



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

December 3, 1998

**Conditional Approval #295
January 1999**

Mr. James S. Keller, Esq.
Chief Regulatory Counsel
PNC Bank Corporation
249 Fifth Avenue
One PNC Plaza, 21st. Floor
Pittsburgh, PA 15222-2707

Re: Application by PNC Bank, National Association, Pittsburgh, Pennsylvania, to invest in a limited partnership through an operating subsidiary, which will acquire a 50 percent interest in a joint venture that will engage in leasing activities.
Application Control Number: 98-NE-08-0035

Dear Mr. Keller:

This is in response to the above-referenced application filed by PNC Bank, National Association, Pittsburgh, Pennsylvania, ("PNC" or "the Bank") with the OCC pursuant to 12 C.F.R. § 5.34. For the reasons given below, the application is approved, subject to the conditions set forth herein.

Background

PNC seeks to acquire, through its wholly-owned operating subsidiary, PNC Leasing Corp. ("PNC Leasing"), a 49.95 percent limited partnership interest in a proposed Delaware limited partnership, Fairfield Investment Limited Partnership ("Fairfield LP"). The only other limited partner of Fairfield LP would be The Connell Company ("Connell"), also holding a 49.95 percent limited partnership interest. The general partner of Fairfield LP would be Fairfield Investment Inc. ("Fairfield GP"), a proposed Delaware corporation, whose sole purpose would be to own the remaining 0.1 percent general partnership interest in Fairfield LP. Fairfield GP would be owned equally by PNC Leasing and Connell giving each of them, in effect, a .05% indirect general partnership interest in Fairfield LP. Fairfield LP would serve as a special purpose vehicle that would hold the equity interest in the lease of a railroad spur and associated equipment.

The lease transaction is structured as follows. Fairfield LP will establish a business trust, the Fairfield Investors Ltd. Co. ("Owner Trust"), of which it will be the sole beneficiary,

to finance and construct a railroad spur ("Spur") to be leased out for use in the transport of coal.¹ Fairfield LP will make an equity contribution of 3% of the \$130 million cost of the project while the remaining 97% of the cost would be financed through non-recourse loans made to the Owner Trust by various lenders. The Owner Trust will then use the funds to contract with Texas Utilities Electric Company ("the Company") for the construction of the railroad Spur. Once constructed, the Company will lease the Spur from the Owner Trust for three years pursuant to a net full-payout lease ("Facility Lease"). At the expiration of the Facility Lease the Company will have the option to purchase the Spur. If it does not exercise the option, the Company must pay the Owner Trust 89.99% of the cost of the project and, in addition, may be forced to use the Spur and pay a usage fee, pursuant to a Usage Agreement ("Usage Agreement"), for up to an additional twenty-five years. As a result, the residual value of the Facility Lease will be less than 25% of the project.²

The Owner Trust will also lease from the Company easements and rights-of-way (the "Site"), necessary for the operation of the Spur pursuant to a head ground lease ("Head GL"). The Owner Trust will then sublease these interests to the Company under the Facility Lease. The cost of the Site to the Owner Trust under the Head GL totals \$600; \$10 per year for a term of 60 years.³ This cost is built into the rent requirement of the Facility Lease.

The Facility Lease and Head GL are cross-defaulted so that a default under either agreement will give the Owner Trust the opportunity to operate the Facility in place and in use. The Bank also has represented that the Owner Trust is taking an interest in the Site for the sole purpose of protecting the interest in the Spur in the event of a default.

Discussion

The Bank's application raises the issue of the authority of a national bank to hold, through an operating subsidiary, a non-controlling 50% interest in a corporation (Fairfield GP)

¹ The Spur is considered personal property under applicable Texas state law. *Texas and New Orleans Railroad Co. v. Mrs. Nellie Gillette Schoenfeld, et vir*, 136 Tex. 193, 146 S.W.2d 724 (Texas 1941).

² According to GAAP, a guaranteed residual payment at the close of a lease is included in the minimum lease payments. Therefore, it is deducted from the project cost in determining the residual value of the project. In this case, because the Company is obligated to pay 89.99% of the project cost if it opts not to buy the Spur, the residual value of the Facility Lease would be no more than 10.01%.

³ The Facility Lease, which is 3 years in duration, is 57 years shorter in duration than the Head GL. As a result, the Bank, through the Owner Trust, will bear the risk of the Company not exercising its option to purchase the Spur upon the expiration of the Facility Lease. The Bank has represented that it must take a longer durational interest in the Head GL to protect itself from this possibility. In order for the Spur to be resold or released and the Bank to recoup its investment, the Owner Trust must be able to convey an interest in the Site to ensure the operability of the Spur.

whose activity is being general partner of a limited partnership (Fairfield LP) that will engage in various leasing activities. The Bank will also hold, through PNC Leasing, a non-controlling 49.5% interest in the Fairfield LP. A number of recent OCC Interpretive Letters have analyzed the authority of national banks, either directly or through their subsidiaries, to own a non-controlling interest in an enterprise.⁴ These letters each concluded that the ownership of such an interest is permissible provided four standards, drawn from OCC precedents, are satisfied.⁵ They 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 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;
- (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.

Each of these four 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.*

a. *Personal Property Leasing*

Lease financing transactions are addressed in the OCC's leasing regulation, 12 CFR Part 23. That regulation states that a bank may enter into lease financing transactions pursuant to two separate statutory authorities: 12 U.S.C. 24(Seventh) or 12 U.S.C. 24(Tenth). You have requested authority for this lease transaction under 12 U.S.C. 24(Seventh).

Section 23.3 of the OCC's leasing regulation defines the general requirements for a conforming personal property lease and provides that:

⁴ See, e.g., Interpretive Letter No. 697, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-013 (November 15, 1995); Interpretive Letter No. 732, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-049 (May 10, 1996); Interpretive Letter No. 705, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,020 (October 25, 1995).

⁵ 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.

A national bank may acquire personal property for the purpose of, or in connection with leasing that property, and may engage in activities incidental thereto, if the lease qualifies as a full-payout lease and a net lease.

12 CFR § 23.3. A “full-payout lease” is defined as a lease in which a national bank reasonably expects to realize the return of its full investment in the leased property and the estimated cost of financing the property over the term of the lease from rentals, estimated tax benefits and the estimated residual value of the property. 12 CFR §23.2(e). The “net lease” requirement means that the national bank will not, directly or indirectly, provide or be obligated to provide for, among other things, servicing and repairs on the leased property or the payment of insurance for the lessee. 12 CFR §23.2(f).

Subpart C of Part 23 further describes the rules governing a 24(Seventh) lease and provides that:

Pursuant to 12 U.S.C. 24(Seventh) a national bank may invest in tangible or intangible personal property . . . for the purpose of, or in connection with leasing that property, if the related lease is a conforming lease representing a noncancelable obligation of the lessee (notwithstanding the possible early termination of that lease).

12 CFR § 23.20(a). In addition, this subpart limits the estimated residual value of a lease authorized under 12 U.S.C. 24(Seventh) to a maximum of 25% of the original cost of the property unless the bank receives a guarantee for any excess residual value above that amount.⁶ 12 CFR § 23.21(a) and (b).

Based on your description of the proposed transaction, summarized above, as well as the supporting documentation with which we have been provided, we conclude that the Facility Lease is a conforming lease which complies with the above-mentioned requirements of 12 CFR Part 23.

b. *Activities “Incidental to” Personal Property Leasing*

Part 23, as recently revised, recognizes that a national bank may engage in activities that are “incidental” to permissible personal property leasing. In the preamble to the final rule,⁷ the OCC stated that it retained the authority to approve those activities on a case-by-case

⁶ As discussed in n.2, above, the residual value of the Facility lease will be no more than 10.01%. At the close of the Facility Lease, the Company will be required to pay the Owner Trust, at a minimum, 89.99% of the cost of the project. GAAP considers this guaranteed payment to be part of the minimum lease payment. Therefore, it is deducted from the cost of the project to determine the residual value.

⁷ See 61 Fed Reg. 66554 (December 18, 1996).

basis.⁸ In your letter, you request that the OCC find that the acquisition of an interest in real property, represented by the Head GL, is incidental to the Facility Lease.

You represent that PNC Leasing's obligation, through Fairfield LP and the Owner Trust, under the Head GL will not involve the acquisition or leasing of real property for the purpose of speculation. Rather, the Owner Trust is entering into the \$600 Head GL strictly in order to better protect the value and utility of the financed equipment. The Head GL allows PNC Leasing to sustain the value of the personal property collateral in the event of default by ensuring the use of the Spur as a going concern rather than requiring the liquidation of the Spur if such ground lease did not exist.

Real property leasing as an "incidental" activity was contemplated in the promulgation of the Part 23 leasing rule. In the preamble to the final rule, the OCC discussed a facility leasing transaction and concluded that

... under some circumstances real estate leasing may be an incidental component of a personal property leasing transaction. Therefore, consistent with its decision to retain a case-by-case approach to activities incidental to leasing generally, the OCC will determine the permissibility of personal property lease financing transactions that have a real estate leasing component based upon the facts of a given lease financing transaction This will enable the OCC to review any safety or soundness or other supervisory concerns that particular transactions may present.

61 Fed Reg. 66554, 66556 (December 18, 1996).

The primary concern in permitting a bank to become a party to a real property lease is the restrictions imposed by 12 U.S.C. § 29 which states:

A national banking association may purchase, hold and convey real estate for the following purposes, and for no others:

- First** Such as shall be necessary for its accommodation in the transaction of its business.
- Second** Such as shall be mortgaged to it in good faith by way of security for debts previously contracted.
- Third** Such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings.

⁸ *Id.*, at 66556.

Fourth Such as it shall purchase at sales under judgments, decrees, or mortgages held by the association, or shall purchase to secure debts due to it.

But no such association shall hold the possession of any real estate under mortgage, or the title and possession of any real estate purchased to secure any debts due to it, for a longer period than five years except as otherwise provided in this section.

12 U.S.C. § 29.

A threshold question raised by Section 29 is whether real property leasing was contemplated as being within the purview of the statute. For the purposes of this analysis only, we assume that a leasehold interest in real estate is subject to the restrictions of Section 29.⁹

The OCC has previously approved facility leasing transactions.¹⁰ As discussed above, Part 23 recognizes as permissible the incidental use of real property to secure a bank's interest in personal property that it is leasing, depending on the facts of a given case. This position is predicated on the real property interests being, in fact, incidental to the primary transaction - the personal property lease. The measure of what constitutes "incidental" will vary in each case depending on the facts.

In the proposed transaction, several factors indicate that the \$600 Head GL is incidental to the Facility Lease. First, PNC Leasing, through Fairfield LP and the Owner Trust, need not advance any money for the Site because the rent amount owed to the Owner Trust by the Company under the Facility Lease includes the amount of rent that the Owner Trust must pay under the Head GL.¹¹ Because of these matched obligations, there is no cost to PNC Leasing for the Head GL as compared to the substantial cost for the Facility Lease. Further, PNC Leasing, through Fairfield LP and the Owner's Trust, only has a leasehold interest in the real property - not legal title. Its interest in the real property is directly related to the amount of time it will take PNC Leasing to recoup its investment in the Spur,

⁹ This proposed leasehold interest arguably is permissible under the actual wording of the statute. Section 29 says that no bank may hold "possession" or "title and possession" of real estate. In this case, the bank would have neither title to the property, nor actual possession of it during the term of the Facility Lease. At the point that the bank might take possession of the property, i.e. upon termination of the Facility Lease, the bank would be required to divest itself of its interest in the Head GL within 10 years.

¹⁰ See, Interpretive Letter No. 770 (February 10, 1997), *reprinted in* [1996-1997 Transfer Binder] Fed. Banking L. Rep. ¶ 81-134; Corporate Decision No. 98-35 (June 10, 1998).

¹¹ The Head GL does contain a provision assessing a rent of \$10 per year. However, in light of this nominal obligation, there will be no meaningful cost for the Head GL.

at which point its leasehold interest will expire.¹² Finally, the Bank has represented that the Owner Trust's only purpose in entering into the Head GL is to ensure the value of the equipment being leased under the Facility Lease.

The Head GL is not inconsistent with any of the purposes underlying the restrictions of Section 29.¹³ The Bank's funds are not being removed from the channels of commerce, nor is there speculation in the value of real estate, because the amount owed under the Head GL is directly covered by the rental payments received under the Facility Lease. In addition, no large mass of real estate will be accumulated or held by the Bank as the Bank, through the Owner Trust, is limited to a leasehold interest in the Site.

In addition, the proposed transaction poses no particular safety and soundness concerns. As mentioned earlier, the Owner Trust's obligation to pay on the Head GL is covered by payments received under the Facility Lease. Further, the Facility Lease and the Head GL both have cross-default provisions which would allow the Owner Trust to operate the Spur if there were a default under either agreement. This provision would insulate the Bank from the possibility of having to disassemble the Spur and liquidate it in the event of default.

Thus, 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 first acquires its

¹² Although the Head GL runs approximately 57 years longer than the Facility Lease, the Bank has indicated that the reason for this provision is to ensure the marketability of the Spur at the close of the Facility Lease term. If the remaining useful life of the Spur cannot be utilized because the Site on which it sits no longer is transferable, then the Bank will be unable to sell or release the Spur after the Facility Lease with the Company ends. This fact becomes clear when it is viewed in light of the Usage Agreement. The Owner Trust would be unable to enforce the Usage Agreement, and require the Company to use the Spur for up to an additional 25 years, unless it held the rights to the Site on which the Spur sits. The remaining 32 years under the Head GL would ensure the continued useful life of the Spur following the expiration of the Usage Agreement, thereby allowing the bank to market the Spur at that time.

¹³ For example, the Supreme Court in *Union National Bank v. Matthews*, stated that

[t]he object of [Section 29] was obviously threefold. It was to keep the capital of the banks flowing in the daily channels of commerce; to deter them from embarking in hazardous real estate speculations; and to prevent the accumulation of large masses of such property in their hands, to be held, as it were, in mortmain.

98 U.S. 621, 626 (1878).

ownership, but for as long as the bank has an ownership interest. This standard may be met in different ways, depending upon the type of entity in which the investment is made. Ordinarily, in the absence of agreement otherwise, each partner in a general partnership has equal rights in the management and conduct of the partnership business, regardless of the level of “ownership.” Uniform Partnership Act § 401(f)(1994). In addition, partners can allocate control among themselves through a partnership agreement. *Id.* § 103(a). Such agreements commonly require a unanimous vote on matters deemed to be fundamental, thus giving each partner a veto power. Therefore, when a national bank invests (through an operating subsidiary) in a general partnership, the OCC requires that the bank be able to exercise a veto power over the activities of the partnership, or be able to dispose of its interest. *See, e.g.,* Interpretive Letter No. 625, *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,507 (July 1, 1993). This ensures that the bank will not become involved in impermissible activities.

The terms of the limited partnership agreement and bylaws of Fairfield LP will enable the Bank, through PNC Leasing, to limit Fairfield LP’s actions and Fairfield GP’s actions as general partner thereof, to activities that are permissible for national banks. Specifically, the limited partnership agreement states that in no event shall Fairfield LP engage in any activity that is not part of, or incidental to, the business of banking without the prior consent of all partners. Additionally, the agreement also specifies that any changes may be made only with the consent of both limited partners. Therefore, the Bank (through PNC Leasing) will have the right to veto any proposed activities of Fairfield LP that it considers to be impermissible for national banks. These provisions assure that the Bank will effectively be able to prevent Fairfield LP and the Owner Trust from engaging in any impermissible activity as long as PNC Leasing continues to be a partner in Fairfield LP. Thus, the 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.

a. Loss exposure from a legal standpoint

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 the 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 it is generally accepted that a corporation is an entity distinct from its shareholders, with its own separate rights and liabilities, provided proper corporate separateness is maintained. 1 W. Fletcher, *Cyclopedia of the Law of Private Corporations* § 25 (rev. perm. ed. 1990). The same is generally true when a national bank invests in a limited partnership. Under Delaware law, the corporate veil of PNC Leasing will protect the Bank from the potentially open-ended exposure associated with a direct investment in the general partner of a limited partnership. Delaware law also provides that PNC Leasing,

as a Limited Partner in Fairfield LP, is liable only up to the amount of its interest in the partnership. Del. Code Ann. tit. 6, § 17-303 (Mitchie 1996). In addition, the draft partnership agreement provides that the limited partners are not liable for the obligations of the Fairfield LP over the amount of their investment and limits the total amount of capital contributions that the limited partners may be required to make. Section 11.2, Draft Partnership Agreement.

National banks are not permitted to be partners in general partnerships due to the potential unlimited liability for the acts of other partners within the scope of the partnerships. See *Merchants National Bank v. Wehrmann*, 202 U.S. 295 (1906). However, the OCC permits operating subsidiaries of national banks to enter into general partnerships that engage in permissible activities because the corporate veil of the subsidiary corporation protects the bank from the potentially open-ended exposure associated with a direct partnership investment. Interpretive Letter No. 289, *reprinted in* [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,453 (May 15, 1984) (national bank's operating subsidiary permitted to act as general partner in banking-related venture--joint ATM network). Such is the case here, where the general partner of Fairfield LP is Fairfield GP, a partnership that is 50% owned by PNC Leasing, an operating subsidiary of the Bank.¹⁴

b. *Loss exposure from an accounting standpoint*

From an accounting standpoint, the loss exposure of the Bank will also be limited. The Bank states that the investment by PNC Leasing in Fairfield LP will be accounted for as unconsolidated subsidiaries of PNC under the equity method of accounting. Under this method, losses recognized by the investor will not exceed the amount of its investment (including extensions of credit or guarantees, if any) shown on the investor's books. See *generally*, Accounting Principles Board, Op. 18 ¶ 19 (1971). In assessing a bank's loss exposure as an accounting matter, the OCC has previously recognized that the appropriate accounting treatment for a bank's 20-50% ownership share in an entity is to report it as an unconsolidated entity under the equity method of accounting.

Therefore, for both legal and accounting purposes, the Bank's potential loss exposure relative to Fairfield LP and Fairfield GP should be limited to the amount of its investment in those entities. Since that exposure will be quantifiable and controllable, the third standard is satisfied.

¹⁴ PNC has stated that the bylaws of Fairfield GP will include provisions stating that Fairfield GP shall not engage in any activity that is not part of, or incidental to, the business of banking, and that it is subject to supervision, regulation, and examination by the OCC.

(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.*

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 was intended to make it clear that it did not authorize speculative investment banking activities in connection with stock. 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.¹⁵

PNC is currently engaging in leasing activities similar to those to be conducted by Fairfield LP. The proposed joint venture investment in the special purpose entity would enable PNC Leasing to engage in a leasing transaction that is consistent with and an extension of its equipment leasing business.

The fact that PNC Leasing will be a 50% owner of Fairfield LP is evidence of its intention to remain actively involved in these lines of business. The management and control of Fairfield LP will be vested in Fairfield GP, that will be managed by its board of directors consisting of no fewer than two directors. By virtue of its one-half ownership of Fairfield LP, at least one half of the directorships can be selected by PNC Leasing. Far from being a passive or speculative investment, the subsidiary's 50% ownership interest will enable the Bank to continue to be an active provider of leasing and related services.

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.

¹⁵ *See, e.g.*, Interpretive Letter No. 543, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,255 (February 13, 1991) (national bank authorized to acquire nominal stockholding for membership in corporation of primary dealers in government securities); Interpretive Letter No. 427, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988) (national bank permitted to buy Farmer Mac stock in nominal amounts); Interpretive Letter No. 421, *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,645 (March 14, 1988) (national bank permitted to invest in the Government Securities Clearing Corporation).

Conclusion

Based upon a thorough review of all information available, including the representations and commitments made in the application and by the Bank's representatives, we conclude that the Bank, through its operating subsidiary, PNC Leasing, may make a 50% non-controlling investment in Fairfield GP and a 49.95% non-controlling investment in Fairfield LP. We further conclude that the lease transaction is permissible under 12 U.S.C. § 24(Seventh). The Bank is reminded that it must comply at all times with the conditions set out in 12 C.F.R Part 23, including the requirement to divest of any off-lease interests within the appropriate divestiture period.

Fairfield LP may engage in the leveraged lease transaction in the manner and as described herein, subject to the following conditions which are deemed to be "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:

- (1) Fairfield LP, Fairfield GP and the Owner Trust will engage only in activities that are part of, or incidental to, the business of banking;
- (2) the Bank, through PNC Leasing, will withdraw from either entity in the event they engage in an activity that is inconsistent with condition number one;
- (3) the Bank will account for the investments in Fairfield LP and Fairfield GP under the equity method of accounting; and
- (4) PNC Leasing, Fairfield LP, Fairfield GP and the Owner Trust will be subject to OCC supervision, regulation, and examination.

This approval is limited to the facts as presented herein and may not be relied on as an approval for future transactions. If you have any questions, please contact Licensing Manager Michael G. Tiscia, Northeastern District, at 212-790-4055, or Attorney Laura Goldman at 202-874-5300.

Sincerely,

/s/

Raymond Natter
Acting Chief Counsel