



---

Comptroller of the Currency  
Administrator of National Banks

---

Washington, DC 20219

January 31, 2003

**Interpretive Letter #956**  
**February 2003**  
**12 USC 24(7)**

Re: Request for Opinion

Dear [ ]:

This letter is in response to your request for a legal opinion confirming the permissibility of several aspects of an agreement entered into by [ *Bank* ], [ *City, State* ] (“Bank”) and [ ], a California corporation (“[ ]”). The Bank and [ ] have executed an Opportunity Development Agreement (“Agreement”), pursuant to which the Bank finances [ ]’s purchase of real properties and then benefits from the appreciation in such properties. You have requested that we confirm that this lending arrangement is permissible pursuant to Interpretive Ruling 7.1006, 12 C.F.R. § 7.1006 (2002), the OCC’s regulation permitting national banks to take a share of the borrower’s profits as part of the interest on the loan. You have also requested that we confirm that each of the lender covenants imposed by the Bank as part of the financing it provides to [ ] is legally permissible. Finally, you have requested that we confirm that the nature of compensation paid by the Bank to [ ] is consistent with OCC precedent. For the reasons discussed below, we confirm each of your requests.

**A. Background**

As represented by the Bank, the facts are as follows. The relationship between the Bank and [ ]’s principals (“the Principals”) began in the 1980s when the parties entered into an agreement for the Principals to manage certain of the Bank’s other real estate owned (“OREO”) portfolio. Based upon the Principals’ successful management of the OREO assets, the Bank and [ ] entered into the Agreement.

Pursuant to the Agreement, [ ] seeks out potential real estate investment opportunities for the Bank to finance. After identifying an opportunity, [ ] gathers comprehensive information regarding the property and presents that information to the Bank to

assist the Bank in evaluating the lending opportunity.<sup>1</sup> The Bank then applies its underwriting criteria to determine whether to make the loan. If the Bank extends credit for [ ] to purchase the property ("Bank Loan"), the purchase money for the property consists of the proceeds of the Bank Loan (95 percent) and an equity contribution from the Principals (five percent). With limited exceptions, each Bank Loan has been an unsecured, five-year loan with an eight percent rate of interest. The Agreement requires that [ ] personally manage each property after purchase.

In consideration for the performance of [ ]'s services, the Bank contributes to the cost of [ ]'s general expenses, including the expenses associated with the pre-investment evaluation of potential real property financing opportunities. The Bank does so (i) by providing [ ] with office space and associated services and (ii) by contributing, each calendar quarter, \$100,000 for [ ]'s expenses.<sup>2</sup> Once the Bank approves a Bank Loan, the deal-specific expenses are included in the loan to [ ] if the deal is consummated or, if not consummated, the expenses are shared 95 percent by the Bank and five percent by [ ].

In addition to the Bank Loans, the Bank has a right of first refusal to provide conventional, secured commercial financing to either [ ] or the business entity in which [ ] is investing ("Primary Loan"). Even if the Bank chooses to make a Bank Loan, it may decline to make a Primary Loan. The Bank has made several Primary Loans secured by the ultimate real estate assets; in other instances, another lender has made the Primary Loan.

The Agreement provides for the use of funds received by [ ], whether realized from the sale or refinance of a property or from some other source. These funds are used first to repay principal and interest on the Primary Loan and the principal amounts of the Bank Loan and the Principals' equity contribution. Any remaining funds are used next to pay the base interest amount on the Bank Loan and to provide the Principals with a base return on their equity contribution. Finally, [ ] pays any remaining funds as contingent interest, in the amount of 80 percent to the Bank and 20 percent to [ ].<sup>3</sup>

Consistent with its role as a lender, the Bank imposes certain lender covenants to protect its loans to [ ].

---

<sup>1</sup> The Agreement provides that neither [ ] nor its principals are employees or agents of the Bank. Further, the Agreement states that the Bank and [ ] are not engaged in a partnership or joint venture.

<sup>2</sup> One-half of this amount is reimbursable out of [ ]'s cash flow. Pursuant to the personal services agreement entered into by the Principals, which is described *infra*, [ ] pays the Principals \$45,000 each quarter for their services.

<sup>3</sup> The Agreement also provides that, prior to the payment of contingent interest, [ ] must use any remaining funds to pay the Bank an amount equal to the full principal amount of any other Bank Loan as to which the Bank has determined that the prospect of repayment from the related real property underlying such Bank Loan is for any reason impaired.

- First, the Bank conditions the continuation of the Agreement upon the Principals' maintaining 100% ownership of [ ];
- Second, the Bank requires that the Principals maintain a personal services agreement with [ ], pursuant to which they agree to devote as much time as "reasonably necessary for a satisfactory performance of their duties";
- Third, the Bank precludes [ ] from purchasing properties not financed by Bank Loans;
- Fourth, the Bank retains approval rights upon the sale of a portion (as opposed to all) of a real property and the distribution of [ ]'s assets;
- Fifth, the Bank imposes a debt to equity ratio of 19-to-1 in cases where it provides the Bank Loan. As described above, the Bank finances 95 percent of the acquisition costs and [ ]'s Principals put up the remaining five percent; and
- Sixth, the Bank requires [ ] to provide various financial statements and reports.

## **B. Discussion**

### ***1. The Lending Arrangement***

#### *a. Interpretive Ruling 7.1006, 12 C.F.R. § 7.1006*

The OCC has long recognized the authority of national banks to share in the profit, income, or earnings from a business enterprise as a full or partial substitute for interest on a loan. Interpretive Ruling 7.1006 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.... The share ... may be taken in addition to, or in lieu of, interest. The borrower's obligation to repay principal, however, may not be conditioned upon the value of the profit, income, or earnings of the business enterprise ...

This ruling recognizes that extensions of credit may take many forms. In order for national banks to have a greater degree of flexibility in their lending activities, Interpretive Ruling 7.1006 makes clear that repayment of an extension is not necessarily limited to a bank's receipt of principal and a specified amount of interest on a demand or installment basis over time.<sup>4</sup> Moreover, this ruling represents the OCC's long-standing position on the authority of national banks to employ participatory financing arrangements. In November 1966, the OCC added Paragraph 7312 to the "Comptroller's Manual for National Banks." Paragraph 7312 provided that:

---

<sup>4</sup> See Letter from John G. Heimann, Comptroller of the Currency (May 21, 1980) (unpublished); Letter from Charles F. Byrd, Asst. Director, Legal Advisory Services Division (Oct. 18, 1977) (unpublished).

[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.

Several interpretive letters in 1969 and 1970, citing to Paragraph 7312, confirmed that a national bank could accept a share in the profit, income, or earnings of a business enterprise as consideration for a loan in lieu of interest or partially in lieu of interest.<sup>5</sup> However, the authority to share in the profit, income, or earnings from a business enterprise as a full or partial substitute for interest pursuant to Interpretive Ruling 7.1006 is subject to certain limitations. These limitations are designed to ensure that the bank's role in providing such financing is that traditionally assumed as a lender.<sup>6</sup> First, there must be no risk to loan principal other than that arising from a borrower's default; in this regard, Interpretive Ruling 7.1006 requires that the obligation to repay principal shall not be conditioned upon the profit, income, or earnings of the business enterprise. Second, in keeping with the provisions of 12 U.S.C. §§ 24(7) and 29, a national bank can have no possessory or ownership interest in a borrower's business or real estate.

Within these parameters, a national bank may calculate its share of the profit, income, or earnings on the basis of either the appreciation of the borrower's business or the appreciation of individual assets.<sup>7</sup> The OCC has never limited the amount of contingent interest – in the form of a share of the profit, income, or earnings – that a national bank may accept. Rather, OCC precedent treats the percentage of profit, income, or earnings that a bank accepts as a contractual matter to be agreed upon by the parties.

Based upon the facts as represented, we find that the arrangement, as described, between the Bank and [ ] is permissible pursuant to Interpretive Ruling 7.1006. The Bank provides financing for [ ] to acquire real properties. The principal of these loans is not at risk, beyond the general default risk inherent in any loan transaction. [ ] is obligated to pay the principal and base interest on all outstanding loans regardless of the ultimate profitability of any

---

<sup>5</sup> Letter from Patrick Parise, Regional Counsel (Oct. 16, 1970) (unpublished) (warrants); Letter from Thomas G. DeShazo, Deputy Comptroller of the Currency (Aug. 26, 1969) (unpublished) (profits); Letter from Robert Bloom, Chief Counsel (May 26, 1969) (unpublished) (warrants). In 1971, the OCC codified Paragraph 7312 as Interpretive Ruling 7.7312, 12 C.F.R. § 7.7312. The current ruling, Interpretive Ruling 7.1006, replaced Interpretive Ruling 7.7312 without substantive change in April 1996.

<sup>6</sup> See, e.g., Interpretive Letter No. 620, *reprinted in* [1993-1994 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,502 (July 15, 1992); Interpretive Letter No. 204, *reprinted in* [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶85,285 (June 17, 1981).

<sup>7</sup> Interpretive Letter No. 244, *reprinted in* [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,408 (Jan. 26, 1982) (bank may accept a set percentage of the sales price upon sale of each developed real estate unit; bank may also accept a set percentage of the appreciation in the value of a business developed and operated on the mortgaged property); Interpretive Letter No. 216, *reprinted in* [1981-1982 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,297 (Sep. 8, 1981) (bank may accept a set percentage share of the net appreciation of the mortgaged property at the end of a stated term).

transactions financed by the Bank. Moreover, the Bank has not assumed a possessory or ownership interest in [ ]'s business or any real property. By agreeing to "take as consideration for a loan a share in the profit, income, or earnings from a business enterprise" of [ ], the Bank is merely exercising its authority under Interpretive Ruling 7.1006. The Bank's share is based upon the available funds of [ ] as a business enterprise, and such basis is consistent with Interpretive Ruling 7.1006. Finally, because OCC precedent treats the percentage of profit, income, or earnings that a bank accepts as a contractual matter to be agreed upon by the parties, the Bank's 80 percent share is consistent with such precedent.

*b. Lender covenants*

From a national banking perspective, it is sound public policy for banks to include covenants in their lending relationships.<sup>8</sup> Indeed, the more lender covenants that a bank includes, the more protection the bank has. In this case, the Bank imposes a series of lender covenants. First, the Bank conditioned continuation of the Agreement upon the Principals' maintaining 100 percent ownership of [ ]. Second, the Bank required the Principals to enter into a personal services agreement with [ ]. With respect to both covenants, the Bank believes that the Principals' continued involvement is essential to the overall success of its relationship with [ ] and the on-going stability of the Bank's unsecured loans. We find that these covenants are permissible prudential measures designed to protect the Bank's position given the limited purpose of [ ] and the Bank's unsecured position.

Third, the Bank precludes [ ]'s purchase of properties not financed by Bank Loans. The Bank's outstanding loans to [ ] are unsecured and its contingent interest payment is based upon the success of [ ]. The Bank believes it has a vested interest in ensuring that [ ]'s subsequent investments are economically sound. We find that this covenant is a permissible prudential measure designed to protect the Bank's position given the limited purpose of [ ] and the Bank's unsecured position.

Fourth, the Bank imposes approval rights upon the sale of a portion (as opposed to all) of a real estate property and the distribution of [ ]'s assets. The Bank believes doing so protects its right to be repaid on its outstanding loans. We find that this covenant is a permissible prudential measure designed to protect the Bank's position given the limited purpose of [ ] and the Bank's unsecured position.

Fifth, the Bank imposes a debt to equity ratio of 19-to-1 in cases where it provides the Bank Loan. The Bank does so to ensure that [ ] has an equity interest in each transaction. We find that this covenant is a permissible prudential measure designed to protect the Bank's position given the limited purpose of [ ] and the Bank's unsecured position.

---

<sup>8</sup> See Interagency Guidelines for Real Estate Lending Policies, at Appendix A to Subpart D of 12 C.F.R. part 34. See generally Comptroller's Handbooks, "Agricultural Lending" (Dec. 1998), "Loan Portfolio Management" (Apr. 1998), and "Commercial Real Estate and Construction Lending" (Nov. 1995).

Sixth, the Bank requires [ ] to provide various financial statements and reports to permit the Bank to monitor the financial condition of the business. We find that this covenant is a permissible prudential measure designed to protect the Bank's position given the limited purpose of [ ] and the Bank's unsecured position.

Finally, we find that these covenants, taken collectively, are a permissible prudential measure designed to protect the Bank's position.

## **2. Compensation Paid by Bank to [ ]**

Rather than paying a per-loan fee, the Bank compensates [ ] for its services by providing [ ] with office space and paying a portion of [ ]'s operating expenses. Twelve C.F.R. § 7.1004(a) provides that "a national bank may use the services of, and compensate persons not employed by, the bank for originating loans." As a legal matter, the OCC has neither specified nor limited the nature and amount of compensation that a bank may pay a third party for originating loans.<sup>9</sup> Therefore, the nature and amount of the Bank's compensation to [ ], in the form of office space and expenses, is consistent with OCC precedent.

## **C. Conclusion**

For the reasons discussed above, we conclude that the Bank's lending arrangement with [ ] is permissible pursuant to Interpretive Ruling 7.1006. We further conclude that the lender covenants described above, individually and collectively, are permissible prudential measures designed to protect the Bank's position. Finally, we conclude that the nature of compensation paid by the Bank to [ ] is permissible. If you have any questions about the foregoing analysis, please feel free to contact me at (202) 874-5300.

Sincerely,

*Eric Thompson*

Eric Thompson  
Director  
Bank Activities & Structure Division

---

<sup>9</sup> See Letter from Charles F. Byrd, Assistant Director, LASD (October 30, 1977) (unpublished). As a supervisory matter, the bank must not compensate the third party in a manner that adversely affects the safety and soundness of the bank.