



NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

GC/HMU:jrm

TO: Regional Director, Region IV (Chicago)
H. Allen Carver

FROM: Assistant General Counsel | 51
Steven R. Bisker

SUBJ: C.U. Processing CUSO's

DATE: FEB 27 1987

This is in response to your memorandum of October 1, 1986, two proposals submitted to your Office concerning C.U. Processing CUSO ("CUP") and several telephone conversations with Regional staff concerning CUP. Our understanding of the facts of the two proposals is more fully described in the attached memorandum from Hattie Ulan to Steven Bisker.

Briefly, in the first proposal (described in two letters by Attorney Petz attached to your memorandum), a CUSO will be formed by several credit unions. The CUSO will purchase computer equipment from a second CUSO, CUP. The first CUSO will enter into an agreement with CUP whereby CUP will provide data processing services to affiliated and nonaffiliated CU's. As part of the first CUSO's agreement with CUP, CUP can purchase the computer equipment back from the CUSO at book value (which will be zero in seven years) at the end of the term of the agreement. In our view, this proposal complies with the CUSO regulation (Section 701.27 of the NCUA's Rules and Regulations). Both CUSO's are involved in providing credit unions with data processing services, a permissible CUSO activity. Also involved is the sale and servicing of computer equipment, which is listed as a permissible CUSO activity. We do not reach any conclusions as to the safety and soundness of this proposal. Gerald Shultz of your Region has informed us that the Region may require credit unions directly or indirectly involved with CUP to make certain write-offs and set aside certain reserves for safety and soundness reasons. We defer to your Office to address these concerns. If further legal questions arise concerning this proposal, please contact us.

In the second proposal (described by a letter from attorney Sherman attached to your memorandum), several credit unions have formed CDRM CUSO. CDRM CUSO will purchase computer equipment from CUP and then lease the equipment back to CUP. CUP is entitled to buy the computer equipment back from CDRM for one dollar in five years. CUP will enter into agreements with CDRM

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CUSO- affiliated credit unions to provide data processing services to those credit unions. CDRM CUSO is providing its affiliated CU's with access to data processing services to be provided by CUP. CDRM and CUP are involved in the sale and lease of computer equipment and the provision of data processing services. As noted above, these are permissible CUSO activities. The Region has raised the issue that the purchase/sale and subsequent lease of computer equipment between CDRM and CUP may be a financing transaction (loan) rather than a sale and leaseback. A final determination of this issue need not be made. Even if it is a loan, it would not, in our opinion, violate the CUSO regulation. The loan is being made to another CUSO, CUP, which must comply with NCUA's CUSO regulation. In addition, the loan is being made as a means of providing CU's with data processing, a permissible CUSO activity. NCUA's regulation is not being circumvented since, even if CDRM is viewed as a mere conduit, the loan would be treated as a loan from the FCU's to CUP. Provided the FCU's are in compliance with all aspects of the CUSO regulation if the transaction is considered as a loan to CUP, we would not object on legal grounds to the arrangement. As noted above under proposal one, we defer to your Office to address the safety and soundness concerns.

Attachment



NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

GC/HMU:sg

TO: Steve Bisker
FROM: Hattie Ulan *HUll*
SUBJ: GC 10-10 - CU Processing CUSO's
DATE: February 18, 1987

The Region has submitted two proposals involving CU Processing (CUP) and asks us whether the proposals are permissible under the CUSO regulation. My understanding and opinion of the two proposals follows.

Proposal 1

The first proposal submitted to the Region is described in two letters from Attorney Petz which were attached to the Region's incoming memo. Several credit unions (this may include both federally- and state-chartered) will form either a limited partnership or corporate CUSO. The CUSO will purchase computer equipment from and enter into a software licensing agreement with CUP. The equipment will be set up at a regional data processing center. According to Gerald Shultz of the Region, CUP is also a CUSO. Nothing in the materials submitted reflects that fact. In order to be a CUSO subject to our regulations, an FCU has to loan to or invest in it. None of the materials submitted state that FCU's will either invest in or loan to CUP. However, Gerald Shultz has informed me that other FCU's have invested in and loaned directly to CUP. The CUSO will also enter into a Facilities Management Agreement with CUP whereby CUP will operate and maintain the computer and provide data processing services to the CUSO affiliated credit unions. Each affiliated credit union will enter into an agreement with the CUSO for data processing services at a determined monthly cost (see Petz letter, paragraph 6). CUP will also be able to provide nonaffiliated CU's with data processing services. CUP will pay the CUSO a monthly fee (base fee plus certain charges) for each nonaffiliated CU that uses the service. Of course, the nonaffiliated CU's will pay CUP a fee for the services provided. The CUSO will return this outside income to its affiliated CU's either in the form of repayments on loans and/or dividends on investments.

The basic setup of the CUSO and the services to be provided by the CUSO seem to be in compliance with the CUSO regulation. However, I do have some questions and concerns.

One provision of the Facilities Management Agreement to be entered into between the CUSO and CUP bothers me. Paragraph 1 of Schedule C of the Agreement allows for CUP to provide services to nonaffiliated CU's upon CUP paying a certain fee to the CUSO (this is addressed above). Paragraph 4 of Schedule C sets forth the agreement that CUP may purchase the computer equipment back from the CUSO, the consideration being the fees CUP pays the CUSO under paragraph 1 of Schedule C, for book value in accordance with GAAP at the end of the term of the Agreement. The term of the Agreement is five years, with extensions available. According to Gerald Shultz, the equipment will be depreciated down to zero in seven years. After seven years, the CUSO would be obligated to give the equipment back to CUP. As noted above, the CUSO will first purchase the computer hardware from CUP. We do not know the price for such equipment (see Schedule B of Agreement, paragraph 11. and exhibit B-4). The CUSO buys the equipment from CUP and turns around and agrees to give the equipment back to CUP after seven years. It seems that the value of the computer after seven years is part of the compensation the CUSO pays to CUP for its services. It is not clear why this is not spelled out in one of the contracts.

The only attachments to Proposal 1 are the Facilities Management Agreement, the Source Code Escrow Agreement, and a Limited Partnership Agreement, although the CUSO is to be organized as a corporation. None of the dollar amounts are filled in in the Agreements. The Agreements have not been executed.

Proposal 2

This proposal is described in a letter to Allen Carver from Attorney Sherman. Several FCU's formed a corporate CUSO (CDRM). They all purchased stock in the CDRM CUSO and agreed to make loans to the CUSO. The CDRM CUSO purchased computer equipment from CUP for \$300,000. The CUSO then leased the equipment back to CUP. The term of the lease is five years (2 years with a 2-year and 1-year mandatory option). CUP will be entitled to purchase the computer equipment back from the CUSO for one dollar after five years (see Attachment 13 to second proposal). CDRM-affiliated CU's will enter into similar (almost identical) Facilities Management Agreements as in proposal 1. for data processing services to be provided by CUP. The Region believes that the CUSO has entered into a loan agreement with CUP rather than a valid sale and leaseback. CDRM CUSO buys computer equipment from CUP. CDRM then leases the equipment back to CUP. The lease payments CUP makes equate to loan payments if the computer purchase money from CDRM to CUP was a loan. The Region then references IRPS 81-7 in its reasoning that the transaction is a loan rather than a valid sale/leaseback. I have several problems with this reasoning. First, IRPS 81-7 applies to FCU's, not to CUSO's. It also contemplates that the FCU will be the seller and that the assets sold and leased back will be the FCU building. I do not think IRPS 81-7 is applicable in this CUSO situation. However, the Region may be correct in that this

sale/leaseback is actually a loan under AICPA standards. I am not qualified to answer that question. Perhaps E&I should be consulted.

There were many documents attached to Proposal 2. The following is a list and explanation of the documents. I have numbered the documents as Attorney Sherman numbered them. His number 8 is missing.

1. Articles of Incorporation of CDRM CUSO in the State of Ohio, approved 4/15/85. Attorney Sherman is the registered agent for the CUSO.

2. Meeting of Incorporator of CDRM CUSO dtd. 4/19/85 - common stock issued, 400 shares each at \$1.25. 100 shares to each of 4 investing FCU's.

3. Stock certificates, dtd. 4/19/85

4. Action of Shareholders (without a meeting), dtd. 4/19/85, elected directors, set forth Code of Regulations for CDRM CUSO (looks like bylaws).

5. Action of Directors (without a meeting), dtd. 4/19/85; named officers; stated that CDRM CUSO borrow \$300,000 from 4 FCU's, with security interest in computer equipment purchased from CUP; agreed to lend \$300,000 to CUP at 12% interest due 8/1/85; upon repayment, purchase computer equipment from CUP for \$300,000; agree to lease computer equipment to CUP. There is no document evidencing a loan from CDRM to CUP although it is resolved in this action that such loan be made.

Here the CUSO resolves to borrow \$300,000 from 4 FCU's, turns around and resolves to lend the \$300,000 to CUP, then purchases computer equipment from CUP for \$300,000 and also agrees to then lease the equipment back to CUP. It doesn't make a whole lot of sense. From the documents submitted, the \$300,000 loan from CDRM to CUP was not made.

6. Four promissory notes evidencing FCU loans to the CDRM CUSO dtd. 4/26/85.

7. Security agreement assignment of lease to FCU's for loans made to CDRM CUSO, dtd. 4/26/85. Collateral is the lease and all inventory, equipment, property and goods described in the lease.

8. Missing - UCC forms filed with state and county.

9. Agreement between FCU's regarding transfer of stock in or loans to CDRM CUSO, dtd. 4/26/86.

11. Bill of Sale evidencing CDRM purchase of computer equipment from CUP for \$300,000, dtd. 4/26/86

12. Lease agreement for computer equipment between lessor CDRM CUSO, and lessee, CUP, dtd. 4/26/85. Equipment leased is the same as that listed in Bill of Sale. Lease is for 2 years.

13. Letter from CDRM CUSO to CUP stating that lease will be renewed for one 2-year term and then a 1-year term. At that point, CUP can purchase equipment from CDRM CUSO for 1 dollar, dtd. 4/25/86.

14. Financing statements filed with state and county by CDRM CUSO as secured party and CUP as debtor with same list of equipment. State dtd. 9/10/85, county date not legible.

15. Security agreement whereby CUP (assignor) grants CDRM CUSO (assignee) security interest in property described in Exhibit. Exhibit is not attached and agreement is not signed. This Security Agreement states that it secures a \$300,000 loan from CDRM CUSO to CUP. There is an error in this Agreement -- 2nd paragraph states that "Agreement secures payment of indebtedness of Assignee." The assignee (CDRM) is not the debtor. It should read "indebtdness of Assignor." Since this Agreement is not executed, it is further support that CDRM did not make a \$300,000 loan to CUP.

16. Addendum to Lease dtd. 4/26/85 (lease is Item 12) granting lessor CDRM CUSO a security interest in source code and software; royalty-free license to use software in case of default; and contingent assignment of lessee's lease rights to the premises.

17. Escrow agreement for the source code between CUP, CDRM CUSO and one of the FCU's, dtd. 4/26/6/85.

18. CUP lease of premises from Duke and Associates to house data processing ctr., dtd. 5/17/85, for a term of 63 months.

19. Letter from GEAC to CUP stating that if CUP cannot fulfill obligations to customers, GEAC will provide support to such customers, dtd 10/12/84. This is merely a letter. It is not a contract. It is a promise to provide support with no consideration stated. It is my opinion that it would not be enforceable. Gerald Shultz tells me that CUP is in terrible financial condition and may not be able to continue to provide the services it is now providing.

20. Insurance binder for CUP on hardware naming CDRM CUSO as loss payee, dtd. 7/21/86.

21. Data Processing Services Agreement, dtd. 4/26/85 between one of the FCU's & CUP. According to Attorney Sherman's letter, each FCU entered into the same agreement with CUP. FCU will pay CUP \$2970.52/month less certain credits (See Exhibit 32 to Agreement). FCU is entering into contract with CUP (a CUSO according to Gerald Shultz) not with their primary CUSO CDRM.

22. Bill of Sale from CUP to FCU for certain computer equipment (price \$22,515), dtd. 4/26/85.

23. Agreement between CUP and FCU where CUP agrees to maintain certain computer equipment, dtd. 4/25/86.

24. Agreement between 2 FCU's where one FCU will purchase a part of the second FCU's loan to CUSO once the first FCU can, under the law and regulations, increase its loan amount to the CUSO.