



Office of the Comptroller of the Currency

Interpretive Letter #738

Published in Interpretations and Actions September 1996

12 U.S.C. 24(7)2G

August 14, 1996

[]

Re: Syndicated Credit Transaction/12 C.F.R. 7.1016

Dear []:

This is in response to your letters of July 8 and July 19, 1996, and our related telephone conversations, in which you request the OCC's concurrence with your view that, under the facts as described below, the [] ("Bank")'s participation in a guaranty issued by an agent for a syndication of lenders with respect to their borrower's letter of credit reimbursement obligations to another bank or financial institution is permissible under OCC Interpretive Ruling 7.1016, 12 C.F.R. 7.1016.

Background

From time to time, the Bank is asked to participate in asset-based, syndicated credit facilities. These syndicated facilities may involve a revolving line of credit and frequently include a subfacility for the issuance of letters of credit to fund the working capital needs of the borrower. In many such lender group transactions, the letter of credit issuer is a member of the lender group and each lender purchases a pro rata participation in the letter of credit. This purchase involves the transfer of both a pro rata share of the contingent liability to honor draws on the letter of credit and an offsetting pro rata right of reimbursement from the borrower. It is well established that participation in such facilities is a permissible activity for national banks. *See, e.g.*, OCC Interpretive Letter No. 412 (Jan. 26, 1988), reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) 85,636.

However, your inquiry involves a variation on the above type of syndication because the issuer of the letter of credit will not be a member of the lender group (the "Lenders"). In the type of transaction in question, the agent for the Lenders is a non-bank financial institution such as a finance company ("Agent"). Since non-bank financial institutions generally do not issue letters of credit themselves, their practice is to make arrangements with a third party bank ("Issuer") (usually a bank which has an affiliate or credit relationship with the finance company) to issue a letter of credit for the account of the borrower ("Borrower"). In connection with such arrangements, the Agent provides a reimbursement guaranty to the Issuer to support the issuance of the letter of credit and guaranty to the Issuer the performance by the Borrower of the latter's reimbursement obligations under the letter of credit ("Guaranty"). Although the Borrower is usually a party to the letter of credit application and/or the guaranty agreement between the Agent and the Issuer, it is generally the creditworthiness of the Agent, not the Borrower, on which the

Issuer relies in evaluating the credit risk of the transaction.

The Lenders, including the Bank, are not parties to the Guaranty given by the Agent to the Issuer. The rights and obligations of the members of the lender group are separately enumerated in the syndication agreement among the Borrower, the Agent and the Lenders ("Syndication Agreement"). Only the Agent, and not the Lenders, has any direct obligation to the Issuer under the Guaranty. However, the Syndication Agreement provides that immediately upon the issuance of a letter of credit to which the Guaranty applies, each Lender is deemed to have irrevocably and unconditionally purchased a pro rata interest and participation in the obligations of the Agent under the Guaranty relating to that letter of credit. If the letter of credit is drawn, the reimbursement obligation owing by the Borrower to the Issuer will either be paid directly by the Borrower or else the Issuer will look to payment by the Agent pursuant to the Guaranty. If the Agent is required to honor the Guaranty, then according to the Syndication Agreement each Lender (including the Bank) is obligated, on a pro rata basis, to reimburse the Agent for any and all amounts due the Issuer under the Guaranty. Under the Syndication Agreement, those amounts are deemed to be a loan to the Borrower, and each Lender has a post-honor right of reimbursement from the Borrower.

The obligation of the Lenders to fund the Guaranty, upon receipt of proper documentary notice by the Agent, is irrevocable and not subject to resolution of any issues of fact or nondocumentary conditions. If the Lenders are called upon to make advances in order to fund the reimbursement guaranty, then according to the Syndication Agreement, the Borrower incurs an irrevocable obligation to reimburse the Lenders for such advance. Like the Lenders' obligations to fund the Agent's liabilities under the Guaranty, the Borrower's obligation to repay the Lenders for such funding is not subject to any qualification or nondocumentary conditions. The Borrower must reimburse the Lenders for advances they make to fund the Guaranty, notwithstanding any issues or disputes which may arise concerning any transaction underlying a letter of credit issued by the Issuer or any payment made by the Agent pursuant to the Guaranty. In the event of such a dispute, the Borrower must pursue a separate action against the Issuer and/or the Agent.

The Syndication Agreement is structured to ensure that the Lenders will not incur any undue risk as a result of their funding of the Agent's obligations under the Guaranty. First, it specifies limitations on both the amount and duration of each letter of credit to which a reimbursement guaranty relates. Second, it provides that the Agent, on behalf of the Lenders, must approve all the terms and conditions of both the letter of credit application and the letter of credit itself, including any modifications that would increase the amount of the letter of credit, extend its duration or otherwise affect the status of the letter of credit as an independent undertaking. Third, as noted above, it provides that each Lender has a post-honor right of reimbursement from the Borrower in the event the Lender is called upon to honor its participation in the Guaranty. Fourth, it provides that the face amount of any letter of credit to which the Guaranty relates is to be deducted from the Borrower's overall credit availability under the Syndication Agreement, thereby limiting the principal amount of any potential loss to the amount of the revolving credit limit. Finally, upon any event of default under the Syndication Agreement, the Borrower must promptly provide either the Issuer or the Agent with cash collateral in an amount sufficient to secure all outstanding obligations under the letter of credit.

Discussion

As noted above (**supra** at 1), the OCC has previously stated that participation in a syndicated credit

facility where the letter of credit issuer is a member of the lender group is a permissible activity for national banks. However, you have pointed out that the increased involvement in the financial marketplace by non-bank financial institutions has resulted in a significant increase in the number of syndicated credit facilities which require the lenders to participate in letter of credit reimbursement guaranties issued by a non-bank agent to an issuer who is not a member of the lender group. In order for national banks to remain competitive in the loan syndication market, banks must be able to engage in reimbursement guaranty participations as well as letter of credit participations. You therefore seek the OCC's concurrence with your view that a national bank's participation in a reimbursement guaranty transaction such as you have described is permissible under the national banking laws and OCC regulations.

Under I.R. 7.1016, 12 C.F.R. 7.1016 (1996), a national bank "may issue and commit to issue letters of credit and other independent undertakings" where the bank's obligation to honor depends upon the presentation of specified documents, and not upon nondocumentary conditions or resolution of questions of fact or law at issue between the account party and the beneficiary. In addition, I.R. 7.1016 provides that a national bank may also "confirm or undertake to honor" specified documents upon their presentation under another person's independent undertaking. This interpretive ruling, which went into effect on April 1, 1996, replaced the earlier OCC Interpretive Ruling 7.7016, "Letters of Credit." One of the stated reasons for the promulgation of the new interpretive ruling was "to cover a broader array of transactions in this area" than merely the issuance of letters of credit.<NOTE:Interpretive Rulings (12 C.F.R. Part 7), 61 F.R. 4849, 4852 (Feb. 9, 1996), "Independent Undertakings to Pay Against Documents (Section. 7.1016).">

The Bank's participation in a reimbursement guaranty as described above appears to satisfy the requirements for an independent undertaking under I.R. 7.1016, which are that the bank's obligation be dependent on the presentation of specified documents and that it not be subject to the resolution of nondocumentary conditions. Under the terms of the Syndication Agreement, the Bank and the other lenders are deemed to have automatically purchased without recourse a pro rata participation in the reimbursement guaranty. When there is a draw upon any letter of credit to which the Guaranty applies, each Lender is obligated, upon proper notice, to reimburse the Agent for any amounts due the Issuer under the terms of the Guaranty. The Syndication Agreement specifically provides that the Lenders' obligations to make payments to the Agent are irrevocable and not subject to any nondocumentary conditions or the resolution of any claims, rights, or default of the Borrower. <NOTE: Art. 2.8(g) of the Syndication Agreement, entitled "*Obligations Irrevocable*," provides:

"The obligations of each Lender to make payments to the [Agent] with respect to any Letter of Credit...shall be irrevocable, not subject to any qualification or exception whatsoever, including, without limitation [long list of possible defenses, claims and offsets including any defense that the borrower might have against the Agent or the Issuer].">

For purposes of I.R. 7.1016, the Bank's position appears to be the same as in the situation where each Lender purchases a risk participation in a letter of credit issued by the Agent, instead of through an intermediary. **See** OCC Interpretive Letter No. 412, **supra**. Further, in another interpretive letter, dealing with lending limit calculations, the OCC described a transaction similar to the instant reimbursement guaranty transaction as "one that is similar to a standby letter of credit because it represents a presently unfunded commitment to reimburse [the letter of credit issuer] if a future draw is made on a letter of credit which the Customer cannot cover with funds in his own account...." OCC Interpretive Letter No. 681 (Aug. 4, 1995) reprinted in [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) 83,629. The fact that the members of the lender group are buying their obligation from the Agent rather than the Issuer directly does not affect the status of their commitment as an independent undertaking.

It is noted that this type of reimbursement guaranty transaction appears to satisfy the safety and soundness conditions of I.R. 7.1016, which are aimed at preventing banks from being exposed to undue risk. The independent nature of the undertaking is made clear by the terms of the Syndication Agreement. The Lenders' obligation is limited in amount, because the reimbursement obligation under the Guaranty relates to a letter of credit which is itself limited in amount. Changes in the amount of the letter of credit require the consent of the Agent, on behalf of the Lenders. Each Lender's liability under its participation is limited to its ratable share of the Guaranty obligation, plus certain costs and expenses that may be considered ancillary to the transaction and present no greater risk to the Lenders than would be present if the Issuer were a member of the group. <NOTE: See, generally, Hisert, "Letters of Credit in Syndicated Credit Facilities," 12 *Letter of Credit Update* No. 5 (May 1996).>

The Lenders' participation in the Guaranty is also limited in duration, since the letter of credit to which it relates is limited in duration. As with amount, changes in the duration of the letter of credit require the consent of the Agent, on behalf of the Lenders.

Further, as noted above, the Syndication Agreement provides that each Lender has a post-honor right of reimbursement from the Borrower, whose obligation to reimburse each Lender for funding its respective participation in the Guaranty is not dependent upon whether the Issuer has properly paid the draft under the letter of credit or whether the Borrower has other defenses against either the Agent or the Issuer. If the Borrower has a factual or legal dispute concerning its obligation to reimburse the Issuer but the Agent determines to pay under the Guaranty, then each Lender, absent gross negligence or willful misconduct on the part of the Agent, would be obligated, upon notification from the Agent, to honor its participation in the Guaranty. In such circumstances, the Borrower would still be obligated under the Syndication Agreement to reimburse the Lender for that payment. Any such disputes would have to be resolved separately.

It is also noted that the Syndication Agreement provides that the face amount of all letter of credit to which the Guaranty relates shall, when issued, be deducted from the Borrower's overall credit availability, thereby limiting the principal amount of any potential loss to the amount of the revolving credit commitment. Moreover, upon any event of default, the Borrower must promptly provide either the Issuer or the Agent with cash collateral in an amount sufficient to secure all outstanding obligations under the letter(s) of credit.

In light of the foregoing, it is my view that participation by a national bank in a guaranty of a borrower's reimbursement obligations under the circumstances described constitutes an independent undertaking under I.R. 7.1016 and is a permissible activity for national banks.<NOTE: You have not raised and this letter does not address any issues involving the lending limits of 12 U.S.C. 84 and 12 C.F.R. Part 32. Such issues were discussed in OCC Interpretive Letters Nos. 412 and 681, **supra**, both of which involved participations in extensions of credit directly by the bank/issuer, rather than, as here, through an intermediary. In this instance, the Bank has already applied the amount of its participation in the Guaranty towards its lending limits.>

I trust this has been responsive to your inquiry. Please contact me at (202) 874-5300 if you wish to discuss the matter further.

Sincerely,

/s/

Sue E. Auerbach
Senior Attorney

Bank Activities and Structure Division