OCC Inter. Ltr. 517 (O.C.C.), Fed. Banking L. Rep. P 83,228, 1990 WL 364903

Office of the Comptroller of the Currency (O.C.C.)
OCC Interpretive Letter

Banking Research Digest (c) BRG, Inc.
Interpretive Letter No. 517
August 16, 1990

BRD SECTIONS:

***1** 720A / File 23C

TOPICS:

General Powers:
Business Operations Other than Operating Subsidiaries:
Partnerships & Joint Ventures (non-corporate)
Information Services

LAWS:

12 U.S.C. Section 24(7)

BRG DIGEST:
A national bank may establish an operating subsidiary that will enter into tandem limited partnerships to make commercial loans and hold stock warrants as "equity kickers" in connection with financing highly leveraged transactions and recapitalizations, and the bank may provide credit and investment advice to the limited partnerships. (OCC Interpretive Letter No. 517.)

Carl V. Howard
Associate General Counsel
Citibank, N.A.
425 Park Avenue
New York, New York 10043

Dear Mr. Howard:
In your letter of March 28, 1990, you notified the Office of the Comptroller of the Currency ("OCC") of Citibank, N.A.'s ("Bank") proposal to modify the structure and activities of an existing operating subsidiary. The Bank had been authorized to establish the subsidiary to enter into a partnership with an affiliate of an investment bank. The partnership engaged in the activity of making short-term commercial loans to finance leveraged buyouts and recapitalizations. OCC Interpretive Letter No. 411, [1988-1989 Transfer Binder] Fed.Banking L.Rep. (CCH) ¶ 85,635 (January 20, 1988).

For a variety of reasons, the Bank had suspended the activities of that partnership and now proposes to enter into two other partnerships that will also engage in making commercial loans in connection with highly leveraged transactions (leveraged buyouts and recapitalizations). The new partnerships, which are limited partnerships, however, will involve a different general partner and will be structured differently. In addition, there are differences in funding, allocation of returns and other factors with respect to the lending activities. For this reason, we had considered your letter a notification, pursuant to 12 C.F.R. § 5.34, of new activities in an existing operating subsidiary. As a result of subsequent developments, you have indicated verbally that this notification now should be treated as one to establish a de novo wholly-owned operating subsidiary ("Subsidiary") in which to conduct the proposed activities.

Based on the information, facts and representations provided in your letter, attachments, and supplemental materials submitted subsequently, and through conversations with Madonna Starr of the Legal Advisory Services Division, the OCC has no objection to the Bank establishing an operating subsidiary to conduct the activities described in the Bank's proposal.

Partnership Structure

The Subsidiary and a non-depository subsidiary of Dillon, Read, a different investment bank ("Investment Bank") will be general partners and limited partners of two tandem limited partnerships which will carry on the activities of the Citicorp Mezzanine Fund ("Fund"). [1] One limited partnership, the Subordinated Debt Partnership in which the Subsidiary is general partner and the Investment Bank is a limited partner, will make medium-term commercial loans. The second limited partnership, the Equity Partnership in which the Investment Bank is general partner and the Subsidiary is a limited partner, will hold any "equity kickers," in the form of stock warrants, that are received in connection with such loans. All other limited partners, including the Investment Bank's parent company, will be limited partners of both limited partnerships that jointly operate the Fund.

***2** The Bank's financial commitment, through the Subsidiary, to the Fund will be $110 million, an approximately 17% interest in the limited partnerships. The other general partner and the limited partners will contribute a total of $527 million to the Fund. The other general partner's interest will be approximately 1.5%, including a $10 million capital contribution made by the parent company of the Investment Bank and consolidated with the Investment Bank's contribution. The limited partnership interests were sold in 1989, when the Fund was proposed, in a private placement to sophisticated financial institutions.

Capital committed to the Fund by the limited partner investors will be available for loans by the Fund. Profits and losses to the Fund will be allocated among the partners on an aggregate rather than transaction-by-transaction basis. All net cumulative profits of the partnerships, including both current income and capital gains associated with the stock warrants, will be allocated to all partners pro rata according to capital contributions until all have received a preferential return. The preferential return is a net cumulative profit allocation, set by specifying a number of basis points over the 10-year Treasury rate. All net cumulative profits in excess of this preferential rate will be allocated 80% to all investors pro rata according to capital contribution. The remaining 20%, a form of management incentive fee referred to as the "carried interest," is divided by the general partners, 19% to the Subsidiary and 1% to the Investment Bank.

Losses are to be netted against profits. Accordingly, all net cumulative losses to the Fund will be allocated first to the Subsidiary in an aggregate amount not to exceed 10% of the Fund's original capital commitments, i.e., $63.7 million. Any net cumulative losses thereafter will be allocated to all investors pro rata according to capital accounts. This agreement does not represent a guarantee of the partnerships' performance but is simply a loss allocation device.

Pursuant to a formal investment adviser agreement, the Bank will be the investment adviser to the Fund. All Fund investment decisions will be made by an investment committee, the majority of the members of which shall be officers of the Bank. The Subsidiary will maintain significant credit controls over the activities of the Fund, by means of conducting a thorough independent credit review of each proposed transaction and of exercising its veto authority over investment/credit decisions. Under the terms of the partnership agreements, the Investment Bank will also have veto authority over these decisions. In addition, the Subsidiary will have veto authority over the disposition of the partnerships' assets.

The limited partnership agreements expressly provide that the partnerships cannot perform activities unless they are permissible for a national bank and its operating subsidiary, and that the limited partnerships are subject to the regulation, supervision and examination of the OCC.

Partnership Activities

***3** The Fund's limited partnerships will be formed for the purpose of making commercial loans and receiving equity participations, typically warrants but possibly stock appreciation rights and net profit participation rights, in leveraged buyouts and recapitalizations in the United States, Europe, Canada and Australia. The commercial loans will be both secured and unsecured, will typically contain subordination terms and will typically be medium-term. Under certain circumstances, the Fund may also make bridge loans. As the Fund makes a loan to a borrower, the loan will be funded by the capital contributions of the general and limited partners, each loan made pro rata on the basis of each partners' capital commitment to the Fund.

The limited partnership agreements also provide that "substantially all" of the loans made shall be in transactions "sponsored" by entities affiliated with the Bank's parent holding company. For example, an affiliate of the Bank, a small business investment company ("SBIC"), will be a major equity investor in substantially all the Fund's portfolio companies. The Fund will have a "right of first refusal" to make the mezzanine loan in substantially all of the leveraged buyouts in the United States in which this SBIC makes a significant equity investment. Additionally, it is anticipated that the Fund will have an opportunity to invest in similar transactions of the Bank's affiliates in Europe, Canada and Australia.

The Bank, as the Fund's investment adviser, will provide advisory, management, administrative and support services to the Fund. Without limitation, the Bank will (1) identify and evaluate potential borrowers; (2) structure and negotiate potential loans; (3) make a credit recommendation to the Fund concerning a potential loan; (4) monitor and report upon the performance of the Fund's loans; and (5) propose "exit strategies" to the general partners concerning the disposition of Fund assets. All investment decisions will conform to the credit analysis procedures and disciplines of the Bank's "Risk Asset Process." Each investment decision must be approved by a member of the Bank's Credit Policy Committee.

Loans made by the Fund will conform to guidelines established by the Bank that describe the target return for the Fund, the current yield, and a leverage ratio (defined as the ratio of subordinated debt to securities junior in preference to the subordinated debt) to determine the level of equity participations (warrants to purchase) eligible to be received in connection with each loan. An aggregate of 10% of total committed capital, however, may be utilized for loans that do not conform to these guidelines. To increase the overall return, the Fund may choose not to provide all of the mezzanine financing or may arrange for others to fund all or a portion of a financing commitment.

The Fund will not provide financing for a hostile tender offer nor will the Fund provide bridge loans except those related to Fund commitments. No more than 25% of the Fund's committed capital will be loaned to a single portfolio company.

***4** Finally, the Bank has indicated that it will comply with the two lending and investment limitations set forth in OCC Interpretive Letter No. 411, supra. First, the total commitment of the Bank, the Subsidiary and other Bank affiliates to the tandem limited partnerships that operate the Fund, including partnership contributions, investments, and loans and other extensions of credit (both direct and indirect), shall not in any event exceed five (5) percent of the Bank's primary capital. Second, with respect to the Subsidiary, the aggregate amount of the Bank's investment and extensions of credit (both direct and indirect) may not exceed an amount equal to the Bank's legal lending limit, i.e., fifteen (15) percent of the Bank's capital and surplus, at the time of the investment or loan of any funds.

Discussion

As stated in OCC Interpretive Letter No. 411, supra, the Bank may conduct activities through an operating subsidiary that are a part of or **incidental** to the business of banking. 12 C.F.R. § 5.34(c) and (d). The activities to be conducted by the Subsidiary through the Fund operated by the tandem partnerships are permissible banking activities. The making

of commercial loans by the Subordinated Debt Partnership to finance highly leveraged transactions is a lending activity that falls squarely within a national bank's express lending authority under 12 U.S.C. § 24 (Seventh).

As an **incidental** activity, the OCC has permitted national banks, in negotiating loan agreements, to accept stock warrants in addition to or in lieu of interest on loans. The receiving and holding of such "equity kickers" is permitted by OCC Interpretive Ruling 7.7312, 12 C.F.R. § 7.7312, which provides that:

> [a] national bank may take as consideration for a loan a share in the profit, income or earnings from a business enterprise of a borrower. Such share may be in addition to or in lieu of interest. The borrower's obligation to repay principal, however, shall not be conditioned upon the profit, income or earnings of the business enterprise.

While the receiving and holding of stock warrants is permitted in connection with making a loan, however, this **incidental** power does not authorize a national bank to exercise such warrants. The exercise of such warrants would result in a "purchase" of stock in violation of 12 U.S.C. § 24 (Seventh). Under the Bank's proposal, the Equity Partnership would merely receive and hold the stock warrants, a legally permissible activity.

The OCC has permitted an operating subsidiary to be a general partner or a limited partner in a limited partnership with a nondepository institution formed to engage in activities that are permissible for a national bank, provided certain conditions are met. While some features of the proposed limited partnerships are not identical to those of partnerships approved previously, e.g., the general partnership interests of the Subsidiary and the Investment Bank are proportionately lower, they are consistent with the conditions the OCC has cited in prior letters dealing with partnership activities of national bank operating subsidiaries.

***5** The Subsidiary will be adequately capitalized and, except in its capacity as paid investment adviser to the Fund, the Bank will be insulated from the partnerships. The partnership agreements will define and limit the activities of the partnerships to activities consistent with the powers of national banks and will recognize that the partnerships are subject to OCC regulation, supervision and examination. The Subsidiary will have veto power over all of the Fund's activities. It has veto authority over all credit decisions and all investment decisions are made by a committee controlled by the Bank.

Finally, the Bank has agreed to comply with the previously set limitations on the operations of an operating subsidiary conducting certain activities by means of a partnership structure: (1) the Bank, the Subsidiary and other Bank affiliates shall limit their total aggregate commitment to the limited partnerships, including contributions and extensions of credit (both direct and indirect) to five (5) percent of the Bank's primary capital. OCC Interpretive Letter No. 346, reprinted in [1985-1987 Transfer Binder] Fed.Banking L.Rep. (CCH) ¶ 85,516 (July 31, 1985); and (2) the Bank's total aggregate contributions and extensions of credit to the Subsidiary may not exceed fifteen (15) percent of capital and surplus. See OCC Interpretive Letter No. 411, supra; OCC Interpretive Letter No. 423, reprinted in [1988-1989 Transfer Binder] Fed.Banking L.Rep. (CCH) ¶ 85,647 (April 11, 1988).

In sum, given the purpose and characteristics of the partnerships and the Bank's and Subsidiary's level of participation, I find that the Bank is acting through its Subsidiary to develop and perform legally permissible banking activities by means of the two limited partnerships.

The proposed credit analysis and management activities of the Bank as investment adviser to the Fund are also permissible because they are **incidental** to a bank's power to make loans. Banks have traditionally performed their own credit evaluations and analyses, structured and negotiated loans and monitored loan performance with respect to loan decisions made by the bank. Performing these services for the Fund for a fee pursuant to a formal investment adviser agreement, therefore, is likewise permissible.

As was the case with the suspended partnership approved by the 1988 letter, the Subsidiary's other general partner in the proposed limited partnerships is related to an investment bank. Consequently, the affiliation and employment interlocks issues under Sections 20 and 32 of the Glass-Steagall Act, 12 U.S.C. §§ 377 and 78, raised in the earlier approval are also at issue here. Although the limited partnerships are structured differently, with lower proportionate general partnership interests, the levels of participation of the general partners and the manner in which the partnerships' activities are conducted are substantially the same. The analyses applied in the 1988 approval letter, therefore, apply here to reach the same conclusions.

***6** Accordingly, the proposed limited partnerships would not cause the Bank to become affiliated with the Investment Bank and, thus, they are not prohibited by Section 20 of the Glass-Steagall Act. Moreover, although the Bank by contractual agreement is the Fund's investment adviser, the limited partnerships and the Bank and the Investment Bank would be separate entities for purposes of Section 32. Bank and Investment Bank personnel, therefore, would not be prohibited from employment by the limited partnerships.

Conclusion

For the reasons stated above, the OCC does not object to the proposal as described. This letter serves to notify the Bank, pursuant to 12 C.F.R. § 5.34(d)(1)(ii) and based on the representations made by the Bank to comply with the conditions set forth in the 1988 approval letter, that the Bank may establish an operating subsidiary to conduct the proposed activities. Please note that changes in the Subsidiary's proportionate interest in the limited partnerships, changes in the management and control provisions of the partnership agreements, and proposed changes in the identity of the other general partner will be considered new activities of the Subsidiary for purposes of the notification requirement of 12 C.F.R. § 5.34(d)(1).

Our position is based upon the representations made in your submissions to, and discussions with staff of, our office. Different facts or circumstances may lead to another conclusion. Our analysis also reflects current legal and prudent standards and may be subject to revision as future developments warrant. We reserve the right to modify the views expressed herein or to provide additional comments in the future.
Sincerely,

J. Michael Shepherd
Senior Deputy Comptroller
Corporate and Economic Programs

Footnotes

1 The Citicorp Mezzanine Fund is not a legal entity. Rather, it is a trade name used to describe the two limited partnerships that jointly operate the Fund.

OCC Inter. Ltr. 517 (O.C.C.), Fed. Banking L. Rep. P 83,228, 1990 WL 364903

End of Document