NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

GC/HMU:sg
4660

TO: Regional Director, Region II (Capital)
Harvey J. Baine, III

FROM: Assistant General Counsel
Steven R. Bisker

SUBJ: Franklin Mint Employees FCU - Charter No. 20042

DATE: March 9, 1987

This is in response to your memorandum of October 10, 1986, concerning two FCU loans made to nonnatural person members (partnerships) in excess of the partnerships' shareholdings in the FCU.

Enclosed with your memorandum were, among other documents, two attorneys' opinions stating that the loans in question are not subject to Article XII, Section 1 of the Standard FCU Bylaws, which limits loans to nonnatural persons to their shareholdings in the FCU. The first opinion was written by a partner in the law firm to which one of the loans in question was made. It states that loans to partnerships should be treated as loans to individual partners rather than to the partnership since a partnership is not a separate legal entity under the common law. It has been NCUA's longstanding position that the FCU Act recognizes a distinction between an account held by a natural person and one held by an unincorporated association such as a partnership. The first legal opinion misstates our position on the issue. A loan to a partnership is not automatically treated as a loan to the natural person partners in the partnership for purposes of the restriction contained in Article XII, Section 1. of the Bylaws.

The second legal opinion submitted (written by Bruce Jolly) better addresses issues we have dealt with concerning the bylaw provision. However, we do not necessarily concur with its conclusion that the loans are not subject to, and hence not in violation of, the bylaw provision. Mr. Jolly's opinion relies on several of GC's opinions. None fit the facts of the two loans in question. Opinion EI-5-104 (attached) concerned three loans to natural person members. The proceeds were used for each member's closely held nonmember business. The loans were secured by business assets. We concluded that such loans were legal based

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on the closeness of the member-borrower and his nonmember business and the lack of a sham transaction. We did not address the bylaw issue. In opinion EI-11-12 (attached), loans were made to natural person members and their closely held corporations. Both parties signed the notes and security agreements. We concluded again that these loans were legal based on the closeness of the two parties and that the natural person member remains primarily liable on the note. The bylaw provision was not addressed since these were regarded as loans to natural person members. However, it is noted in the opinion that if these were loans to nonnatural person members, they would be subject to the bylaw provision. The last opinion upon which Mr. Jolly relies (dated 4/7/77, attached) concerns 650 individual loans. The members formed a limited partnership and obtained individual loans so that the partnership could purchase an airplane. We stated that such loans would be legal loans to natural person members and not an illegal loan to a nonmember organization (general partner of partnership did not qualify for membership) if certain conditions were met. The individual borrowers had to be independently and unconditionally liable for their loans, and security other than the airplane had to be obtained.

The loans here in question were made to two partnerships; the first to a law firm and the second to an accounting firm. The loans were not made jointly to the partners and partnerships. All of the partners qualified for membership. Hence, the firms (organizations of such persons) also qualified. The loan to the law firm specifically limits the liability of individual partners. The individual partners are not personally liable on the loan. The loan to the accounting firm also appears to be made to the firm only (see loan note, attached to incoming). According to Mr. Jolly's letter, the loan is guaranteed by the individual partners of the firm. It is not clear whether or not the partners are primarily liable on this loan. The note is signed by the individual partners for the partnership. There is no limit on personal liability as in the law firm loan.

It is my conclusion, based on our prior opinions, that in order to be considered a loan to the natural person members and not the partnership (hence, not subject to the Article XII, Section 1 restriction) that (1) the natural person members and the organization must be very closely tied and the benefits of the loan proceeds must flow to both; and (2) the natural person members must be primarily liable on the loan. The first criteria is satisfied by both loans. The second criteria is not satisfied by the first loan and may not be satisfied by the second loan.

Lastly, it should be noted that the newly proposed business lending regulation, if finalized, will amend Article XII, §1 of the Bylaws. The amended bylaw will provide an exception for loans that are made jointly to one or more natural person members and a business organization in which they have a majority ownership interest. It would permit the loan to exceed shares of

the nonnatural person in the credit union if all of the borrowers are jointly and severally liable on the full loan amount. The exception to the bylaw does not fit either of the loans in question.

Please contact Hattie Ulan of this Office if further questions rise.

Attachments

NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

GC COMMENTS: EI-5-104 GC/RPK:kgl
/ /80

1. These comments concern Gesa FCU and three loans made by it that were characterized by our examiner as illegal. The Regional Office has concurred in this assessment and has sought the input of the Washington Office. EI has stated that in its opinion the loans are not illegal.

2. Certain characteristics common to each of the three loans in question prompted the examiner's assessment. In each case, an individual member of the credit union and a nonmember corporation or business partnership with which he is affiliated are the interested parties. In two of the cases, assets belonging to a corporation formed by the member have been pledged to secure the loans. It is not clear whether the SFGB partnership has pledged partnership assets to secure the third (Hoch) loan. However, the examiner has stated that in all three cases, proceeds from the loans have been utilized by these business entities and that in each case the named borrower's ability to repay is dependent upon the success of the business venture. In view of the fact that none of these business entities is a member of the credit union, the examiner suggests that each loan is illegal.

3. In addressing the question of illegality, we first make note of the fact that none of these cases raises a question of fraud or wilful misapplication of credit union funds. In other words, we see no evidence to indicate that these loans were made with any intent to harm the credit union. There is no suggestion that these loans were made with the expectation that the money would never be repaid. These are not cases in which the credit union has been duped into making a sham transaction with a nominal "dummy" borrower who has no relationship with the ultimate user of the funds. The credit union was, in each case, fully aware of the relationship between its member and his business enterprise. This is evidenced by the fact that, in at least two of the three cases, pledges of business assets were obtained. In the third case, it is clear that the credit union did know of the affiliation between Hoch and the SFGB partnership.

4. Even though this case does not involve a fraudulent misapplication of credit union funds, a question is raised regarding whether there has been a circumvention of the prohibition against lending money to nonmembers. Essentially, the question is whether the fact that these nonmember business ventures obtained the benefit of these loan proceeds requires us to treat the loans as having been illegally made directly to the nonmember business. In our opinion, the question should be answered in the negative. We recently commented upon a factually similar case involving Citizens FCU (see GC Comments to EI-11-12, dated February, 1980). A copy of these comments is attached for your

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filename: EI-5-104

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loans w/ business interests not nec. illegal

reference. Our comments there concerning the closeness of identity between the individual member and his closely held corporation apply to this case as well. We noted that because of the functional identity of the member and his corporation, benefit from the loan proceeds must be deemed to flow to both entities. We also noted the practical difficulty a credit union has in controlling the ultimate use to which the funds it lends to a member are put. In addition, we stated that recent opinions rendered in the area of nonmember usage of member credit cards and share drafts indicated a relaxation on the prohibition of nonmember access to credit union funds. Our conclusion was that where a member who is in business for himself incorporates the business but still retains control over it, a loan made to the member by the credit union should not be viewed as illegal because the proceeds thereof are utilized by or benefit the corporation. Although each of the corporations involved in that case was within the field of membership, we do not believe that fact to be determinative of the issue based upon our analysis in this memorandum. We note that the businesses involved here are equally small and closely held. We also would reach the same conclusion that we did in that case.

5. EI's response to the Region tends to indicate that the fact that the nominal borrower was a member settles entirely the question of legality. In our opinion, this sweeps too broadly. We can conceive of a case in which a credit union member as nominal borrower funnels funds to an unrelated third party who has no intention of providing for the loan's repayment. It is the closeness of the member and his business enterprise, together with the lack of any suggestion of fraud, that leads us to accept these loans. EI also discounts the issue of the pledging of corporate assets as irrelevant because loans of less than 12 years need not be secured. In our opinion, this discussion provides little guidance. Instead, we would indicate that the fact the loans have been secured solidifies the tie between the member and his business and is, therefore, an important aspect of our determination that the loans are legal. EI does indicate that loans of this type require a good deal of expertise in the making. With this we concur. Without further explanation as to the basis of your reasoning, however, we would not concur in your characterization of the loans as unsafe or unsound. Prior to making of such an assessment, we would expect to see some recitation of facts and criteria which form the basis of such a conclusion.

JOHN L. OSTBY
General Counsel

by: JAMES J. ENGEL
Assistant General Counsel

NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

GC COMMENTS

EI-11-12

GC/RPK:kgl
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1. Citizens FCU #10170 was informed during its most recent examination that several of its outstanding loans are illegal. This characterization was based almost exclusively on the fact that corporations are parties to the loans. The credit union has challenged this characterization and in support of its position has submitted arguments to Region V, which in turn forwarded them to the Washington Office. EI's preliminary thoughts have been routed here for comment.

2. The particular facts of this case have significant bearing on our assessment of it. Citizens FCU has made several loans to corporations formed and run by individuals who are either members of the credit union or who are within its field of membership. In each case, except that of the Faith Baptist Church, the corporations are small, privately owned businesses. Most have been set up by individual businessmen for legitimate tax and related reasons. All the corporation shareholders and officers are within the FOM of the credit union. Nonmember outside parties have no involvement with any of the corporations. In the case of each loan, both the corporation and its shareholders/members have signed the note and the security agreement. The members have signed the notes as principals whose liability is direct and shared jointly with the corporation, as opposed to signing as accomodation parties. In most cases, security pledged to assure the repayment of the loan is assets owned by the corporation and not the individual members.

3. EI suggests that one issue for resolution here is whether these corporations are eligible for membership in the credit union. Based on our review of the relevant background materials, it is our understanding that aside from the Faith Baptist Church, none of these corporations has joined the credit union as yet. Since all are comprised exclusively of persons within the credit union's FOM, our opinion is that each could be admitted to membership on the strength of the "organizations of such persons" language. Once admitted, such "other than natural person" members would be limited to borrowing amounts less than or equal to their share account balance (Article XII, §1).

4. As EI's memo points out, the remaining issue concerns the appropriate characterization of the loans that are currently outstanding. The examiner's characterization of these loans as illegal was based on his opinion that the proceeds of the loans went primarily to the benefit of the corporations and not the individual members. The credit union has taken the position that each of these corporations (excluding the Church) is a mere extension of the member who organized it and that it is therefore unrealistic to look upon the two as separable. In effect, the credit union

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invites us to "pierce the corporate veil" and recognize that these are merely loans to member/businessmen who happen to be incorporated.

5. EI suggests that the issue to resolve here is whether these loans amount to a "circumvention" of the statutory and regulatory requirements that govern FCU lending. It is clear that if each of these corporations were a member of the credit union in its own right, it would be precluded from borrowing in excess of its share account balance. Equally clear is the fact that as nonmembers none would be permitted to obtain a loan directly from the credit union. However, it is not clear to us that the mere fact that some portion of the proceeds of these loans found its way either to the benefit of or the outright use by these corporations renders the loans illegal.

6. Cases of this nature addressed in the past by NCUA were resolved by examining the underlying facts of a given case in an attempt to determine who the "real borrower" was. Where the nominal borrower acted purely as a conduit, funnelling the proceeds of the loan to a third party while receiving little or no benefit himself, our view was that the loan was illegal. If, on the other hand, some benefit flowed to the nominal borrower from the transaction, then our view was that the loan was not illegal. This test has worked well in the obvious cases, e.g., where ten members of Self Reliance FCU each sought to borrow $100,000 to turn over to the use of an Ukranian Association. However, its application in this case yields less than clear results. Simply put, benefit from these loans flows to both the member and to his corporation. Due to the closeness of their association, benefit flowing to the corporation cannot but help benefit the member/incorporator. We note in passing that in addition to this observation, a credit union can exercise only a minimal amount of control over which particular individual receives a "benefit" from the granting of a given loan. If a member decides to purchase a gift for a friend with the proceeds of a loan, and yet continues to repay his debt according to its terms, it would be difficult for us to say that the loan was illegal because a nonmember received some benefit from it. In fact, except in the egregious case, the concern of the credit union in making loans extends to whether the particular borrower is sufficiently able, either in his own right or with the aid of a comaker, to make the repayments according to the terms of the loan. What he does with the proceeds is essentially beyond the scope of the credit union's control or concern, "provident and productive purposes" notwithstanding.

7. In the area of credit cards, GC has stated that the authorized use by a nonmember of a member's credit card does not amount to an extension of credit to a nonmember. This position rested on the observation that permitting the member to let his card be used by another is providing a service to the member. The benefit gained by the nonmember was regarded as incidental. Also significant was the fact that the member remained liable to the credit union for the authorized charges incurred by nonmember

users. Similar results were reached in the areas of share drafts and special loan plans. In our opinion, the rationale underlying these decisions should be extended to cover the issues presented here. Thus, where a member who is in business for himself incorporates that business but still retains control over it, a loan made to him by the credit union should not be viewed as illegal because the proceeds thereof are utilized by or benefit the corporation.

8. We feel that the conditions set forth in EI's memo to cover these types of cases are reasonable. First, EI states that all shareholders or association members must be within the FOM and be able to legally borrow from the credit union. This condition tends to assure that the corporation in question will truly be a closely held, local business and not a public corporation in which a member happens to own several shares. The second of EI's criteria is that all the owners of the corporation or all members of the association also sign the note. In our opinion, it is unnecessary to require everyone to sign. Since we gather that the corporation is being made a party to the loan primarily because title to the assets that actually secure the loan is held in its name, no further protection to the credit union would result by requiring all the shareholders to sign the note (unless each signatory were actually pledging some of his own assets). We would, however, recommend that the signature of the credit union member who also appears to be the primary personality behind the corporation, e.g., the majority shareholder, be obtained.

9. To summarize our opinion briefly, it is the closeness of the relationship between member and corporation that induces us to view these loans as legal. We note that the member remains personally liable on the loan and that the pledge of corporate assets is obtained primarily for the protection of the credit union. This case exhibits none of the characteristics of the typical sham transaction. Here there is no funnelling of funds from the member through to a disinterested or unrelated third party. The corporations here are closely held and within the field of membership. Benefits that accrue to the corporation must be viewed as benefits likewise accruing to the member/incorporator. We find no evidence of an attempt to circumvent statutory or regulatory prohibitions.

10. We agree that the loan made to the Faith Baptist Church is distinguishable from the other loans in question here. We have no problem with EI's suggestion to merely let this loan run its course and to obtain from the credit union an agreement not to refinance it.

JOHN L. OSTBY
General Counsel

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by: JAMES J. ENGEL
Assistant General Counsel

Memorandum

GC/EJD:ltm
FCU #2042
DATE: April 7, 1977

FROM: General Counsel

TO : Regional Director
Region III (Atlanta)

SUBJ : Eastern Airlines Employees FCU #2042

REF : (a) RD Region III memo III/FCB:jj dtd March 28, 1977, same subj., with enclosures.
(b) RD Region III memo III/FCB:jj dtd March 30, 1977, same subj., with enclosures.
(c) RD Region III memo III/FCB:jj dtd March 31, 1977, same subj., with enclosures.

1. Our understanding of the partnership proposal outlined in enclosure (1) to reference (c) is as follows. A partnership will be created consisting of 650 limited partners (who are all employees of Eastern Airlines and within the FOM of the subject FCU) and, as general partner, E.F. Hutton (who is not within the subject FCU's FOM). The partnership contemplates the purchase of an airplane with the intent of leasing that airplane to Eastern Airlines. A substantial portion of the purchase price for the plane will be obtained by the 650 limited partners via loans from the FCU (650 loans of $12,500 each, totalling 8.1 million dollars). Each of these 650 loans will be secured by the airplane.

2. Given the fact that E.F. Hutton is to be a general partner of the proposed partnership, such partnership is not an "organization of such persons" as contemplated in Article XVIII, Section 2(b) of the FCU Bylaws. Thus, under such an arrangement, the subject FCU may not lend its funds to the partnership.

3. Nor would the partnership be an "organization of such persons" if an FCU member is named the general partner and he contracts to E.F. Hutton his responsibilities of management and E.F. Hutton assumes the liability for such responsibilities. Such a "straw man" relationship would, in our view, make E.F. Hutton the general partner in fact, and therefore, the partnership would not qualify as an "organization of such persons."

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4. In the event that the FCU intends to make 650 loans to 650 individuals (total of $8.1 million), the question arises as to whether such a scheme is, in essence, a "constructive" organization, i.e., whether, in the eyes of the FCU, the 650 individuals should be treated, along with E.F. Hutton, as an organization, which, in order to be eligible for the loan(s), must meet the requirements of Article XVIII, Section 2(b), of the FCU Bylaws.

5. The answer to the question stated above is dependent upon the circumstances of the making of the 650 loans. It is our opinion that such loans may be granted, if the following conditions are met, and, if the FCU demonstrates to NCUA how such conditions will be met.

(a) The FCU must make an independent determination of the creditworthiness of each of the 650 borrowers;

(b) Each borrower must be independently and unconditionally liable for his $12,500 loan, (i.e., upon default, he cannot assert as a defense the fact that the loan was made to an organization and that the organization is therefore liable for repayment); and

(c) The FCU must obtain adequate security for each loan. What constitutes adequate security is, of course, a matter for the FCU's Credit Committee, limited by safe and sound policy. However, we believe that security in the form of each borrower's share in the airplane is not sufficient, for the following reasons:

(1) Loans secured solely by the airplane lends further support for the fact that the loan is, in effect, a loan to an organization. This is not to say that the FCU cannot accept the plane as security. Only that other collateral on each note must be sufficient to adequately secure the loan. The FCU can, of course, oversecure each loan by securing the airplane;

(2) In the event that the plane is the sole security and a borrower defaults, there may be much difficulty in liquidating the security to cover the loan. Even if the partnership will assume the defaulted payments in such a situation, (thus obviating the need of liquidation), the factor of lending to an organization would reappear.

6. Note that the FCU must submit to NCUA evidence that it will and can meet the above stated conditions. When such a proposal is forthcoming, NCUA will then make a determination of whether or not the contemplated loans are proper.

7. In regard to the impending legislation (i.e., 12 year loan limit), NCUA has not yet decided on whether it will regulate security requirements for various types of loans. When that determination has been made, and if such regulations are promulgated, NCUA will examine the FCU's proposal accordingly.

8. Finally, the March 29, 1977, letter from FCU's DeRusso to RD Ganzfried states that "the lease payments will be made directly to the Credit Union. Any funds not required for debt service will then be forwarded to the partnership." It is our view that such action casts the FCU in prohibited agency relationship with both Eastern and the Partnership. The FCU may receive the loan payments from a person other than the borrower, but it may not transmit excess funds to the Partnership. In addition, such an arrangement would indicate that the loan is one to an organization. The FCU must receive only the loan payments, and devise a way to apply them to each individual loan. In short, all aspects of the loan transaction must be done on an individual basis and must meet all applicable requirements of the FCU Act, NCUA Regulations, and FCU Bylaws.

9. Inform subject FCU accordingly, and advise that, if the officials desire to meet with NCUA Washington Staff to discuss the matter, we would be happy to do so.

JOHN L. OSTBY