Office of the Comptroller of the Currency

Interpretations - Conditional Approval #216

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September 11, 1996

Ms. Beverly H. McCaskill
Executive Vice President and Secretary to the Board of Directors
Texas Commerce Bank National Association
P.O. Box 2558
Houston, Texas 77252-8053

Re: Texas Commerce Bank National Association, Houston, Texas

Proposal to Establish a New Operating Subsidiary to Invest in Two Limited Liability Corporations - Application No. 96-SW-08-0009

Dear Ms. McCaskill:

This is in response to the operating subsidiary notice filed by Texas Commerce Bank National Association, Houston, Texas ("Bank") on August 8, 1996, to establish an operating subsidiary (the "Operating Subsidiary") pursuant to 12 C.F.R. 5.34. The Operating Subsidiary will invest in two limited liability companies that will engage in a broad array of consumer lending activities, including marketing of consumer loans and borrowing to finance the carrying of consumer loans. The Bank is a wholly-owned subsidiary of the Chase Manhattan Corporation ("Chase Bancorp"). We have completed our review and your notice is hereby approved, as described herein.

Facts

In April of 1994, The Chase Manhattan Bank (National Association) ("Old Chase"), now a wholly-owned subsidiary of Chase Bancorp, entered into a series of agreements (the "Old Agreements") with the Student Loan Marketing Association ("Sallie Mae") pursuant to which Old Chase continued to originate student loans and to own those loans for at least some period of time, while outsourcing the balance of the student loan business. In that context, Sallie Mae acquired the marketing personnel and related infrastructure from Old Chase and undertook the roles of marketing, financing, and ultimately purchasing, owning and servicing student loans sourced from what had been the marketing network of Old Chase. The Old Agreements would, by their terms, continue until the year 2002. The Old Agreements include a covenant by Old Chase that it will not engage in the marketing, making, purchasing, servicing, or owning of student loans so long as the Old Agreements remain in effect, except as contemplated thereby. On July 14, 1996, Old Chase and Chemical Bank merged to form The Chase Manhattan Bank ("New Chase").

The Bank conducts a student loan business serviced by the Chemical Education Finance Group ("EFG"),

a division of New Chase. The Bank currently holds approximately $400 Million in student loans. Chemical Bank and Chemical Bank, N.A. (now renamed The Chase Manhattan Bank and Chase Manhattan Bank USA, National Association ("Chase USA"), respectively), which like the Bank are wholly-owned subsidiaries of Chase Bancorp, also originate and service student loans. These two banks hold in the aggregate an approximately $2.3 billion portfolio of student loans as well as having marketing and servicing capacity. It is unclear under the Old Agreements how the various provisions would apply in light of the merger of Old Chase and Chemical Bank to form New Chase.

To resolve the ambiguity referred to above and to enable the banking subsidiaries of Chase Bancorp to engage in the student loan business and to enable Sallie Mae to purchase student loans and provide related servicing, in each case on mutually satisfactory terms, it is proposed that the Old Agreements be terminated and replaced with arrangements under which the Bank and its affiliates, including New Chase, would remain in the student lending business and would have their student loans serviced by Sallie Mae, and Sallie Mae would have an interest with the Bank in the ongoing business. The benefits of this new arrangement are that, not only will it avoid any dispute between New Chase and its affiliates and Sallie Mae, but it will also result in the Bank and its affiliates, including New Chase, continuing the student loan business, offering a broader spectrum of consumer credit products to the benefit of the communities they serve, and enjoying a portion of the revenue stream from the business.

As proposed, the Operating Subsidiary will hold a 50 percent interest in two limited liability companies ("LLCs") chartered under the laws of the State of Delaware. Sallie Mae will own the other 50 percent interest in the LLCs. Through this LLC arrangement, the Bank has agreed to have its student loans serviced by Sallie Mae and Sallie Mae will have an interest with the Bank in the ongoing student loan business generated within Chase Bancorp. The Bank and Sallie Mae will each make a capital contribution to the LLCs to provide capital for the acquisition of facilities necessary to carry out their respective functions, as well as working capital.<**NOTE:** In the alternative, the Bank may form two operating subsidiaries. Each operating subsidiary would become a 50% member of one of the two Delaware limited liability companies.>

The first LLC ("Marketing LLC"), will engage in the marketing of student loans to be originated by the Bank and certain of its affiliated banks. (A bank that makes student loans is referred to herein as an "Originating Bank".) Initially, in addition to the Bank, New Chase is likely to be an Originating Bank. Marketing LLC will acquire from the Bank, New Chase and Chase USA, their existing marketing infrastructures and will acquire from Sallie Mae much of the marketing infrastructure that Sallie Mae originally acquired from Old Chase. Marketing LLC will have a license to use the Chase name in marketing student loans.

The second LLC ("Financing LLC"), will acquire newly originated student loans from the Originating Banks. Each Originating bank will be obligated (subject to its credit policy) to make and sell such loans, after a seasoning period of approximately 60 days after full disbursement, under contract at a price above par plus accrued interest calculated to compensate the Originating Banks for the costs of loan origination. In addition, the existing portfolio of student loans owned by the Bank and New Chase would be acquired by the Financing LLC for cash at a price of par plus accrued interest. <**NOTE:** Because the LLCs will be "subsidiaries" of the Bank for purposes of 23A and 23B of the Federal Reserve Act, 12 U.S.C. 371c and 371c-1, all of Chase Bancorp's subsidiaries will be "affiliates" of the LLCs for purposes of 23A and all of Chase Bancorp's nonbank subsidiaries will be affiliates of the LLCs for purposes of 23B. Therefore, all transactions between the LLCs and companies controlled by Chase Bancorp (other than the Bank) must comply with applicable restrictions imposed by those statutes, including the prohibition against purchasing low-quality assets and the requirement that all transactions between

the LLCs and Chase Bancorp's other subsidiaries be on terms and conditions that are consistent with safe and sound banking practices.>

The Financing LLC would obtain financing to fund both the initial purchase of the student loan portfolio and the loans to be acquired in the future by selling a 50% participation in such loans to the Operating Subsidiary and a 50% participation to Sallie Mae. The Financing LLC also would be free to securitize or otherwise finance loans, and profits would be split evenly between the two members. The loans owned by the Financing LLC would be serviced by Sallie Mae under a servicing agreement.

The foregoing arrangements, including the investment in the Marketing LLC and the Financing LLC by the members, would continue for a period of six years, unless terminated earlier as provided by the agreements establishing the Marketing LLC and the Financing LLC. Thereafter, the Originating Banks, acting through the Operating Subsidiary, and Sallie Mae would each have the option to terminate the venture by having one buy out the interest of the other or to continue the venture. In summary, at the end of six years, either the Operating Subsidiary or Sallie Mae would have the right to identify a price to the other. The recipient of the price would have the option to either buy the interest of the other in the Marketing and Financing LLCs or sell its interest to the other, in either case, at the identified price.

The Marketing LLC and the Financing LLC will conduct business pursuant to a business plan adopted annually with the consent of the Operating Subsidiary. Any significant business decision made by either the Marketing LLC or the Financing LLC must be approved by the Operating Subsidiary. The agreements establishing the Marketing LLC and the Financing LLC contain provisions designed to assure that each of them remain in businesses which the existing operating subsidiary is permitted to conduct under applicable law and regulations, that bank examiners have full access to appropriate business records, and that the Operating Subsidiary will not be subject to liability for the actions of the LLCs. <**NOTE:** The agreements establishing the Marketing LLC and the Financing LLC would each contain the following provisions: (1) the Marketing LLC and the Financing LLC would be permitted to engage only in activities permitted for a national bank; (2) the activities in which each of the Marketing LLC and the Financing LLC is permitted to be engaged would be defined as described above, and not permitted to be changed without the Operating Subsidiary's consent; (3) each member and each of the Marketing LLC and Financing LLC would be prohibited in engaging in any activity that would put any member in violation of any rule, regulation or order applicable to it; (4) each member would agree that each of the Marketing LLC and the Financing LLC will submit to, and cooperate with, governmental regulatory authorities who audit, inspect or examine either the Marketing LLC or the Financing LLC under regulatory schemes applicable to their respective members; (5) if any regulatory agency makes a determination that membership in the Marketing LLC or the Financing LLC or the relationship of either member or its affiliates to either such LLC constitutes a violation of any law, rule, regulation or order, then either member may promptly initiate a buy-out through the offer procedure described above, and; (6) the Operating Subsidiary, as a member of the LLC, will not be liable for the debts, obligations or liabilities of the limited liability companies or the other member.> The Operating Subsidiary will be consolidated for financial reporting purposes with both the Bank and Chase Bancorp under generally accepted accounting principles. Neither of the two limited liability companies will be so consolidated and, instead will be accounted for by the equity method of accounting.

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). The activities of the new operating subsidiary (to be conducted indirectly through its 50 percent ownership of the Marketing LLC and the Financing LLC) would constitute consumer lending activities. As discussed in more detail below, consumer lending activities clearly are part of or incidental to the business of banking, and thus a national bank may engage in such activities through an operating subsidiary. 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.> The Bank will own 100 percent of the voting stock of the Operating Subsidiary.

Your letter raises the issue of the authority of a national bank to make a minority or non-controlling investment in an LLC. In a variety of circumstances the OCC has permitted national banks to own, either directly, or indirectly through an operating subsidiary, a minority or non-controlling interest in an enterprise. The enterprise might be a limited partnership, a corporation, or in more recent examples, a limited liability company. In recent interpretive letters, the OCC concluded that national banks are legally permitted to make a minority or non-controlling investment in an 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* Interpretive Letter No. 697 (November 15, 1995), *reprinted in* [Current] Fed. Banking L. Rep. (CCH) 81,012; Interpretive Letter No. 705 (October 25, 1995), reprinted in [Current] Fed. Banking L. Rep. 81,020.> *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 or non-controlling 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.

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 making, arranging, purchasing, selling and servicing extensions of consumer credit, both secured and unsecured, and performing such other activities as may be necessary to carry on the business of a finance company, either directly or through an operating subsidiary, are activities that are part of or incidental to the business of banking under 12 U.S.C. 24(Seventh) (a national bank may carry on the business of banking ". . . by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits . . . [and] by loaning money on personal security . . . "). National banks have the express authority under 24(Seventh) to make loans. Incidental to this authority, national banks may service and manage loans and assets.

Moreover, the agreements establishing the Marketing LLC and the Financing LLC would each contain a provision that the LLCs will only engage in activities that are part of, or incidental to the business of banking. Accordingly, this first standard is satisfied.

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

foregoing standard.

As a corollary to the above, 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.

The Delaware Limited Liability Act allows a limited liability company "to carry on any lawful business, purpose or activity with the exception of the business of granting policies of insurance, or assuming insurance risks or banking. . . ". Del. Code Ann., tit. 18 106(a) (1994).

The agreements establishing the Marketing LLC and the Financing LLC will provide that if any regulatory agency makes a determination that membership in the Marketing LLC or the Financing LLC or the relationship of either member or its affiliates to either such LLC constitutes a violation of any law, rule, regulation or order, then either member may promptly initiate a buy-out through the offer procedure set forth in the agreements. These agreements will also provide that the LLCs will only engage in certain defined activities and these defined activities cannot be changed without the consent of the new operating subsidiary. In addition, these agreements will provide that each member of the LLCs and each of the Marketing LLC and Financing LLC would be prohibited from engaging in any activity which would put any member in violation of any rule, regulation or order applicable to it. Therefore, this 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.*

Loss Exposure from a Legal Standpoint

A primary concern of the OCC is that national banks should not be subjected to undue risk, especially 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 Delaware 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. Del. Code Ann. Tit. 18, 303 (1994). 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 can be effectively avoided in states where a corporation (with limited liability under state corporate laws) can be the general partner.>

Thus, the Bank's loss exposure for the LLCs' liabilities will be limited by statute and the agreements establishing the Marketing LLC and the Financing LLC.

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 investments will be made through its new operating subsidiary and will amount to 50 percent of the total membership interest in the LLCs. Where a subsidiary owns 50 percent in the LLCs, they generally are able to use the equity method of accounting. The Bank has stated that the LLCs will be reported on an equity accounting basis on the books of the new operating subsidiary. In addition, the Bank has stated that the Bank and Chase Bancorp will be consolidated for financial accounting purposes under generally accepted accounting principles.

In addition, as noted above, Delaware law limits a members' losses to their capital investment and, therefore, the new operating subsidiary 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* Interpretive Letter No. 697 (November 15, 1995), *reprinted in* [Current] Fed. Banking L. Rep. (CCH) 81,012. 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 Marketing LLC and the Financing LLC are each structured to fall within the parameters previously authorized for indirect conduct of business by operating subsidiaries through unconsolidated limited liability companies. The investment is not passive or speculative. The Marketing LLC and the Financing LLC will conduct aspects of the student loan business which have been conducted in the past by several of the banks owned by Bancorp, including the Bank. Thus, the nature of the business is not speculative but is a part of the business of consumer banking and the Bank's investment in the LLC's will allow it to better serve the lending needs of its customers and communities.

In short, the Bank's investment in the LLCs (through the new operating subsidiary) is part of and furthers its consumer banking business and will be convenient and useful to the Bank in carrying out its business. Therefore, the fourth standard is satisfied.

Conclusion

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

> (1) the LLCs and the Operating Subsidiary engage only in activities that are part of or incidental to the business of banking;
>
> (2) the Bank, through the Operating Subsidiary, will have veto power over any activities and major decisions of the LLCs that are inconsistent with condition (1), or will withdraw from the LLCs in

the event they engage in an activity that is inconsistent with that condition;

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

(4) the Operating Subsidiary and the LLCs will be subject to OCC regulation, 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 John W. Graetz, Senior Bank Structure Analyst, Corporate Activity at (202) 874-5060 or Randall M. Ryskamp, District Counsel, Southwest District at (214) 720-7012.

Sincerely,
/s/
Julie L. Williams
Chief Counsel