

INTERPRETIVE LETTER 96-6 (OCTOBER 3, 1996)

State bank may make minority equity investment in limited liability company, corporation or partnership pursuant to conditions outlined.

This is in reply to your inquiry regarding the authority of an Illinois state-chartered bank to acquire a minority equity interest in a limited liability company ("LLC"), a corporation, or a partnership (collectively "Entity"). Your specific inquiry asks whether a state-chartered bank may invest in an LLC formed for the purpose of operating a mortgage originating entity. Based on the tests and conditions set forth in this letter, the Office of Banks and Real Estate ("Office") concludes that a minority equity investment by a state-chartered bank is permissible as part of the general business of banking.

Authority to Invest in an Entity

The Illinois Banking Act ("Act"), 205 ILCS 5/1 et seq., grants powers to state banks, sets forth their permitted activities and investments, and imposes certain limits on their powers, activities and investments. The Act does not specifically authorize a state-chartered bank to make a minority equity investment in an Entity. Section 5(12) of the Act permits a bank to establish subsidiaries "that is, or are, engaged in...(c) carrying on or administering any of the activities...[except deposit taking and paying checks]...in which a bank may engage in carrying on its general banking business." 205 ILCS 5/5(12) (1994).

Minority equity investments do not qualify as a subsidiary under Section 5(12) of the Act because a subsidiary must be "controlled" by the bank (which the Office interprets to mean that the bank must own a majority of the stock in an Entity--at least 50% plus 1 share). If a state bank owns less than a controlling interest, the Entity will not qualify as a subsidiary, but rather will be a minority equity investment. Since a state bank does not possess the enumerated power to make a minority equity investment, the power to make the investment or engage in the activity must be a general corporate power incidental and germane to a general banking business.

Section 3 of the Act provides that a state bank may conduct a "general banking business." 205 ILCS 5/3 (1994). The term "general banking business" has expanded to include the power to engage in activities which are incidental and germane to carrying on a general banking business. Corbett v. Devon Bank, 299 N.E.2d 521, 529 (1973). An activity is considered incidental to the business of banking if it is convenient or useful in connection with the performance of one of the bank's express powers. Id. The activities previously found by the Office to be incidental and germane to a general banking business include: purchasing securities as agent for a bank's customers (Interpretive Letter 89-5); offering debt cancellation agreements (Interpretive Letter 94-11); and purchasing guaranty bonds to secure excess deposits (Interpretive Letter 94-4).

While not restricted by the provisions of Section 5(12), the Office concludes that a state bank may only make a minority equity investment in an Entity that conducts activities

which are lawful for a state bank to conduct directly. State banks are clearly authorized to invest in activities incidental and germane to the business of banking through a subsidiary. Allowing state-chartered banks to make equity investments in an Entity engaging in permissible banking activities permits a state bank, perhaps with other banks, to provide a permissible service through the Entity which the bank might not have provided because of the cost or lack of management expertise. By making an equity investment in an Entity, a bank is able to engage in a permissible activity while sharing the cost and risk associated with the activity among other banks and participants and while receiving the benefits. Allowing the investment in an Entity does not expand the types of activities that banks may conduct, but rather allows banks in concert to conduct activities that are already permitted. Therefore, the Office concludes that a minority equity investment in an Entity is incidental and germane to the general business of banking if the investment is made under the guidelines described below.

Federal laws or regulations do not prohibit a state bank from investing in an Entity. Equity investments made by state banks are limited by 12 CFR 362.3 to an "equity investment of a type, or in an amount...permissible for a national bank." The Office of the Comptroller of the Currency ("OCC"), the primary regulator of national banks, recently issued a series of Interpretive Letters concluding that a national bank could acquire a minority equity interest in an Entity. See, OCC Interpretive Letter No. 705, reprinted at Fed. Banking L. Rep. (CCH) par. 81-020. See also, OCC Interpretive Letters No. 711, reprinted at Fed. Banking L. Rep. (CCH) par 81-026; OCC Interpretive Letter No. 692, reprinted at Fed Banking L. Rep. (CCH) par. 81-007; and OCC Interpretive Letter No. 697, reprinted at Fed. Banking L. Rep. (CCH) par. 81-012.

State and national banks often collaborate on a project, activity or investment. After reviewing the guidelines set forth by the OCC in Interpretive Letter 705, the Office concludes that the limitations and conditions set forth in that letter are appropriate. State banks should have the same opportunity to invest in Entities and the organizers of those Entities should be subject to consistent requirements. The Office will therefore require that the following conditions be met when a bank proposes to invest in an Entity:

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 investing bank must be in a position (by contract, organizing document or otherwise) to prevent the enterprise or entity from engaging in activities that do not meet the foregoing standard;
3. The bank's loss exposure must be limited (by contract, organizing document, or otherwise), 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 the bank's business.

These guidelines are not exclusive and the Office may add to or amend the guidelines for bank minority equity investments in an Entity. Also, at examinations of the participating state banks these investments will be examined and reviewed by the Office for compliance with safety and soundness guidelines and compliance with applicable laws and regulations.

Investment in a Mortgage Originating Entity

Your specific inquiry relates to a state-chartered bank that plans to make a minority equity investment in an LLC. The other members of the LLC would include a mortgage brokerage corporation ("Mortgage Broker") and approximately five banks. The LLC would seek to become a dominant residential mortgage banker/broker origination company in the local area and would attempt to maximize the profit opportunity from mortgage operations. Mortgage Broker would provide management and operational expertise and services, and the banks would provide desk space and telephones for use by LLC personnel. The banks would furnish warehouse lines-of-credit (within each bank's lending limit) to be used by the LLC to fund loans until they were sold. Applying the criteria outlined above to your inquiry, we conclude that an Illinois state-chartered bank may acquire and hold a minority equity interest in an LLC that performs an activity that is part of the business of banking, including a mortgage origination or mortgage brokerage function, subject to the conditions listed above. Each of the conditions is addressed further below to respond to the specific parts of your inquiry.

First, the mortgage-related activities of the LLC are clearly "activities that are part of, or incidental to, the business of banking." We assume that the LLC would limit its activities to such mortgage-related activities. If the LLC engages in additional activities that the Office has not acknowledged previously to be clearly part of or incidental to the business of banking, we recommend that a participating state bank promptly notify the Office so that we can determine whether a state-chartered bank may continue to hold an equity interest in the LLC.

Second, a state-chartered bank investing in the LLC must have independent authority within the legal framework of the organizing and operating documents of the LLC to prevent the LLC from engaging in activities that are not part of or incidental to the banking business. In the alternative, each state-chartered bank must have, and exercise, clear authority to withdraw from the LLC and recover distribution of its capital contribution or fair value of its interest in the LLC if the LLC becomes involved in business activities that are not part of or incidental to the banking business. Your inquiry does not make clear how and to what extent a state-chartered bank that invests in the LLC can prevent the LLC from engaging in activities that are not part of or incidental to the business of banking. The limitation on the LLC's powers, the ability of each bank to prevent the LLC from engaging in "non-banking" activities, and/or the ability of each

bank to withdraw from the LLC and receive its capital contribution if the LLC elects to engage in "non-banking" activities should be clearly documented in the LLC's articles of organization or its operating agreement.

Third, risk of loss to a state-chartered bank as a result of its investment in the LLC must be limited to the amount of the bank's investment. The bank must not assume any liability beyond that of a member in an LLC as specified in Section 10-10(a) of Illinois' Limited Liability Company Act, 805 ILCS 180/10-10(a) (1994). Also, the bank should not be legally obligated to provide additional capital should the LLC need additional investment. If a state-chartered bank extends any loans to the LLC, the loans must be made pursuant to the bank's normal credit standards and procedures, and such loans are subject to the bank's legal lending limit(s).

Finally, it is apparent that the proposed LLC's activities will be convenient and useful to the investing state-chartered bank(s) and will not constitute a mere passive investment. The plan is for the LLC to originate mortgage loans in the "local area" and to enhance the profitability of the mortgage operations of Mortgage Broker and the investing banks. Mortgage brokerage is clearly an appropriate activity for state and nationally chartered banks.

If the LLC and the investment of state-chartered banks in the LLC comply with the standards and conditions set forth herein, the Office concludes that a state-chartered bank may acquire and hold a minority equity interest in the LLC that is the subject of your inquiry. The same four criteria listed above also apply generally to state-chartered banks in Illinois making other minority equity investments in an Entity. This letter does not apply to investments by or activities of national banks in Illinois. If any national banks would be potential investors in this LLC, that bank should contact the appropriate federal regulatory agency to determine whether that agency will permit such an investment by a national bank in these circumstances.