



Comptroller of the Currency
Administrator of National Banks

Central District Office
One Financial Place
Suite 2700
440 South LaSalle Street
Chicago, Illinois 60605

Interpretive Letter #951
February 2003
12 USC 84(d)(2)(b)

January 17, 2002

Dear []:

This is in response to your letter of December 17, 2001. You have requested the OCC's opinion as to the application of the legal lending limit at 12 U.S.C. § 84 to loans by [*National Bank*], [*City, State*] ("Bank") to [] ("[*Co.*]"), Mr. and Mrs. [*Mates*] (as co-makers), and two land trusts. Based on the information in your letter and subsequent phone conversations, as well as information previously submitted by National Bank Examiners Jeff Leigh and Jason Joy, it is my opinion that for purposes of the legal lending limit at 12 U.S.C. § 84 the existing loans to [*Co.*] are attributed to Mr. [*Mates*] and therefore are combined with the loans to Mr. and Mrs. [*Mates*], and 50 percent of the loans to the two land trusts are attributed to Mrs. [*Mates*] and therefore combined with the loans to Mr. and Mrs. [*Mates*]. However, based on the facts presented, I do not believe that the loans to all five borrowers -- [*Co.*], Mr. [*Mates*], Mrs. [*Mates*], and the two land trusts -- should be aggregated as a whole for purposes of the legal lending limit.

I. Facts

The Bank has five outstanding loans to [*Co.*] with an aggregate outstanding balance of \$2,485,434, net of participations sold, to other financial institutions. [*Co.*] is a Subchapter S corporation owned 100% by [*Mr. Mates*]. The company is engaged in the business of acquiring and developing lots and constructing single-family residences. The proceeds of the five loans were used for the acquisition of real estate and construction of residential properties. [*Mr. Mates*] provides a limited personal guaranty of the [*Co.*] loans.

The Bank also has three outstanding loans to [*Mr. Mates*] and his spouse, as co-makers: a home equity line of credit secured by his personal residence with a current balance of \$293,000, a home equity line of credit secured by a rental property owned by Mr. and Mrs. [*Mates*] with a current balance of \$201,000, and a \$2,000 credit reserve loan (collectively the "[*Mates*]

Loans”). The proceeds of the two home equity loans were used for working capital for [*Co.*]. The [*Mates*]’ sources of income for the years 1997 through 2000 were as follows (in thousands):¹

| | 1997 | 1998 | 1999 | 2000 |
|---|------|------|------|------|
| Salary from [<i>Co.</i>] - [<i>Mr. Mates</i>] | 120 | 120 | 120 | 120 |
| Non-Salary Distributions from [<i>Co.</i>] | 0 | 0 | 0 | 0 |
| Rental Income – Joint | 41 | 42 | 46 | 45 |
| Rental Income - Land Trust | 56 | 100 | 101 | 107 |
| Total | 217 | 262 | 267 | 272 |

Finally, the Bank has two loans to two separate land trusts (the “Land Trusts”) in the amounts of \$758,296 and \$589,087 (the “Land Trust Loans). Mrs. [*Mates*] is a 50% beneficiary of each of the Land Trusts. [*Mr. Mates*] personally guarantees \$100,000 of each of the Trust Loans. The proceeds of the Trust Loans were used to acquire rental properties. The expected source of repayment of the Trust Loans is rental cash flow from the properties, and that cash flow is sufficient to service the Trust Loans.

II. Legal Analysis

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 securities.² A “borrower” includes a person who is named a borrower or debtor in a loan or extension of credit.³ Also, loans to one borrower will be attributed to another person and both will be considered a borrower (1) when the proceeds are used for the *direct benefit* of the other person, or (2) when a *common enterprise* is deemed to exist between the persons.

The proceeds of a loan to borrower will be deemed to be used for the *direct benefit* of another person and will be attributed to that other person when the proceeds, or assets purchased with

¹On their joint federal tax returns the [*Mates*] also report the gross income from [*Co.*] as part of their adjusted gross income. As a Subchapter S corporation, [*Co.*]’ gross income and deductions are allocated to its shareholder [*Mates*] *for federal tax purposes only*. See I.R.C. § 1366. Notwithstanding that allocation for tax purposes, [*Co.*]’ undistributed earnings have not been paid to [*Mates*] and from legal and financial accounting perspectives they remain the property of the corporation. Thus, a more accurate reflection of [*Mr. Mates*]’s income from [*Co.*] is the distributions paid to him by [*Co.*] in the form of salary, dividends, or other cash or property distributions, rather than the corporation’s gross income that is allocated to him for tax purposes. Accordingly, for the purposes of the legal lending limit analysis only the salary, dividends, and other cash or property distributions paid by [*Co.*] to [*Mr. Mates*] will be included in the [*Mr. Mates*]’ income figures.

²See 12 U.S.C. § 84(a); 12 C.F.R. § 32.3(a).

³12 C.F.R. § 32.2(a).

such proceeds, are transferred to that other person, other than in a bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services.⁴

A *common enterprise* is deemed to exist when:

- (1) 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 repaid;
- (2) the borrowers are related through common control and there is substantial financial interdependence between or among the borrowers;
- (3) the borrowers use the loan proceeds to acquire more than 50 percent of a business enterprise; or
- (4) the OCC determines that a common enterprise exists based on the facts and circumstances of particular transactions.⁵

Thus, in determining whether a loan to one borrower should be attributed to another borrower for lending limit purposes, one must apply each of the five loan combination/attribution tests set forth above -- the one direct benefit test and the four common enterprise tests -- to the specific facts of each loan relationship.⁶

1. Direct Benefit Test

The proceeds of the [*Co.*] loans were used to acquire real property and construct residential housing. The proceeds of the two [*Mates*] home equity loans were used for working capital for [*Co.*]. Since the proceeds of the home equity, or assets purchased with such proceeds, were transferred to [*Co.*], [*Mates*]'s home equity loans are attributed to [*Co.*] under the direct benefit test at 12 C.F.R. § 32.5(b). Accordingly, the [*Mates*] home equity loans and the [*Co.*] loans are combined for purposes of the legal lending limit.

⁴12 C.F.R. § 32.5(b).

⁵See 12 C.F.R. § 32.5(c).

⁶In addition to the general limit on loans to one borrower, there is an additional limit that applies to loans to a corporate group. See 12 C.F.R. § 32.5(d). Loans to a corporate group may not exceed 50% of a national bank's capital and surplus. 12 C.F.R. § 32.5(d)(1). A corporate group is defined as a person and all of its subsidiaries. *Id.* For the purpose of this rule, a corporation or limited liability company is a subsidiary of a person if that person owns more than 50% of the voting interests of the corporation or company. *Id.* This limit is independent of the general 15% limit on loans to one borrower set forth at 12 U.S.C. § 84 and 12 C.F.R. § 32.3. This special limit applies to a corporate group regardless of whether loans to different members of the corporate group are combined for the general 15% limit.

Also, 50 percent of the loans to the Land Trusts will be combined with all of the [*Mates*] Loans for the purposes of the lending limit under the direct benefit test. In Illinois, true ownership of real estate held in a land trust remains with the beneficiary, even though legal and equitable title to the land lies with the trustee.⁷ The Bank's loans to the Land Trusts were used to acquire and improve real estate. Mrs. [*Mates*] has a 50 percent beneficial interest in the Land Trust and, therefore, is the true owner of a 50 percent interest in the property held by the trust. Since Mrs. [*Mates*] is one of the true owners of the assets purchased with the proceeds of the Land Trust Loans, she has directly benefited from those loan proceeds in proportion to her beneficial interest in the Land Trusts. Thus, 50 percent of each of the Land Trust Loans is attributed to Mrs. [*Mates*] for lending limit purposes pursuant to 12 C.F.R. § 32.5(b). Since Mrs. [*Mates*] is a borrower on the [*Mates*] Loans, 50 percent of the loans to the Land Trusts will be combined with the [*Mates*] Loans for the purposes of the lending limit under the direct benefit test.

Since the proceeds of the [*Co.*] loans were not transferred to the Land Trusts, and the proceeds of the Land Trust Loans were not transferred to [*Co.*], the [*Co.*] and Land Trust Loans will not be combined under the direct benefit test.

2. *Common Enterprise Test # 1 - Common Expected Source of Repayment*

A common enterprise is deemed to exist when:

- (1) the expected source of repayment for each loan is the same, and
- (2) neither borrower has another source of income from which the loan and the borrower's other obligations can be repaid.

The expected source of repayment on the [*Co.*] loans is cash flow from the business' operations and the sale of lots or residences securing the loans. The expected source of repayment for the Land Trust Loans is rental cash flow from the properties held in the Trust. Since the expected sources of repayment for the [*Co.*] loans and the Land Trust Loans are not the same, then the loans to those two borrowers will not be combined with each other for purposes of the legal lending limit under the common source of repayment test at 12 C.F.R. § 32.5(c)(1).

The expected source of repayment on the [*Mates*] Loans is the personal income of the [*Mates*]. Part of the [*Mates*] joint income comes from [*Mr. Mates*] 's salary from [*Co.*]. As such, [*Co.*] may be the ultimate source of repayment for the [*Mates*] Loans. I note, however, that the [*Mates*] have other sources of income, and that other income may be sufficient to repay the [*Mates*] Loans together with their other obligations. If the [*Mates*] ' other income is not sufficient by itself to repay those loans and their other obligations, then there may be grounds to combine the [*Mates*] Loans with the loans to [*Co.*] under the common source of repayment test.⁸

⁷*Podvinec v. Popov*, 658 N.E.2d 433, 436 (1995) (citing *People v. Chicago Title & Trust Co.*, 389 N.E.2d 540 (1979)).

⁸The common source of repayment test at 12 C.F.R. § 32.5(c)(1) specifically states that an employer (*[Co.]*) will not be treated as a source of repayment because of wages or salaries

3. ***Common Enterprise Test # 2 - Common Control and Substantial Financial Interdependence***

As stated above, one way in which a common enterprise is deemed to exist is when:

- (1) the borrowers are related through common control, and
- (2) there is substantial financial interdependence between or among the borrowers.⁹

Borrowers are related through common control when one person or entity controls another, or two or more entities are each controlled by the same person or entity. For the purposes of this combination rule, control is deemed to exist if a person directly or indirectly, or acting through or together with one or more persons either (1) owns or controls 25 percent or more of the voting securities of another person, (2) controls in any manner the election of a majority of the directors or trustees of another person, or (3) has the power to exercise a controlling influence over the management or policies of another person.¹⁰

Based on the information in your letter, the Land Trusts are not related through common control to either [*Co.*] or [*Mr. Mates*]. However, [*Co.*] is related to [*Mr. Mates*] because of his 100% ownership interest in the company. The next question, then, is to determine whether substantial financial interdependence exists between [*Co.*] and [*Mr. Mates*]. Substantial financial interdependence is deemed to exist when 50 percent or more of one person's annual gross receipts or gross expenditures are derived from transactions with the other person.¹¹ In determining whether substantial financial interdependence exists, we look at the borrower's gross receipts or gross expenditures on an annual basis.

Accordingly, if 50 percent or more of [*Co.*]' annual gross receipts or gross expenditures were received from or paid to [*Mr. Mates*], then substantial financial interdependence would exist between [*Co.*] and [*Mr. Mates*]. As a result, loans to [*Co.*] would be attributed to [*Mr. Mates*] and combined with the Bank's other loans to [*Mr. Mates*]. Similarly, if 50 percent or more of [*Mr. Mates*]'s annual gross receipts or gross expenditures were received from or paid to [*Co.*], then substantial financial interdependence would exist between [*Mr. Mates*] and

paid to an employee (*Mr. Mates*), unless the standards of the common control and substantial financial interdependence at 12 C.F.R. § 32.5(c)(2) are met. However, as noted in section II. 3. below, there is common control and substantial financial interdependence between [*Co.*] and [*Mr. Mates*]. Thus, [*Co.*] can be viewed as a source of repayment on the [*Mates*] Loans under the common source of repayment test because of the salary it pays to [*Mr. Mates*].

⁹See 12 C.F.R. § 32.5(c)(2).

¹⁰See 12 C.F.R. § 32.2(g). The term "person" as used section 32.2(g) means, among other things, a corporation, limited liability company, partnership or a trust. See 12 C.F.R. § 32.2(k).

¹¹12 C.F.R. § 32.5(c)(2)(ii).

[*Co.*], the loans to [*Co.*] would be attributed to [*Mr. Mates*], and they would be combined with the [*Mates*] Loans.

Here, for the past four years [*Mates*]'s salary from [*Co.*] has represented more than 50% of his gross receipts.¹² Thus, substantial financial interdependence exists between [*Co.*] and [*Mr. Mates*], two borrowers that are related through common control. Accordingly, loans to [*Co.*] are combined with loans to [*Mr. Mates*] for the purposes of the legal lending limit under common enterprise test at 12 C.F.R. § 32.5(c)(2).

4. *Common Enterprise Test # 3 - Borrowing to Acquire Control*

[*Co.*], the [*Mates*], and the Land Trusts did not use the proceeds of their loans to collectively acquire a 50% or more interest in a single business enterprise. Thus, this test is not applicable to the loans to [*Co.*], the [*Mates*], and the Land Trusts.

5. *Common Enterprise Test # 4 - Facts and Circumstances*

OCC rulings and interpretations reveal that a very strong evidentiary record based upon a number of factors must exist before a common enterprise will be found to exist solely on the basis of the facts and circumstances test.¹³ Instances in which the facts and circumstances test will apply where the other direct benefit and common enterprise tests do not will be rare.¹⁴ In administrative opinions and interpretive letters, the OCC has indicated that the facts and circumstances test will be applicable when enterprises "engage in supporting lines of business, use common facilities, have common arrangements, or generally mingle their assets and

¹²For the fiscal year 2000, Mr. [*Mates*]'s salary and distributions from [*Co.*] represented 73% of his gross receipts for that period (\$120,000 salary/(\$120,000 salary + \$45,000 joint rental income). The [*Co.*] salary and distributions represented 72%, 74%, and 75% of Mr. [*Mates*]'s gross receipts for the years 1999, 1998, and 1997, respectively.

As discussed in note 1 *supra*, [*Co.*]'s gross income that is reported as income on the [*Mates*]' federal tax return is not included as part of the [*Mates*]'s "gross receipts" for the purposes of determining whether substantial financial interdependence exists. The lending limit regulation defines the term "gross receipts" to include gross revenues, intercompany loans, dividends, capital contributions, and similar receipts. These examples represent actual transfers of cash, property, or rights to cash or property. Although a Subchapter S corporation's gross income is allocated to its shareholders for federal income tax purposes, the undistributed portion of that income remains the property of the corporation and therefore cannot be considered part of a shareholder's gross receipts. Only distributions paid by a Subchapter S corporation to a shareholder, such as salary and dividends, should be included as part of the shareholder's gross receipts.

¹³Interpretive Letter No. 563, *reprinted in* [1991-1992 Transfer Binder] Fed. Banking L. Rep. ¶83,314, at 71,439 (September 6, 1991).

¹⁴*Id.*

borrowings."¹⁵ A key factor in this analysis is evaluating the extent of the entities' interrelationships and financial and operational interdependence, and determining whether the failure of one borrower would directly effect the other. Other factors considered include the interchange of goods or services between the borrowers, the extent to which one borrower receives income from the other borrower, the volume of operating transactions between the borrowers, and whether the same collateral secures loans to the borrowers.

Without knowing all of the facts relating to the interrelationships among Mr. [*Mates*], Mrs. [*Mates*], [*Co.*], and the Land Trusts, I am unable to determine with certainty whether the loans to those entities should be combined for lending limit purposes under the facts and circumstances test. However, based on the information provided by you and the examiners, it does not appear that [*Co.*] and the Land Trusts are a common enterprise under the facts and circumstances test. The entities do not operate supporting lines of business, use common facilities, or commingle assets or borrowings. Moreover, the success of one of the entities is not dependent on the success of the other.

A remaining issue is whether Mr. [*Mates*] and Mrs. [*Mates*] are a common enterprise, i.e., whether loans attributed to Mr. [*Mates*] should be combined with loans attributed to Mrs. [*Mates*] under the facts and circumstances test. If so, then the [*Co.*] loans and 50 percent of the Land Trust Loans would be combined with the [*Mates*] Loans. There are some facts here that would lend support to such a conclusion. For instance, both individuals are makers on the home equity and credit reserve loans, proceeds from those loans (secured by jointly-owned collateral) were used by Mr. [*Mates*]'s corporation, and Mr. [*Mates*] has personally guaranteed a portion of the Land Trust Loans that benefit Mrs. [*Mates*]. These facts evidence the commingling of certain assets and liabilities, indicating some level of financial interdependence between the two individuals.

Nonetheless, based on the limited facts available, I believe Mr. and Mrs. [*Mates*] should not be considered a common enterprise for the purposes of the lending limit. Although there is evidence of commingling of assets and liabilities between each other, there does not appear to be any commingling of assets and liabilities between their separate borrowing entities -- [*Co.*] and the Land Trusts. Indeed, the successful operation of the properties beneficially owned by Mrs. [*Mates*] through the Land Trusts is not dependent upon the successful operations of [*Co.*], Mr. [*Mates*]'s principal asset, and vice versa. Based upon the facts presented, it appears that the failure of [*Co.*] should not materially affect the ability of the Land Trusts to repay their loans. Likewise, the failure of the Land Trusts should not materially affect the ability of [*Co.*] to repay its loans. In my opinion, this apparent lack of interdependence between [*Co.*] and Land Trusts argues against treating Mr. and Mrs. [*Mates*] as a common enterprise for the purposes of the lending limit, especially since the result of finding such a

¹⁵*Id.* (citing Comptroller's Decision AA-EC-87-77 (August 12, 1988)); *see also* Letter from Richard V. Fitzgerald, Chief Counsel (October 11, 1984) (unpublished) (loans will be combined where corporations are commonly owned, are engaged in the same line of business, interchange services and personnel, and are not completely separate in their operations and financial affairs); Rojc, *National Bank Lending Limits - A New Framework*, 40 *The Business Lawyer* 903, 923-24 (May 1985) (citing various OCC interpretive letters).

common enterprise would be the combination of the loans to both [*Co.*] and the Land Trusts to the [*Mates*] loans. Nonetheless, additional facts might justify a different conclusion.

In summary, all of the loans to Mr. and Mrs. [*Mates*] and all of the loans to [*Co.*] are combined for legal lending limit purposes under the common control and substantial financial interdependence test at 12 C.F.R. § 32.5(c)(2). The two [*Mates*] home equity loans are combined with all of the loans to [*Co.*] under the direct benefit test at 12 C.F.R. § 32.5(b). Finally, 50 percent of the Land Trust Loans are combined with the [*Mates*] Loans under the direct benefit test at 12 C.F.R. § 32.5(b). These loan combinations are summarized in the chart below.

| | [<i>Mates</i>] Home Equity Loans | [<i>Mates</i>] Credit Reserve Loan | Land Trust Loans | [<i>Co.</i>] Loans | Aggregate Subject to Lending Limit |
|---|---|---|------------------------------------|-------------------------|---|
| [<i>Mates</i>]/[<i>Co.</i>] Combination under Common Control and Substantial Financial Interdependence Test 12 C.F.R. § 32.5(c)(2) | \$494,000 | \$2,000 | | \$2,485,434 | \$2,981,434 |
| [<i>Mates</i>]/[<i>Co.</i>] Combination under Direct Benefit Test 12 C.F.R. § 32.5(b) | \$494,000 | | | \$2,485,434 | \$2,979,434 |
| Mrs. [<i>Mates</i>] Land Trusts Combination under Direct Benefit Test 12 C.F.R. § 32.5(b) | \$494,000 | \$2,000 | \$1,347,383 X 50% \$ 673,692 | | \$1,169,692 |

6. Guarantees

In your letter you inquire about the impact of Mr. [*Mates*]'s guaranty of the loans to [*Co.*] and the Land Trusts on the lending limit calculations. The fact that Mr. [*Mates*] personally guarantees loans to the Land Trusts and [*Co.*] does not necessarily mean that those loans are combined with his personal loans for lending limit purposes. The OCC's lending limit

regulation provides that a guarantor is considered a “borrower” for the purposes of the lending limit only if that guarantor is deemed to be a borrower under the direct benefit or common enterprise tests set forth at 12 C.F.R. § 32.5.¹⁶ In other words, a loan will not be attributed to the loan’s guarantor and combined with any of the guarantor’s direct loans unless one of the five loan combination/attribution tests discussed above has been met.

Mr. [*Mates*] personally guarantees a portion of the Land Trust loans. As discussed above, the Land Trust Loans are not attributed to Mr. [*Mates*] under the direct benefit, common source of repayment, common control and substantial financial interdependence, or the borrowing to acquire control tests. Assuming the loans to the Land Trust are not attributable to Mr. [*Mates*] under the facts and circumstances test, then Mr. [*Mates*] will not be deemed a “borrower” with respect to the Land Trust loans. Accordingly, the Land Trust Loans will not be combined with Mr. [*Mates*]’s personal loans at the bank, notwithstanding his personal guaranty of the Land Trust Loans.

Mr. [*Mates*] also guarantees a portion of the [*Co.*] loans. As noted above, all of the loans to [*Co.*] will be attributed to Mr. [*Mates*] under the common control and substantial financial interdependence test. The fact that Mr. [*Mates*] is a guarantor of the [*Co.*] loan was not relevant to the application of that loan combination/attribution test. Consequently, the loans to [*Co.*] will be combined with loans to Mr. [*Mates*] regardless of whether he guarantees some or all of the [*Co.*] loans.

III. Conclusion

In my opinion the facts presented indicate that the loans to all five borrowers -- [*Co.*], Mr. [*Mates*], Mrs. [*Mates*], and the two Land Trusts -- are not combined as a whole for purposes of the legal lending limit. However, in my opinion the [*Co.*] loans are combined with the [*Mates*] Loans for purposes of the legal lending limit. Further, the 50 percent of the Land Trust Loans are combined with the [*Mates*] Loans.

This opinion is based on the facts set forth in this letter, as provided in your letter and subsequent phone conversations and by National Bank Examiners Leigh and Joy. Different facts may warrant different conclusions.

I trust this is responsive to your request. If you have any further questions, please contact me at (312) 360-8805.

Very truly yours,

Christopher G. Sablich

¹⁶See 12 C.F.R. § 32.2(a).

Christopher G. Sablich
Senior Counsel