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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

September 7, 2004

**Interpretive Letter #1007**  
**September 2004**  
**12 USC 24(7)**

Re: [ ] (“Bank”)

Dear [ ]:

We understand that the Bank owns [ *ABC* ] corporate debt and holds it as a Type III investment security. As part of [ *ABC* ]’s bankruptcy reorganization plan, all holders of that particular issue will be required to exchange their debt for an equity interest in [ *Co.* ], *i.e.*, stock, or for debt that would not qualify as an investment security, due to its below-investment grade rating. We have been asked whether it is permissible for the Bank to accept [ *Co.* ] equity or below-investment grade debt in an exchange for [ *ABC* ] debt, on the theory that the bank would accept the securities as an exercise of its power to take bank-impermissible property in satisfaction of debt previously contracted (“DPC”). For the reasons discussed below, we conclude that the Bank may accept [ *Co.* ] equity or below-investment grade debt in an exchange for [ *ABC* ] debt.

### **Background**

As we understand the facts, the Bank held [ *ABC* ] corporate debt as a Type III investment security under its authority to purchase and hold investment securities. As part of [ *ABC* ]’s bankruptcy reorganization plan, all holders of that particular issue will be required to exchange their debt for an equity interest in [ *Co.* ], *i.e.*, stock, or for debt that would not qualify as an investment security, due to its below investment grade rating.

### **Law**

The ability of a national bank to take DPC property is an extension of a national bank’s authority to make loans. A national bank may negotiate directly with a borrower to extinguish a poor quality credit in exchange for some form of property, including assets the bank otherwise is not permitted to own or hold, such as real estate and corporate stock, so that the bank may obtain a better recovery through the acceptance and later sale of property than through holding the loan. National banks may acquire and hold equity securities in order to improve the prospects for recovery on loans that are in default, are nonperforming, or otherwise have a history of poor

performance. In certain circumstances and subject to limitations, national banks can invest additional cash to improve DPC property and increase ultimate recoveries.<sup>1</sup>

There is explicit authority for national banks to take and hold real estate in satisfaction of DPC.<sup>2</sup> The ability to take and hold other DPC property is incidental to a national bank's authority to lend.<sup>3</sup> National banks also may purchase and hold debt securities as an exercise of their lending authority.<sup>4</sup>

National banks may not use their DPC authority as a means of speculation<sup>5</sup> and cannot hold DPC property indefinitely. National banks must dispose of the property within five years, with the opportunity to apply to extend the holding period for an additional five years.<sup>6</sup> Congress recognized this authority, in effect, in placing a time limitation on a national bank's holding of real estate obtained in satisfaction of debt previously contracted.<sup>7</sup> The OCC has applied the five-plus-five holding period limitation to other forms of property as well.<sup>8</sup>

The OCC's regulation governing national bank investment in investment securities, 12 C.F.R. Part 1, recognizes the ability of national banks to use DPC authority to convert or exchange holdings of non-performing investment securities into stock or other bank-impermissible property.<sup>9</sup> Section 1.7 states that, with three exceptions, the restrictions and limitations of Part 1 do not apply to securities acquired through foreclosures on collateral, in good faith by way of compromise of a doubtful claim, or to avoid loss in connection with a debt previously contracted.<sup>10</sup> A national bank may hold securities acquired in satisfaction of debt previously contracted ("DPC securities") for no more than five years, with a possible five year extension,

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<sup>1</sup> See *First National Bank of Charlotte v. National Exchange Bank of Baltimore*, 92 U.S. 122, 127 (1875), and *Atherton v. Anderson*, 86 F.2d 518, 525 (6<sup>th</sup> Cir. 1936), *rev'd on other grounds*, 302 U.S. 643 (1937).

<sup>2</sup> Under 12 U.S.C. 29 (Third), a national bank may "purchase, hold, and convey real estate . . . such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings."

<sup>3</sup> See 12 U.S.C. 24 (Seventh) and OCC Interpretive Letter No. 643 (July 1, 1992), *reprinted in* [1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,551.

<sup>4</sup> See, e.g., OCC Interpretive Letter No. 908 (Apr. 23, 2001), *Interpretations and Actions* (May 2001). Banks that acquire securities under their lending authority must observe a number of rules and restrictions that apply to the making and administration of loans, such as underwriting standards and the lending limit, found at 12 U.S.C. 84

<sup>5</sup> See OCC No-Objection Letter No. 89-01 (Jan. 25, 1989), *reprinted in* [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,009.

<sup>6</sup> See 12 U.S.C. 29(Third).

<sup>7</sup> See 12 U.S.C. 29(Third).

<sup>8</sup> See OCC Interpretive Letter No. 643, *supra*.

<sup>9</sup> See 12 C.F.R. 1.7.

<sup>10</sup> See 12 C.F.R. 1.7(a)(1)-(3).

shall account for DPC securities in accordance with Generally Accepted Accounting Principles, and may not hold DPC securities for speculative purposes.<sup>11</sup>

## Discussion

When a national bank exercises its lending authority, regardless of the legal form that the extension of credit takes, the bank should be able to use its DPC authority when a credit event warrants. A bank may exercise its lending authority, for example, by taking a note directly from a borrower collateralized by securities, or by buying debt securities in the market. In the latter case, if the security loses its value due to the issuer's failure to perform, the bank should be able to exchange the security for DPC property in a DPC transaction. It would be anomalous to deny a bank this authority for an asset acquired under the authority to lend, simply because the asset takes the form of a security. OCC precedent makes clear that a national bank acquiring a security under its lending authority must observe a variety of restrictions applicable to the making and administration of loans, and without specifically denying the authority to engage in DPC transactions with respect to those assets.<sup>12</sup>

DPC theory does not necessarily limit itself conceptually only to situations involving the exercise of lending authority. National banks may acquire assets through a variety of authorities other than the authority to make loans, and those acquisitions, when made in good faith, can result in impairment of values due to credit events, just as in the case of a loan. If it is incidental to a bank's authority to lend to acquire bank-impermissible property to improve the prospects of recovery on an impaired loan, that analysis is equally valid in the case of another impaired asset the bank has acquired under separate authority. It is anomalous to permit a national bank the ability to exchange a nonperforming asset in a DPC transaction when the bank acquired that asset using its lending authority, and simultaneously deny the bank the authority to engage in an identical DPC transaction, simply because the economically identical asset originally was acquired under a different authority.

National banks may use DPC authority to protect their interests in resolving a troubled credit relationship, regardless of whether the bank acquired the asset using its authority to lend or purchase and hold investment securities. National banks may use DPC authority to exchange investment securities in DPC transactions for securities that are otherwise not permissible for investment where the banks clearly establish the need to protect their interest in a troubled credit relationship. Banks must be able to demonstrate that any instruments acquired using DPC authority were taken to resolve a troubled credit situation in which the bank otherwise would face credit losses. Accordingly, a national bank may rely on its authority to take otherwise impermissible securities in DPC transactions, in cases of settlements offered through bankruptcy proceedings. In this case, as part of [ *ABC* ]'s bankruptcy reorganization plan, all holders of [ *ABC* ] debt will be required to exchange their debt for an equity interest in [ *Co.* ], *i.e.*, stock,

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<sup>11</sup> See 12 C.F.R. 1.7(b)-(d).

<sup>12</sup> See Interpretive Letter No. 908, *supra*. This precedent details the obligation of a national bank to observe various legal requirements relating to the holding of securities that were acquired under lending authority, but does not address whether the bank may effect a DPC transaction in the event of a credit-related impairment of those assets.

or for debt that would not qualify as an investment security, due to its below investment grade rating. Taking the equity security or below-investment grade debt is the only option the Bank has to recover on the troubled debt situation.

## **Conclusion**

We conclude that in the context of the [ *ABC* ] bankruptcy reorganization plan established by the bankruptcy court, it is permissible for the Bank to accept [ *Co.* ] equity or below-investment grade debt in an exchange for [ *ABC* ] debt, on the theory that the bank would accept the securities as an exercise of its power to take bank-impermissible property in satisfaction of DPC.

Sincerely,

*/s/ Julie L. Williams*

Julie L. Williams  
First Senior Deputy Comptroller  
and Chief Counsel