challenge the action in court.\textsuperscript{31} However, banks are generally unlikely to challenge their regulators in court, so if litigation is pursued, such litigation will likely be brought by nonbank institutions. The U.S. Chamber of Commerce, which includes many nonbanks that will be subject to CFPB authority, or other similar organizations, might also bring legal challenges to proactively protect members.\textsuperscript{32}

Although litigation seems to be a likely outcome of the appointment, there is hope that the Administration and Congress will reach a resolution acceptable to both sides. Despite the fact that recent years have shown the decline of political compromise between the two major parties, Cordray appears to be a candidate with bipartisan support\textsuperscript{33} and both sides may be able to reach a mutually agreeable solution.

\textsuperscript{30} Cordray’s appointment has not formally been challenged by members of the Senate or nonbank trade groups to date.
\textsuperscript{31} In testifying before the House subcommittee on January 24, Cordray said that the CFPB “will not hesitate to use enforcement actions to right a wrong.” See Wagner, “Consumer chief,” supra n. 4. A nonbank subject to such enforcement action may seek to challenge the action on the basis that Cordray’s appointment was unconstitutional, and thus, the CFPB had no authority to act.
WHAT IS GOOD FAITH? SUBJECTIVE AND OBJECTIVE STANDARDS FOR BANKS ACCEPTING PAYMENT ORDERS

by Mark E. Wilson and Jeremy D. Kerman

The Uniform Commercial Code ("UCC") contains several provisions incorporating the concept of "good faith." But what exactly does "good faith" mean? The Code originally defined "good faith" as "honesty in fact in the conduct or transaction concerned." See UCC § 1-201(19) (2006). While many in the banking industry are familiar with this subjective, "pure heart and empty head" standard, banking lawyers may be surprised to learn that the current uniform text imposes an objective standard as well as the traditional subjective one. This dual, subjective-objective standard of good faith applies to funds transfers under Article 4A of the UCC. The Federal Financial Institution Examination Council ("FFIEC") has established guidelines that may assist financial institutions in meeting the objective component of the good faith standard with regard to funds transfers, especially with regard to Internet schemes such as "phishing" frauds.

Article 4A of the UCC governs electronic funds transfers. In general, a payment order submitted by a customer to a financial institution must be authorized by the customer. Under Section 4A-202(b), however, even unauthorized payment orders are binding on the customer if (1) the bank and the customer agreed that the authenticity of the payment order will be verified pursuant to a security procedure; (2) the security procedure is commercially reasonable; and (3) the bank proves that it accepted the payment order in good faith, and in compliance with the security procedure and any written agreement or instruction of the customer.

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Under the current UCC definition, good faith means “honesty in fact and the observance of reasonable commercial standards of fair dealing.” UCC § 1-201(20) (2011). This definition has both subjective and objective components: “honesty in fact” is subjective, i.e. whether the individual knew, as a factual matter, that the transaction was unauthorized; while “reasonable commercial standards of fair dealing” imposes an additional objective standard, i.e. whether the individual’s actions were consistent with commercially reasonable standards of fairness. This new, dual subjective and objective standard imposes a potentially higher standard of conduct on parties than the earlier version of the Code that had only a subjective standard.

The UCC Official Comments to the new definition explain that “fair dealing” differs from a mere standard of ordinary care:

Although “fair dealing” is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed. This is an entirely different concept than whether a party exercised ordinary care in conducting a transaction.

UCC § 1-201 cmt. 20 (2011). How should financial institutions assure that they meet this objective component of the good faith standard with regard to funds transfers? Recent case law holds that the bank has the burden of proof as to good faith, and that FFIEC guidelines may be relevant to the issue.

In *Experi-Metal, Inc. v. Comerica Bank*, 2011 WL 2433383 (E.D. Mich. 2011), a bank customer, Experi-Metal, was the victim of a “phishing” attack. An Experi-Metal employee received an e-mail instructing the recipient to click a website link to complete a “Comerica Business Connect Customer Form.” The Experi-Metal employee clicked the link and entered confidential information for Experi-Metal’s on-line banking account with Comerica. The criminal third-party who sent the e-mail soon began initiating wire
transfer payment orders from one of Experi-Metal’s Comerica bank accounts. All in all, the crooks initiated ninety-three fraudulent payment orders totaling over $1.9 million to bank accounts, mostly located in Russia and Estonia. J.P. Morgan Chase reported the suspicious wires to Comerica, which then called Experi-Metal. Some of the transfers were successfully reversed, but the crooks ultimately got away with $561,399 of Experi-Metal’s funds.

Experi-Metal sued Comerica, alleging that the bank had debited its account pursuant to unauthorized funds transfer orders. The bank successfully claimed that it had followed commercially reasonable security procedures, but under Section 4A-202(b) the bank also had to prove that it had acted in good faith. The court found no evidence that any Comerica employee had acted dishonestly in accepting the fraudulent wire transfers, so the bank met the subjective, “honesty in fact” prong of the good faith standard. The question of whether the bank met the objective “observance of reasonable commercial standards of fair dealing” prong, however, was less clear.

Experi-Metal presented expert testimony that Comerica failed to meet industry standards in accepting the fraudulent wire transfers because the bank did not engage in fraud scoring and fraud screening that would have immediately stopped the wire transfers by recognizing certain variables and risk factors. The court was not persuaded by this expert testimony, but entered judgment against the bank anyway because the bank, rather than the customer, had the burden of proof on good faith and that the bank had not met the objective prong of the good faith standard.

According the this Michigan federal district court, a bank accused of sending an unauthorized funds transfer bears the burden of proving not only that it acted honestly in
fact when accepting funds transfer order, but that it has also observed reasonable commercial standards of fair dealing. How can a bank meet this burden? The *Experi-Metal* case suggests that compliance with FFIEC guidelines, if those particular guidelines have been implemented by other banks in the banking community, may constitute evidence of good faith.

The FFIEC’s Handbook on E-Banking was most recently revised in 2003 and is available at [http://ithandbook.ffiec.gov/it-booklets/e-banking.aspx](http://ithandbook.ffiec.gov/it-booklets/e-banking.aspx). The Handbook includes chapters on E-Banking Risks and Risk Management of E-Banking Activities, as well as appendices addressing, among other topics, “Laws, Regulations, and Guidance,” and “Wireless Banking.” While the guidelines are not mandatory, banks may wish to consider the guidelines as a possible method of meeting the objective prong of the good faith standard under UCC Article 4A.
Bank Owned Life Insurance (BOLI) and PLR 201152014

An Innovative Arrangement Poses Numerous Issues

By

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And

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BACKGROUND

Private Letter Ruling 201152014 (the “PLR”) describes a novel approach to managing Bank Owned Life Insurance (“BOLI”). This article outlines the most significant issues that counsel should call to the attention of bank management should they be considering participation in this untested arrangement.

The stated purpose of the transaction described in the PLR is to provide banks with a more effective, centralized way to manage BOLI and, where appropriate, either negotiate the terms of new replacement life insurance policies or renegotiate the terms of existing BOLI. Probably of at least equal importance, the conclusions in the PLR bless the arrangement as a structure that eliminates the income tax impediments to updating BOLI plans that otherwise would effectively prevent a bank from purchasing replacement life insurance coverage or renegotiating the terms of existing BOLI.

One of the unfortunate problems with updating BOLI plans is that doing so could cause the bank to lose interest deductions on its debt. The PLR concludes that the transaction, as

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4 For readers who may be unacquainted with it, BOLI is life insurance purchased by a bank on the lives of its employees. Employees are notified of the proposed purchase of the life insurance and asked to provide their written consent to their lives being insured. The bank pays the premiums and is the owner and beneficiary of the BOLI. Banks purchase BOLI because the cash flows from a BOLI policy are generally income tax-free if the institution holds the policy for its full term. BOLI can provide attractive tax-equivalent yields and is used by banks to help offset the rapidly rising cost of providing employee benefits.
5 Congress changed the law in 1997 to reduce the interest deduction on debt by the percentage that any BOLI holdings purchased thereafter on the lives of non-employees bears to the bank’s total assets. New BOLI exchanged
structured, does successfully eliminate the risk that banks holding minority interests in the LLC will lose those interest deductions but it does not address many other concerns to which the proposed transaction may give rise.

OVERVIEW

An experienced BOLI insurance professional created a limited liability company (the “LLC”) in which he assumed the role of “Managing Member.” The LLC is managed by the Managing Member in conjunction with a “Management Committee” on behalf of (initially) two Member Banks (Bank A and Bank B). The stated intent is that additional banks will join the LLC in the future.

Banks will transfer General Account and Separate Account BOLI covering both current and former bank employees to the LLC in exchange for “Membership Interests” (partnership interests for federal tax purposes) subject to the following conditions:

1. The BOLI must have been in force at least five years;
2. The BOLI was issued pursuant to insureds’ notice and written consent; and
3. The arrangement must not be used by any bank to justify increasing the amount of BOLI otherwise permitted under bank regulatory rules.

The LLC will then be the owner and beneficiary of the BOLI.

The Banks will receive “Membership Percentages” in proportion to their BOLI contributions which will determine their share in the capital and profits of the LLC. Membership Interests are neither redeemable nor transferable without the consent of the Managing Member, which ordinarily will not be given except in rare and extraordinary circumstances. Any transferee must be a banking institution.

The Managing Member and the Management Committee will:

1. Review the BOLI to determine whether any of it should be replaced (most, if not all, likely will be replaced with new life insurance coverage);
2. Select insurance companies and negotiate the terms of any new policies;
3. Administer the life insurance holdings;

for old BOLI would be deemed to have been purchased on the lives of non-employees in the case of any insureds who had terminated employment subsequent to the purchase of the original BOLI.

The restrictions on redemptions and transfers are rather extraordinary; their purpose is not explained in the PLR. We can speculate, however, that these provisions are intended to prevent any single bank from becoming a majority owner of the LLC, a result which would defeat the beneficial income tax result of the arrangement and thereby cause that bank to lose interest deductions on its debt.
4. Allocate contract values among investment options (where applicable);

5. Issue periodic reports to the banks; and

6. Distribute death benefits and other cash flows pro rata among the Member Banks in accordance with their Membership Percentages.

It may be observed that, prior to transferring their policies to the LLC, the banks unquestionably own BOLI. Characterization of the banks’ Membership Interests after the transfer may not be so clear. As is discussed below, the transfer creates a bank asset which has numerous characteristics that are not attributes of a bank’s BOLI holdings.

**ISSUES TO BRING TO THE ATTENTION OF BANK MANAGEMENT**

Before any bank participates in an arrangement such as this, counsel should call bank management’s attention to the numerous issues left unaddressed by the PLR, the most important of which are:

1. **Bank regulatory issues** are posed for Member Banks under the LLC structure.

   **OCC 2004-56a, Interagency Statement on the Purchase and Risk Management of Life insurance (December 7, 2004) (“OCC 2004-56a”)**, provides general guidance for banks and savings associations regarding supervisory expectations for the purchase and risk management of BOLI. OCC 2004-56a provides, in pertinent part:

   The safe and sound use of BOLI depends on effective senior management and board oversight. Regardless of an institution’s financial capacity and risk profile, the board must understand the complex risk characteristics of the institution’s insurance holdings and the role this asset is intended to play in the institution’s overall business strategy. Although the board may delegate decision-making authority related to purchases of BOLI to senior management, the board remains ultimately responsible for ensuring that the purchase and holding of BOLI is consistent with safe and sound banking practices.

   An institution holding life insurance in a manner inconsistent with safe and sound banking practices is subject to supervisory action. Where ineffective controls over BOLI risks exist, or the exposure poses a safety and soundness concern, the appropriate agency may take supervisory action against the institution, including requiring the institution to divest affected policies, irrespective of potential tax consequences.\(^7\)

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\(^7\) OCC 2004-56a at p. 5.
It is far from clear how a bank could participate in the LLC and still comply with the explicit statement that an institution “should not delegate its selection of product design features to its vendors.”

OCC Bulletin 2002-19, Unsafe and Unsound Investment Portfolio Practices (May 22, 2002) ("OCC Bulletin 2002-19"), alerts banks to the risk of poor investment decisions and emphasizes the importance of maintaining prudent credit, interest rate, and liquidity risk management practices to control risk in the bank’s BOLI investment portfolio. OCC Bulletin 2002-19 provides, in pertinent part:

This bulletin alerts banks to the potential risk to future earnings and capital from poor investment decisions made at the current low level of interest rates. It emphasizes the importance of maintaining prudent credit, interest rate, and liquidity risk management practices to control risk in the investment portfolio. [Emphasis added.]

* * *

Bank-Owned Life Insurance (BOLI). A number of banks have begun to use BOLI as a means of protecting against the loss of key employees or hedging employee compensation and benefit plans. As detailed more thoroughly in OCC Bulletin 2000-23, “Bank Purchases of Life Insurance: Guidelines for National Banks,” dated July 20, 2000, banks purchasing BOLI must demonstrate and document a thorough understanding of the risks associated with this product. Management must determine the need for insurance by identifying the specific risk of loss or obligation to be insured against, quantifying the amount of insurance needed, and performing a careful review of vendors and carriers.

In addition to the credit risk associated with this typically long tenor asset, BOLI presents potential volatility to earnings and capital due to liquidity and tax considerations. Although banks can surrender their BOLI policies for their cash surrender value, they typically would incur substantial losses to do so. Moreover, a determination that the policies do not satisfy insurable interest requirements may result in a forced cancellation, and/or jeopardize the tax-free status of the accumulation of cash surrender value, thereby negatively impacting the originally anticipated return. Because of heightened liquidity, credit and tax risks, purchasing or holding excessive BOLI represents an unsafe and unsound banking practice.

Given the complete transfer of control of its BOLI to the Managing Member and the Management Committee and the lack of liquidity (discussed below) of Membership Interests in the LLC, it may be difficult for a bank to transfer BOLI to the LLC and still meet its obligations under OCC Bulletin 2002-19.

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8 Id. at p.7.
9 Id. at pp. 1 and 7.
2. **Lack of liquidity** could be a serious concern for bank management.

The PLR indicates that the LLC will acquire all ownership rights in the BOLI that is transferred to it. Only the LLC will have the right to surrender the BOLI for cash after the exchange of the BOLI for Membership Interests since Member Banks will have relinquished that right.

3. **Accounting issues** are posed for Member Banks by the exchange of BOLI for a Percentage Interest in the LLC.

   *Financial Accounting Standards Board (“FAS”) Technical Bulletin 85-4, Accounting for Purchases of Life Insurance (November 14, 1985)* provides that, with respect to its BOLI holdings, the bank reports as an asset on its balance sheet the amount that could be realized upon cash surrender of the life insurance contract. Given the fact that Membership Interests will be neither redeemable nor transferable without the consent of the Managing Member, which ordinarily will not be given except in rare and extraordinary circumstances, the applicability of Technical Bulletin 85-4 seems unclear at best and the appropriate amount of asset to report on the Member Bank’s balance sheet could be more a function of the Member’s equity interest in the LLC rather than any interest in BOLI.

   Cash will be distributed only when death proceeds are received (or if the policy is otherwise disposed of based upon a decision of the Managing Member and the Management Committee to do so). The bank may well be exchanging an asset with “smooth” changes in value for an asset that can be reported only when deaths occur with “lumpy” financial results on its income statement.

   *FAS Accounting Standards Update (“ASU”) 2009-12, Fair Value Measurements and Disclosures (Topic 820), Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent) (September, 2009)* does not apply to either the BOLI or (for Separate Account BOLI) its underlying separate account investments. After its BOLI is transferred to the LLC, however, a bank probably will realize a change in accounting under ASU 2009-12 since the Standard likely will apply to the ownership of an interest in the LLC.

   *FAS Statement of Financial Accounting Standards 157, Fair Value Measurements (September, 2006) (“FAS 157”)* establishes a three level fair value hierarchy as a basis for considering market participant assumptions in fair value measurements of assets and liabilities. FAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements of assets and liabilities. The expanded disclosures about the use of fair value to measure assets and liabilities are intended to provide users of financial statements with better information about the extent to which fair value is used to measure
recognized assets and liabilities, the inputs used to develop the measurements, and the effect of certain of the measurements on earnings (or changes in net assets).

FAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels for the purpose of increasing consistency and comparability in fair value measurements and related disclosures. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

BOLI generally is classified at Level 2 in that hierarchy although some would argue that BOLI can be classified at Level 1. It is not clear that the investment in the LLC will be classified at Level 2, with the possibility of classification at Level 3.

4. **Lack of transparency** may well prove troubling because Member Banks may have limited ability to influence decisions.

   It is not clear from the PLR whether all LLC members will have a representative on the Management Committee. If not, it is not clear how Committee membership will be determined. The PLR does not explain whether Management Committee members get equal votes or, if all LLC members are represented, whether they vote their Membership Percentages. Likewise, the PLR does not explain how many votes the Managing Member will have. Regardless of the resolution of those open questions, it may be difficult for the Management Committee to be able to react sufficiently promptly in a fast-changing and volatile economic environment to satisfy Member Banks’ regulatory obligation to engage solely in safe and sound banking practices. Moreover, a likely result of the decision-making framework is that individual bank interests will be sacrificed to the common-denominator interest of all bank members.

5. **Conflicts of interest** may arise if the Managing Member is an insurance broker who will make decisions about replacing the old BOLI with new life insurance. If the Managing Member is in a position to realize, directly or indirectly, any additional compensation as a result of policies being replaced, a strong system of checks and balances must be in place to ensure that Member Banks’ interests are held foremost at all times.

6. **State insurance law issues** are crucial.

   **Insurable Interest** rules are a major barrier to the replacement of BOLI in the LLC on the lives of non-employees (*i.e.*, persons not employed by the LLC), particularly those persons who have terminated employment and are not active employees of a Member Bank at the time the new insurance coverage is issued.

   Insurable interest is an essential prerequisite to valid BOLI under state insurance law. The insurable interest statutory provisions blessing BOLI have been enacted over many years and only after prolonged discussions over the propriety of corporations purchasing
life insurance on the lives of employees other than key employees. As a general rule, a lack of insurable interest will cause a court either to (a) find the BOLI to be void ab initio (generally requiring a return of premiums to the bank and loss of the BOLI asset) or (b) enforceable in favor of the estate of the insured. The adverse financial implications to the bank would be significant under either scenario.

For BOLI purchases, most states require an employment relationship as well as notice and consent as conditions precedent to the existence of an insurable interest. (Also, without regard to state insurable interest rules, the major insurance companies require that prospective insureds be given written notice and the opportunity to provide written consent to being covered under a BOLI policy as a matter of best practice.) Even if state insurable interest barriers are overcome, a number of insureds will have terminated their employment with the bank transferor prior to the transfer of the BOLI to the LLC and the subsequent policy exchange. It will be difficult, if not impossible, to locate those people in order to provide them notice of the new coverage and obtain their written consent.

**Stranger Owned Life Insurance (STOLI)** prohibitions being enacted by several states pose additional concerns.

STOLI is a controversial arrangement involving life insurance that, after it has been issued, is acquired by a third party who does not have an insurable interest in the life of the insured. The STOLI transaction takes advantage of the fact that once a life insurance contract has been purchased by a person or entity possessing an insurable interest in the life of the insured (as in the case of BOLI on the lives of a bank’s employees), the owner can then transfer the life insurance contract to another person not possessing an insurable interest in the life of the insured, since the insurable interest standard for life insurance need only be met at time of policy issue. A typical STOLI transaction features an elderly insured who is persuaded to sign an application for life insurance and, for a fee, assign ownership to an investor with the understanding that the investor will become the policy beneficiary and pay future premiums.

Even “normal” BOLI is subject to some hostility from bank employees, regulators, and the general public (because it is seen in some quarters as an arrangement whereby the banks profit from the deaths of employees). Because bank regulations require that it be purchased only in support of employee benefit liabilities, “normal” BOLI, however, has a reasonably rational relationship between the life insurance death benefits and the employee benefits being supported by the bank’s BOLI asset.

Bank regulators may have cause for concern under the arrangement described by the PLR since the life insurance held in the LLC will cover the lives of individuals who have never been employed by the Member Bank (and, therefore, have not and will not receive employee benefits from the Member Bank). Unlike “normal” BOLI, that life insurance

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10 Id. at p. 2.
will have no rational relationship to the employee benefits liabilities justifying the product from a bank regulatory perspective.

Moreover, adverse publicity and/or lawsuits could now emerge based on the view that the banks are profiting from the deaths of individuals who have never had any employment relationship, or in many cases likely never had any relationship, with the bank.

7. **Important tax issues** are omitted from the ruling.

    **Transfer for value:** The exchange of an interest in the LLC for the BOLI may create a transfer for value under section 101(a)(2) of the Internal Revenue Code of 1986, as amended (the “Code”), thereby risking loss of the tax-free receipt of death benefits. This is an untested area of the tax law that would require its own private letter ruling in light of the significant dollar amounts at risk and dependent on the answer.

    **Estate tax implications:** Life insurance contracts are included in the taxable estate of insured decedents who either possessed “incidents of ownership” in those contracts at death (pursuant to Code section 2042) or who possessed incidents of ownership within three years of death in the case of an assignment of the life insurance contracts to a third party such as an irrevocable life insurance trust (pursuant to the three year throwback rule under Code section 2035). Incidents of ownership include the right to name a beneficiary, the right to make policy loans and the right to transfer ownership of the policy.

    The written consent by an insured employee authorizing the purchase of BOLI by an employer and authorizing designation of the bank as the beneficiary of the BOLI that is required by the insurable interest rules, as well as the tax rules, authorizes bank ownership of the BOLI and bank designation as beneficiary under the BOLI. Consequently, the consent has the hallmarks of those two incidents of ownership (i.e., transfer of ownership to the bank and designation of the bank as beneficiary).

    New written consents from the insureds granting permission for the LLC to be the owner and beneficiary of the new life insurance policies (which, as previously discussed, are generally required under state insurance law and by life insurance companies) could be seen to constitute the exercise of an incident of ownership that invokes the three year throwback rule, thereby risking that the insurance will be thrown into the insured’s estate if the insured dies within three years of the consent. This is a tax issue that has not been addressed in any IRS rulings.

8. **Insurance carrier rules and BOLI contract restrictions** must be considered.

    Most insurers have internal rules that may preclude them from giving their ready consent to the transfer of the BOLI policies to the LLC. The insurers make their own determinations whether the BOLI transfer to the LLC meets all of the insurer’s
requirements, does not compromise any of the insurer’s guarantees and is permitted under the terms of the BOLI contracts.

Loss of the insurer’s guarantees would be a very serious matter having significant implications under the regulatory requirement that banks engage in safe and sound banking practices. Best of class BOLI contracts include numerous guarantees including:

a. Guarantee of compliance with the insurable interest rules,
b. Guarantee of compliance with applicable tax rules (essentially a guarantee that there is a “tax deferred” inside buildup and there will be tax free death proceeds),
c. Guarantee that death proceeds will be paid to the bank even if a family member sues to divert those death proceeds under insurable interest principles,
d. Guaranteed defense of lawsuits involving the above issues at the sole expense of the insurance company, and
e. Guaranteed reimbursement of taxes incurred in the event that the BOLI tax benefits are lost.

Unless clarity can be achieved around the open income tax and state insurance law issues, it is doubtful that an insurer will be willing to mirror existing BOLI guarantees in the new coverage acquired by the LLC. A refusal of the insurance companies to provide those guarantees when the purchase decision for the new life insurance policies is being made should be a red flag suggesting that the purchase is not consistent with safe and sound banking practices.

Furthermore, many Separate Account BOLI policies include stable value agreements designed to eliminate earnings volatility created by fluctuating separate account asset values. Given the explicit provisions in stable value agreements prohibiting tax free exchanges, it is unlikely that the LLC can implement the exchange of the old BOLI for new policies without a market value adjustment and a corresponding financial impact on the LLC financial statements.

9. **Forum shopping issues** arise for the LLC.

It is not clear from the PLR whether the Managing Member established the LLC in a state which is both sympathetic to BOLI and accepting of the LLC. Similarly, it is not clear whether the choice of law specified in the BOLI contracts will be the same as the law governing the LLC.

Courts have applied the law of the state in which the insured resides frequently when resolving disputes over the applicable law, based on the view that the state in which an insured resides has the primary interest in determining whether a life insurance policy is a prohibited wagering contract on the life of that insured. Given the typical approach employed by the courts in addressing the choice of law issue, the insurance laws of the state of residence of an insured may apply rather than the laws of the jurisdiction in which the LLC was formed.
For example, in addressing the choice of law issue where a Corporate Owned Life Insurance (COLI)\textsuperscript{11} contract was issued in Georgia on the life of a Texas resident, the Federal District Court for the Southern District of Texas, Houston Division stated in \textit{Mayo v. Hartford Life Ins. Co.}\textsuperscript{12}:

Defendants argue that Georgia law -- which Defendants contend does not recognize Plaintiffs' causes of action -- governs this dispute. Alternatively, Defendants (led by Wal-Mart) argue that if Georgia law is not selected, then the law of Arkansas, North Carolina, or Delaware applies. In any event, Defendants contend that Texas has no material connection to the dispute and Texas law does not govern. In response, Plaintiffs argue that Texas state courts would apply the Texas common law insurable interest doctrine to Defendants' COLI policies on the lives of Texas citizens. **\* \* The Court concludes, after the detailed analysis set forth below, that Texas courts would select Texas law to decide this case. Thus, the Court will apply the Texas insurable interest doctrine. The Court also rejects Wal-Mart's contention that the law of the states of Arkansas, North Carolina and/or Delaware, states with which at least one of the parties is connected, should be applied.

As can be seen, the choice of law question will be an important consideration for any new life insurance policies issued to the LLC.

10. **The Financial realities of costs of acquisition** (primarily state premium tax, the so-called “DAC tax” and possibly policy loads associated with broker compensation) that will be incurred in the course of replacement can make it difficult to justify a policy exchange financially.

In light of the costs of acquisition, even poorly-priced BOLI often performs better than newly-issued insurance with competitive pricing. If, as is often the case, the existing BOLI can be restructured or updated in some manner with an eye toward improving financial performance, the performance gap discouraging a replacement might even be greater.

Updating BOLI rather than replacing it generally is preferable, since doing so can often be accomplished at far lower financial cost and with far fewer state insurance law and tax challenges.

\textsuperscript{11} BOLI is COLI since banks are corporations. The acronyms can be used interchangeably with respect to life insurance purchased by banks on the lives of employees. BOLI is the acronym typically used in the context of bank ownership of these policies.

11. **The financial implications of pro rata distribution of death benefits** present potential disadvantages.

    Whether policies are experience-rated or fixed-rated, rates of death among the insured group will affect financial results. Experience-rated contracts (where mortality charges are adjusted retrospectively to recognize differences, within a prescribed corridor, between the actual and the expected number of deaths) often deliver better financial performance if death rates are low whereas fixed-rated contracts (where mortality charges are set at issue and do not change regardless of actual death rates) deliver better financial performance if death rates are high.

    By spreading the financial performance of the BOLI among all Member Banks, a bank will lose the benefit of its bargain to the extent that favorable financial results generated under policies covering its own insured employees is allocated away from the bank in question.

**CONCLUSION**

    The LLC discussed in *PLR 201152014* is without precedent. The issues for banks considering participation in such a structure are wide-ranging and complex. The foregoing summaries touch on just some of the most important issues and are not exhaustive of the questions that need to be addressed. The potential for unintended consequences is significant.

    Counsel should advise their bank clients to proceed only after obtaining advice from qualified independent professional advisors who are knowledgeable in the relevant bank regulatory, financial accounting/reporting, state insurance law and tax rules bearing on the decision, do not have any personal interest in the success of the LLC and do not have any transaction-related financial interest in the replacement of the bank’s BOLI.