LENDING LIMITS REVISITED: COMBINATION OF LOANS

Shortly after the financial crisis of 2008, the financial services industry experienced a significant number of financial institution failures. Among the financial institutions taken over by the Federal Deposit Insurance Corporation (FDIC) during this period was a small commercial bank in Northern California. One of the primary causes for this bank failure was an over-concentration of commercial real estate loans to a group of related borrowers.

The regulations, established by the Office of the Comptroller of the Currency (OCC) for national banks and federal savings banks, that impose limits on loans to a single borrower and that borrower’s “related interests” (the lending limit rules) are designed to avoid over-concentration of loans to a related group. To determine when loans or other extensions of credit must be combined, the OCC lending limit rules focus on the use of loan proceeds, the source of repayment for loans and the relationship between related entities.

The lending limit rules provide four tests which are applied to loans to different borrowers when determining whether loans must be combined: (i) the direct benefit test (focusing on the use of loan proceeds); (ii) the common source of repayment test (focusing on the source of repayment); (iii) the economic interdependence test (focusing on the economic interrelationship among related borrowers); and (iv) the corporate group test (focusing on the control of related borrowers). Each of these tests, if applied correctly, assist a lender in identifying which loans must be combined when determining compliance with the lending limit rules.

For lending institutions that are not regulated by the OCC, the OCC’s rules that limit loans to a single borrower and its related interests may provide guidance on when a combination of loans is required. Unfortunately, not all lending limit rules provide clear guidance in this area. For example, California state-chartered banks are subject to the provisions of California Financial Code Section 1481 et seq., which establish the rules that limit the aggregate amount of loans to a single borrower and its related interest, including some general rules that establish the basis for the combination of loans. Beyond these broad rules, the Financial Code and related regulations do not provide further guidance as to the combination of loans. In the absence of such guidance, California state-chartered banks are often advised to follow the OCC lending limit rules regarding when to combine loans.

Whether a lender is subject to the OCC lending limit rules or the rules of another regulator, the loan combination guidance provided in the OCC lending limit rules represent “best practices” when lending to borrowers that are related in some way. Understanding the loan combination rules is essential for lenders that consider making loans to a group of related borrowers.

**Attribution Based on Direct Benefit**

Under the OCC lending limit rules, a loan or extension of credit to one person will be attributed to another person when the proceeds of the loan are to be used for the “direct benefit” of the other person. When a loan or extension of credit to one person is attributed to another person, each person is deemed to be a borrower of the loan for lending limit purposes. For lending limit purposes, the loan attributed to the non-borrower must be combined with all other loans made directly or attributed to that person.

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1 12 CFR Part 32, issued by the OCC under authority granted in 12 USC 1 et seq., 12 USC 84, and 12 USC 93a.
2 12 CFR Part 32.5(a)(1)
The proceeds of a loan will be deemed to be used for the direct benefit of a person other than the borrower when the loan proceeds (or assets purchased with the loan proceeds) are transferred to the other person. The amount attributed to the non-borrower may not be the full amount of the loan, but only the amount for which the non-borrower received a direct benefit (see the example below). A “person” includes an individual, sole proprietorship, partnership, joint venture, association, trust, estate, business trust, corporation, limited liability company, non-profit corporation, sovereign government or agency, instrumentality or political subdivision of a sovereign government.

For example, Lender makes a loan to LLC 1 to refinance a commercial real estate loan. The loan amount exceeded the amount needed to satisfy the existing lien; as a result, LLC 1 received $400,000 in cash from escrow. LLC 1 transferred the $400,000 to a sister LLC (LLC 2) for use in the renovation of the commercial real estate owned by LLC 2. Under the direct benefit test, $400,000 of the loan to LLC 1 would be attributed to LLC 2.

Loan proceeds transferred to a person in a bona fide arm’s length transaction for the acquisition of property, goods or services are not treated as used for the direct benefit of that person. In that case, the loan or extension of credit would not be attributed to the recipient of the proceeds by virtue of the direct benefit test.

For example, Lender makes a second loan to LLC 1 to finance the renovation of commercial real estate. LLC 1 has contracted with its sister LLC (LLC 3) as general contractor. The construction contract reflects an arm’s length transaction. As a result of the construction contract, LLC 3 will receive from the loan proceeds $50,000 in contractor fees. Provided Lender can establish that the construction contract between LLC 1 and LLC 3 was an arm’s length transaction, the $50,000 in fees received by LLC 3 would not be attributed to LLC 3 under the direct benefit test.

In applying the direct benefit test, a lender must determine how all loan proceeds are to be used. If the settlement statement for the loan escrow shows a payment to the borrower, the lender should inquire as to the use of the proceeds and note any transfer to an affiliate of the borrower (as this information may become relevant should the lender be asked to make a loan to the affiliate that received the proceeds).

**Aggregation Based on Common Source of Repayment**

The OCC lending limit rules also require the aggregation of loans to different borrowers if a common enterprise exists between the borrowers. A common enterprise exists between or among borrowers when the expected source of repayment for each loan in question is from the same source. This common source of repayment for these loans means that the risk of repayment for each loan is centralized at the source of the repayments. If the source of the repayments is impaired, then each of the loans may be at risk. Accordingly, the common source of repayment test requires the aggregation of each loan that relies on the same source of repayment. When loans are aggregated, they are combined and considered as loans to one borrower for purposes of determining compliance with the lending limit rules.

For example, Lender makes three separate loans to B1, B2 and B3. Each loan was made at different times and by different loan officers. B1, B2 and B3 are each partners at a law firm and each partner’s sole source of income is partnership distributions from the law firm. Since the three loans share the same source of repayment (i.e., income from the law firm), the common source of repayment test requires that the three loans be aggregated for lending limit purposes.

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3 12 CFR Part 32.5(b)
4 12 CFR Part 32.5(b)
5 12 CFR Part 32.5(a)(2)
6 12 CFR Part 32.5(c)(1)
However, if the borrowers in the example above received their income in the form of wages instead of distributions, the common source of repayment test would not require aggregation since an employer is not treated as a common source of repayment. An exception to the exception applies to an employer that is controlled by the employees (control is presumed when a person owns or controls 25 percent of the subject entity) and the employees derive more than 50 percent of their respective incomes from the employer. So, even if the borrowers in the example received their income in the form of wages (making them employees of the law firm), if each of our borrowers owned 25 percent or more of the law firm and, since each receives all of their income from the law firm, the exception to the exception would apply and the loans would have to be aggregated.

A lender may not be required to aggregate loans under the common source of repayment test if a borrower’s other sources of income (other than the common source of income) are sufficient to repay all of the borrower obligations including the lender’s loan. In the example above, if one of the borrowers had other sources of income (for example, real estate investments) and the income from these other sources was enough to repay all of the borrower’s obligations (including the lender’s loan), then that borrower’s loan would not have to be aggregated with the other loans to partners of the law firm.

To avoid any unpleasant surprises, such as discovering after all three loans to B1, B2 and B3 were made that they have to be aggregated and that the aggregate amount of the three loans exceeded the lender’s lending limit, a lender should keep track of loans to borrowers related through co-ownership of other entities, as well as certain employment relationships (where ownership of the employer is held by a few employees).

**Aggregation Based on Common Control and Financial Interdependence**

The common control and financial interdependence test is the third type of common enterprise requiring aggregation. As stated above, loans to separate borrowers must be aggregated when a common enterprise exists. A common enterprise is deemed to exist when borrowers are related by common control (or one borrower controls the other) and substantial financial interdependence exists between or among the borrowers.

A person (including an entity) is deemed to have control of an entity when that person directly or indirectly owns or controls 25 percent or more of the voting shares of the entity. As aggregation requires both control and financial interdependence, a lender should first identify the owners of each related borrower and each owner’s ownership interest. In this way, the lender is able to isolate those owners holding an ownership interest of 25 percent or more in more than one borrower, focusing these borrowers and owners when applying the test for financial interdependence.

Substantial financial interdependence is considered to exist when 50% or more of one borrower’s gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other borrower. The test for substantial financial interdependence focuses on intercompany transfers of funds, whether in the form of fees paid for goods or services, or inter-company loans, dividends and other distributions to owners, capital contributions and similar payments.
If Borrower 1 (which is under common control with Borrower 2) receives 50 percent or more of its gross receipts from Borrower 2, or if Borrower 1 pays 50% or more of its gross distributions (including expenses, inter-company loan repayments and dividends or other distributions) are paid to Borrower 2, then financial interdependence is considered to exist between them and any loans to Borrower 1 and to Borrower 2 must be aggregated for lending limit purposes. The same test should be applied to Borrower 2, with respects to amounts received from, and amounts paid to, Borrower 1. Similarly, transfers between any owner with control and the related borrower should be examined, as well as transfers between any borrowers under common control.

A variation on this type of common enterprise is the situation where a lender lends to separate persons to finance the acquisition of a business enterprise. When a lender finances the acquisition of more than 50 percent of the voting interests of a business enterprise, even though the lender has made separate loans to each investor, a common enterprise is considered to exist among the separate borrowers and the loans must be aggregated for lending limit purposes.

To accurately apply the financial interdependence test, a lender will need information about all inter-company transfers. Financial statements on a consolidated basis will not suffice, unless the statements include details with regard to all inter-company payments. The more active the inter-company transactions, the greater the risk that problems experienced by one company will adversely affect its sister companies. In addition to inter-company transfers, a lender must also consider distributions to the owners of the borrowing entity. This information should be required as part of the loan application, when the lender learns that a borrower is part of a family of related entities.

**Facts and Circumstances Test**

The OCC lending limit rules also provide that loans may be combined when the OCC determines, based upon an evaluation of the facts and circumstances of a particular transaction, that a common enterprise exists. Under this approach, loans that would otherwise not be combined under the direct benefit test, the common source of repayment test or the common control and financial interdependence test, could nevertheless be combined given the right set of facts and circumstances.

A lender should be vigilant in looking at the big picture and ensuring that the various borrowers do not constitute a common enterprise. The lender should also identify any other facts revealed through its due diligence process suggesting commonalities between borrowers. In looking at the overall relationship, the lender should avoid putting “all of its eggs in one basket.”

**Special Rule for Loans to Corporate Groups**

The OCC lending limit rules include a special rule to avoid excess lending to any particular corporate group. Under this rule, loans or extensions of credit to a corporate group may not exceed 50 percent of the lender’s capital and surplus. A corporate group includes a person and all of its subsidiaries and a person can be an individual or an entity. A corporation or a limited liability company is a subsidiary of a person if the person owns or beneficially owns, directly or indirectly, more than 50 percent of the voting securities or voting interests of the corporation or company.

As with the financial interdependence test described above, the special rule for corporate groups requires that the lender have full knowledge of who owns its borrowing entities. When the same person or entity owns more than 50 percent or more of multiple borrowers, then the lender must apply this test.

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12 12CFR 32.5(c)(3)
13 12 CFR 32.5(c)(4)
14 12 CFR 32.5(d)
Conclusion

Despite the fact that the loan combination rules are required under a federal regulation, lenders should consider these tests as an issue of best practices. More importantly, lenders should implement these tests and apply them as part of their standard lending limit analysis procedures. If applied objectively and accurately, these tests should enable a lender to avoid a drain on its capital because of over-reliance on a group of related borrowers.