

INTERPRETIVE LETTER 10-02 (JUNE 15, 2010)

A BANK MAY EXCHANGE PROPERTY OBTAINED IN SATISFACTION OF DEBT PREVIOUSLY CONTRACTED FOR AN EQUITY INTEREST IN AN ENTITY WHICH WOULD MANAGE, MARKET, AND DISPOSE OF THE PROPERTY PURSUANT TO 205 ILCS 5/5(11) BECAUSE IT ENCOMPASSES A PERMISSIBLE ACTIVITY FOR NATIONAL BANKS.¹

INTRODUCTION

This letter turns on whether Bank A is allowed to exchange property obtained in satisfaction of debt previously contracted (DPC)² for an equity interest in an entity which would manage, market, and dispose of the property. For reasons discussed below it is the opinion of the Illinois Department of Financial and Professional Regulation – Division of Banking (Division) that Bank A may engage in the proposed activity outlined in its proposal pursuant to 205 ILCS 5/5(11) because it encompasses a permissible activity for national banks.³

On December 29, 2006, Bank A entered into a real estate participation loan with 68 other financial institutions. The debtors filed for Chapter 11 bankruptcy protection on December 16, 2009. A bankruptcy sale commenced and the 69 financial institutions, including Bank A, were awarded the Other Real Estate Owned (OREO)⁴ property for \$65 million dollars. The property was transferred to the Group and subsequently divided pro rata.

On May 11, 2010 the board of directors (Board) for the Bank voted to authorize an exchange of its participation interest in the OREO property for an equivalent interest in an LLC. The Board Authorization authorizes Bank A to exercise its authority only upon prior approval of the Division.⁵ The Board represents the exchange would create economic and managerial efficiencies for the Group by allowing the property to be marketed, negotiated and conveyed in whole to a purchaser, rather than in part. Management of the OREO property by the LLC would guarantee the efficient day-to-day operation of the premises and assure continued regulatory compliance. Additionally, Bank A would be able to limit its loan losses, expenses, and liability.

¹ This response is meant solely as a general overview of the applicable law and should not be relied upon as legal advice or counsel.

² The Division adopts the following definition of DPC, "...real estate (including capitalized and operating leases) acquired by a [state] bank through any means in full or partial satisfaction of a debt previously contracted." 12 C.F.R. 34.81: Real Estate Lending and Appraisals; Subpart 3-Other Real Estate Owned: Definitions (current through January 1, 2010). Text from the Code of Federal Regulations: Available from the Government Printing Office, www.gpo.gov (accessed June 4, 2010).

³ OCC Interpretive Letter No. 1123 (October 2009); OCC Interpretive Letter No. 1118 (July 2009)

⁴ The Division adopts the following definition of OREO, "...All other real estate owned (i.e., foreclosed and repossessed real estate), reported on a regulatory financial report, and does not include direct and indirect investments in real estate ventures." 12 C.F.R. 925.1: Member of the Banks; Subpart A – Definitions. (Current through January 2009). Text from the Code of Federal Regulations: Available from the Government Printing Office www.gpo.gov (accessed June 4, 2010)

⁵ See March 1, 2010 Bank A Board Authorization.

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The Board further represents the exchange is not being made for speculative purposes or an expectation of profit⁶ and is subject to the terms and conditions (“1123 conditions”) specified in Office of the Comptroller of Currency (OCC) Interpretive Letter Number 1123 (October 2003), restated below:

- (1) Prior to making the exchange, Bank A’s directors must determine that the exchange is in the best interest of Bank A and would improve the ability of the Bank to recover, or otherwise limit its loan loss. The basis for such determination must be documented.
- (2) Prior to making the exchange, Bank A must notify its Examiner-in-Charge, in writing, of the proposed exchange and must receive written notification of supervisory non-objection, based on an evaluation of the adequacy of the Bank’s risk management and measurement systems and controls to enable the Bank to exchange for, hold, and dispose, of the LLC interest in a safe and sound manner, and an evaluation of any other supervisory consideration relevant to the exchange.
- (3) The Bank may not further exchange the LLC interest for an interest in any other real or personal property. Such property would be too far removed for Bank A’s original DPC⁷ interest in the OREO Properties to be considered DPC property.
- (4) Bank A must ensure the LLC complies with the provisions of the OCC’s ORE regulation, 12 C.F.R. Part 34, Subpart E, including obtaining a current appraisal on the OREO Properties.
- (5) Consistent with the limitation in 12 U.S.C. §29 and 12 C.F.R. Part 34, Bank A must dispose of its interest in the LLC no later than five years from the date it initially acquired title to the OREO properties, unless granted an extension by the [Division].

ANALYSIS

The Illinois Banking Act (Act), 205 ILCS 5/1 *et seq.*, grants powers to state banks, establishes permitted activities and investments, and establishes related limits. The Act does not specifically authorize a state-chartered bank to exchange its participation interest in OREO property for an equivalent interest in a third-party LLC. Section 5(12)(c) of the Act permits a bank to establish subsidiaries engaged in “carrying on or administering any of the activities... in which a bank may engage in carrying on its general banking business,” subject to certain limitations. 205 ILCS 5/5(12)(c)(West 2010). However, in order to qualify as a subsidiary, a bank must exercise “control”⁸ over the entity. Historically, the Division has defined “control” to mean “at least 50% plus 1 share”⁹ or more than 50% membership interest for an LLC. When “control” is exercised, a state-chartered bank must provide the Division with 60 days notice before

⁶ Id.

⁷“DPC” is an acronym for Debt Previously Contract. Note, for purposes of the instant discussion DPC and OREO are interchangeable and synonymous.

⁸ The statute does contemplate transactions where affiliates of a bank are also stockholders. In such a scenario, “control” for purposes of the section will not depend solely upon ownership of stock, but upon actual control exercised by the affiliate group. See 205 ILCS 5/2 (West 2010).

⁹ Division Interpretive Letter No.96-6 (October 3, 1996).

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the subsidiary may be established. Absent “control,” section 5(12) does not apply to a bank wishing to partake in the described DPC exchange.

Notwithstanding Section 5(12), the Division has found certain activities permissible when they are incidental to a “general banking business”¹⁰ even if they are not specifically stated in the Act. An activity is incidental if “it is convenient or useful in connection with the performance of the Bank’s established activities.”¹¹ Notwithstanding the aforesaid, the Act provides a mechanism by which a state-chartered bank may elect to participate in an activity permissible for national banks.

Section 5(11) empowers any state-chartered bank the authority “...to do any act...that is at the time authorized or permitted to national banks...but subject always to the same limitation and restrictions as are applicable to national banks by pertinent federal law...” National banks under the supervision of the OCC are allowed to exchange property obtained in satisfaction of DPC for an equity interest in an entity which would manage, market and dispose of the property.¹² National banks are allowed to do so only if it would be in the best interest of the bank, aid in its recovery of loan loss, and is a compromise in good faith¹³. If the exchange is made for the purpose of speculation or the expectation of profit, it is not permitted. Therefore, in order for an Illinois state-chartered bank to engage in an exchange of OREO property for an equity interest in a non-subsiary LLC under Section 5(11), it must first adopt and conform to the guidance provided by the OCC in its Interpretive Letter No. 1123, including adherence to all 1123 conditions in order to promote and assurance safety and soundness.

In the alternative,¹⁴ and pursuant to Section 3 of the Act, an Illinois state-chartered bank may also engage in the described exchange by adhering to all 1123 conditions, with the exception of the notice requirement found in condition number two. This notice exception is not required for state-chartered banks partaking in the exchange activity pursuant to Section 5(11). In the event affiliates of Bank A are also involved in the LLC, and to the extent control over the operations or management is exercised, Section 5(12) notice provisions may apply.¹⁵

¹⁰ See Division Interpretive Letter No. 92-5 (May 14, 1992); Division Interpretive Letter No.96-6 (October 3, 1996).

¹¹ *Corbett v. Devon Bank*, 12 Ill.App.3d 559, 571 (1973), citing *Arnold Tours Inc. v. William B. Camp*, 472 F.2d 427, 432 (1st Cir. 1972).

¹² OCC Interpretive Letter No. 1123 (October 2009) and OCC interpretive Letter No. 1118 (July 2009).

¹³ See *Union Nat’l Ban v. Matthews*, 98 U.S. 621, 626 (1879).

¹⁴ Although Bank A has requested an opinion as to its interpretation of Section 5(11) of the Act, the Division finds it useful to include the Section 3 alternative in order for Bank A to fully appreciate its options.

¹⁵ “Any bank intending to establish a subsidiary under this subsection (12) shall give written notice to the Commissioner 60 days prior to the subsidiary’s commencing of business...” 205 ILCS 5/5(12) (West 2010).

CONCLUSION

The proposal of the Board, as adopted in its March 1, 2010 Board Authorization, describes a permissible banking activity pursuant to Section 3 of the Act. Additionally, the proposal is permissible pursuant to section 5(11) of the Act and the guidance established by OCC Interpretive Letter No. 1123. Therefore, the Division does not object to the proposal as represented by the Board Authorization, and only to the extent the guidance provided by the OCC remains reliable authority subject to all conditions, limitations and future amendments, if any.