Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

October 26, 1989

Interpretive Letter No. 719
May 1996
12 U.S.C. 371C-B

This is in response to your letter dated October 12, 1988, on behalf of your client,
("Bank"), involving the transaction described below.

According to your letter, the Bank established an employee stock ownership plan ("ESOP"). The ESOP is administered by an administrative committee appointed by the Bank's board of directors. The administrative committee currently consists of some of the Bank's directors (but not a majority of the Bank's directors). The Bank's contributions to the ESOP are held and managed by an employee stock ownership trust ("ESOT"). The ESOT's trustees currently consist of certain of the Bank's executive officers. The ESOT has or will be qualified under the Internal Revenue Code Section 401, 26 U.S.C. § 401.

The ESOP proposes to borrow money to purchase the Bank's stock. In this regard, it is a leveraged ESOP. The loan is to be made by a third-party lender ("Lender") that is not affiliated with the Bank or the ESOP. The Lender has requested that the Bank guaranty the debt of the ESOP or agree to purchase the ESOP's note from the Lender. Finally, the Lender may desire the Bank to commit to fund a specified dollar amount to the ESOP over a specified number of years. You have represented that the ESOP will initially purchase not more than five percent of the Bank's stock.

You have asked the following questions with regard to the above described transaction:

(1) Is the ESOP an affiliate of the Bank for purposes of 12 U.S.C. § 371c;

(2) May the Bank guarantee the debt of the ESOP to the Lender and, if so, would the guarantee constitute a covered transaction requiring the collateral requirements of 12 U.S.C. § 371c(C) to be met;

(3) May the Bank enter into an agreement to purchase the ESOP's note from the Lender at any time upon demand, whether or not there was a default and, if so, would such an agreement constitute a covered transaction requiring the collateral requirements of 12 U.S.C. § 371c(C) to be met; and

(4) May the Bank commit to the Lender to fund a specified dollar amount to the ESOP for a specified number of years, and if so, would such a commitment be a transaction with an affiliate.

Your questions will be addressed individually.

With regard to your first question, you argue that based on Interpretive Letter No. 261 by Charles Byrd, Acting Director, Legal Advisory Services Division, dated June 16, 1983, _reprinted in_ (CCH) Fed. Banking L. Rep. ¶ 85,425, an ESOP is not an affiliate for purposes of 12 U.S.C. § 371c. Interpretive Letter No. 261 concluded that an ESOP is not an "affiliate" for purposes of 12 U.S.C. § 221a. The conclusion was based, in large part, on a Michigan Supreme Court case interpreting 12 U.S.C. § 221a.

However, on reconsideration of this issue, it is my opinion that an ESOP may be an affiliate of a national bank for purposes of 12 U.S.C. § 371c. The term "affiliate" is defined, in pertinent part, as:

(C) any company -

(i) that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who

> beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank; or
>
> (ii) in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank.

12 U.S.C. § 371c(b)(1)(C).

The term "company" is defined to include a "corporation, partnership, business trust, association, or similar organization." It is my opinion that for purposes of 12 U.S.C. § 371c, an ESOP should be included in this definition. This is because ESOPs are designed to be business related entities like that of a business trust. In this regard, ESOPs may be used to borrow money for capital improvements and other corporate investments. See 129 Cong. Rec. 51,629, 51,636 (statement by Senator Long that leveraged ESOPs are a "technique of corporate finance.") and First Nat'l Bank of Blue Island v. Bd. of Governors of the Fed. Reserve Sys., 802 F.2d 291 (7th Cir 1986) (discussing the purpose of an ESOP and finding that for purposes of the Bank Holding Company Act, 12 U.S.C. § 1841 et seq., an ESOP is a "business trust or similar organization"). Accordingly, for purposes of 12 U.S.C. § 371c, an ESOP is included within the definition of "company."

Since an ESOP is included in the definition of "company," it may be an affiliate of the Bank when the ESOP is in "control" of the Bank. The term "control" is defined to include the power to vote twenty-five percent or more of any class of voting stock of the Bank, the power to appoint a majority of the board of directors or trustees of the Bank, or the power to influence the management and policies of the Bank. See 12 U.S.C. §§ 371c(b)(3)(A)(i) - (iii). If the ESOP is in control of the Bank, then it is an "affiliate" and subject to the constraints of 12 U.S.C. § 371c. Accordingly, in this respect Interpretive Letter No. 261 is superseded.

In the Bank's particular case, you have represented that the ESOP will initially own no more than five percent of the Bank's stock. This amount will not place the ESOP in control for purposes of 12 U.S.C. § 371c. It is also presumed that the ESOP will not have the power to elect a majority of the board of

directors of the Bank nor the ability to influence the management or policies of the Bank. Accordingly, if this exists, it will not be an affiliate of the Bank for purposes of 12 U.S.C. § 371c. However, if the ESOP eventually "controls" the Bank, it would become an affiliate and subject to 12 U.S.C. § 371c.

With regard to your second question, there are three possible answers. First, if the debt which the Bank would guarantee is collateralized by the Bank's stock, then the Bank may not make the guarantee because the Bank may end up owning its own stock.

See 12 U.S.C. § 83. Second, if the debt is not collateralized by the Bank's stock and the ESOP does not become an affiliate of the Bank, then the Bank may guarantee the debt of the ESOP. A national bank may guarantee the debts of another when the bank has a substantial interest in the performance of the transaction. *See* Interpretive Ruling 7.7010, 12 C.F.R. § 7.7010. In this particular case, the Bank would have a substantial interest in the performance of the ESOP because it relates to the retirement benefits of the Bank's employees. Finally, if the debt is not collateralized by the Bank's stock and the ESOP becomes an affiliate of the Bank, then the guarantee would be a "covered transaction" and subject to 12 U.S.C. § 371c. *See* 12 U.S.C. § 371c(b)(7)(E). However, in order to avoid such a result, the ESOP could have the Bank's holding company (provided one exists) guarantee the debt.

With regard to your third question, there are three possible answers. First, if the notes are collateralized by the Bank's stock, the Bank may not purchase them because like the guarantee situation above, it may end up owning its own stock. *See* 12 U.S.C. § 83. Second, if the notes are not collateralized by the Bank's stock and the ESOP is not an affiliate of the Bank, then the Bank may purchase the ESOP's notes from the third-party lender. The buying and selling (*i.e.*, the discounting and negotiating) of promissory notes is a core banking power. *See* 12 U.S.C. § 24(Seventh). Finally, if the notes are not collateralized by the Bank's stock and the ESOP is an affiliate of the Bank, then the purchase of the ESOP's notes would be subject to 12 U.S.C. § 371c. *See* Federal Reserve Regulatory Service 3-1131 (indicating that all purchases of affiliates' notes are loans or extensions of credit to the affiliated organizations and subject to 12 U.S.C. § 371c).

With regard to your final question, absent an unsafe or unsound banking practice, there is nothing in the federal banking laws which would prohibit the Bank from committing to fund a specified dollar amount to the ESOP for a specified number of

years. Whether the commitment would constitute an unsafe or unsound banking practice would be based on an analysis of the size of the commitment as measured against the size and condition of the Bank. It is presumed that this commitment would be in the form of a capital contribution by the Bank to the ESOP. However, this commitment alone may not be the basis for servicing the debt to the third-party lender. If this were the case, then the commitment would be the functional equivalent of a guarantee and, therefore, governed by the interpretation set out above.

I trust this is responsive to your inquiry.

Very truly yours,

/S/

Peter Liebesman
Assistant Director
Legal Advisory Services Division