Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #771
March 1997
12 U.S.C. 24(7)23C

February 24, 1997

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Re: [Bank]'s Acquisition of a 20% Interest in [ ].

Dear [ ]:

This is in response to your letter of December 13, 1996, requesting confirmation that the [ ], [city, state] (the "Bank") may lawfully acquire and hold a non-controlling minority interest in [ ], a [state] corporation (the "Company"), which offers payroll processing services to commercial customers. For the reasons set forth below, it is our opinion that this transaction is legally permissible in the manner and as described herein.

A. Background

The Bank intends to acquire a 20 percent interest in the Company. The Company is engaged in providing payroll processing services to commercial customers under which it administers all payroll computations, deductions and tax escrow account management, and processes salary payments to employees either by direct deposit or by preparation of checks. The Company administers this service based upon information provided by its customers through traditional means or through customer PC-based data input. The Company also uses technology that enables it to tailor its payroll services to address the specific needs of its employer clients for the handling of payroll deductions and reports, including, PC modem, data entry, electronic tax payment services, direct deposit services and third party access.

The Bank believes that its investment in the Company will enable it to offer new and improved service to: (i) its own customers, (ii) to the Company's present customers, and (iii) to future new customers. The Bank envisions that it will be able to offer the Company's payroll services to commercial banking customers of the Bank not currently using the payroll services of the Company. The Bank also expects to be able to offer its commercial banking services to the existing clients of the Company currently banking with other financial

institutions. These services will include loan, deposit and cash management services, as well as employee trust administration services, plan trustee services, group health insurance and other insurance programs offered by the Bank's affiliated insurance agency. The Bank will also be able to offer its registered collective investment funds and other investment services for employee trust and pension investments. Finally, the Bank will be able to offer checking accounts and other banking services to employees of the commercial clients of the Company, including retail nondeposit investment products and insurance products through the use of payroll deductions and direct deposit.

The Company presently has only one series of common stock outstanding, of which 200 shares are issued and outstanding. These shares are owned entirely by the two principals of the Company (the "Principals"), each of whom owns 100 shares. The Bank intends to purchase 50 authorized but unissued shares of the Company thereby providing the Company with additional working capital for the expansion of its business. The purchase of these shares will make the Bank a 20 percent shareholder of the Company and each of the principals will own 40 percent of the Company's shares.

A number of contractual provisions governing the relationship between the Company and the Bank will cause the Company to restrict its activities to those permissible for national banks:

- The certificate of incorporation of the Company will be amended to limit its activities to those activities permissible for national banks, and the Bank will be entitled to vote on (and effectively veto) any amendments to the certificate of incorporation.

- The Company, the Bank and the Principals will enter into a shareholders agreement (the "Shareholders Agreement"), which will permit the Bank to demand redemption of its common stock at a specified price should the Company engage in activities that are impermissible for national banks.

- The Shareholders Agreement will also restrict the transfer of shares by any shareholder without the approval of the other shareholders, and without having offered such shares at a specified price first to the Principals and then to the Bank. It will also require that all shareholders vote to elect two directors, one of which will be a representative of the Bank.

B. Discussion

The Bank's plan to purchase a 20 percent interest in the Company raises the issue of the authority of a national bank to hold a non-controlling minority interest in a corporation. A recent OCC interpretive letter extensively analyzed the authority of national banks under 12 U.S.C. § 24(Seventh) to own stock, and reviewed OCC precedents on the ownership of stock in amounts less than that required for an operating subsidiary, i.e., non-controlling stock investments. Interpretive Letter No. 732, reprinted in [1995-1996 Transfer Binder] Fed.

Banking L. Rep. ¶ 81-049 (May 10, 1996).[1] That letter concluded that ownership of a non-controlling interest in a corporation is permissible provided four standards, drawn from OCC precedents, are satisfied.[2] They are:

> 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;
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> 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;
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> 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
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> 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.

Each of these factors is discussed below and applied to your proposal.

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.

Our precedents on non-controlling minority stock ownership have recognized that the enterprise in which the bank takes an equity 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 [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (Dec. 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 (Nov. 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).

You have represented that the Company's activities will involve the offering of payroll processing services by traditional as well as electronic means. The OCC previously has approved the activities the Company will perform. The OCC has long recognized that

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[1] See also Interpretive Letter No. 697, reprinted in [1995-1996 Transfer Binder] Fed. Banking L. Rep. ¶ 81-013 (Nov. 15, 1995).

[2] 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.

providing payroll services to its employees is part of the business of banking and offering this service to its customers is incidental to the business of banking. OCC Interpretive Ruling § 7.1011 (national bank acting as payroll issuer), permits national banks to disburse to an employee of a bank customer payroll funds deposited with the bank by that customer. The OCC has also approved the offering of electronically based services, such as payroll services, as a permissible activity for national banks within their ability to offer electronic data processing services, Interpretive Letter No. 653, reprinted in [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,601 (Dec. 22, 1994) (informational and payments interface). National banks may use automated data processing to provide billing services and accounts receivable services for itself and others, Interpretive Letter No. 419 reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,6443 (Feb. 16, 1988), and engage in data processing related to funds transfer and cash management, id. (funds transfer); Letter from Peter Liebesman, Assistant Director, Legal Advisory Services Division (Dec. 13, 1985) (cash management); Interpretive Letter No. 611, reprinted in [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,449 (Nov. 23, 1992) (cash management funds transfer).

In addition, it is well established that a national bank may use electronic means to perform services expressly or incidentally authorized to national banks.[3] The OCC Interpretive Ruling setting forth this authority was recently revised, in recognition of the rapid advancement of technology, to authorize a national bank to "perform, provide, or deliver through electronic means and facilities any activity, function, product, or service that it is otherwise authorized to perform, provide, or deliver." 61 Fed. Reg. 4849 (1996) (codified at 12 C.F.R. § 7.1019). Thus, a national bank may, as incidental to the business of banking, provide its customers with the electronic and traditional payroll processing services provided by the Company.

Thus, the activities to be performed by the Company are activities that are part of or incidental to the business of banking, and the 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, 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 initially purchases stock, but for as long as the bank has an ownership interest. However, minority shareholders in a corporation do not possess a veto power over corporate activities as a matter of corporate law. One way to assure continuing compliance with the first standard is for the corporation's

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[3] See OCC Interpretive Letter No. 677, reprinted in [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,625 (June 28, 1995); OCC Interpretive Letter No. 284, reprinted in [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,448 (Mar. 26, 1984); and OCC Interpretive Letter No. 449, reprinted in [1988-1989] Fed. Banking L. Rep. (CCH) ¶ 85,673 (Aug. 23, 1988).

articles of incorporation or bylaws to limit its activities to those that are permissible for national banks. See, e.g., Letters from Peter Liebesman, Assistant Director, Legal Advisory Services Division (January 26, 1981 and January 4, 1983).

You have stated that the Company's articles of incorporation will be amended to limit its activities to those permissible for national banks. Also, several other provisions, described in the "Background" section above, provide additional avenues for the Bank to ensure that while it has an investment in the Company, the Company's activities will remain permissible. These provisions assure that the Company will not engage in any activity that is not permissible for a corporation having a national bank shareholder. The Bank effectively will be able to prevent the Company from engaging in any impermissible activity as long as it continues to own shares in the Company. Thus, the second standard is satisfied.

3. The bank's loss exposure must be limited and the bank must not have open-ended liability for the obligations of the enterprise.

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 national bank's investment not expose it to unlimited liability. Normally, this is not a concern when a national bank invests in a corporation, for shareholders are not liable for the debts of the corporation, provided proper corporate separateness is maintained. 1 William M. Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 25 (perm. ed. rev. vol. 1990). In the present case, both the Company and the Bank will be separate corporations, with their own capital, directors, and officers.

Further, the Bank has advised that the appropriate treatment for its investment in the Company will be 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).

Therefore, for both legal and accounting purposes, the Bank's potential loss exposure should be limited to the amount of its investment. Since that exposure will be quantifiable and controllable, 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 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. 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). 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, reprinted in [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-013 (Nov. 15, 1995). 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. See, e.g., Interpretive Letter No. 543, reprinted in [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,225 (Feb. 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 (Mar. 14, 1988).

As set forth in the "Background" section, the Bank is using its investment in the Company as a means to offer its customers and potential customers an electronically based payroll service that the Bank could not as economically or effectively offer directly as a start up product line. The Company's services will provide the Bank with the opportunity to offer payroll processing without establishing separate systems and maintaining them itself. The Company's expertise in payroll processing will enhance the product being offered by the Bank and enable the Bank to compete more effectively in this highly specialized line of business. Many of the Bank's current retail nondeposit investment products, insurance products and trust products/capabilities will be enhanced by the ability to offer a payroll processing service.

In addition, the Bank's investment will also enable it to provide this complete line of banking and bank related services to a broader range of customers. These customers will include existing commercial banking customers of the Bank not currently using the payroll services of the Company, existing clients of the Company currently banking with other financial institutions, and future new customers attracted by, among other things, the Bank's enhanced product lines and payroll processing services. The Bank will be able to offer its registered collective investment funds and other investment services for employee trust and pension investments. The Bank will also be able to offer checking accounts and other banking services to employees of the commercial clients of the Company, including retail nondeposit investment products and insurance products through the use of payroll deductions and direct deposit. Also, by having a seat on the Company's Board of Directors and by reason of the high vote requirements of the Board and the shareholders for certain major matters, the Bank will be able to monitor and influence the development of the Company in ways best adapted to the needs of the Bank's customer base. In this way, a minority investment enhances the Bank's ability to serve and preserve its customer relationships. Thus, the investment is "necessary" to the Bank's ability to efficiently and capably offer these specialized services, to attract a broader customer base, and to compete more effectively.

The Common Stock purchased by the Bank will be restricted in its transferability. Once acquired by the Bank, the Bank's shares may not be sold to a third party unless they have been offered to the Principals at a specified price. Thus, the Bank will not be able to dispose of its stock as freely as a shareholder merely interested in a passive investment.

For these reasons, the proposed investment 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.

C. Conclusion

Based upon the information and representations you have provided, and for the reasons discussed above, we conclude that the Bank may directly hold a 20 percent interest in the Company in the manner and as described herein, provided:

(1) the Company 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 decision of the Company that is inconsistent with consistent number one, or will withdraw from the Company in the event it engages in an activity that is inconsistent with condition number one;

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

(4) the Company will be subject to OCC supervision, regulation, and examination.

These conditions are imposed in writing by the OCC in connection with its action on the request for a legal opinion confirming that the proposed 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 James Vivenzio, Senior Attorney, Northeast District at (212) 790-4010.

Sincerely,

/s/

Julie L. Williams
Chief Counsel