Comptroller of the Currency
Administrator of National Banks

Southeastern District Office
Marquis One Tower
245 Peachtree Center Ave., NE
Suite 600
Atlanta, Georgia 30303

Interpretive Letter #819
February 1998
12 U.S.C. 24(7)

January 20, 1998

Dear [ ]:

This is in response to your letter dated December 3, 1997, requesting confirmation that [ ] ("Bank") may lawfully acquire and hold a fifty percent non-controlling interest in [ ], a general insurance agency which will be a Tennessee limited liability company ("LLC"). The principal office of the LLC will be located in the branch office of the Bank in [*City1*], Tennessee. For the reasons set forth below, it is our opinion that this transaction is legally permissible in the manner and as described herein.

I. Background

The Bank proposes to hold a 50 percent non-controlling interest in a newly-formed LLC. [ ] ("*Co.*") will acquire and hold the remaining 50 percent interest in the LLC. The LLC will be established under Tennessee law pursuant to a written agreement between the Bank and [*Co.*]. Initially, [*Co.*] will form a wholly-owned subsidiary corporation ("[*Co.*]Sub") and will contribute approximately one-half of its insurance divisions in [*City2*], Tennessee, to [*Co.*]Sub. [*BHC*], the Bank's holding company, will also form a wholly-owned subsidiary ("InterimSub"). [*Co.*] will then merge [*Co.*]Sub into InterimSub, resulting in the business of [*Co.*]Sub being owned entirely by InterimSub. The consideration for the merger will be the issuance to [*Co.*] of 16,431 shares of

common stock of [*BHC*], 2.15% of the 764,245 shares outstanding after the issuance thereof.[1]

Immediately after the merger of [*Co*.]Sub into InterimSub, [*BHC*], will contribute all of its ownership of InterimSub to the Bank.[2] The Bank will then form the LLC and InterimSub will contribute its insurance division assets and business, along with approximately $216,000 in cash from the Bank to the LLC in exchange for 50% ownership of the LLC. [*Co*.] will contribute its remaining [*City2*] insurance business assets and business along with approximately $216,000 worth of furniture, fixtures, and equipment to the LLC in exchange for the remaining 50% ownership in the LLC. You have represented that these contributions should be deemed tax-free under IRC Section 721. Finally, InterimSub will dissolve.

The LLC will be governed by a Letter Agreement, a Management Agreement and a Buy/Sell Agreement between the Bank and [*Co*.]. Each shareholder will elect an equal number of members to the board of directors. Under the terms of the Letter Agreement, the LLC is specifically prohibited from engaging in activities that would be impermissible for the Bank or a subsidiary of the Bank. Moreover, the Bank will have the authority to veto decisions of the LLC that will result in the company engaging in activities that are inconsistent with activities that are part of, or incidental to, the business of banking. Under the terms of the Buy/Sell Agreement, the Bank is also authorized to sell its interest in the LLC in the event the company engages in activities in which the Bank or a subsidiary of the Bank may not engage.

The LLC will provide general insurance agency activity with its main office in [*City1*], Tennessee, a place of less than 5,000, as shown by the 1990 census. [*Co*.] will provide direct management, support functions, computer operations and clerical functions for the LLC. Agents will be managed through the [*City1*] office. The LLC will be responsible for collecting commissions from the insurance carriers and paying commissions and all other expenses relating to the operations of the agency. The LLC will be generally responsible for processing insurance applications, delivery of insurance policies, and collection of premiums, where consistent with procedures of the relevant insurance carriers. Management fees to be derived from the LLC shall consist of an equal 50/50 division of net profits in payment of services provided by [*Co*.] and the Bank.

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[1] The actual number will be finally determined based upon appraisals currently being conducted of the value of the LLC and the shares. The current estimate is based upon the total estimated value of the[*City2*] insurance business (exclusive of furniture, fixtures, and equipment) being $2,464,719 and the [*BHC*] shares being $75.00 per share. You have represented that this contribution should be deemed tax free under IRC Section 368(a)(2)(D).

[2] You have represented that the Federal Reserve Bank of St. Louis has opined that [*BHC*] is not required to provide an application or notice to the Federal Reserve Bank since InterimSub will not generate any earnings as a subsidiary of the holding company.

II. Discussion

A. National Bank Express and Incidental Powers (12 U.S.C. § 24(Seventh))

The Bank's plan to purchase and hold a 50 percent interest in the LLC raises the issue of the authority of a national bank to make a non-controlling investment in a limited liability company.[3] A number of recent OCC Interpretive Letters have analyzed the authority of national banks, either directly or through their subsidiaries, to own a non-controlling interest in an enterprise. *See, e.g.*, Interpretive Letter No. 697, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-013 (November 15, 1995); Interpretive Letter No. 732, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-049 (May 10, 1996). These letters each concluded that the ownership of such an interest is permissible provided four standards, drawn from OCC precedents, are satisfied.[4] They 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 bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment;

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 and useful to the bank in carrying out its business and not a mere passive investment unrelated to *that bank's* banking business.

Based upon the facts presented, the Bank's proposal satisfies these four standards.

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[3] The OCC recently amended its operating subsidiary rule, 12 C.F.R. § 5.34, as part of a general revision of Part 5 under the OCC's Regulation Review Program. Operating subsidiaries in which a national bank may invest include corporations, limited liability companies, or similar entities if the parent owns (1) more than 50 percent of the voting (or similar type of controlling) interest, or (2) less than 50% so long as the bank "controls" the subsidiary and no other party controls more than 50 percent. 12 C.F.R. § 5.34(d)(2). Here, the LLC will not be considered an operating subsidiary since the Bank will not "control" the LLC.

[4] *See also* 12 C.F.R. § 5.36(b). National banks are permitted to make various types of equity investments pursuant to 12 U.S.C. § 24(Seventh) and other statutes.

Our precedents on non-controlling ownership have recognized that the enterprise in which the bank holds an interest must confine its activities to those that are part of, or incidental to, the conduct of the banking business. *See, e.g.*, Interpretive Letter No. 380, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (December 29, 1986) (since a national bank can provide options clearing services to customers it can purchase stock in a corporation providing options clearing services); Letter from Robert B. Serino, Deputy Chief Counsel (November 9, 1992) (since the operation of an ATM network is "a fundamental part of the basic business of banking," an equity investment in a corporation operating such a network is permissible).

The LLC will act as a general insurance agency. It is clear that the Bank may establish an LLC to engage in general insurance agency activities as permitted under 12 U.S.C. § 92. *See, e.g.*, OCC Corporate Decision 97-24 (April 15, 1997) (approving operating subsidiary to engage in general insurance agency activities pursuant to 12 U.S.C. § 92). Section 92 specifically authorizes a national bank located and doing business in a place having a population of less than 5,000 to act as the agent for fire, life, or any other insurance company. In its letter, the Bank has represented that the LLC's activities will be limited to those permissible for national banks under 12 U.S.C. § 92 and that the LLC's activities will be conducted in accordance with the principles set forth in OCC Interpretive Letter No. 753, *reprinted in* [1996-97 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-107 (November 4, 1996) and Advisory Letter 96-8 (Guidance to National Banks on Insurance and Annuity Sales Activities, dated October 8, 1996).[5] Thus, we conclude that the activities to be conducted by the LLC are activities that are part of, or incidental to, the business of banking.

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment.

The activities of the enterprise in which a national bank may invest must be part of, or incidental to, the business of banking not only at the time the bank first acquires its ownership, but for as long as the bank has an ownership interest. This standard may be met if the bank is able to exercise a veto power over the activities of the enterprise, or is able to dispose of its interest. *See, e.g.*, Interpretive Letter No. 711, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-026 (February 3, 1996); Interpretive Letter No. 625, *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,507 (July 1, 1993). This ensures that the bank will not become involved in impermissible activities.

Pursuant to the proposed Letter Agreement, the LLC is prohibited from engaging in activities which would be impermissible for the Bank or a subsidiary of the Bank. Also, the Bank will have the authority to veto activities or decisions by the LLC that are inconsistent with activities that are

[5] The Bank has also represented that it will follow, to the extent appropriate, the Interagency Statement on Retail Sales of Nondeposit Investment Products, dated February 15, 1994, which provides guidance to banks on the sale of retail nondeposit investment products.

part of, or incidental to, the business of banking, as determined by the OCC. The activities of the LLC are limited to those powers in its charter (or articles of organization) and the Bank's vote, as a 50% owner, will always be required to amend the charter (or articles). This provision will enable the Bank on an ongoing basis to prevent the LLC from engaging in new activities which may be impermissible. Furthermore, the Letter Agreement and the Buy/Sell Agreement authorizes the Bank to dispose of its interest in the LLC if the company engages in any activities that are not part of, or incidental to, the business of banking.

Therefore, the second standard is satisfied.

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.

a. 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 the national bank's investment not expose it to unlimited liability. As a legal matter, investors in a Tennessee limited liability company will not incur liability with respect to the liabilities or obligations of the limited liability company solely by reason of being a member or manager of the limited liability company. Tenn. Code. Ann. § 48-16-203(b) and 48-217-101(a) (West Supp. 1996). Thus, the Bank's loss exposure for the liabilities of the LLC will be limited by statute.

b. 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 of investment in a limited liability company is to report it as an unconsolidated entity under the equity method of accounting. Under this method, unless the bank has guaranteed any of the liabilities of the entity or has other financial obligations to the entity, losses are generally limited to the amount of the investment, including loans and other advances 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 No. 692, *supra.*

As proposed, the Bank will have a 50 percent ownership interest in the LLC. The Bank will account for its investment in the LLC under the equity method of accounting. Thus, the Bank's loss from an accounting perspective would be limited to the amount invested in the LLC and the Bank will not have any open-ended liability for the obligations of the LLC.

Therefore, for both legal and accounting purposes, the Bank's potential loss exposure relative to the LLC should be limited to the amount of its investment in those entities. Since that exposure will be quantifiable and controllable, the third standard is satisfied.

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

Twelve U.S.C. § 24(Seventh) gives national banks incidental powers that are "necessary" to carry on the business of banking. "Necessary" has been judicially construed to mean "convenient or useful". *See Arnold Tours, Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972). Our precedents on bank non-controlling investments have indicated that the investment must be convenient or useful to the bank in conducting *that bank's* business. The investment must benefit or facilitate that business and cannot be a mere passive or speculative investment. *See, e.g.*, Interpretive Letter No. 697, *supra*; Interpretive Letter No. 543, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (February 13, 1991); Interpretive Letter No. 427, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988); Interpretive Letter No. 421, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988); Interpretive Letter No. 380, *supra.*

By entering the general insurance business, the Bank will be able to provide expanded services to its customers. Through its investment in the LLC, the Bank expects to quickly and efficiently enter the general insurance business. Moreover, the Bank believes it will gain experience and expertise through its joint venture partner, and leverage that experience and expertise for its own benefit and that of its customers. Furthermore, this arrangement also provides for access to a greater number of underwriters and limits the Bank's risk in entering this business.

For these reasons, the Bank's investment in the LLC is convenient and useful to the Bank in carrying out its business and is not a mere passive investment. Thus, the fourth standard is satisfied

III. Conclusion

Based upon the information and representations you have provided, and for the reasons discussed above, it is our opinion that the Bank is legally permitted to acquire and hold a non-controlling interest in the LLC in the manner and as described herein, subject to the following conditions:

1. the LLC will engage only in activities that are part of, or incidental to, the business of banking;

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

3. the Bank will account for its investment in the LLC under the equity method of accounting; and

4. the LLC will be subject to OCC supervision, regulation, and examination.

These conditions are conditions imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that Bank's investment is permissible under 12 U.S.C. § 24 (Seventh) and, as such, may be enforced in proceedings under applicable law.

If you have any questions, please contact me or Javier A. Maymir, Senior Attorney, at (404) 588-4520.

Sincerely,

/s/

H. Gary Pannell
District Counsel