INTERPRETIVE LETTER 92-17 (DECEMBER 8, 1992)

Earn-out portion of sale of state bank subsidiary financed by selling bank is not subject to Section 32 lending limits, provided sale is performed in commercially reasonable manner that minimizes risk to bank in event purchaser defaults.

On *, the Office of the Commissioner of Banks and Trust Companies ("Commissioner") issued a preliminary response to your inquiry regarding the applicability of the Illinois lending limits to the financed sale of * ("Subsidiary") by the * ("Bank") to the Purchaser.

You informed us that under the terms of the transaction, the Purchaser would purchase all of the shares of the Subsidiary. A portion of the purchase price would be paid in cash at the closing, and the balance, if any, paid in accordance with an "earn-out" formula based on the Subsidiary's earnings through 1995. In addition, in lieu of transferring certain assets to the Bank prior to the transaction, the Subsidiary might issue its promissory note (the "Note"), secured by these assets, to the Bank. You inquired whether the "earn out" obligations of the Purchaser would be subject to the limits set forth in Section 32 of the Illinois Banking Act (the "Act"), Ill. Rev. Stat. ch. 17, par. 339 (1991). You indicated that the amount of the Note would not exceed the lending limits set forth in Section 32.

Section 32 limits the total obligations of any one person for "money borrowed" to 20% of the lending bank's unimpaired capital and unimpaired surplus, unless the excess amount is secured by readily marketable collateral and the total does not exceed 30% of such unimpaired surplus and capital. In addition, Section 32 limits the obligations of any one person for "money borrowed, or otherwise" to 25% of deposits and 50% of unimpaired capital and surplus. "Money borrowed" does not include 1) the purchase or discount of bills of exchange, 2) the purchase or discount of commercial or business paper, 3) the purchase or the making of loans secured by real estate appraised at twice the amount of the principal debt secured, 4) the purchase of marketable securities, and 5) the liability of persons as guarantors.

The phrase "money borrowed, or otherwise" is not defined in the statute. The Commissioner has issued a regulation "implementing" Section 32 which states that the "purpose" of Section 32 is to "prevent one person or a relatively small group of persons, from borrowing an unduly large amount of a bank's funds." 38 Ill. Admin. Code ch. II, part 330 (1992). Section 32 is also intended to safeguard depositors by diversifying loan risks. According to this regulation, Section 32 is intended to protect a bank from losses resulting from its more traditional banking functions, not from the sale of its assets.

Based on the above interpretation and the plain language of Section 32, the financed sale of a state-chartered bank's assets is not the type of financial risk Section 32 is intended to restrict. The financed sale of a state-chartered bank's own assets is clearly distinguishable from the various transactions described in Section 32. Section 32 places limits on transactions in which the bank's funds are advanced and are at risk or are invested in

exchange for a stated return. The limits apply when a bank puts its funds at risk by speculating on the creditworthiness of the borrower. The categories listed in Section 32 which are not "money borrowed" also involve the investment or extension of funds by the bank with the speculative expectation that it will receive a return of its principal and interest. The financed sale of a state-chartered bank's assets involves the disposition of the bank's real or personal property in exchange for the receipt of consideration in the form of cash, a promissory note, or real or personal property. In the financed sale of assets, the bank is not putting its funds at risk in exchange for a return on its investment but is disposing of its property in a commercially acceptable manner.

Applying the limits of Section 32 to the financed sale of a state-chartered bank's assets would unduly limit the ability of a bank to dispose of non-performing assets. However, to protect the integrity of the state bank's financial condition, the conclusion that Section 32 is not applicable is limited by the requirement that the disposition of the bank's assets must be done in a commercially reasonable manner which does not place the bank in a worse position than it would have been if it had not disposed of the assets in a financed sale. Such a requirement assures that the sale will not have a detrimental effect on the bank's financial condition and that the financed obligation will not be among the risks which Section 32 addresses.

This Agency's interpretation of the applicability of Section 32 to the financed sale of a state-chartered bank's assets is consistent with the position of the Office of the Comptroller of the Currency ("OCC") which has consistently interpreted 12 U.S.C. 84, the national bank lending statute, as not applying to the financed sale of a national bank's assets, provided that the national bank's position would be no worse as a result of accepting the financing instrument. See, OCC Interpretive Letter No. 501, reprinted in [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) par. 83,096 (March 13, 1990). Applying the limits of Section 32 to financed sales of state-chartered banks' assets would place regulatory obstacles in the path of state-chartered banks which do not exist for national banks doing business in Illinois. Such a result would be inconsistent with the intent of Section 5(11) of the Act, Ill. Rev. Stat. ch. 17, par. 311(11)(1991).

Finally, in your inquiry letter you referred to three Illinois Attorney General Opinions, Ill. A.G. Op. No. 896 (May 19, 1936), Ill. A.G. Op. No. 456 (April 7, 1958) and Ill. A.G. Op. No. 12 (July 15, 1959)(collectively, the "Opinions") in which the phrase "money borrowed, or otherwise" was interpreted to include all direct, indirect and contingent liabilities. A review of the Opinions reveals that in each instance the liabilities at issue are the type that Section 32 is intended to govern. The Opinions address whether to include advances against sight drafts, guarantees, and the purchase and sale of commercial paper within the lending limits of Section 32. The Opinions encompass traditional borrowing and credit transactions and should not be read as a limitation on the ability of a state-chartered bank to enter into a financed sale of its assets.

It is the position of this Agency that the Bank is authorized to sell Subsidiary to Purchaser for the terms set forth in your letter of inquiry, and the earn-out portion of the purchase price is not subject to the lending limits of Section 32, provided that the sale of the

Subsidiary is conducted in a commercially reasonable manner that minimizes the risk to the Bank in the event the Purchaser defaults on its obligations under the earn-out provision.

This Interpretive Letter is limited to the applicability of Section 32 to the earn-out portion of the purchase price. You have indicated that the principal amount of the Note will not exceed the limits set forth in Section 32. Therefore, this Interpretive Letter does not reach the issue of whether Section 32 applies to that portion of the transaction.