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Abstract

This article discusses and analyzes three distinct legal doctrines available to the Office of the Comptroller of the Currency (the "OCC" or the "Office") to issue policy statements and interpretive letters enabling banks to participate in transactions designed to restructure developing-country debt. Additionally, this article comments on Regulation K, promulgated by the Federal Reserve Board (the "Board"), which the Board twice amended in recent months to grant U.S. banks more investment flexibility in foreign operations.

REGULATORY ASPECTS OF DEVELOPING NATION DEBT-EQUITY SWAPS

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I. *ECONOMIC AND FINANCIAL OVERVIEW*

At the middle of 1988, commercial bank lending to the world's fifteen most heavily indebted countries[1] totaled approximately US$400 billion, nearly all floating rate and denominated in U.S. dollars.[2] U.S. commercial banks held slightly more than US$70 billion of the troubled developing countries' debt with Japanese and European banks and other nonbank financial institutions around the world accounting for the balance.[3] Total foreign debt held by U.S. commercial banks at the end of 1987 equaled US$291 billion, having declined steadily from a peak of US$359 billion in December 1983.[4] As a percent of total U.S. bank capital,[5] foreign exposure likewise fell from a high of 499% in 1982 to 255% at the

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1. The "Baker 15" countries, originally designated by Secretary of the Treasury James Baker III in 1986, consist of Argentina, Brazil, Chile, Mexico, the Philippines, Bolivia, Colombia, Ivory Coast, Ecuador, Morocco, Nigeria, Peru, Uruguay, Venezuela, and Yugoslavia. Dullforce, *Creditors Urged to Assist Heavily Indebted Nations*, Fin. Times, Sep. 2, 1988, at 1, col. 3.

2. Statistical information provided by the Office of the Comptroller of the Currency.

3. For purposes of calculating total country exposure of principal accounts owed, the debt obligations of both public sector and private borrowers are aggregated.

4. R. Clarke, Statement of the Comptroller of the Currency before the Committee on Banking, Housing, and Urban Affairs, United States Senate 7 (May 25, 1988) [hereinafter Comptroller's Statement] (available at the *Fordham International Law Journal* office).

5. Bank capital, or primary capital, is defined to include the following balance

end of 1987.[6] This decrease over the last five years resulted from two factors: a US$58 billion increase in capital and a US$61 billion decline in total foreign lending.[7]

Despite the substantial decrease in overall U.S. commercial bank exposure to the most troubled developing countries and to foreign borrowers generally, the twenty-nine largest federally-chartered U.S. commercial banks[8] reported a 50% increase in 1987 over 1986 for non-performing assets as a percent of total assets.[9] Accordingly, non-performing assets held by these twenty-nine largest national banks rose from 2.4% in 1986 to 3.59% in 1987, with the increase largely attributable to the banks' developing-country loans.[10] Testifying to the magnitude of the developing country problem for U.S. banks, Chase Manhattan Corporation, the second largest banking institution in the United States, recently reported to its shareholders that "the largest uncertainty facing Chase and the entire banking system remains the outlook for LDC debt, particularly in Latin America."[11]

In October 1985, Secretary of the Treasury James A. Baker III, announced a comprehensive initiative (the "Baker Initiative") for addressing the problems in troubled developing countries of excessive debt, slow economic growth, and inadequate management of local economies.[12] From 1985

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sheet items: shareholders' equity, undivided profits, earned surplus, and allowance for loan and lease losses.

6. Comptroller's Statement, *supra* note 4, at 7.

7. *Id.*

8. At the end of 1987, some 29 national banks held total assets of more than US$10 billion. The following institutions, all regulated by the Office of the Comptroller of the Currency (the "OCC"), fall into this category: Fidelity Bank, N.A.; Seattle-First National Bank; Connecticut National Bank; First Fidelity Bank, N.A.; Texas Commerce Bank, N.A.; National Westminster Bank, USA; Citizens & Southern National Bank; Wachovia Bank & Trust Company, N.A.; Sovran Bank, N.A.; Citibank South Dakota, N.A.; Southeast Bank, N.A.; Bank of New England, N.A.; National Bank of Detroit; Pittsburgh National Bank; North Carolina NB of NC; First Union National Bank, NC; First Bank, N.A.; Republic National Bank of New York; First RepublicBank Dallas, N.A.; Marine Midland Bank, N.A.; Mellon Bank, N.A.; First National Bank of Boston; Continental Illinois NB&TA; First National Bank of Chicago; Wells Fargo Bank, N.A.; Security Pacific National Bank; Bank of America NT&SA; Chase Manhattan Bank, N.A.; Citibank, N.A.

9. Comptroller's Statement, *supra* note 4, at 7.

10. *Id.*

11. CHASE MANHATTAN CORP., 1987 ANNUAL REPORT 4 (1988).

12. Program For Sustained Growth: Joint Annual Meeting of the International Fund and the World Bank 3 (Oct. 8, 1985) (statement of Secretary of the Treasury

through mid-1988, holders of nearly US$8 billion of developing-country debt with a history of non-performance, payment interruption, or rescheduling of original principal and interest obligations have exchanged that debt for equity ownership interests in a variety of public and private investments situated within the developing countries. The benefits of debt-for-equity ("debt-equity") conversion redound both to debtor and creditor and advance the major goals of debt management: improved economic performance and long-term growth for the developing country, and reduced vulnerability to risk on developing-country loans for the international banking system.[13] Creditors exchange non-performing assets with market values less than the original contractual amount for equity ownership interests in productive enterprises. If successful, this allows creditors to recover their original investment and, in addition, offers the potential for appreciation, protected in part from the severe inflation experienced by many debtor countries. As the burden of debt service declines, a developing country may also expect to devote more of its resources to growth of the internal economy and thereby contribute to a more favorable economic environment for local businesses.

By rebuilding their capital generally and through specific provisions for loan losses, banking institutions have been able to reduce the percentage of capital at risk in developing-country loans. In the second quarter of 1987, banks set aside more than US$12 billion.[14] From the end of 1982, when the first Mexican rescheduling awakened the world to the seriousness of the debt crisis, to the end of 1987, the exposure of nine U.S. money centers to the most heavily indebted developing countries fell from 212% of primary capital to 90%.[15]

Supportive of the Baker Initiative, federal financial regulators have taken steps to assist banks in restructuring their portfolios of troubled developing-country debt. We discuss and analyze below three distinct legal doctrines available to the Of-

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James Baker III), *reprinted in* Comment, *Treasury Secretary James Baker's "Program for Sustained Growth" for the International Debt Crisis: Three Steps Toward Global Financial Security*, 4 DICK. J. INT'L L. 306 (1986).

13. *See* Frydl & Sobol, *A Perspective on the Debt Crisis, 1982-87*, in FED. RESERVE BANK OF N.Y., SEVENTY-THIRD ANN. REP. 5 (1988).

14. *See supra* note 2.

15. *Id.*

fice of the Comptroller of the Currency (the "OCC" or the "Office") to issue policy statements and interpretive letters enabling banks to participate in transactions designed to restructure developing-country debt. Additionally, we comment on Regulation K,[16] promulgated by the Federal Reserve Board (the "Board"), which the Board twice amended in recent months to grant U.S. banks more investment flexibility in foreign operations.[17]

II. *DPC POWERS OF NATIONAL BANKS*

A. *Real Estate*

As early as 1791, when the First Congress of the United States considered the scope of permissible banking powers, the doctrine of "debts previously contracted" ("DPC") became recognized as an exception to the Hamiltonian view that money, not land, should constitute the primary security underlying a national bank.[18] Due to its illiquidity, Treasury Secretary Hamilton thought real property generally unsuitable as security.[19] Twenty-five years later, on chartering the Second Bank of the United States, Congress perpetuated the DPC doctrine as an exception to the general rule favoring liquid portfolio assets.[20]

Codifying national banks' ability to own equity interests in real estate, the National Currency Act of 1863[21] officially recognized DPC and did not restrict the time period for retention of DPC real estate.[22] One year later, however, the National Bank Act of 1864[23] imposed on banks a five-year limitation,

16. 12 C.F.R. pt. 211 (1988).

17. 52 Fed. Reg. 30,914 (1987), *amended by* 53 Fed. Reg. 5358 (1988) (to be codified at 12 C.F.R. § 211.5(f)).

18. *See* Act Incorporating Bank of U.S., ch. 10, § 7(VIII), 1 Stat. 191 (1791) (expired). Restrictions on the power to hold real estate originated in the charter of the First National Bank of the United States. However, included in that same charter was the power to hold real estate "conveyed to it in satisfaction of debts previously contracted in the course of its dealings." *Id.*

19. *See* SENATE COMM. ON BANKING AND CURRENCY, 88TH CONG., 1ST SESS., FEDERAL BANKING LAWS AND REPORTS, 1780-1912, at 24-25 (Comm. Print 1963).

20. Act Incorporating Bank of U.S., ch. 44, § 11(7), 3 Stat. 266, 271-72 (1816) (expired).

21. National Currency Act of 1863, ch. 58, 12 Stat. 665. The 1863 Act was subsequently revised and reenacted by the National Bank Act of 1864. *See infra* note 23.

22. *Id.* § 14, 12 Stat. at 669.

23. National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified as amended in

responding to a concern that an indefinite holding of equity real estate could transform a bank into "a monopoly in the acquisition of real estate . . . ."[24] Without substantive modifications to the DPC provision, the 1863 and 1864 Acts have for the last 125 years defined the circumstances under which national banks could own interests in real property other than bank premises. The modern section 29 provides that banks can hold and convey title to real estate in two circumstances: (1) for the transaction of business (i.e., business premises) and (2) as a result of debts previously contracted.[25]

In 1980, Congress amended section 29[26] by granting the Comptroller of the Currency discretion to approve a bank's holding of real estate for a period longer than five years if the bank makes a good faith attempt to dispose of the property within the first five years or if disposal within the first five years would be detrimental to the bank.[27]

More than a century ago, the U.S. Supreme Court announced three cautions in justifying the general restrictions placed by statute on national banks' ownership of real property. "[I]t was to keep the capital of the banks flowing in the daily channels of commerce; to deter them from embarking in hazardous real estate speculations; and to prevent the accumulation of large masses of such property in their hands, to be

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scattered sections of 12, 19, 31 U.S.C.). For a discussion of the convoluted legislative history of the National Bank Act, see Levin, *In Search of the National Bank Act*, 97 BANKING L.J. 741 (1980).

24. CONG. GLOBE, 38th Cong., 1st Sess. 2020 (1864).

25. 12 U.S.C. § 29 (1982). Pursuant to 12 U.S.C. § 29, national banks may hold real estate only for the following purposes:

> First. Such as shall be necessary for its accommodation in the transaction of its business.
>
> Second. Such as shall be mortgaged to it in good faith by way of security for debts previously contracted.
>
> Third. Such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings.
>
> Fourth. Such as it shall purchase at sales under judgments, decrees, or mortgages held by the association, or shall purchase to secure debts due to it.

Id. The OCC has promulgated regulations, codified at 12 C.F.R. §§ 7.3020, 7.3025 (1988), which implement the above provisions.

26. Depository Institution Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 [hereinafter DIDA].

27. *Id.* § 701, 94 Stat. at 186.

held . . . in mortmain."[28]

Guided by these three broad judicial cautions and consistent with long-standing statutory authority, recent OCC interpretive letters adhere to the principle that exchanges of debt for real estate are permissible when banks act in good faith to salvage doubtful loans. Real estate speculation, on the other hand, provides no basis for justifying the use of DPC.[29]

B. *Securities*

Legal authority permitting banks to acquire securities, both shares of stock and debt obligations, in satisfaction of debts previously contracted or in settlement of disputed claims, emanated originally from case law. In affirming the right of a national bank to accept shares of stock in a railroad, a bank, and a coal mining company in partial satisfaction of a non-performing loan, the U.S. Supreme Court in 1876 granted national banks the authority to transact "all such incidental powers necessary to carry on . . . . " the business of banking.[30] The Court stated:

> In the honest exercise of the power to compromise a doubtful debt owing to a bank, it can hardly be doubted that stocks may be accepted in payment and satisfaction, with a view to their subsequent sale or conversion into money so as to make good or reduce anticipated loss. Such a transaction would not amount to dealing in stocks. . . . Of course, all such transactions must be compromises in good faith, and not mere cloaks or devices to cover unauthorized practices.[31]

Sixty-one years later, a unanimous Supreme Court of Ala-

28. Union Nat'l Bank v. Matthews, 98 U.S. 621, 626 (1878); *see* First Nat'l Bank v. Comptroller of the Currency, 697 F.2d 674, 681 (5th Cir. 1983).

29. *See, e.g.*, OCC Interpretive Letter from W.R. Dehnke, Senior Attorney (Jan. 21, 1983) (available from Communications Office, Office of the Comptroller of the Currency) (since purpose of 12 U.S.C. § 29 was to prevent real estate speculation by national banks, bank's purchase of non-DPC parcel adjacent to already owned DPC real estate was found illegal); OCC Interpretive Letter from J.E. Shockey, Deputy Chief Counsel (Oct. 2, 1975) (available from Communications Office, Office of the Comptroller of the Currency) (bank could not "secure" US$75,000 of US$375,000 debt by advancing US$350,000 to purchase property owned by third party in debt to bank's borrower, with subsequent intent to resell at US$75,000 profit).

30. First Nat'l Bank v. Nat'l Exchange Bank, 92 U.S. 122, 127 (1875); *see* John A. Roebling Sons' Co. v. First Nat'l Bank, 30 F. 744 (D.W. Va. 1887).

31. First Nat'l Bank v. Nat'l Exchange Bank, 92 U.S. at 128.

bama interpreted the forerunner of 12 U.S.C. § 24(7) to permit the First National Bank of Birmingham to endorse a note held as security, and thereby convert it into a negotiable instrument (a modern day investment security), in satisfaction of a borrower's failure to perform. The court held: "[W]e do not think the restriction on the business of dealing in securities by buying and selling them was intended to be a restriction on negotiating promissory notes taken and sold in ordinary bank transactions . . . ."[32]

Regulations issued by the OCC, moreover, clearly permit banks to hold securities DPC and distinguish the investment securities limitation from permitted DPC transactions: "The restrictions and limitations of this part [12 C.F.R. Part 1] do not apply to securities acquired through foreclosure on collateral, or acquired in good faith by way of compromise of a doubtful claim or to avoid a loss in connection with a debt previously contracted."[33]

Recent OCC interpretive letters likewise allow banks to acquire and hold securities DPC. In an interpretive letter dated December 12, 1973, the Office reviewed statutory and regulatory precedent in finding that national banks may "acquire the stock of any corporation to prevent loss on a debt previously contracted in good faith."[34] This letter recognized a five-year holding period for corporate shares[35] and a two-year holding period for shares of affiliate banks acquired DPC.[36]

In another OCC interpretive letter,[37] the Office reviewed the foreclosure rights of three national banks that participated in a US$5.5 million loan to a corporate debtor. When the

32. Bouchelle v. First Nat'l Bank, 233 Ala. 598, 599, 173 So. 83, 84 (1937).

33. Regulation 1, Investment Securities, 12 C.F.R. § 1.12 (1988).

34. OCC Interpretive Letter from J.D. Gwin, Deputy Comptroller of the Currency (Dec. 3, 1973) (available from Communications Office, Office of the Comptroller of the Currency).

35. The five-year time limitation on holding securities DPC may be traced to a similar limitation contained in 12 U.S.C. § 29 (real estate), prior to its amendment by DIDA, *supra* note 26, in 1980.

36. *Accord* OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK FOR NATIONAL BANK EXAMINERS § 203.1 (1982). A bank's own stock may be received DPC, with the limitation that it be held no more than six months. *See* 12 U.S.C. § 83 (1982).

37. OCC Interpretive Letter from J.E. Shockey, Deputy Chief Counsel (Feb. 3, 1976) (available from Communications Office, Office of the Comptroller of the Currency).

debtor declined to honor the terms of various share repurchase agreements with the banks and individual bank directors, the Comptroller found that purchasing additional (minority) shares owned by individual directors would facilitate an ultimate sale of the entire debtor corporation. Accordingly, the Office held DPC applicable to the acquisition by the national banks of shares in a debtor corporation (1) taken as collateral from the corporation and (2) through individual purchase arrangements with individual directors of the banks.

C. *Expansions and Limitations of DPC Power*

1. Condition of the Debt

OCC precedents stop short of requiring that a loan be in default in order to invoke the doctrine. However, the loan must be in a *very poor condition* with DPC action necessary to prevent *imminent loss*.

Construing 12 U.S.C. § 29, another interpretive letter, dated July 2, 1973, addressed a construction and real estate lending transaction where no loans were yet in default.[38] The creditor national bank, however, projected US$2-5 million of payment shortfalls by the borrower and estimated the borrower's net worth to be negative US$15 million. To achieve an orderly liquidation of indebtedness, the Office approved the bank's proposal to purchase eight parcels of land on which it held mortgages at 90% of appraised value, requiring a payment of US$2.85 million of new cash. Relying on both paragraphs three (DPC authority) and four (foreclosure/judgment purchases) of 12 U.S.C. § 29, the letter also found that property held DPC should not be subject to the lending limitations of 12 U.S.C. § 84.

2. DPC Property Unrelated to Loan: Subsequent Exchanges

Using DPC authority, national banks are not constrained

38. OCC Interpretive Letter, from T.G. DeShazo, Deputy Comptroller of the Currency (July 2, 1973) (available from Communications Office, Office of the Comptroller of the Currency); *accord* OCC Interpretive Letter from F.H. Ellis, Chief National Bank Examiner (Nov. 19, 1971) (available from Communications Office, Office of the Comptroller of the Currency) (taking of DPC property approved after borrower's net worth fell dramatically to US$274,000 even though borrower remained current on US$1.6 million loan); *see also* Mapes v. Scott, 88 Ill. 352 (1878).

to acquire only assets that secure the loan or belong to the debtor. Moreover, once a bank acquires legal title to DPC property, it may subsequently exchange original DPC property for other DPC property, either real estate or securities. The holding period for property received in an exchange starts on the date a bank first acquires property DPC.

Two recently published OCC interpretive letters[39] provide guidance on the permissible scope of unrelated property and exchange transactions. Interpretive Letter No. 349 dealt with two single family residences acquired as Other Real Estate Owned ("OREO") by a national bank following foreclosure proceedings. When the bank's efforts to sell the properties for cash proved unsuccessful, the bank structured exchange transactions with a third party that resulted in the bank receiving condominium units, an additional single-family residence, and cash. The bank did not enter into either transaction with the intent of making a profit from a contemplated resale of the exchanged properties received in the sale. In addition, the bank reduced its exposure to loss on OREO property to the extent it received cash in the exchange transactions.

Interpretive Letter No. 349 notes that 12 U.S.C. § 29 does not expressly prohibit real estate swaps (i.e., swapping OREO property for other real estate) and finds that a national bank under 12 U.S.C. §§ 24, 29 has *implied authority to exchange* OREO property for other real estate in appropriate circumstances. In so finding, the letter distinguishes older case law where virtually no cash was involved in the exchange transactions.[40]

Interpretive Letter No. 395 similarly relied upon implied authority under 12 U.S.C. §§ 24(7), 29 to permit a national bank to exchange OREO acquired DPC for preferred stock listed on the New York Stock Exchange. The bank benefited by improving the liquidity of assets held DPC, and the facts demonstrated an intention to reduce loss by engaging in the transaction. Interpretive Letter No. 395 went on to establish

39. OCC Interpretive Letter No. 395, Fed. Banking L. Rep. (CCH) ¶ 85,619 (Aug. 24, 1987); OCC Interpretive Letter No. 349, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,519 (Sept. 12, 1985).

40. *See* Williams v. Merchants' Nat'l Bank, 42 F.2d 243 (D. Minn. 1930); Kosse Nat'l Bank v. Derden, 36 S.W.2d 295 (Tex. Civ. App. 1931).

certain guidelines for future real estate/securities exchange transactions:

> (1) Once stock has been acquired in exchange for OREO, that stock should not be further swapped for other stock. Further transactions become too far removed from the original OREO, speculation becomes more likely, and the five year holding period applies in any case to the date of original DPC acquisition.
>
> (2) Stock received in exchange should be more marketable than the real estate given up, which tends to favor publicly-traded securities over privately-owned companies, particularly if the bank is left holding a minority interest.
>
> (3) Based on the bank directors' duty to exercise due diligence, the directors should determine that the exchange advances the best interests of the bank (considering such factors as value, quality and liquidity), and the directors' determination should be documented.[41]

3. Expenditures, Development, and Operation

Prior to 1980, judicial precedents[42] and OCC interpretive rulings[43] allowed national banks to make expenditures and pay construction completion charges for DPC property in circumstances that justified preserving the underlying DPC property and saving the debt. To advance the same objectives, case law and OCC precedents also allowed banks to operate non-banking businesses.[44]

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41. OCC Interpretive Letter No. 395, Fed. Banking L. Rep. (CCH) ¶ 85,619 (Aug. 24, 1987)

42. *See, e.g.*, Cooper v. Hill, 94 F. 582, 585 (8th Cir. 1899) (bank permitted to expend funds for cleaning and necessary repairs in order to put OREO "in presentable condition to attract purchasers"); Cockrill v. Abeles, 86 F. 505, 511 (8th Cir. 1898) (bank authorized to purchase other interests in the same property and remove liens and encumbrances in order for the bank to manage and dispose of the property).

43. *See, e.g.*, OCC Interpretive Letter from P. Nelson, Senior Attorney, Legal Advisory Services Division (May 27, 1980) (available from Communications Office, Office of the Comptroller of the Currency) (finding that national banks would not engage in prohibited speculative activities by exercising the debtor's option to purchase real estate and thereafter lease the property and a gambling business to a third party operating group).

44. *See* Atherton v. Anderson, 86 F.2d 518 (6th Cir. 1936), *rev'd on other grounds*, 302 U.S. 643 (1937). The Atherton court explained its rationale for permitting a bank to operate a wagon manufacturing business as follows:

> [A] bank may lawfully do many things in securing and collecting its loans, in

In 1980, as part of Depository Institutions Deregulation Act ("DIDA"),[45] Congress amended section 29 to expand the authority for *development and improvement of DPC real estate* to "enable [the bank] to recover its total investment"[46] after notice to the OCC and subject to such regulatory conditions and limitations as the OCC may impose. Shortly after enactment of DIDA, the OCC issued revised policies and procedures that established guidelines as to when banks could commit additional funds to DPC property:

> It will be the policy of this Office that additional expenditures to develop and improve other real estate owned may be made only when they are:
>
> a. Necessary to increase the fair market value of the real property to the minimum level at which the bank can recover its total investment; or they are
>
> b. Reasonably calculated to significantly minimize any shortfall between the property's fair market value and the bank's total investment.[47]

Recent OCC interpretive letters have relied on the new statutory language of section 29 and the regulatory guidelines of our agency to define the scope of permissible expenses, de-

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> the enforcement of its rights and in the conservation of its property previously acquired, which it is not authorized to engage in as a primary business.
>
> . . .
>
> The controlling principle seems to us to be that while the bank has no power, either express or implied, to enter upon an original speculative enterprise, yet as an incident to its express powers the bank has a right to acquire property . . . and where such property is a manufacturing establishment whose value depends substantially upon uninterrupted operation, we think implied power exists to continue such operation for a time providing the primary purpose of the bank is to *save its debt* rather than to speculate in future profits, and there is a reasonable prospect of realization.

Id. at 525 (*emphasis supplied*); *see also* OCC Interpretive Letter from R.V. Fitzgerald, Director, Legal Advisory Services Division (Sept. 9, 1979) (available from Communications Office, Office of the Comptroller of the Currency) (finding permissible a bank's operation of supermarket and related lottery businesses acquired DPC); OCC Interpretive Letter dated from H. J. Selby, First Deputy Comptroller for Operations (Nov. 15, 1977) (available from Communications Office, Office of the Comptroller of the Currency) (authorizing a bank subsidiary to exercise operating rights acquired DPC in a freight forwarding business; conditions of approval included limited capital expenditures, operation in a commercially reasonable manner, and disposition within one year).

45. *See supra* note 26.

46. 12 U.S.C. § 29 (1982).

47. OCC EXAMINING BULLETIN 80-14 (Aug. 20, 1980).

velopment, and operation of DPC businesses and properties.[48]

4. Permissible Holding Period

For both real estate[49] and securities,[50] statutory authority provides DPC holding periods of five years from the date of acquisition. Under section 29, as amended in 1980, the Comptroller may extend the holding period for real estate up to an additional five years.[51] Since 1980, OCC interpretive letters have not directly addressed greater than five-year holding periods for securities acquired DPC. In appropriate circumstances and consistent with section 29's intent, the OCC in the future may consider extending the holding period for securities where an applicant establishes such factors as a greater likelihood of investment recovery, no undue concentration of assets, and a history of good-faith efforts to dispose of the security.

Divestiture of DPC property, under the precedent of OCC interpretive letters, is established by outright sale, entry into a lease-purchase agreement,[52] or transfer of title to a trust for the benefit of bank shareholders.[53]

48. OCC Interpretive Letter from J. Rushdoony, Attorney (Sept. 26, 1986) (available from Communications Office, Office of the Comptroller of the Currency) (denying a bank's request to operate a full service insurance brokerage business after the bank obtained shares of stock DPC from a debtor engaged in administering employee benefit plans. The Office found the proposed new business to be an "independent enterprise" and lacking any concrete plan for eventual divestiture.); OCC Interpretive Letter from R. Boylan, Director, Legal Advisory Services Division (Jan. 17, 1986) (available from Communications Office, Office of the Comptroller of the Currency) (disallowing a bank's proposed creation of a new joint venture oil and gas business of unspecified duration with a drilling contractor and contribution to the venture of idle drilling rigs in exchange for common stock as too speculative and not sufficiently related to recovery of the original DPC property); OCC Interpretive Letter from M. Patriarca, Deputy Comptroller of the Currency (Apr. 2, 1985) (available from Communications Office, Office of the Comptroller of the Currency) (authorizing a national bank to pay additional construction completion costs, ground lease rent, taxes, building management costs and legal fees for OREO consisting of a 41 story commercial/residential building and a 13 story garage).

49. 12 U.S.C. § 29.

50. 12 U.S.C. § 24 (1982 & Supp. IV 1986).

51. 12 U.S.C. § 29.

52. OCC Interpretive Letter from C.F. Byrd, Assistant Director, Bank Structure & General Banking (June 24, 1981) (available from Communications Office, Office of the Comptroller of the Currency).

53. OCC Interpretive Letter from K.W. Leaf, Regional Administrator (July 14,

D. *DPC in International Transactions*

In the last year, the OCC has issued two no-objection letters relying on DPC authority to permit transactions designed to salvage developing-country debt through debt-equity swap programs sponsored by the governments of Chile and Mexico.[54]

The first proposal reviewed by the OCC involved an attempt by the International Bank of Miami (the "Bank") to salvage developing-country debt through the Mexican government's debt-equity swap program (the "Mexican Program"). The Bank proposed to acquire a 60% interest in a holding company, the sole asset of which was a resort hotel. A Swiss management group agreed to hold the remaining 40%. The Bank's proposal raised several novel DPC issues. The OCC recognized the public policy interests in resolving troubled third-world debts, the unique nature of sovereign debt, and the fact that the Bank had little choice but to participate in the rescheduling at terms generally imposed by the Mexican government.[55]

In the first Bank of Miami proposal, the Bank contemplated exchanging its portfolio of Mexican sovereign debt for an interest in a privately owned Mexican hotel, pursuant to the Mexican Program. The Mexican Program permits the exchange of foreign debt with the Mexican government for Mexican currency to be invested in approved investment projects in Mexico. The debt consisted of three loans, two of which had been rescheduled, with repayment of the third to begin in 1989. The Mexican government, however, annnounced in 1987 a general intention to reschedule all of its debt.

In its *Bank of Miami I* letter, the OCC allowed the Bank to participate in the Mexican Program. The letter addressed several issues basic to the exercise of DPC authority. First, none of the three loans was in an actual default. However, consistent with precedent allowing the use of DPC power regardless

1975) (available from Communications Office, Office of the Comptroller of the Currency).

54. OCC No-Objection Letter No. 88-7, Fed. Banking L. Rep. (CCH) ¶84,047 (May 20, 1988) [hereinafter *Bank of Miami II*]; OCC No-Objection Letter No. 87-10, Fed. Banking L. Rep. (CCH) ¶ 84,039 (Nov. 27, 1987) [hereinafter *Bank of Miami I*].

55. *Bank of Miami I, supra* note 54.

of the occurrence of an actual default, the letter found that the prior rescheduling of the first and second loans combined with an anticipated further rescheduling provided evidence of a change in the financial capacity of the borrower sufficient to invoke use of DPC authority.[56]

Further, since the debt was unsecured, the Comptroller addressed the issue of whether to allow third party collateral in satisfaction of the debt extinguished. Relying on OCC and judicial precedent previously discussed, the Office concluded that the transaction would place the Bank in a better position to recover amounts lent and did not appear to be for speculative purposes. Accordingly, no objection was expressed to the acquisition of third-party property.[57]

Finally, the OCC determined the Bank could comply with the requirements applicable to the disposition of OREO within the requirements of 12 U.S.C. § 29.[58] As mentioned previously, due to the Mexican Program's requirements, the Bank would hold an interest in the company owning the hotel for at least eight years with full repatriation not possible before thirteen years. However, the transaction was structured to resolve the divestiture problem. The Bank was permitted to sell its domestic operating subsidiary holding the DPC property and to execute "put" and "call" agreements[59] with the Swiss group in order to allow compliance with holding period restrictions.

The most recent interpretation of DPC authority of a national bank involving developing-country debt occurred in the second request by the Bank of Miami. Relying upon the interpretation of DPC power in *Bank of Miami I*, the Bank proposed a similar transaction under the Chilean government's debt-equity swap program (the "Chilean Program"). The Bank proposed to exchange its Brazilian and Venezuelan debt for qualified Chilean debt and then, in turn, swap the Chilean debt under the Chilean Program for local Chilean currency. The

56. *Id.*

57. *Id.*

58. *Id.*

59. To assure divestiture within the statutory time frame for DPC property, the Bank negotiated a "put" with the Swiss group under which the latter agreed to buy the Bank's interest at a future date; likewise, the Swiss group obtained from the Bank a "call" option, permitting it to purchase the Bank's interest at a future date. *Bank of Miami I*, *supra* note 54.

Bank then proposed to use local currency to acquire a minority interest in an existing Chilean insurance company. Both the Brazilian debt and the Venezuelan debt had been rescheduled by their respective governments and, in the case of Brazil, had been non-performing for approximately one year.

The Chilean Program contained features similar to the Mexican Program. Repatriation of the initial investment could not occur for ten years, with profits (including dividends) not subject to repatriation from Chile for three years from the date of initial investment.

The Bank planned to acquire a minority interest (between 19% and 24%) in the insurance company in exchange for its Chilean debt. The Bank proposed to limit its involvement in the operation of the company to the designation of one of the five to seven directors of the company and to comply with time limits applicable to the sale of DPC property. The Bank intended to hold its interest in a wholly owned subsidiary that, as in *Bank of Miami I*, could be sold at anytime. Furthermore, the Bank intended to enter into a "put" and "call" arrangement for this stock with the majority shareholder of the insurance company.

The Comptroller's Office issued a no-objection letter to the Bank on the Chilean debt-equity swap proposal on May 20, 1988. As in the *Bank of Miami I* letter, the Office based its conclusions upon the following factors: (1) the Bank adequately represented that the borrowers' condition (Brazil and Venezuela) merited the use of DPC authority; and (2) the Bank demonstrated, through the "put" and "call" options and the structure of the transaction, that it was seeking to avoid a loss on its debt and not to speculate.[60]

The bank subsequently proposed to establish an operating subsidiary to hold its interest in the Chilean company. The Comptroller's regulations provide, essentially, that a bank may establish an operating subsidiary to engage in any activity that could be done in the bank.[61] Since it had found that the bank could hold the property DPC, the Comptroller approved the establishment of the subsidiary, even though it was incorpo-

60. *Bank of Miami II*, *supra* note 54.

61. 12 C.F.R. § 5.34 (1988).

rated in Chile.[62]

III. *REGULATION K*

Bank holding companies and banks seeking to participate in debt-equity swaps have relied on the authority to make limited equity investments abroad provided under Regulation K of the Federal Reserve Board[63] and on the statutory authority of national banks to receive property in satisfaction of debts previously contracted.[64] Regulation K, first promulgated in 1919, generally covers a range of equity investments that a bank or bank holding company may hold permanently. Regulation K established restrictions on the extent of a banking institution's equity position in a foreign, nonbanking enterprise, preserving the legal separation of banking and commerce. By contrast, banks may acquire virtually any property DPC, regardless of its use or location, but the time the property may be held is strictly limited.[65] Banks and bank holding companies planning debt-equity swaps as a means of reducing exposure or to acquire an equity position in a foreign enterprise have a range of legal structures to consider. Among the choices are investments in less than 5% of the target company's acquisition of an interest in a company doing no business in the United States by an Edge Act subsidiary;[66] investments of up to 40% of certain companies in connection with an official debt restructuring under the recently liberalized regulations of the Board of Governors of the Federal Reserve System;[67] and the acquisition of property or equity interests located abroad in satisfaction of debts previously contracted. Finally, in addition to debt-equity swaps, some debtor countries have explored ways to offer shares in their debt as securities, with such credit enhancements as U.S. government obligations supporting the issuance. In a recent transaction involving rescheduled Mexican debt, federal regulators authorized banks

62. *See* letter from J. Michael Shepherd, Senior Deputy Comptroller, to Antonio Lucio, Esq. (July 15, 1988) (available from Communications Office, Office of the Comptroller of the Currency).

63. 12 C.F.R. pt. 211 (1988).

64. 12 U.S.C. § 29 (1982).

65. *Id.*

66. 12 C.F.R. § 211.5 (1988).

67. *See infra*, notes 79-84 and accompanying text.

to hold the securitized loans as investment securities.[68]

A. *General Investment Power of Bank Holding Companies*

A bank holding company may acquire up to 5% of any company, regardless of its line of business or its location.[69] Similarly, a bank holding company may own an investment company "which is not engaged in any business other than investing in securities, which securities do not include more than 5 per centum of the outstanding voting shares of any company . . . ."[70] Also exempted from the Bank Holding Company Act's general prohibitions is the ownership of shares of any company "which does no business in the United States except as an incident to its international or foreign business," where the Board has found that the exemption is in the public interest and not inconsistent with the general statutory aim of separating banking and commerce.[71] Subject to the provisions of regulations governing investments, activities, and banks abroad, bank holding companies may own or control voting shares of any company engaged in activities that have been found to be "so closely related to banking or managing or controlling banks as to be a proper incident thereto."[72]

B. *Limited Investments Under Regulation K*

In Regulation K, which generally governs the investments and activities abroad of U.S. bank holding companies, the Board has promulgated an extensive regulatory structure implementing these statutory provisions.[73] Regulation K imposes restrictions on both the type and the extent of the foreign activities of bank holding companies. Determined to preserve the separation of banking and commerce even for international activities, the Board limits the level of holding company investment in firms engaged in nonpermissible activi-

68. *See* OCC Interpretive Letter No. 410 (Jan. 15, 1988) [hereinafter Letter No. 410] (available from Communications Office, Office of the Comptroller of the Currency).

69. 12 U.S.C. § 1843(c)(6) (1982 & Supp. IV 1986).

70. 12 U.S.C. § 1843(c)(7) (1982).

71. 12 U.S.C. § 1843(c)(13) (1982).

72. 12 U.S.C. § 1843(c)(8) (1982). See Regulation Y for a list of activities the Board has found to be "closely related to banking." 12 C.F.R. § 225.25 (1988).

73. 12 C.F.R. pt. 211 (1988).

ties. In addition to the activities currently listed in Regulation K, a subsidiary controlled by a bank or a holding company may seek the Board's approval to engage in activities deemed "usual in the transaction of banking and other business abroad . . . ."[74]

Bank holding companies may make investments in nonbanking firms in three categories. An investing bank holding company may acquire a going concern whose otherwise impermissible activities represent less than 5% of the consolidated assets or revenues of the acquired firm.[75] Second, a bank holding company may own up to a 50% interest in an enterprise that engages primarily in permissible activities,[76] but which derives up to 10% of its assets on revenues from impermissible activities.[77] Finally, a holding company may make a portfolio investment so long as the investment does not exceed 100% of its capital.[78]

C. *Debt-Equity Swaps*

In addition to making permanent investments through the procedures described above, holding companies may follow the procedures provided in the 1987[79] and 1988[80] amendments to Regulation K to make short-term investments in connection with a debt recovery, similar to the DPC authority of national banks. The 1987 amendment permitted bank holding companies and nonbank subsidiaries to acquire corporations owned by foreign governments that have restructured their debt. With Board approval, pursuant to the procedures of Regulation K, the amendment authorized acquisition of a corporation originally owned by the debtor country where the ownership interest was obtained either by a direct exchange for debt obligations or purchased with funds obtained through the payment of debt. In contrast to the "permanent" investments made abroad under Regulation K, the amendment provided that the shares of a foreign, non-financial company ac-

74. 12 C.F.R. § 211.5(d) (1988).
75. 12 C.F.R. § 211.5(b)(1)(i)(A) (1988).
76. 12 C.F.R. § 211.5(d) (1988).
77. 12 C.F.R. § 211.5(b)(1)(i)(B) (1988).
78. 12 C.F.R. § 211.5(b)(1)(C) (1988).
79. 52 Fed. Reg. 30,912 (1987), *amended by* 53 Fed. Reg. 5358 (1988).
80. 53 Fed. Reg. 5358 (1988) (to be codified at 12 C.F.R. § 211.5(f)).

quired through a debt-equity swap must be divested within five years. The Board reserved the option to extend the period for good cause up to an additional five years.[81] Even with a short-term investment, the amendment directed that the acquired company not assume a similar name and that it not receive confidential customer information from the bank.

In its commentary, the Board noted that it was permitting investment by bank holding companies but not by banks themselves in order to "erect an effective barrier" between banks and foreign companies engaged in commercial activities.[82] The Board asserted that this structure would include restrictions on transactions with affiliates contained in 12 U.S.C. § 371(c) to apply, as a matter of law, to transactions between banks and their non-financial foreign company affiliates. The commentary explained that the separation was intended to make clear that the federal safety net insuring the bank's deposits would not extend to non-financial companies. Furthermore, the barrier would eliminate the pressure on banks to extend loans to an acquired corporation on preferential terms. The commentary also emphasized that the intent of the amendment was not to permit permanent investment in foreign non-financial corporations but rather to enable banks to make temporary investments to diminish their exposure to developing countries.

In February of 1988, the Board further liberalized the provisions of Regulation K to provide bankers greater flexibility in participating in debt-equity swaps.[83] It permitted United States banking organizations to invest in up to 40% of the shares of any private company in a debtor country, not just those being privatized. While only sovereign debt is eligible for exchange under these provisions,[84] the debt-equity swaps programs of most debtor countries are only offered through a facility established by the central bank. The Board also im-

81. These divestiture requirements are similar to the regulations of the Office of the Comptroller of the Currency for the divestiture of property acquired in satisfaction of debts previously contracted. *See* 12 C.F.R. § 7.3020 (1988).

82. 52 Fed. Reg. 30,912, 30,913 (1987).

83. 53 Fed. Reg. 5358 (1988) (to be codified at 12 C.F.R. § 211.5(f)).

84. *See* Letter from Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, to Senator William Proxmire (Feb. 18, 1988) (available from Communications Office, Office of the Comptroller of the Currency).

posed several qualifications to this new investment authority. First, the banking organization may hold more than 25% of the voting shares of the acquired company only if there is an unaffiliated shareholder that controls a larger percentage. Second, the bank holding company may not extend credit to the foreign company in amounts greater than 50% of the total loans and extensions of credit the company has received from all sources. Third, the investing bank holding company's representation on the board of directors of the acquiring company must be proportionate to its ownership of voting shares.

Significantly, the 1988 amendment responded to the requirements of certain debtors and revised the divestiture requirement to extend to two years beyond the end of the period during which full repatriation is restricted by the debtor country—up to a maximum of fifteen years. The Board also modified its prohibition against such investments being made by banks rather than by holding companies, subject to the Board finding that special circumstances exist.

IV. *DEBT SECURITIZATION*

In addition to debt-equity swaps, some debtor nations have attempted to offer interests in their obligations to investors. These efforts to securitize debt encountered significant accounting and regulatory barriers. Recently, the Comptroller issued an interpretive letter permitting national banks to hold bonds acquired in an exchange program either as loans or as investment securities and thereby participate in a program to restructure Mexican debt. In August 1988, the Comptroller joined with the Board and the FDIC in issuing a private letter ruling[85] that approved commercial banks' participation in the Federal Republic of Brazil's refinancing package.[86]

A. *Regulatory Treatment of National Bank Investments*

The principal statutory provision regarding the powers of

85. *See* OCC Private Letter, the Board and the FDIC to William M. Friedrich, Esq. (Aug. 4, 1988) (available from Communications Office, Office of the Comptroller of the Currency).

86. *Id*; *see* REPÚBLICA FEDERATIVA DO BRASIL, FINANCING PLAN (1988) [hereinafter FINANCING PLAN].

national banks, 12 U.S.C. § 24(7),[87] authorizes national banks to make loans and to purchase for their own account investment securities consisting of debt obligations in the form of a bond, note, or debenture. The authority of national banks to purchase investment securities was authorized specifically with the enactment of the McFadden Act in 1927.[88] Recognizing existing practice and relying in part on a no-objection letter from the Comptroller, courts found such activity to be permissible.[89]

The Comptroller proposed legislation in 1924 authorizing national banks to purchase investment securities so long as those investments did not exceed 25% of the bank's capital and surplus.[90] These suggestions, which were enacted in the McFadden Act, were intended to clarify banks' authority and to provide a statutory framework for regulation.[91]

The securities activities of national banks were further restricted by the Glass-Steagall Act, which prohibited them from "dealing" in securities, except to buy and sell securities for the account of customers, and reduced to 10% the amount of capital and surplus a national bank could invest in the securities of one obligor.[92]

Following the McFadden Act standards, the Comptroller's Office has traditionally required that a debt obligation be marketable and of investment quality to be considered an "investment security."[93] National banks may not hold as investments instruments that do not meet those standards. In addition to those factors, bank examiners look to the nature of the relationship between the bank and the debtor to determine whether the bank is acting as a lender or as a relatively passive investor. On a case-by-case basis, the Comptroller has recognized that certain obligations in the form of a bond, note, or debenture should be treated as loans. In those cases, the

87. 12 U.S.C. § 24(7) (1982 & Supp. IV 1986).

88. Ch. 191, 44 Stat. 1224 (1927).

89. *See, e.g.*, Atherton v. Anderson, 86 F.2d 518, 532-33 (6th Cir. 1936), *rev'd on other grounds*, 302 U.S. 643 (1937); Bailey v. Babcock, 241 F. 501, 515 (W.D. Pa. 1915).

90. *See* 1924 OCC ANN. REP. 12, 149, 151.

91. *See* H.R. REP. No. 83, 69th Cong., 1st Sess. 3 (1926); S. REP. No. 473, 69th Cong., 1st Sess. 7 (1926); S. REP. No. 666, 68th Cong., 1st Sess. 6 (1924).

92. 12 U.S.C. §§ 24(7), 78, 377, 378 (1982 & Supp. IV 1986).

93. *See* 12 C.F.R. § 1.3 (1988).

Comptroller has based his conclusion on the nature of the dealings between the parties.

B. *The Mexican and Brazilian Refinancing Transactions*

In considering the Mexican program, the Comptroller permitted national banks to elect to hold the new bonds either as loans or as investment securities but prohibited a single bank from holding them in both its loan and investment portfolios. The OCC did not object to the bonds being considered "investment securities" since there was evidence that tended to show that the bonds were of investment quality and that the secondary market in the bonds would be sufficient to ensure their marketability. Since a bank could conclude that there were reliable estimates that the bonds possessed these characteristics, the bonds could qualify as investment securities under 12 C.F.R. § 1.5(b)[94] and could be purchased by national banks subject to the limitations of 12 C.F.R. § 1.7(b).[95] The Office simply required that banks intending to hold the bonds as investment securities do the research necessary to satisfy themselves that the bonds were of investment quality and marketable. This was not significantly different from other analyses of whether a new bond would qualify as an investment security.

The Brazilian financing package introduced an innovative debt securities feature in the amount of US$5 billion. Issued by the Republic of Brazil as investment bonds, holders of these new securities may exchange the instruments for inflation-adjusted "Obrigações do Tesouro Nacional" ("OTNs"),[96] the Brazilian equivalent of U.S. Treasury Bonds. In addition, the investment bonds will be redeemable at face value for purchase of Brazilian exports as part of any future debt-for-export program in that country. The investment bonds will be exempt from all Brazilian taxes and will bear an interest rate of 6% per annum. The Brazilian investment bonds are structured in a way to satisfy liquidity and marketability requirements, with the added feature of convertability into cash for

94. 12 C.F.R. § 1.5(b) (1988).

95. 12 C.F.R. § 1.7(b) (1988).

96. *See* FINANCING PLAN, *supra* note 86, at § V-5.

use in government-approved export programs.[97]

While some prior determinations of the OCC suggest that national banks generally may not purchase investment securities and hold them in their loan portfolio, the OCC has permitted banks to hold investment securities as loans when the bank purchases the security through direct negotiations with the issuer in a transaction that is the equivalent of making a loan. In the context of both the Brazilian refinancing program and the Mexican debt-swap program, participating banks were restructuring existing loans by accepting new bonds through more or less direct negotiations with the debtor government. The transactions, therefore, resembled the extension of a commercial lending transaction. Consequently, banks that acquired the Mexican bonds through the debt-swap program were permitted to hold the bonds as loans.[98] Such treatment is also consistent with prior OCC interpretations involving developing-country debt restructuring programs.[99] In keeping with the rationale supporting treatment of the bonds as loans, banks acquiring the Mexican bonds in the secondary market were not permitted to hold them in the bank's loan portfolio.[100]

CONCLUSION

As Treasury Secretary Baker recognized when advancing a "menu approach" to the resolution of the developing-country debt crisis, the debt problem is so large and complex that no single program can resolve it. Regulatory agencies are likely to continue to provide bankers the flexibility to participate in debt-equity swaps. These programs provide the multiple benefits of (1) additional investment to spur developing-country economic growth, (2) decreased debt service obligations owed by debtor countries, and (3) opportunities for banking organizations, especially those wishing to sustain their long-term commitment to the debtor countries, to reduce their overall

97. *Id.*

98. *See* Letter No. 410, *supra* note 68.

99. *See, e.g.*, OCC Interpretive Letter No. 288, [1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,452 (Apr. 25, 1984) (Argentine debt restructuring program exchanging bonds and notes for existing loans).

100. *See* Letter No. 410, *supra* note 68.

debt exposure, while gaining the option of participating in inflation-hedged equity investments.

Political considerations in the debtor nations, most of which face presidential elections in the next two years, have limited the extent of equity investments to specific industries and sectors often in an attempt to channel foreign investment toward areas that face the greatest needs for infrastructure-related economic reforms. As a consequence, banks have faced restricted investment opportunities in the leading debtor nations.[101] Additionally, uncertainty about U.S. policy in the new administration, including suggested debt-forgiveness schemes,[102] has made both bankers and debtors more reluctant to commit to major transactions. In this environment, regulators likely will continue to encourage banks to build capital and attempt to provide flexibility to engage in transactions like debt-equity swaps and debt securitizations.

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101. *See* Miller, *Equity Swaps Unattractive to U.S. Banks*, Am. Banker, Aug. 15, 1988, at 14, col. 1.

102. Dornbush, Johnson & Krueger, *Our LDC Debts*, in THE UNITED STATES IN THE WORLD ECONOMY 190-92 (M. Feldstein ed. 1987).