Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1052
March 2006
12 USC 84
12 CFR 32

November 30, 2005

Subject: Applicability of Lending Limit to Credit Programs of **[ ]** National Bank, **[*City, State*]**

Dear **[ ]**:

We are writing in response to your request for an opinion as to the application of the lending limit, 12 U.S.C. § 84 and 12 C.F.R. part 32, to three credit programs contemplated by **[ ]** National Bank, **[*City, State*]** (Bank). The programs are independent of each other but all involve the Bank making loans, or making or buying leases,[1] to "captive" independent contractors. Based on the information provided by you and by the Bank, it is our opinion that all the programs result in loan combinations under the lending limit. In addition, Proposal Two (described below) results in partial attribution of leases to the seller under the third-party paper rule in light of the repurchase obligation of the seller.

Facts

Proposal One - **[ ]** *(Bakery)*

The Bank proposes to enter into 48-60 month equipment leases with delivery truck drivers to finance the drivers' acquisition of handheld computers that the drivers would use to track

[1] Pursuant to 12 C.F.R. § 23.6, a lease of personal property authorized under 12 U.S.C. § 24 (Seventh) or 12 U.S.C. § 24 (Tenth) is subject to the lending limit. This letter does not address the permissibility of the Bank's acquisition or origination of leases pursuant to 12 C.F.R. part 23.

inventory. The drivers own their own trucks and act as "captive" independent contractors for Bakery in that they have no other source of income save for their income from Bakery. Bakery produces snacks that the drivers deliver to a variety of customers who owe their payment to Bakery. The Bank purchases the computers from a provider of supply chain information products, services and systems, and leases them to the Bakery drivers. Each computer lease would be in the amount of $4,000 to $5,000. The Bank anticipates total volume of $8,000,000 to $10,000,000 by the end of 2005.

Proposal Two - **[ ]** *(Truck Leasing)*

Truck Leasing builds trucks and leases them to independent contractor drivers of customers of Truck Leasing such as a nationwide ground delivery service or a bakery. Any one driver works only for one such customer of Truck Leasing. The Bank proposes to purchase such truck leases. Each lease represents a debt of $40,000 to $50,000 per driver. The Bank anticipates total volume of $10,000,000. The trucks are manufactured to specifications supplied by Truck Leasing's customer. There will be lessee drivers who will not able to satisfy the Bank's underwriting standards since they will have been in business less than two years. In addition, the drivers will not have sufficient sources of income, other than their income from the program sponsor, *e.g.*, the nationwide ground delivery service, to fully support the leases and their other obligations. As a result, Truck Leasing has agreed to a limited recourse arrangement in which upon any default it will pay to the Bank the lesser of (i) the outstanding balance of the lease (less any recovery) and (ii) an amount equal to 10 percent of the purchase price of all the leases less any prior recourse payments to the Bank. A cash reserve of 2 percent or 2.5 percent of the purchase price of the lease is held by the Bank to secure the limited recourse obligation of Truck Leasing.

Proposal Three – **[ ]** *(Tools Company)*

The Bank proposes to make two secured loans to a number of delivery truck drivers who act as independent contractor distributors for Tools Company, a manufacturer of tools. The first loan finances the distributors' acquisition of a delivery truck, and the second loan finances the distributor's start-up costs including, sales aides, initial inventory and working capital. The distributors purchase or lease the truck from one of a number of vendors specified by Tools Company or from Tools Company itself in bona fide transactions. In addition, they purchase the inventory from Tools Company, also in bona fide transactions. The truck and start-up loans total approximately $130,000 for each distributor. The Bank anticipates a total annual volume of $15,000,000. The distributors own the inventory and deliver tools to mechanics. In most cases, the distributors extend credit directly to the mechanics in small amounts for a short term. In other cases, the mechanics make payment to the distributors in cash or by way of a credit card program set up by Tools Company and another financial institution.

Many of the distributors will not be able to satisfy the Bank's underwriting standards since they will have been in business less than two years. As a result, with respect to the truck loans, Tools Company will establish a non-refillable net loss pool reserve available to the Bank in an amount equal to 10 percent of the total truck loans. The Bank has agreed to treat the amount of the net loss pool reserve as an exposure to Tools Company that is subject to the lending limit. In addition, with respect to the start-up loans, Tools Company will be contractually bound to purchase any defaulted start-up loans from the Bank for the lower amount of 90 percent of the cost of the inventory or the Bank's charge-off balance. If the purchase obligation does not cover the Bank's entire loss on a particular defaulted start-up loan, the truck loan net loss pool reserve is available to cover it.

Legal Analysis

The purpose of the lending limit is to protect the safety and soundness of national banks by preventing excessive loans to one person and to promote diversification of loans and equitable access to banking services.[2] Generally, a national bank's total outstanding loans to one borrower may not exceed 15 percent of the bank's capital and surplus, plus an additional 10 percent of capital and surplus if the amount over the 15 percent general limit is fully secured by readily marketable collateral.[3] A "borrower" includes a person who is named a borrower in a loan or extension of credit and also a guarantor who is deemed to be a borrower under the common enterprise test in 12 C.F.R. § 32.5.[4] Pursuant to section 32.5, loans to one borrower will be attributed to a guarantor when a common enterprise is deemed to exist between the borrower and the guarantor. A common enterprise is deemed to exist, *inter alia*, (i) when the expected source of repayment for each loan is the same and neither borrower has another source of income from which the loan and the borrower's other obligations can be fully repaid;[5] (ii) when loans are made to borrowers who are related directly or indirectly through common control, including where one borrower is directly or indirectly controlled by another borrower; and substantial financial interdependence exists between or among the borrowers;[6] or (iii) when the OCC determines, based on an evaluation of the facts and circumstances of particular transactions, that a common enterprise exists.[7]

Proposal One - Bakery

The common source of repayment prong of the common enterprise test provides that loans to borrowers are combined when the expected source of repayment for each loan is the same and none of the borrowers has another source of income from which the loan and the borrower's other obligations can be fully repaid. Here, the expected source of repayment for each lease is income from Bakery and the drivers do not have other sources of income with which to fully repay their loans and other obligations. Thus, absent an exception, the extensions of credit to

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[2] 12 C.F.R. § 32.1(b)

[3] 12 U.S.C. § 84(a); 12 C.F.R. § 32.3(a).

[4] 12 C.F.R. § 32.2(a).

[5] 12 C.F.R. § 32.5(c)(1).

[6] 12 C.F.R. § 32.5(c)(2). Substantial financial interdependence is deemed to exist when 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other borrower. Gross receipts and expenditures include gross revenues/expenses, inter-company loans, dividends, capital contributions, and similar receipts or payments.

[7] 12 C.F.R. § 32.5(c)(4).

Bakery's drivers are combinable under the common source of repayment prong. The common source of repayment prong contains a limited exception under which an employer is not treated as a common source of repayment based only upon its employees' receipt of wages and salaries from the employer (unless the standards of the common control and substantial financial interdependence prong are met). The facts here do not meet the terms of the exception and thus the leases must be combined.[8]

Proposal Two – Truck Leasing

The leases that the Bank purchases from Truck Leasing are combined as to drivers of each customer of Truck Leasing under the analysis set forth above for Proposal One. Thus, for example, all leases pertaining to drivers for the nationwide ground delivery service are combined under the common source of repayment prong and, separately, all leases pertaining to the bakery drivers are similarly combined. In addition, as noted above, Truck Leasing has a limited recourse obligation with respect to defaulted leases. Under 12 C.F.R. § 32.2(k)(1)(iv), a bank's purchase of third-party paper subject to an agreement that the seller will repurchase the paper upon default or at the end of a stated period is a loan to the seller in the amount of the paper purchased less any reserve held by the bank as collateral security. Where the seller's obligation to repurchase is limited, the bank's loan is measured by the total amount of paper the seller may ultimately be obligated to repurchase. Here the Bank has limited recourse to Truck Leasing. Thus, 10 percent of the outstanding leases, less the cash reserve, is the amount that is treated as an extension of credit to Truck Leasing under the third-party paper rule.

Proposal Three – Tools Company

As noted above, many of the Tools Company borrowers will not be able to satisfy the Bank's underwriting standards since they have not been in business for two years. As a result, Tools Company provides a net loss pool reserve available to the Bank in an amount equal to 10 percent of the total truck loans. In addition, Tools Company is obligated to purchase all defaulted start-up loans from the Bank for the lower amount of 90 percent of the cost of the inventory or the Bank's charge-off balance. If the purchase obligation does not cover the Bank's entire loss on a particular defaulted start-up loan, the truck loan net loss pool reserve is available to cover it. Thus, Tools Company is a "guarantor"[9] on the Bank' loans to its borrowers and the guarantee could cover all defaulted loans. Under the lending limit, a guarantor is deemed to be a borrower,

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[8] Though it has no explicit geographic limitation, the employer/employee exception is often referred to as the "company town" exception since it is understood as having been originally intended to facilitate the location of national banks, and the granting of credit to employees, in such a town. A "company town" is a town in which residents are dependent on the economic support of a single firm for maintenance of retail stores, schools, hospitals, and housing. Without the exception, it would be difficult for a local bank to serve effectively the credit needs of the town's residents. The OCC has not expanded the employer/employee exception to a case that involves neither employees' wages and salaries nor "unique and compelling similarities" to the company town. *Cf.* OCC Interpretive Letter No. 979, reprinted in [2003-2004 Transfer Binder] Fed. Banking L. Rep. (CCH) 81,502 (Dec. 18, 2003).

[9] The term "guarantor" is not defined in the lending limit. A guarantor's obligation can be described as a "promise to answer for the payment of some debt, or the performance of some duty, in case of the failure of another who is liable in the first instance." *See* Black's Law Dictionary, 8th ed., 2004.

with the named borrower, if the common enterprise test is satisfied.[10] The guarantor rule applies to this proposal, not the third-party paper rule discussed above, since this proposal involves direct loans and not the purchase of paper.

With respect to the common enterprise test, Tools Company is in a common enterprise with the named borrower because there is common control and substantial financial interdependence between Tools Company as guarantor and the named borrower. For the purposes of the common control with interdependence prong, control is presumed to exist when a person directly or indirectly has power to exercise a controlling influence over management or policies of another person. Each of the distributors is dependent on Tools Company, the guarantor, for critical business functions. Tools Company exclusively determines the terms that goods and services are provided to the distributors. For example, the distributors are prohibited from offering products from any other manufacturer. Tools Company decides on what products to offer for sale and their price. Tools Company also largely determines the distributor's customers; each distributor is provided an exclusive route or territory. Tools Company does not allow distributors to compete for the same clients. Each distributor has a regional and district manager that provides training and product support. The Tools Company district manager will from time to time accompany the distributor on sales calls to aide in direct marketing efforts. In addition, Tools Company provides product promotion and marketing efforts and Tools Company receives all payments on credit card orders and forwards payments to the distributors. It is therefore clear that Tools Company has power to exercise a controlling influence over the management and policies of the distributors.[11] With respect to interdependence, the distributors are required to sell Tools Company products exclusively and so all of their expenditures are to the guarantor, Tools Company. Substantial financial interdependence is deemed to exist when 50 percent or more of one borrower's gross expenditures are derived from transactions with the other borrower, here the guarantor Tools Company.[12] Thus, the loans to the distributors must be attributed to Tools Company and combined under the common control with interdependence prong of the common enterprise test.[13]

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[10] 12 C.F.R. § 32.2(a).

[11] The case at hand is very different from proposals involving loans to franchisees such as automobile dealerships or restaurants in which the franchisor typically does not guarantee the franchisees' borrowing and franchisees arrange their own financing from different sources. Non-guarantor franchisors are generally not "borrowers" and thus combination of loans to different franchisees under the common control and financial interdependence prong would not occur. However, if a national bank did make a substantial number of loans to franchisees of the same franchisor, the OCC may view those as a concentration of credit.

[12] The OCC has noted that substantial financial interdependence can also exist below the 50 percent threshold depending on the presence of other factors. *See, e.g.,* Letter of William B. Glidden, Assistant Director, Bank Activities & Structure (unpublished) (Jan. 24, 2001).

[13] With respect to the common source of repayment prong of the common enterprise test, if the Bank reasonably were to expect that the borrowers can fully repay their loans from their income and other resources, principally the income they generate from the sale of tools to the different mechanics to whom they deliver, the common source of repayment prong of the common enterprise test would not cause the loans to be attributed to Tools Company, the guarantor. Conversely, if the borrowers were not reasonably expected to be able to fully repay the loans from their income and other resources, Tools Company, as guarantor, would be the expected source of repayment of the loans and the common source of repayment prong, in addition to the common control with interdependence prong, would cause the loans to be attributed to Tools Company.

Safety and Soundness

Independently from the applicability of the lending limit, loans made by national banks must be consistent with safe and sound banking practices. A bank management's creation of excessive credit concentrations within a loan portfolio is an unsafe and unsound banking practice. If the individual transactions under the proposals were not subject to aggregate limitations, Bank management would be able to create a commercial loan portfolio with a risk profile that is highly dependent on the financial condition of a handful of corporations. If a program sponsor were to experience financial deterioration and cease operations, a significant portion of the associated borrowers would likely default simultaneously given the financial interdependence between the program sponsors and the individual borrowers. Given the Bank's capital base and Bank management's projected volume of loans and leases for the programs, such a situation could threaten the viability of the institution.

Conclusion

Based on the application of the lending limit, and consistent also with safe and sound banking practices, extensions of credit are combined as to Bakery (Proposal One), each customer of Truck Leasing (Proposal Two) and Tools Company (Proposal Three), and 10 percent of the outstanding leases in Proposal Two, less the cash reserve, is the amount that is treated as an extension of credit to Truck Leasing.

We trust the foregoing is responsive to your inquiry. If you have any questions, please contact Jonathan Fink of my staff at (202) 874-5300.

Sincerely,

signed

Eric Thompson
Director, Bank Activities & Structure