Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #855
March 1999
12 USC 24(7)

March 1, 1999

Dear [ ]:

This is in response to your letter dated February 4, 1999 to Mr. Richard T. Erb, Licensing Manager, Corporate Activities, on behalf of [ ], ("the Bank") [*City, State*]. You requested confirmation that it would be lawful for the Bank to acquire a direct non-controlling minority investment in [ ], ("*Inc.*") a Delaware corporation, and thereby acquire indirectly, a non-controlling minority interest in [*Inc.*]'s sole subsidiary, [ ] ("the LLC"), a limited liability company providing stored value systems. You have also requested confirmation that the Bank may acquire, retain and exercise options on shares of [*Inc.*] common stock in connection with the proposed investment. Subject to the conditions set forth herein, it is our opinion that the transactions, as described below, are legally permissible.

Background

The Bank is a limited purpose credit card bank and a wholly owned subsidiary of [ ] ("*Corp.*"), a registered multi-bank holding company headquartered in [*City, State*]. The LLC is an existing for-profit Delaware limited liability company owned directly by [ ] ("*A1*"), [ ] ("*A2*"),[ ], ("*A3*"), and a group of officers and managers of the LLC ("the Management Group"). ([*A1, A2, A3*], and the Management Group collectively referred to as "Current LLC Owners"). The LLC engages in "smart card" activities and in the development, marketing, delivery and maintenance of stored value and information systems intended for use by System Customers and other businesses.[1] The LLC's

[1] A "smart card" is a plastic card with an embedded integrated circuit that looks like a credit card. A smart card is essentially a mini-computer that can store both data and programs. Depending on the capacity of the integrated circuit, the smart card may hold only limited information, or may have the capability of performing more complex computing

stored value system enables cardholders to make cashless payments to participating users in a "closed system" with a sponsoring System Customer, such as a university and its students, faculty, departments and merchants, or to other merchants outside of a sponsoring System Customer. The LLC has been operational for two and one-half years and presently has installed stored value and smart card systems for fourteen System Customers, including twelve universities, and has agreements to provide such systems to six other entities.

According to your letter, the LLC will be reorganized in the near future so that not less than 98% of the membership interests in the LLC presently held by the Current LLC Owners will be converted into interests in the common stock of [*Inc*.] and [*Inc*.] will become the parent holding company of the LLC. The sole activity of [*Inc*.] will be to hold not less than 98% of the membership interest and voting control of the LLC. Following the contemplated reorganization of the LLC, [*A1*] will hold a 2% membership interest in the LLC while the other Current LLC Owners will hold approximately the same percentage ownership interests in the common stock of [*Inc*.] as they presently do in the equity of the LLC.[2] The common stock in [*Inc*.] to be held by the Management Group will be nonvoting.[3]

The Bank seeks to acquire a minority ownership interest (between 10% and 19.8%of the capital stock) in [*Inc*.]. Under the terms of the proposal, the Bank would initially acquire 10% of the common stock of [*Inc*.] and options for purchasing an additional 9.8% of the common stock of [*Inc*.] in consideration of $4 million in cash. The LLC will use these funds for its operations. The option for purchasing the additional 9.8% of the common stock of [*Inc*.] may be exercised by the Bank at $0.10 per share if certain conditions are met, *i.e.*, the Bank successfully causes the LLC to acquire new contracts, primarily with colleges and universities and potentially also with hospitals, business centers,

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functions. For stored value smart cards, an electronic device is used to load (add) or deduct value stored on the computer chip. The plastic card is able to pass information to a card reader that stores such information for later downloading, processing and use.

[2] Currently,[*A1*] holds a 35% voting membership interest in the LLC, [*A2*] and [*A3*] each have a 25% voting membership interest in the LLC, and the Management Group holds a 15% non-voting membership interest in the LLC.

[3] The first three-quarters of the Bank's initial 10% ownership interest in [*Inc*.] will reduce, proportionally, the percentage ownership interest of [*A1*], [*A3*] and [*A2*], but will not reduce the percentage ownership interest of the Management Group in [*Inc*.]. The last one-fourth of the Bank's initial 10% ownership interest in [*Inc*.], and any additional shares that the Bank might acquire pursuant to the exercise of options on [*Inc*.] common stock, will reduce the interest of all the Current LLC Owners, including the Management Group, proportionally.

theme parks and military installations (collectively referred to as "System Customers"). The option must be exercised in full by December 31, 2000. If the option is fully exercised, the Bank will hold approximately 19.8% of [*Inc*.]'s common stock.

Analysis

The Bank's proposal to hold up to a 19.8% interest in [*Inc*.] raises the issue of the authority of a national bank to make a non-controlling minority investment in a corporation that provides stored value systems and services through a subsidiary organized as a limited liability company. In a variety of circumstances the OCC has permitted national banks to own, either directly or indirectly through an operating subsidiary, a non-controlling interest in an enterprise. The enterprise might be a limited partnership, a corporation, or a limited liability company.[4] In various interpretive letters, the OCC has concluded that national banks are legally permitted to make a non-controlling investment in a limited liability company, provided four criteria or standards are met.[5] These standards, which have been distilled from our previous decisions in the area of permissible 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 bank must be able to prevent the entity or 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 factors is discussed below and applied to your proposal.

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[4] *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.

[5] *See, e.g.*, Interpretive Letter No. 778 (March 20, 1997), *reprinted in* [1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-205 and Interpretive Letter No. 692 (November 1 1995), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,007.

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 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 business of banking.[6] It is well established that a national bank may use electronic or data processing technology to perform services expressly or incidentally authorized to national banks.[7] The OCC previously approved [*A3*]'s acquisition of a minority interest in this LLC after determining that the LLC's activities were part of, or incidental to, the business of banking, and thus, permissible activities for national banks and their subsidiaries.[8] Therefore, this standard is satisfied.

2. *The bank must be able to prevent the entity or enterprise from engaging in activities that do not meet the foregoing standard or be able to withdraw its investment.*

This is an obvious corollary to the first standard. 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 ownership, but for as long as the bank has an ownership interest.

Your letter states that the organizational, membership and operational documents and agreements with respect to [*Inc*.] and the LLC provide adequate means to prevent [*Inc*.] and its subsidiary, the LLC, from engaging in activities not authorized for national banks. Although all of the documents providing for the Bank's acquisition of a minority interest in [*Inc*.] have not been finalized, several provisions of these documents submitted to us at our request confirm your representations that this standard is satisfied.

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[6] *See, e.g.*, Interpretive Letter No. 380 (December 29, 1986), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,604 n.8 (since a national bank can provide options clearing services to customers, it can purchase stock in a corporation providing options clearing services); Interpretive Letter No. 694 (December 13, 1995), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 91-009 (national bank permitted to take non-controlling minority investment in a limited liability company that purchases secured home improvement loans and resells them in the secondary market); Interpretive Letter No. 711, *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-026 (February 23, 1996) (national bank may take a minority equity interest in a mortgage banking company).

[7] *See* Interpretive Letter No. 677, *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,625.

[8] *See* Interpretive Letter No. 737, *reprinted in* [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,101.

Specifically, the Third Article of the Draft Certificate of Incorporation of [*Inc*.], Article 2, Section 2.3 of the Amended and Restated Limited Liability Company Operating Agreement and Article VI, Section 6.2(j) of the Draft Shareholder's Agreement among the Current LLC Owners and the Bank, state that the activities of [*Inc*.] and the LLC must be "permissible for a national banking association". Additionally, these documents require that "all necessary regulatory notices and applications have been given and any necessary consents received prior to engaging in any such activity." Moreover, because these provisions cannot be amended without unanimous shareholder consent, the Bank will be able to veto any expansion of activities of [*Inc*.] and the LLC that are impermissible for national banks. Therefore, this 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 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.[9] In the present case, both [*Inc*.] and the Bank will be separate corporations, with their own capital, directors, and officers.

As a legal matter, the Bank's risk of loss will be limited by Delaware law. No member or manager of a Delaware limited liability company is personally liable for any debts, obligations or liability of the limited liability company solely by being a member or acting as a manager of the limited liability company.[10] Therefore, the Bank's risk of loss is limited to the amount of its capital investment in the LLC. In addition, under Delaware corporate law, a shareholder as a general rule is not liable or responsible for the debts of a corporation solely because he or she is a shareholder of that corporation. The Bank is further insulated from liability by the "corporate veil" under corporate law since its interest in the LLC stems from being a shareholder of the parent corporation, [*Inc*.].

Thus, the Bank's loss exposure for any liabilities of [*Inc*.] and the LLC will be limited.

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[9] 1 William M. Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 25 (perm. ed. rev. vol. 1990).

[10] *See* DEL. CODE ANN. tit. 6 § 18-303 (1998).

b. *Loss exposure from an accounting standpoint*

The Bank's investment will be made by cash purchase in the amount of $4 million, although actual exercise of the option requires, in addition to the $0.10 per share exercise price, that certain conditions be met. The Bank's accountants have advised that the appropriate treatment for its investment in [*Inc.*], whether it is 10%, 19.8%, or some percentage between 10% and 19.8%, is as an unconsolidated investment under the equity method of accounting.[11]

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% ownership share of investment in a corporation or limited liability company is to report it as an unconsolidated entity under the equity method of accounting. Under this method, unless the bank has guaranteed any of the liabilities of the entity or has other financial obligations to the entity, losses are generally limited to the amount of the investment, including loans and other advances shown on the investors's books.[12] Similarly, under the cost method of accounting (generally used for equity interests of less than 20% in a corporation), the investor records an investment at cost, dividends or distributions from the entity are the basis for recognition of earnings, and losses recognized by the investor are limited to the extent of the investment. In sum, regardless of which accounting method is used, the investing bank's potential loss is limited to the amount of the investment.

As proposed, the Bank will have between a 10% and 19.8% ownership share in [*Inc.*], depending on whether it exercises its option to purchase additional stock. As noted above, Delaware law limits the Bank's losses to its capital investment. In addition, the relevant agreements contain provisions that confirm that no investor in the LLC will have liability for the debts, obligations and liabilities of the LLC. Therefore, for both legal and accounting purposes, the Bank's potential loss exposure to [*Inc.*] and the LLC should be limited to the amount of its investment. Since that exposure will be quantifiable and controllable, the third standard is satisfied.

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[11] The Bank's accountants believe that the equity method is appropriate in this case because they anticipate that the Bank will exercise its option to purchase additional stock, bringing it very close to a 20% ownership interest in [*Inc.*]. Even if the Bank were not to exercise the option, under generally accepted accounting principles, the Bank will still evidence indicia of its ability to exercise control or influence the operating or financial decisions of the investee, [*Inc.*], *e.g.*, through shareholder and board representation and the symbiotic relationship between the Bank and [*Inc.*] in which each is dependent on the others' efforts in attracting new customer lines and banking products.

[12] *See generally* Accounting Principles Board, Op.18 § 19 (1971) (equity method of accounting for investments in common stock).

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 that bank's banking business, *i.e.*, it must be convenient or useful to the investing bank's business activities and not constitute a mere passive investment unrelated to the 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."[13] Therefore, a consistent concept 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.[14]

The Bank's investment in [*Inc*.] will not be a passive investment. The Bank anticipates the enhancement of its credit card business and the development of new business opportunities as a result of its ownership interest in [*Inc*.]. The Bank hopes to serve as the issuing bank for participating System Customers and its cardholders. In addition, the Bank expects to be actively involved as a shareholder and through anticipated board representation in [*Inc*.]'s activities. The Bank's desire to exercise options to purchase additional stock in [*Inc*.] is part of the Bank's broader business plan and is further evidence that this is a not a speculative investment. The Bank's investment will forge a symbiotic relationship with [*Inc*.] based on mutual dependency whereupon each will derive benefits from the efforts of the other in attracting new Systems Customers and selling Bank products. Thus, the fourth standard is satisfied.

Conclusion

Based upon the information and representations you have provided, and for the reasons discussed above, we conclude that [*Bank*], [*City, State*], may acquire and hold a non-controlling 19.8% interest in [*Inc*.

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[13] *Arnold Tours Inc. v. Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

[14] *See e.g.*, Interpretive Letter No. 543, *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,225 (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).

], and thereby acquire, indirectly, a 19.8% non-controlling interest in [*Inc.*]'s sole subsidiary, [*LLC*].[15] Our conclusion is conditioned upon compliance with the commitments made in your letter of inquiry and with the conditions listed below:

(1) [ ] (" *Inc.* ") and [ ] ("the LLC") may 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 decisions of [*Inc.*] and the LLC that are inconsistent with condition number one or the Bank will withdraw its investment from [*Inc.*] and the LLC if either proposes to engage in any activity that is inconsistent with condition number one;

(3) The Bank will account for its investment in the LLC as an unconsolidated entity under the equity or cost method of accounting; and

(4) [*Inc.*] and the LLC will be subject to OCC supervision, regulation, and examination.

These commitments and conditions are conditions 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.

I hope that this has been responsive to your inquiry. If you have any questions, please contact Susan L. Blankenheimer, Senior Attorney, Bank Activities and Structure Division at (202) 874-5326.

Sincerely,

/s/

Julie L. Williams
Chief Counsel

[15] Since the Bank has satisfied the four part test for minority investments, it may make the initial 10% investment in these entities as well as exercise the option for up to an additional 9.8% investment, for a total combined investment of 19.8%.