



**Comptroller of the Currency
Administrator of National Banks**

Washington, DC 20219

March 23, 1998

**Corporate Decision #98-17
May 1998**

Mr. Mark Schifferdecker
Executive Vice President
Girard National Bank
100 N. Summit
Girard, Kansas 66743

Re: Operating Subsidiary Notification by Girard National Bank, Girard, Kansas
Application Control Number: 97-MW-08-0048

Dear Mr. Schifferdecker:

This is in response to your letter notifying the OCC of the intent of Girard National Bank, Girard, Kansas ("Bank"), to establish G.N. Resources, Inc. ("Operating Subsidiary"), as a wholly-owned operating subsidiary of the Bank. The Bank has extended credit to the owners of natural gas leases. The Bank now proposes for the Operating Subsidiary to hold a working interest in the natural gas interests and receive certain tax credits, which would be used in part to repay the Bank's extension of credit to the owners and operators of the gas reserves. For the reasons set forth below, I find that these activities would be permissible for a national bank and its subsidiaries. Accordingly, the Bank's operating subsidiary notification is approved.

I. Background

The Bank has extended credit of approximately \$320,000 to a limited liability company that owns and operates oil and gas leases in southeastern Kansas ("Borrower"). The Operating Subsidiary would purchase, for \$1 from the Borrower, working interests in approximately six natural gas leases owned by the Borrower. This arrangement would be undertaken so that the leases would qualify for tax credits under 26 U.S.C. § 29 ("IRC § 29 Credits").¹

Under the terms of the "Well Management Agreement" between the parties, the Borrower and the Operating Subsidiary will share the value of the IRC § 29 Credits.² The ability to arrange the

¹ Section 29 of the Internal Revenue Code allows tax credits for the production and sale of natural gas produced from tight sands and coal seam formations. According to section 29, the taxpayer taking the credits must own a working interest in the qualifying leases.

² The Bank has represented that the Operating Subsidiary would pay the Borrower, as part of a management fee, an amount representing two-thirds of the tax credits realized each quarter.

transaction in this fashion reduces the costs of financing to the Borrower because a portion of its repayment to the Bank is composed of the IRC § 29 Credits, while providing an appropriate yield to the Bank.³

II. Discussion

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(d)(1) (1997). A loan or extension of credit is “a bank’s direct or indirect advance of funds to or on behalf of a borrower based on an obligation of the borrower to repay the funds or repayable from specific property pledged by or on behalf of the borrower.” 12 C.F.R. § 32.2(j) (1997). The financing transactions proposed by the Bank fit this definition and therefore are permissible.

It is established OCC precedent that a national bank may structure a financing transaction in such a manner so as to qualify for IRC § 29 Credits. On November 4, 1994, an OCC letter confirmed that a national bank could extend credit to owners of natural gas reserves through a trust arrangement in which the funds advanced by the bank were repaid through the sale of gas produced from reserves in which the trust acquired a working interest. As a participant in the trust, the bank received a fixed, after-tax return on the funds advanced to the trust and an equity interest in the residual earnings of the trust following repayment of the amount advanced. Importantly, the letter noted that the trust arrangement added nothing to the transaction because a national bank could not invest in a trust that engaged in an otherwise impermissible bank activity. Letter from Horace G. Sneed, Senior Attorney (November 4, 1994) (unpublished).

A second OCC letter confirmed that, where the financing arrangement is merely a preliminary step in furtherance of the bank’s extension of credit, the arrangement is not contrary to 12 U.S.C. § 29.⁴ Letter from Robert J. Herrmann, Deputy Comptroller (October 4, 1994) (unpublished). There, the bank jointly established a trust with a creditworthy marketer of hydrocarbon products. The marketer made a commitment to purchase the hydrocarbon producer’s output, and the trust, with funds borrowed from the bank, purchased corresponding production payments from the producers. The bank’s loan to the trust was secured by an agreement between the trust and marketer and by a security interest in the production payments. Id.

The letter opined that while it might appear that the bank was acquiring an interest in real estate in violation of 12 U.S.C. § 29 such a narrow view of the statute would elevate form over substance. Because acquiring legal title was merely a preliminary step, undertaken to further an authorized

³ The Bank would continue to receive a share of the benefit from the IRC § 29 Credits even after it has received repayment of the amount it advanced plus a return on those amount. National banks are authorized to take a share in the profits, income, or earnings of a business as consideration for an extension of credit. This form of compensation may be received in addition to, or in lieu of, interest. 12 C.F.R. § 7.1006 (1997).

⁴ In the situation addressed in this letter, Kansas law provides that “real estate” includes “not only the land itself, but all . . . wells, rights and privileges appertaining thereto.” Kansas Stat. Ann. § 79-102 (1989).

banking activity, the trust's purchase of the production payments was permissible. Id. See also Interpretive Letter No. 603 (Aug. 3, 1992), reprinted in [1992-93 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,437 (permitting national bank to acquire options to purchase real estate in connection with its activities in a community development corporation); No-Objection Letter No. 86-2 (February 25, 1986), reprinted in [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,008 (permitting national bank to hold legal title to real property incidental to making of a loan).

Taken together these two letters confirm that the Bank's proposal is permissible. The Bank has advanced funds to the Borrower and would receive repayment of principal plus interest. The Well Management Agreement not only obligates the Borrower to repay the amount advanced plus interest out of the Borrower's management fees, but also supplies the Bank with the equivalent of a security interest in the Operating Subsidiary's working interest because all sale proceeds and IRC § 29 Credits must first be used to repay the loan. Although the instruments that memorialize the transaction describe the interests of the Bank and the Borrower in different terms, in substance the Bank is extending credit to the Borrower, receiving a security interest in the natural gas reserves, and receiving repayment of the funds advanced from sale of the natural gas reserves. For these reasons, it is appropriate to treat the transaction as an extension of credit that is permissible for national banks.

III. Conclusion

Based upon the information and representations you have provided, and for the reasons discussed above, we conclude that the Bank may establish the Operating Subsidiary.

If you have any questions, please contact Steven V. Key, Attorney, Bank Activities and Structure Division, at (202) 874-5300.

Sincerely,

/s/

Steven J. Weiss
Deputy Comptroller for
Bank Organization and Structure