Office of the Comptroller of the Currency

Interpretive Letter #735

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12 U.S.C. 24(7)

July 15, 1996

Gregory K. Thoreson
Assistant Secretary
First National Bank of Maryland, D.C.
555 13th Street, N.W.
Washington, D.C. 20004

Re: Notice of First National Bank of Maryland, D.C., of Intent to Establish an Operating Subsidiary Pursuant to 12 C.F.R. 5.34 to Become a Member of a Limited Liability Company - Application Control No. 95-NE-08-0020

Dear Mr. Thoreson:

This is in response to the operating subsidiary notice ("Notice") filed by First National Bank of Maryland, D.C., ("the Bank" or "FNB, D.C.") with the OCC pursuant to 12 C.F.R. 5.34. We have now completed our review and your notice is hereby approved, as described herein.

Facts

On July 18, 1995, the Bank filed an operating subsidiary notice ("Notice") of its intent to establish a new operating subsidiary to acquire, manage and sell real property conveyed to it as security for or in satisfaction of debts previously contracted ("DPC"). As originally proposed, the operating subsidiary would hold a 58.6 percent interest in a limited liability company ("LLC") chartered under the laws of the District of Columbia. The LLC would acquire a single piece of property from the Bank and a co-lender. The Bank subsequently notified the OCC that it would not proceed with the proposed transaction. However, in a letter to the OCC dated December 14, 1995, the Bank requested that its Notice be considered notification of the Bank's intent to establish one or more operating subsidiaries ("Subsidiaries") to acquire title to and hold OREO property. Currently, the Bank has no authority to establish an OREO operating subsidiary. The Bank also seeks approval to make investments through an operating subsidiary, in one or more LLCs in conjunction with other participants in loans secured by real property. Additional information and clarification of the proposal was requested from the Bank. In a letter dated May 16, 1996, the Bank further amended its Notice and provided additional clarification of its proposal as follows.

The Bank is a participant in a series of real estate secured loan transactions ("Participation Loans"). The Bank owns either approximately a 58 percent or 42 percent interest in each of the Participation Loans.

The Participation Loan documents provide that participants representing at least 60 percent of the outstanding balance must consent to any foreclosure or other action with respect to the debt or collateral securing such loan. Therefore, neither the Bank nor the other participants can control the disposition of the collateral securing any Participation Loan without the other party's consent. In the event the participants in any such Participation Loan deem it necessary to acquire the real estate securing such loan, the Bank seeks approval to do so through one or more limited liability companies.<**NOTE:**Since the Bank currently has no specific transaction planned, the identity of the other participants or members of the LLCs are not yet known.> The Bank states that its investment in the LLCs, whether majority (58 percent) or minority (42 percent), will be non-controlling. The Bank has represented that the Bank and its Subsidiaries will report on a consolidated basis and that the Subsidiaries' investment in each of the LLCs will be accounted for by the equity method of accounting. Management of the LLC will be vested in its members and the LLC Operating Agreement will require a supermajority vote (60 percent) approval of the members for all LLC actions. Therefore, even if the Bank were to hold a 58 percent interest in the Participation Loan and membership interest in a LLC, it would not be able to control the management of the LLC.

Analysis

A national bank may engage in activities that are part of or incidental to the business of banking by means of an operating subsidiary. 12 C.F.R. 5.34(c). To qualify as an operating subsidiary, the parent bank must own at least 80 percent of the voting stock of the corporation.<**NOTE:**The OCC has proposed to reduce this 80 percent ownership requirement for establishing an operating subsidiary. *See* 59 Fed. Reg. 61034,61056 (1994). However, this proposal has not yet been implemented.> A national bank is authorized to make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real property. See 12 U.S.C. 371. A national bank may acquire real estate and other property or assets securing a loan, manage and operate those assets, and employ any reasonable means to avoid the loss of its extensions of credit within the parameters of 12 U.S.C. 29, and the applicable rulings concerning retention of real estate. See Interpretive Letter No. 657 (March 31, 1995), reprinted in [Current] Fed. Banking L. Rep. (CCH) 83,605. It is also well established that national banks have the authority to purchase, hold, and convey DPC property. See 12 U.S.C. 29 (Third). Moreover, the OCC has held that a national bank can own an interest in a LLC which will manage and dispose of the bank's DPC assets. See Unpublished Letter by Law Department Assistant Director William Glidden, April 8, 1994 ("1994 Glidden Letter"). Therefore, the Bank may establish operating subsidiaries to hold OREO property either directly or through a LLC.

Your letter raises the issue of the authority of a national bank to make a non-controlling majority and minority investment in a LLC. In approving a national bank's majority participation in a LLC, the OCC has looked at whether the underlying activities are permissible under 12 U.S.C. 24(Seventh) as part of or incidental to the business of banking, whether the national bank is shielded from unlimited liability for the acts of the LLC, and whether the national bank has the power to influence and, if necessary, withdraw from membership in the LLC in the event the LLC engages in activities which are impermissible for national banks. Separately, in a variety of circumstances the OCC has permitted national banks to own, either directly, or indirectly through an operating subsidiary, a minority interest in an enterprise. The enterprise might be a limited partnership, a corporation, or in more recent examples, a limited liability company. In a recent interpretive letter, the OCC concluded that national banks are legally permitted to make a minority investment in a LLC provided four criteria or standards are met. *See* Interpretive Letter No. 692, (November 1, 1995), *reprinted in* [Current] Fed. Banking L. Rep. (CCH) 81,007, and No. 694 (Dec. 13, 1995), *reprinted in* [Current] Fed. Banking L. Rep. (CCH) 81,009. <**NOTE:** In two other recent letters, the OCC has permitted national banks to make a non-controlling investment in an

enterprise other than an LLC, provided the investment satisfies these four standards. *See* Letter of Stephen R. Steinbrink, Senior Deputy Comptroller, Bank Supervision Operations (November 15, 1995, unpublished); Letter of William B. Glidden, Assistant Director, Bank Activities and Structure Division (October 25, 1995, unpublished).> *See also* Letter of Steven J. Weiss, Deputy Comptroller, Bank Organization and Structure, (December 27, 1995 unpublished) ("Weiss Letter"). These standards, which have been distilled from our previous decisions in the area of permissible minority investments for national banks and their subsidiaries are: (1) The activities of the entity or enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking; (2) The investing bank must be in a position to prevent the enterprise or entity from engaging in activities that do not meet the foregoing standard; (3) The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and (4) The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.

Despite the fact that the Bank, through its Subsidiaries, may own a 58 percent interest in the LLCs, the investment will still be considered a "non-controlling" investment for purposes of legal and accounting treatment because of the way the LLCs will be operated and managed, i.e., a 60 percent supermajority approval of the members is required for all LLC actions. Therefore, the analysis for these transactions will be essentially the same as it was in Interpretive Letter No. 692 and the Weiss Letter.

Applying these four standards to the facts presented, I conclude, as discussed below, that the Bank's proposal satisfies these four standards and that the proposed activities may be conducted through an operating subsidiary pursuant to 12 C.F.R. 5.34.

1. *The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking.*

The acquisition, management and sale of real property conveyed to the Bank as security for or in satisfaction of debts previously contracted, either directly or through an operating subsidiary, is an activity that is part of or incidental to the business of banking under 12 U.S.C. 24(Seventh). It is well established that national banks have the authority to purchase, hold and convey DPC property. *See* 12 U.S.C. 29 (Third). National banks also have the ability to make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real property. *See* 12 U.S.C. 371. In addition, a national bank may acquire real estate and other property or assets, securing a loan, manage and operate those assets, and employ any reasonable means to avoid the loss of its extensions of credit within the parameters of 12 U.S.C. 29, and the applicable rulings concerning the retention of real estate. *See* Interpretive Letter No. 657, *reprinted in* Fed. Banking L. Rep. (CCH) at 83,605 (March 31, 1995). The OCC has previously held that a national bank can own an interest in a LLC which will manage and dispose of the bank's DPC assets. *See* 1994 Glidden Letter. Thus, the proposed activities of the LLCs, the purchase of and conveyance of real property, including DPC property, are permissible activities for national banks. Moreover, the amended Notice provides that the articles of organization and Operating Agreements of the LLCs will provide that the LLCs will only engage in activities permissible for national banks. Accordingly, this criteria is satisfied.

2. *The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard.*

This is an obvious corollary to the first standard. It is not sufficient that the LLC's activities are permissible at the time the bank initially purchases LLC membership shares; they must also remain permissible for as long as the bank retains an ownership interest in the LLC.

Under District of Columbia law, unless the articles of organization provide otherwise, a LLC may exercise "all powers necessary or convenient to effect any or all of the purposes for which the limited liability company is formed...". D.C. CODE ANN. 29-1303 (1991).

The amended Notice provides that the draft Operating Agreement will be amended to provide that the LLCs will only engage in bank permissible activities and that the operating subsidiaries will be able to withdraw from a LLC and require the LLC to commence winding up its business and liquidate its property in the event it engages in activities impermissible for national banks. Accordingly, this standard will be satisfied provided the Operating Agreements confirm that the Bank will only engage in activities that are part of, or incidental to the business of banking, and that the Bank will withdraw from the LLCs in the event the LLCs engage in activities that are inconsistent with this standard.

3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise.

Loss Exposure from a Legal Standpoint

A primary concern of the OCC is that national banks should not be subjected to undue risk. Where an investing bank will not control the operations of the entity in which the bank holds an interest, it is important that a bank's investment not expose it to unlimited liability. Such is the case here. As a legal matter, investors in a District of Columbia LLC will not incur liability with respect to the liabilities or obligations of the LLC solely by reason of being a member or manager of the LLC -- even if they actively participate in the management or control of the business. D.C. CODE ANN. 29-1314(b) (1991). This limited liability feature is what differentiates LLCs both from general partnerships, where all partners are generally liable for the debts of the partnership, and from limited partnerships, which must have at least one general partner who is personally liable for the obligations of the partnership.<**NOTE:**The necessity for at least one general partner reflects a policy that someone have personal liability. *See* section 1 of the Uniform Limited Partnership Act. However, this is frequently circumvented in states where a corporation (with limited liability under state corporate laws) can be the general partner.>

You have represented that the amended Operating Agreements will shield the Bank from any liability for the obligations of the LLCs. See May 16, 1996 Notice at p. 4; July 17, 1995 Notice at p.3. You have also represented that FNB, D.C.'s risk of loss exposure for any debts, liabilities or potential depreciation of the value of assets of the LLCs will be limited to its investment in the LLC. The authority to manage and control the business affairs of the LLC will be vested in the members of the LLC. The Operating Agreement will require a supermajority vote of 60 percent for all actions to be taken by the LLC. Thus, the Bank's loss exposure for the LLCs' liabilities will be limited by statute and the Operating Agreement.

Loss Exposure from an Accounting Standpoint

In assessing a bank's loss exposure as an accounting matter, the OCC has previously noted that the appropriate accounting treatment for a bank's 20-50 percent ownership share or investment in a LLC is to report it as an unconsolidated entity under the equity method of accounting. Under this method, unless the bank has extended a loan to the entity, guaranteed any of its liabilities or has other financial obligations to the entity, losses are generally limited to the amount of the investment shown on the investor's books. *See generally*, Accounting Principles Board, Op. 18 19 (1971) (equity method of accounting for investments in common stock). Interpretive Letter 692, supra.

In this case, the Bank's investment will be made through its Subsidiaries and will amount to either approximately 58 or 42 percent of the total membership interest in an LLC. Where a subsidiary owns

over 50 percent in the LLCs, they generally are not able to use the equity method of accounting. Thus, the Subsidiaries' ownership of more than a 50 percent interest in an LLC raises a presumption of control over the LLC. The Bank or its Subsidiaries would, under the general rule, be required to report with the LLC on a consolidated basis.

The Bank has stated, however, that the Bank and its Subsidiaries will report on a consolidated basis and that the Subsidiaries' investment in each of the LLCs will be accounted for by the equity method of accounting. The Bank believes, and its auditors will opine, that the equity method of accounting is appropriate in this instance because the Subsidiaries will not have a controlling voting interest or control over the management of the LLCs. <**NOTE:**OCC's Chief Accountant has concluded that the Bank's investment in the LLCs should be recorded as OREO on the Bank's Consolidated Reports of Condition and Income ("Call Reports"). Such classification is consistent with the Call Report instructions. *See* Instructions to Schedule RC-M.> A supermajority vote of 60 percent will be required for all actions taken by the LLCs. In addition, as noted above, the agreements governing the LLCs and District of Columbia law limit members' losses to their capital investment and, therefore, the Subsidiaries and the Bank will not have open-ended liability for the obligations of the LLCs. Therefore, the third standard is satisfied.

4. *The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to that bank's banking business.*

A national bank's investment in an enterprise or entity that is not an operating subsidiary of the bank must also satisfy the requirement that the investment have a beneficial connection to the bank's business, i.e., be convenient or useful to the investing bank's business activities, and not constitute a mere passive investment unrelated to that bank's banking business. "Necessary" has been judicially construed to mean "convenient or useful". See *Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972). The provision in 12 U.S.C. 24(Seventh) relating to the purchase of stock, derived from section 16 of the Glass-Steagall Act, was only intended to make it clear that section 16 did not authorize speculative investments in stock. *See* Letter of Stephen R. Steinbrink, Senior Deputy Comptroller, Bank Supervision Operations (November 15, 1995, unpublished). Therefore, a consistent thread running through our precedents concerning stock ownership is that it must be convenient or useful to the bank in conducting *that bank's* banking business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment.

The Bank has stated that the proposed investment in the LLCs is intended to support and facilitate the Bank's authority to acquire, hold and convey OREO property to protect the value of real property which serves as collateral for a loan. The investment in the LLCs provides the Bank with an opportunity to protect its interest in an efficient and cost-effective manner. The use of an LLC to acquire title to OREO property is a reasonable and convenient method for the Bank to hold an investment in which it has a security interest.

Overall, the Bank's investment in the LLCs is related its business and would be convenient and useful to it in carrying out its banking business. Therefore, the fourth standard is satisfied.

Conclusion

For the reasons discussed above, the Bank's investment in the LLCs through the operating subsidiaries satisfies the four standards for a national bank's majority and minority, non-controlling investment in a LLC. Therefore, the Bank's operating subsidiary notification is approved subject to the following special conditions:

(1) the LLCs and the operating subsidiaries may engage only in activities that are part of or incidental to the business of banking;

(2) the Bank, through the operating subsidiaries, will have veto power over any activities and major decisions of the LLCs that are inconsistent with condition number one, or will withdraw from the LLCs in the event they engage in an activity that is inconsistent with condition number one;

(3) the Bank will account for the investment in the LLCs under the equity method of accounting; and

(4) the operating subsidiaries and the LLCs will be subject to OCC supervision and examination.

Please be advised that all conditions of this approval are "conditions imposed in writing by the agency in connection with the granting of any application or other request" within the meaning of 12 U.S.C. 1818.

If you have any questions, please contact Nancy Cody, National Bank Examiner, Corporate Activity at (202)874-5060 or Susan L. Blankenheimer, Senior Attorney, Bank Activities and Structure Division at (202)874-5300.

Sincerely,
/s/
Julie L. Williams
Chief Counsel