

**Decision of the  
Supervision Appeals Review Committee**

*In the Matter of  
Undisclosed Holding Company, for Its Subsidiary Bank*

**Case No. 2013-01**

***I. Summary of Findings.***

After consideration of the timely filed written submissions of the parties, the record of this case, and the parties' oral statements at the July 23, 2013, deliberative meeting of this Committee, we have denied the appeal of [Holding Company]. Holding Company initially filed this appeal on behalf of the board of directors of [\*\*\*\*\*] its subsidiary bank ("Subsidiary Bank"). [\*] As outlined in this decision, the Committee upholds the decision of the Director, Division of Risk Management Supervision ("Division Director") that certain notes receivable issued by Holding Company to Subsidiary Bank were improperly accounted for and should be excluded from equity capital, and that the [quarter-end report date], Consolidated Report of Condition and Income ("Call Report") should be amended.

Specifically, the Committee finds that Subsidiary Bank improperly accounted for capital notes issued by Holding Company in its [quarter-end report date], Call Report. Regardless of the treatment of capital notes in past quarters, Subsidiary Bank is required to comply with the Call Report Instructions and generally accepted accounting principles ("GAAP") and, therefore, the notes in question should be offset in equity capital in its [quarter-end report date], Call Report. In addition, Holding Company failed to set forth substantial evidence of its ability and intent on [quarter-end report date], to fund its \$[entire amount] capital note commitment within a reasonably short period of time.<sup>1</sup>

***II. Background.***

***A. Prior Division Director Review and Regional Office Proceedings.***

On February 4, 2013, the [\*\*\*\*\*] Regional Office of the Division of Risk Management Supervision ("Regional Office") issued a determination that on [quarter-end report date], when Holding Company issued capital notes totaling \$[entire amount] to Subsidiary Bank, it failed to demonstrate substantial evidence of its ability and intent to pay the notes within a reasonably short period of time. Because of these deficiencies, the capital notes could not be reflected as assets by the subsidiary, with [a] corresponding increase in the equity capital as recorded in [its] [quarter-end report date], Call Report.

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<sup>1</sup> For purposes of providing context, Holding Company's ability and intent to fund the capital note commitment will be discussed first, followed by a discussion of the applicable Call Report Instructions and GAAP.

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The Regional Office directed Holding Company to amend the subsidiary's Call Report, in compliance with these findings.

On March 5, 2013, on behalf of its subsidiary, Holding Company timely filed a request for Division Director review of the Regional Office's material supervisory determination, arguing that the use of such capital notes had been a customary practice of the subsidiary for many years with the "knowledge and approval" of the FDIC. Holding Company asserted that these notes had been funded in the past with the use of Holding Company [\*\*\*\*\*]. Holding Company disputed the Regional Office's finding that Holding Company lacked the ability and intent to fund the \$[entire amount] of capital notes. In support, Holding Company cited correspondence with its State regulator, [\*\*\*\*\*], and its executed agreement between Holding Company and a third party, Non-bank purchaser (the "Asset Purchaser,") for the latter's purchase of an asset from Holding Company. The proceeds from [the sale of such asset] would fund \$[the entire amount of] the capital notes issued. Holding Company additionally asserted that this transaction closed before the Call Reports were filed, stating "[t]he proceeds from this sale transaction were received" by Holding Company, and that Holding Company "funded the [n]otes at the [b]anks on [date, post quarter-end, that financial statement must issue]."<sup>2</sup>

In response to Holding Company's request for review of the material supervisory determination, the Division Director considered the issues and rendered her written determination on April 11, 2013. She concluded that the Regional Office had reached the correct determination on the appropriate accounting treatment of Holding Company's capital notes and the need for [an] amended Call Report[] for [quarter-end report date]. In her attached rationale, the Division Director reached this conclusion based on two reasons: (1) at the time the capital notes were issued by Holding Company on [quarter-end report date], the subsidiary and Holding Company had failed to demonstrate substantial evidence of ability and intent to fund the capital notes within a reasonably short period of time, as required by GAAP;<sup>3</sup> and (2) because Holding Company issued multiple capital notes with fixed face amounts to the subsidiary, applicable Call Report guidance specifies that the capital notes to the subsidiary are deemed one note having a variable payment amount and must be deducted from equity capital. Holding Company filed this appeal on May 8, 2013.

In accordance with the *Guidelines for Appeals of Material Supervisory Determinations* ("Guidelines"),<sup>4</sup> the Committee reviews the appeal for consistency with the policies, practices, and mission of the FDIC, as well as the reasonableness of, and support for, the positions advanced by the parties. The Committee granted Holding Company's request to appear at the Committee's July 23, 2013, deliberative meeting. Under the *Guidelines*, the burden of proof on all matters at issue rests with the institution.

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<sup>2</sup> Holding Company March 5 Memorandum at 4. Holding Company did not identify the *amount* of proceeds received or the number and *amount* of notes actually funded.

<sup>3</sup> The Division Director cited FASB Accounting Standards Codification ("ASC") Subtopic 505-10-45-2.

<sup>4</sup> The *Guidelines* are set out at 77 Fed. Reg. 17,055 (March 23, 2012).

The scope of the Committee's review is limited to the facts and circumstances existing at the time of the material supervisory determination. No consideration has been given to facts or circumstances that developed after that period.<sup>5</sup>

***B. Facts.***

Holding Company is registered as a bank holding company under the Bank Holding Company Act of 1956. The Division of Risk Management Supervision ("RMS") indicates that [\*\*\*\*\*], Holding Company's Subsidiary Bank had experienced significant capital erosion over the past few years.

[\*\*\*\*\*] Holding Company contemplated [various] measures to bolster the financial stability of the Holding Company and its Subsidiary Bank. In [letter dated 27 days prior to quarter-end report date], Holding Company, on behalf of Subsidiary Bank, wrote to Subsidiary Bank's State regulator to lay out several options for recapitalization in response to State regulator's notice of the State's intent to take control of Subsidiary Bank. These options included: (1) [\*\*\*\*\*]; (2) arranging a sale of Subsidiary Bank; (3) injecting \$[sum] from available Holding Company funds to cover Subsidiary Bank's capital deficiency, with the \$[remaining capital balance shortfall] remaining shortfall to be funded on a going-forward basis from [future earnings from an identified Non-bank Asset of Holding Company ("Non-bank Asset")]; (4) negotiating an early settlement of the [identified Non-bank Asset with the obligor on the Asset]; and (5) selling the [Non-bank Asset] to a third party. As to the latter alternative, Holding Company noted that its "[r]eluctance to this alternative rests on the fact that a quick sale of the [Non-bank Asset] would yield approximately \$[estimated quick-sale amount]," while placing their Non-bank Asset on the market could generate a greater return.

Holding Company also indicated that, over the course of [multi-year period], [its financial advisor] held settlement discussions with [the obligor on the Non-bank Asset] regarding a one-time cash settlement of the Non-bank Asset. Obligor reportedly stated in negotiations that under no circumstances would they contemplate approval for a settlement "in excess of [a dollar amount less than, but no greater than, an estimated quick-sale amount]."

On [quarter-end report date], Holding Company entered into an agreement to sell its interest in the [Non-bank Asset] with a third-party non-bank purchaser ("Third-Party Asset Purchaser"). [\*\*\*\*\*]. Regional Office staff indicated that [individual], who serves as the Chairman of Holding Company, is also a large shareholder in Third-Party Asset Purchaser, and that [a second individual], who is the president of the Third-party Asset Purchaser, is [related to] Holding Company's President. [All three individuals have the same surname].

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<sup>5</sup> *Id. at M.* "Scope of Review and Decision." 77 *Fed. Reg.* at 17,058.

Under the agreement between Holding Company and Third-Party Asset Purchaser, Third-Party Asset Purchaser committed to purchase Holding Company's interest in the [Non-bank Asset] for \$[amount 50 percent greater than estimated quick-sale amount], with the sale to be completed by [date, post quarter-end, that financial statement must issue], and Holding Company to provide "any necessary regulatory approval." Holding Company informed the Regional Office of this agreement in an electronic message sent on the afternoon of [quarter-end report date].

In this [quarter-end report date], message, Holding Company also informed the Regional Office that on that same date "capital notes totaling \$[amount identical to the 50 percent greater than estimated quick-sale amount][the entire amount]" had been issued [\*\*\*\*\*] by Holding Company and that "the notes were generated by the planned sale of [Holding Company's] interest in the [Non-bank Asset]." In sum, the [quarter-end report date], sale agreement for the [Non-bank Asset] would, when closed before [date, post quarter-end, that financial statement must issue], fund the \$[entire amount] in capital notes that Holding Company issued on [quarter-end report date]<sup>6</sup>

***C. Summary of Holding Company's Contentions.***

Holding Company maintains that the evidence of record of its intent and ability to fund the notes is clear and undisputed. Holding Company asserts that, in correspondence with regulators in [letter dated 27 days prior to quarter-end report date], it provided specific plans of its sale of the [Non-bank Asset]. Holding Company believes it provided further evidence of this intent and ability in communications on [quarter-end report date], which described and enclosed the sale agreement with Third-Party Asset Purchaser, which it asserts is undisputed evidence of Holding Company's intent and ability to fund its capital note obligation. Holding Company maintains that this ability was not contingent on any supervisory review or [\*\*\*\*\*], that Third-Party Asset Purchaser had sufficient liquidity to close the deal, and that the transaction did not violate any State law pertaining to Third-Party Asset Purchaser. Holding Company challenges the Division Director's reliance on the fact that Third-Party Asset Purchaser later sold the [Non-bank Asset] to yet another party as evidence of Third-Party Asset Purchaser's inability to fund as of [quarter-end report date]. Holding Company asserts it had the ability to fund the notes within a reasonably short time because it "actually funded the notes by [date, post quarter-end, that financial statement must issue]."

Holding Company argues that the Call Report provisions do not require that capital notes be funded by the sale of an affiliate bank, and that funding by the sale of the [Non-bank Asset] is not prohibited. Holding Company further contends that Third-Party Asset Purchaser is independent of Holding Company despite there being "an intermingling of board[s] of directors." Holding Company also argues that it is immaterial whether Third-Party Asset Purchaser had placed the purchase funds in

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<sup>6</sup> Holding Company issued [multiple] separate capital notes to Subsidiary Bank in varying amounts.

escrow, because in two prior transactions in [\*\*\*\*\*], such an escrow was not required and, in any event, Third-Party Asset Purchaser did not lack sufficient liquidity.

Holding Company stressed that [\*\*\*\*\*] it had issued capital notes in numerous instances (including times under the current Call Report Instructions) with the intention to fund some or all of the notes, as necessary, before its submission of the Call Reports following the close of the quarter. Holding Company maintains that because the use of capital notes was a longstanding practice both suggested and approved by the Regional Office, and on which Holding Company relied, disallowing favorable accounting treatment of the Subsidiary Bank capital notes in this instance amounts to a selective application of GAAP and the Call Report Instructions.

### ***III. Applicable Call Report Instructions and GAAP Guidance.***

In February 2012, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve made reporting changes and instructional revisions to the Call Reports.<sup>7</sup> These changes were proposed and published for public comment on November 21, 2011,<sup>8</sup> and, following the comment period and review, the revisions became effective as of March 31, 2012. Holding Company does not dispute that the express Call Report terms are applicable to the reporting period that closed on [quarter-end report date], nor does it assert that the Call Report terms fail to address the accounting and equity capital treatment of capital notes.

The Glossary for the Call Report Instructions, as in effect on March 2012, provides:

When an institution receives a note receivable rather than cash as a capital contribution, ASC Subtopic 505-10<sup>9</sup> states that it is generally *not* appropriate to report the note as an asset. As a consequence, *the predominant practice is to offset the note and the capital contribution in the equity capital section of the balance sheet, i.e., the note receivable is reported as a reduction of equity capital.* In this situation, the capital stock issued or the contribution to paid-in capital should be reported in Schedule RC, item 23, 24, or 25, as appropriate, and the note receivable should be reported as a deduction from equity capital in Schedule RC, item 26.c, “Other equity capital components.” No net increase in equity capital should be reported in Schedule RI-A, Changes in Bank Equity Capital....

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<sup>7</sup> See 77 Fed. Reg. 9,727 (Feb. 17, 2012) (see FIL-10-2012, dated March 2, 2012 and FIL-18-2012, dated April 5, 2012).

<sup>8</sup> See 76 Fed. Reg. 72,035, 72,044-45 (Nov. 21, 2011); see also FIL-72-2011, dated December 7, 2011.

<sup>9</sup> “ASC Subtopic” is a short-hand reference to “Accounting Standards Codifications” of the Financial Accounting Standards Board” (referred to herein as “FASB Subtopic [#]” or “ASC Subtopic [#]”).

However, ASC Subtopic 505-10 provides that an institution *may* record a note received as a capital contribution as an asset, rather than a reduction of equity capital, only *if the note is collected in cash “before the financial statements are issued.” The note receivable must also satisfy the existence criteria described below.* When these conditions are met, the note receivable should be reported separately from an institution’s other loans and receivables in Schedule RC-F, item 6, “All other assets,” and individually itemized and described in accordance with the instructions for item 6, if appropriate.

Call Report Instructions Glossary, “Capital Contributions of Cash and Notes Receivable,” at A-13, [http://www.fdic.gov/regulations/resources/call/crinst/2012-09/912Gloss\\_092812.pdf](http://www.fdic.gov/regulations/resources/call/crinst/2012-09/912Gloss_092812.pdf) (emphasis added). The Call Report Instructions Glossary specifies that financial statements are generally considered issued 30 calendar days after the quarter-end report date, the submission deadline for Call Reports. *Id.* The Glossary continues:

*To be reported as an asset, rather than a reduction of equity capital, as of a quarter-end report date, a note received as a capital contribution (that is collected in cash as described above) must meet the definition of an asset under generally accepted accounting principles by satisfying all of the following existence criteria:*

1. There must be written documentation providing evidence that the note was contributed to the institution prior to the quarter-end report date by those with authority to make such a capital contribution on behalf of the issuer of the note (*e.g.*, if the contribution is by the institution’s parent holding company, those in authority would be the holding company’s board of directors or its chief executive officer or chief financial officer);
2. *The note must be a legally binding obligation of the issuer to fund a fixed and stated dollar amount by a specified date; and*
3. The note must be executed and enforceable before quarter-end.

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*Furthermore, if a note receivable for a capital contribution obligates the note issuer to pay an amount that is variable or otherwise not specifically stated, the institution must offset the note and equity capital. Similarly, an obligor’s issuance of several notes having fixed face amounts, taken together, would be considered a single note receivable having a variable payment amount, which would require all the notes to be offset in equity capital as of the quarter-end report date.*

Call Report Instructions Glossary, *id.* at A-14 (emphasis added).

The specific accounting guidance cited in this Call Report Instructions excerpt, FASB Subtopic 505-10-45-2, provides that, “[r]eporting the note as an asset is generally not appropriate, except in very limited circumstances in which there is *substantial evidence of ability and intent to pay within a reasonably short period of time.*” (Emphasis added.) While this FASB Subtopic states that the “predominant practice” is to offset the notes, it further acknowledges that the notes “may be recorded as an asset if collected in cash before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25).”

The referenced FASB Subtopic 855-10-25-1 provides that an entity shall recognize in the financial statements the effects of all subsequent events “that provide *additional* evidence about conditions that *existed at the date of the balance sheet*, including the estimates inherent in the process of preparing financial statements.” (Emphasis added.) FASB Subtopic 855-10-25-3 cautions that an entity “shall *not* recognize subsequent events that provide evidence about conditions that *did not exist at the date of the balance sheet* but arose after the balance sheet date but before financial statements are issued or are available to be issued.” (Emphasis added.)

#### ***IV. Analysis.***

In response to Holding Company’s request for review, the Division Director conducted a review of the Regional Office’s application of the applicable Call Report and GAAP standards to the \$[entire amount] capital note commitment Holding Company issued on [quarter-end report date]. In her April 11, 2013, written determination, the Director concluded that Subsidiary Bank incorrectly accounted for the capital notes issued by Holding Company on its [quarter-end report date], Call Report. She reached this conclusion for two fundamental reasons. First, at the time that the capital notes were issued on [quarter-end report date], Holding Company had failed to provide substantial evidence of its ability and intent to fund the capital notes within a reasonably short period of time, as required by FASB Subtopic 505-10-45-2, because Holding Company’s intent and ability to fund the notes was subject to contingencies. Second, she concluded that, because Holding Company issued multiple capital notes with fixed face amounts [\*\*\*\*\*], and the Call Report Instructions consider the capital notes [\*\*\*\*\*] to be one note having a variable payment amount, the capital notes should be deducted from equity capital. *See* Review letter from Doreen R. Eberley, Director, RMS, dated April 11, 2013, Addendum at pp. 1-2, concluding that, as a consequence, Subsidiary Bank was required to file an amended [quarter-end report date], Call Report.

The Committee affirms the Division Director’s two fundamental findings.

- A. Holding Company failed to demonstrate substantial evidence that, at the time that the capital notes were issued, Holding Company had the intent and ability to fund the notes within a reasonably short period of time.***

***1. The [letter dated 27 days prior to quarter-end report date], communication was not substantial evidence of Holding Company's intent and ability to timely fund the capital note obligation.***

The Committee finds that Holding Company's communications on the particular transaction contemplated and completed were inadequate to meet the Call Report and GAAP guidance criteria -- that on [quarter-end report date], Holding Company had demonstrated substantial evidence of its ability and intent to fund its \$[entire amount] capital note obligation within a reasonably short period of time.

Holding Company asserts that it has "demonstrated overwhelming evidence" of both the ability and intent to pay the capital notes in question, and in its request for Division Director review, characterized this evidence as being "clear and undisputed." See Attachments to Holding Company correspondence dated May 8, 2013, at 2, 3, and February 14, 2013, at 2, 4. Holding Company argues that it had informed the Regional Office on, and before, [quarter-end report date], of its desire to settle or sell its [Non-bank Asset] interest, and that it "laid out specific plans" regarding the sale in its letter dated [letter dated 27 days prior to quarter-end report date], to State supervisory authorities (copying Regional Office staff).

A review of this cited correspondence is instructive. In the [letter dated 27 days prior to quarter-end report date], letter to the State authorities, Holding Company outlined [\*\*\*\*\*] and a range of alternatives relating to both Holding Company and Subsidiary Bank. First, Holding Company stated it [\*\*\*\*\*]. Holding Company then proceeded to identify other alternatives under consideration in order of declining preference. For instance, Holding Company indicated that it had "identified a proposed counterparty that is willing to purchase" Subsidiary Bank. Holding Company stated that this purchaser was "prepared to place funds in escrow and is in the process of negotiating a binding agreement" with Holding Company and estimated that a definitive agreement could be presented within 10 days.

A lesser-preferred alternative was a partial capital injection in Subsidiary Bank with proceeds Holding Company had [\*\*\*\*\*from a redacted source], but this option would still result in a capital shortfall at Subsidiary Bank of \$[remaining capital balance shortfall], and anticipated Subsidiary Bank's future use of [earnings from the Non-bank Asset] (not their sale). Another lesser-preferred alternative was for Holding Company to [alternate plan pertaining to the Non-bank Asset], an alternative Holding Company claimed it had been "diligently" pursuing since [the end of the previous quarter before the quarter-end report date] but had encountered challenges obtaining necessary information [\*\*\*\*\*]. In this [letter dated 27 days prior to quarter-end report date] correspondence, Holding Company also stated that it "had identified a couple of prospective purchasers" for the [Non-bank Asset], but specifically noted [that] its "[r]eluctance to this alternative rests on the fact that a quick sale of the [Non-bank Asset] would yield approximately \$[estimated quick-sale value]," whereas placing the [Asset] on the market "for a reasonable period could result in twice the value." No date was provided for either of these alternatives.

In sum, Holding Company mentioned it *could* sell its rights to the [Non-bank Asset] , among multiple possible alternatives of which this latter was the least preferred. And having identified this least-preferred alternative, Holding Company ultimately stated that it was reluctant to pursue that option because it found the economic consequences of such a sale to be unsatisfactory (and would evidently result in a return falling short of the capital shortfall it had estimated and identified at Subsidiary Bank elsewhere in this [letter dated 27 days prior to quarter-end report date] communication).

In the Committee’s view, this [letter dated 27 days prior to quarter-end report date] letter is not substantial evidence of Holding Company’s intent and ability to fund capital notes. It does not mention the issuance of capital notes, nor does it cite a specific source of revenue that would enable Holding Company to fund the issuance of the \$[entire amount] that Holding Company committed itself to fund. Moreover, this correspondence to its State regulator failed to identify such a transaction with particularity. These facts support the Division Director’s determination that the capital notes were improperly accounted for because Holding Company failed to present substantial evidence of intent and ability to timely fund \$[entire amount] of capital notes on [quarter-end report date].

***2. The [quarter-end report date], email correspondence does not reflect substantial evidence of Holding Company’s intent and ability to timely fund the capital note obligation.***

On [quarter-end report date], during the afternoon of the final day of the financial quarter (and with the record reflecting no intervening correspondence since the initial communication on [letter dated 27 days prior to quarter-end report date]), Holding Company sent Regional Office staff an email message indicating that “[c]apital notes were issued [that day] totaling \$[entire amount] and [\*\*\*\*\*],” and added that “[t]he notes were generated by the planned sale of [Holding Company’s] interest in the [Non-bank Asset].” Electronic Message of [Holding Company President] ([quarter-end report date], 1:48 p.m.). The Committee finds that Holding Company’s [quarter-end report date] communication falls short of substantial evidence of both the intent and ability to sell the [Non-bank Asset] and timely fund the \$[entire amount] capital note obligation.

In a response that afternoon, Regional Office staff stated that: (1) the Division likely needed additional detail on this transaction; (2) the agreement described was not the anticipated [previously described deal involving the Non-bank Asset] that Holding Company previously indicated it was pursuing; (3) it was instead an assignment of Holding Company’s rights in [the Non-bank Asset] (that Holding Company referenced in an attachment it did not attach) under an agreement purporting to sell rights to the [Non-bank Asset] to “Third-Party Asset Purchaser” for \$[entire amount]; and (4) FDIC staff would contact Holding Company later after having had a chance “to discuss with the FDIC Accounting Section” whether the agreement Holding Company attached was

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sufficient to comply with accounting guidance on the treatment of capital contributions in the form of notes.<sup>10</sup>

In a response message, Holding Company's [President] reiterated that the agreement with Third-Party Asset Purchaser represented a binding transaction but noted that [\*\*\*\*\*] Holding Company also explained that it had been able to generate a higher price with a third-party buyer instead of [negotiating a different transaction with the obligor on the Non-bank Asset]. The additional information provided by Holding Company in this [quarter-end report date], communication was limited; it consisted of the actual agreement between Holding Company and Third-Party Asset Purchaser that merely identified "Third-Party Asset Purchaser" as the purchaser, provided Third-Party Asset Purchaser's address, and expressed Third-Party Asset Purchaser's obligation to pay a sale price of \$[entire amount].

This agreement between Holding Company and Third-Party Asset Purchaser was signed [quarter-end report date], by Holding Company's Corporate President [name] (seller) and Third-Party Asset Purchaser's President [individual with the same surname] (buyer). In their memorandum seeking review by this Committee, Holding Company asserts that Third-Party Asset Purchaser is independent of Holding Company, but states, "for the sake of completeness, it should be noted that [Holding Company] and [Third-Party Asset Purchaser] have an intermingling of board of directors." Holding Company memorandum seeking SARC review (May 8, 2013) at 8.

These documents, according to Holding Company, constitute "clear and undisputed evidence" of Holding Company's intent and ability on [quarter-end report date], to timely fund the capital notes, consistent with the requirements of GAAP and the Call Report Instructions, and that the transaction was not subject to contingencies. The Committee disagrees.

On [quarter-end report date], in the absence of intervening communication (of record) since the initial communication on [letter dated 27 days prior to quarter-end report date], FDIC staff was first apprised that the [Non-bank Asset] had been sold to a previously never-disclosed party, for a price 50 percent higher than the [estimated quick-sale price] Holding Company had estimated one month earlier. FDIC staff had been provided no information whatsoever on the purchaser's financial ability to complete the transaction within 30 days of the close of the quarter, no information confirming the performance of any due diligence, and no information even suggesting State supervisory authorities were aware of the transaction, much less had provided any review or approval. This sale agreement of [quarter-end report date], was also identified as the sole basis for Holding Company's declaration on [quarter-end report date] that "capital notes were

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<sup>10</sup> Regional FDIC staff cited OTS capital note guidance in this email response to Holding Company, although neither the February 4, 2013, material supervisory determination nor the Division Director Review cites or relies upon the OTS Guidance. Upon being asked by a Committee member during the hearing, FDIC staff confirmed that there was no reliance upon it.

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issued totaling \$[entire amount] and [\*\*\*\*\*]” and that “the notes were generated by the planned sale of [Holding Company’s] interest in the [Non-bank Asset].”

Thus, as of [quarter-end report date], the Regional Office had been apprised that Holding Company had incurred a \$[entire amount] obligation to [\*\*\*\*\*]Subsidiary Bank, in the form of capital notes, and that Holding Company’s intent and ability to fund the notes was contingent on the sale of its [Non-bank Asset] rights. While Holding Company is correct that these circumstances indicate a general intent *to sell* the [Non-bank Asset], and a commitment to inject \$[entire amount] of capital [\*\*\*\*\*], this does not amount to substantial evidence that on [quarter-end report date], Holding Company had both the intent and ability to actually do so.

In this case, neither the asset being sold nor the purchaser was an insured depository institution. Nor is this a situation in which the purchase funds have been placed in escrow pending the completion of the transaction in the 30 days prior to the filing of a Call Report. In such a situation, not only has the purchaser demonstrated that it has the funds on the agreement date, but it has committed those funds on that date by placing the funds in escrow. Here, it was not known, on [quarter-end report date], how either party established a price of \$[entire amount] (a price well in excess of Holding Company’s own estimate), whether any due diligence had been conducted by the purchaser, or from what sources Third-Party Asset Purchaser would fund the purchase. All that Holding Company established on [quarter-end report date], was that it had: (1) entered into agreement that day; (2) with a purchaser about whom it provided a name and address; (3) to sell an asset of Holding Company’s for a price of \$[entire amount], a price identical to, and critical to fund, \$[entire amount] in capital note obligations that Holding Company had also incurred that very day. Also, the relationship between the buyer and seller, and their independence of one another, had not been clearly established. It is on this minimal, factual basis that Holding Company asserts that it established substantial evidence of Holding Company’s intent and ability to fund the \$[entire amount] capital note obligation within a reasonably short period of time.

As evidence of the purchaser’s ability to complete the transaction, and ostensibly Holding Company’s ability to fund the capital notes as of [quarter-end report date], Holding Company provided a May 2013 affidavit of [individual], Third-Party Asset Purchaser’s President, stating that, as of [quarter-end report date], “Third-Party Asset Purchaser’s liquidity, including available credit lines, was well in excess of \$[entire amount].” However, this mere statement as to Third-Party Asset Purchaser’s financials, some three months after the material supervisory determination was rendered, is not persuasive as to Holding Company’s intent and ability to fund its note obligation on [quarter-end report date].<sup>11</sup>

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<sup>11</sup> Moreover, the affidavit post-dates both the date of the material supervisory determination and the Division Director’s review of that determination, and accordingly will not be considered by the Committee. *Guidelines at M. “Scope of Review and Decision.” 77 Fed. Reg. at 17,058.*

**3. *The fact that the transaction that closed was not the agreed-upon [quarter-end report date], transaction confirms Holding Company's lack of ability and intent to fund the capital notes, as contingencies were evident.***

Critically, subsequent events and information identified by the parties further confirm Holding Company's lack of ability and intent to fund the capital note obligation. Holding Company has acknowledged that, after [quarter-end report date], the deal agreed upon on [quarter-end report date] was subsequently changed. Not only did Holding Company fail to obtain \$[entire amount] for the sale of the [Non-bank Asset] to Third-Party Asset Purchaser, but Holding Company was also unable to fund all of the capital notes it obligated itself to fund on [quarter-end report date], [\*\*\*\*\*] to Subsidiary Bank. These facts represent highly persuasive evidence of Holding Company's lack of ability and intent to fund the \$[entire amount] capital note commitment.

Ultimately, the [Non-bank Asset] rights were sold to Third-Party Asset Purchaser for \$[less than entire agreed amount], a fact the Regional Office evidently learned only after the transaction closed. The record does not explicitly establish for the Committee the reason for this change in the terms of the transaction. The Division Director concluded, in the absence of evidence or explanation provided by Holding Company, that the price change was due to the [Third-Party Asset Purchaser's] apparent lack of liquidity, since the purchaser had entered into a legal agreement to pay \$[entire amount] for the [Non-bank Asset] rights but it ultimately did not. The Division Director also questioned the evident ability of Third-Party Asset Purchaser to complete the deal negotiated on [quarter-end report date], citing the perception that [supervisory authorities] had concerns regarding the propriety of Third-Party Asset Purchaser's entering into the transaction. Holding Company insists that Third-Party Asset Purchaser had the financial wherewithal to fund the deal, as well as the legal authority to complete the transaction, and disputes that any contingencies existed. However, Holding Company acknowledges that the purchase price was altered following discussions with [supervisory authorities]. (The record does not clarify the specific issues discussed.)

Assuming Third-Party Asset Purchaser had the funds on [quarter-end report date] and also had the ultimate authority to enter into the transaction, which Holding Company argues is clear, what *is* clear to the Committee is that the terms of the deal changed.

This calls into question the commitment that Third-Party Asset Purchaser made on [quarter-end report date], to fund the transaction. As a direct result, Holding Company's own intent and ability on [quarter-end report date], to fund the \$[entire amount] in notes it committed to fund on the basis of that sole sale transaction, is suspect. As noted above, FASB Subtopic 855-10-25-1 provides that an entity shall recognize in the financial statements the effects of all subsequent events "that provide *additional* evidence about conditions that *existed at the date of the balance sheet*, including the estimates inherent in the process of preparing financial statements." (Emphasis added.) The subsequent events identified by the parties indicated the deal that purportedly existed

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on [quarter-end report date], was not a commitment that Third-Party Asset Purchaser could, or would, close. As this sale transaction did not close at \$[entire amount], and served as the sole stated basis for Holding Company's intent and ability to fund its \$[entire amount] capital note obligation, Holding Company's intent and ability was contingent and not firmly established, as the Division Director correctly affirmed.

The Division Director noted that as of [quarter-end report date], supervisory authorities had not reviewed the Holding Company/Third-Party Asset Purchaser transaction. She also observed that Holding Company had submitted no evidence confirming either that [\*\*\*\*\*] or that [\*\*\*\*\*], and that Third-Party Asset Purchaser appeared to lack sufficient liquidity to complete the [quarter-end report date] transaction as the agreed-upon price was ultimately lowered to \$[less than entire agreed amount] immediately prior to closing. Holding Company challenges the Division Director's observation that, because [supervisory] authorities had not reviewed the proposed [Non-bank Asset] sale as of [quarter-end report date], that unperformed review constituted a contingency. Nevertheless, Holding Company acknowledges that following discussions with [supervisory] authorities, the terms of the [quarter-end report date], deal changed. It is inconsistent for Holding Company to maintain that supervisory review and approval did not constitute a contingency to the [quarter-end report date] agreement and, at the same time, acknowledge that, following this review, the parties ultimately changed a critical term of the sale agreement.

[\*\*\*\*\*]

The ultimate decision reached by the Division Director is supported: outstanding unresolved contingencies remained on Third-Party Asset Purchaser's commitment on [quarter-end report date], and remained on Holding Company's ability and intent on that date to fund \$[entire amount] in capital notes. Otherwise, the deal would not have changed.

In conclusion, Holding Company provided broad and varying information on the deal it contemplated ([letter dated 27 days prior to quarter-end report date]), last-minute and minimal information about the deal it negotiated at quarter-end ([quarter-end report date]), and incomplete and after-the-fact detail about the different deal it ultimately closed.

***B. The Call Report Instructions and GAAP require Subsidiary Bank to deduct the capital notes from equity capital.***

***1. Because Holding Company issued multiple capital notes with fixed face amounts to Subsidiary Bank under the Call Report Glossary, the capital notes are considered one note having a variable payment amount, and must be deducted from equity capital.***

Under GAAP and the Call Report's Instructions, when an institution receives a note receivable rather than cash as a capital contribution, it is generally not appropriate to

report the note as an asset, as “the predominant practice” is to offset the note and the capital contribution in the equity capital section of the balance sheet. An institution *may* record a note received as a capital contribution as an asset, rather than a reduction of equity capital, but this is only appropriate when the note: (1) is collected in cash before the financial statements are issued; *and* (2) the note receivable satisfies the existence criteria described in the excerpted Call Report Glossary.

In its request for review by the Division Director, Holding Company repeatedly emphasized that the notes were funded in cash within [date, post quarter-end, that financial statement must issue].<sup>12</sup> Even if accurate, Holding Company ignored the separate requirement that the notes must meet the definition of an asset under generally accepted accounting principles by satisfying *all* of the existence criteria.

These existence criteria, enumerated in the Call Report language excerpted previously, require that there be written documentation providing evidence that the note was contributed to the institution prior to the quarter-end report date, that the note be a legally binding obligation of the note issuer *to fund a fixed and stated dollar amount* by a specified date, and that the note be executed and enforceable before quarter-end.

Here, Holding Company issued multiple notes to Subsidiary Bank ([multiple] notes total on [quarter-end report date]). Even though each was for a fixed face amount, the applicable Call Report language makes plain that an obligor’s issuance of several notes having fixed face amounts, taken together, are to be considered “a single note receivable having a variable payment amount.”<sup>13</sup> Thus, not only does this mean that Holding Company failed the second of these existence criteria (an obligation to fund a fixed amount), but the Call Report Instructions Glossary expressly concludes that Holding Company’s issuance of several notes having fixed face amounts, taken together, are to be considered a single note receivable having a variable payment amount “which would require all the notes to be offset in equity capital as of the quarter-end report date.” As the Call Report Instructions are clear, the Committee also affirms this second finding of the Division Director which, like the Director’s first finding, is an independently sufficient ground to uphold the Division Director’s determination of the need for the filing of amended [quarter-end report date], Call Reports.

***2. Regardless of the prior treatment of capital notes, Holding Company is required to comply with the Call Report Instructions and GAAP.***

In its written submissions, Holding Company did not dispute that the Call Report Instructions and GAAP apply to Subsidiary Bank, nor did it question the meaning of the

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<sup>12</sup> Holding Company indicated that not all of the original \$[entire amount] note obligation was funded, as the sale transaction with Third-Party Asset Purchaser earned Holding Company only \$[less than entire amount].

<sup>13</sup> See Call Report Glossary “Capital Contributions of Cash and Notes Receivable,” at A-13, 14, [http://www.fdic.gov/regulations/resources/call/crinst/2012-09/912Gloss\\_092812.pdf](http://www.fdic.gov/regulations/resources/call/crinst/2012-09/912Gloss_092812.pdf) (emphasis added).

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express language under the Call Report Instructions Glossary. Holding Company acknowledged that *prospectively* the Call Report language precludes the inclusion of multiple notes issued to a subsidiary in equity capital. However, Holding Company argues that, in this instance, Subsidiary Bank should be permitted to include the notes in equity capital for the quarter ending [quarter-end report date], because Regional Office staff had not objected to those specific notes before [date, post quarter-end, that financial statement must issue], or to the use of capital notes generally in other instances (and ostensibly their inclusion in equity capital), in other reporting quarters. In its request for Division Director review, Holding Company stated:

Between [dates], Holding Company issued and funded [n]otes to its affiliate banks more than [frequency] times; each with the knowledge and approval of the Division. In each of these [frequency] instances, like the one at hand here today, [Holding Company] clearly had the intent to fund the notes, and ultimately, had the ability to fund the notes.

Attachment to request for Division Director review, items 3, 4 (Feb. 14, 2013).

Holding Company further stated that, “Notes such as the ones in question here, have been funded in the past [\*\*\*\*\*].” Holding Company did not otherwise identify these prior transactions for the Director, and, other than this statement suggesting a X-year span, did not otherwise specify under which version of the Call Report these asserted transactions and their proceeds were reported, and did not specify whether *any* fell under the Call Report Instructions as amended effective March 31, 2012 (which provided new Glossary language pertaining to the treatment of capital notes).

In light of these nonspecific assertions [\*\*\*\*\*], it was entirely appropriate that the Director’s April 2013 review, in response, [only discussed general, past historical practice]. [\*\*\*\*\*]

See Director Review letter from Doreen R. Eberley, Director, RMS, dated April 11, 2013, Addendum at 1.

Now, in its written submission to this Committee, Holding Company [provided more detailed, specific assertions]. [\*\*\*\*\*]The use and treatment of capital notes in prior circumstances under the current Call Report provisions were not identified for the Division Director and not under review in this appeal.<sup>14</sup> Moreover, the specific facts of these previous note issuances are not known to the Committee. Further, there is no record evidence that these notes were reviewed and considered by appropriate accounting staff and under applicable provisions of GAAP and Call Report guidance.

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<sup>14</sup> See SARC Guidelines, at I. “Contents of Appeal” (“Only matters previously reviewed at the division level, resulting in a written determination or direct referral to the SARC, may be appealed to the SARC”), 77 Fed. Reg. 17,055, 17,058 (March 23, 2012).

Still, the Committee takes very seriously a fundamental, underlying point that Holding Company raises as to the Glossary provision requiring that multiple fixed notes be treated as one variable note and excluded from equity capital: institutions must be able to rely upon consistent application of the Corporation's regulatory and policy prescriptions, including the Call Report Instructions and accounting interpretations. Consistent application of the Call Report and accounting requirements ensures that institutions are equitably treated and guarantees that supervisors have necessary, accurate information about the health of insured financial institutions.

That said, the Committee cannot agree with Holding Company's assertion that, by its alleged prior silence in other, purportedly similar but not reviewed situations, the Division had "affirmatively misled" Holding Company or any other entity such that an institution should be excused from complying with the Call Report Instructions on a "detrimental reliance" basis, or under any assumption that the Corporation has effectively "waived" any Call Report language or treatment. While the Committee is mindful of Subsidiary Bank's situation, the Call Report provisions were expressly amended, effective March 31, 2012, to clarify the accounting and Call Report treatment of capital notes.

Relief for Holding Company on the facts presented here would in effect estop the FDIC from requiring compliance with the Call Report Instructions based on alleged prior silence in similar transactions. The Supreme Court has not imposed estoppel against the federal government. Rather, the Court has stated the general rule that the federal government may not be equitably estopped on the same terms as private litigants (that is, for negligence or a mistake). The Court has, however, left open the *mere possibility* that a stricter standard -- affirmative misconduct -- *might* merit estoppel against the government. *OPM v. Richmond*, 496 U.S. 414, 419-22 (1990). In the present matter, no evidence suggests any affirmative misconduct on the part of the Division. The Committee rejects the application of the remedy of estoppel on these facts.

In addition, under the Federal Deposit Insurance Act, the responsibility for ensuring accurate and correct Call Reports falls unambiguously on the reporting institution, with significant penalties for failure to comply. 12 U.S.C. § 1817(a). Granting the appeal would also contradict the Call Report Instructions, which provide that each bank is required to prepare and file the Call Report in accordance with the Instructions. The Call Report Instructions also expressly make clear that it is the responsibility of the filing bank to ensure that its Call Report is accurate. The Instructions go on to state that this "responsibility cannot be transferred or delegated to software vendors, servicers, or others outside the reporting bank." Call Report Instructions at p. 6.

**V. *The Committee's Findings.***

The Committee affirms the determination reached by the Division Director that Subsidiary Bank improperly accounted for capital notes issued by Holding Company on its [quarter-end report date], Call Report, and finds that:

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1. At the time the capital notes were issued by Holding Company on [quarter-end report date], the [Subsidiary Bank]and Holding Company had failed to demonstrate substantial evidence of ability and intent to fund the capital notes within a reasonably short period of time, as required by GAAP, in order to report notes receivable as assets, with corresponding increases in equity capital; and
2. Regardless of the prior treatment of capital notes in past quarters, Subsidiary Bank is required to comply with the Call Report Instructions and GAAP and offset the notes in question from equity capital in its [quarter-end report date] Call Report.

Each of these conclusions constitutes an independent basis upholding the Division Director's conclusion that the capital notes under review be excluded from equity capital and that amended [quarter-end report date], Call Reports be filed, consistent with the original material supervisory determination.

**V. *Conclusion.***

For the foregoing reasons, Holding Company's appeal on behalf of Subsidiary Bank is denied as set forth in this opinion. This decision is considered a final supervisory decision by the FDIC.

By direction of the Supervision Appeals Review Committee of the FDIC, date August 30, 2013.

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Valerie J. Best  
Assistant Executive Secretary