Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1048
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12 USC 29

December 21, 2005

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Washington, D.C. 20004-1304

Re: Request for Legal Opinion from Union Bank of California, N.A., San Francisco, California, on Funding Proposal

Dear Mr. Smith:

This letter responds to your request on behalf of Union Bank of California, N.A., San Francisco, California ("Bank"), concerning the Bank's proposal to provide funding to a limited liability company ("Company") that would operate a wind energy project[1] ("Project"). The Project uses wind turbines to generate electricity and sells the electricity through long-term contracts. The sale of the electricity generates renewable electricity production tax credits under section 45 of the Internal Revenue Code, 26 U.S.C. § 45 ("Section 45 Tax Credits"). In order to reduce the cost of financing to the Company while ensuring a proper return on the financing, the Bank proposes a structure that will allow it to take advantage of the Section 45 Tax Credits. For the reasons discussed below, we conclude that the Bank may provide financing to the Company in the manner described, provided the Bank's examiner-in-charge ("EIC") is satisfied that the Bank has adequate risk management and measurement systems and controls to conduct the financing activity in a safe and sound manner.

I. Proposal

The Bank desires to provide financing to the Company. At the request of its customer and in order to provide the financing in a manner that maximizes the use of the available tax credits, the Bank would acquire approximately 70% of the equity interest in the Company. The remaining interest would be acquired by the Project's sponsors and managing members of the Company, *i.e.*, the Bank's customer.[2]

[1] A "wind energy project" consists of an expanse of land covered with wind turbines that harness wind energy.

[2] The Project's sponsors typically are entities experienced in the energy industry with a history of such sponsorship.

The Company would acquire the necessary manufactured wind turbines and all ancillary equipment for the Project and would acquire an interest (either a leasehold interest or an easement) in the underlying real estate. Management and operation of the Company would be the responsibility of the Project's sponsors and managing members, with day-to-day operations handled through an operations and maintenance contract with an experienced third-party. Energy output would be contractually sold on a long-term basis to creditworthy parties.

You represent that the Bank's decision to extend financing to the Company would be based upon a full credit review of the transaction. This review and creditworthiness determination would be made pursuant to the Bank's standard loan underwriting criteria, including the assessment of a variety of project sensitivities based on various risk scenarios to ensure a predictable rate of return. If the financing for the Company is approved, the Bank would provide financing in the form of an investment in the Company. The Bank would be repaid in regular installments consisting of income provided by the revenues produced by the Project and the Section 45 Tax Credits.

In order to avoid recapture of the Section 45 Tax Credits, the Bank must hold its interest in the Company for at least ten years. Promptly after the expiration of the statutory holding period, the Bank would sell its interest in the Company to the Project's sponsors and managing members.

Finally, you represent that the Bank would have a variety of remedies available if a Project proved to be performing poorly. The Bank would have available to it covenants similar to those found in a secured financing transaction, including the ability to force a vote for dissolution of the LLC. If the Bank wished to extricate itself from a distressed Project, it could do so by selling its interest in a manner similar to that employed in selling distressed loans. With respect to a distressed Project, if caused by the Project manager, in addition to removing the manager the Bank would have a variety of claims available against the manager, its assets, and its cash flows. Where the distress is beyond the manager's control, the bank believes the distressed Project would be comparable to a project finance transaction in which the lenders collectively decide to liquidate the asset or individually to sell their loans in the marketplace. In either instance, a key component of the realized value would be based on the circumstances of the underlying assets.

II. Legal Analysis

A. Funding the Company is a permissible exercise of lending authority.

A national bank may engage in activities that are part of, or incidental to, the business of banking. Twelve U.S.C. § 24(Seventh) provides national banks with broad authority to make loans or other extensions credit.

The transaction proposed by the Bank is a form of structured financing patterned after a typical debt transaction – the extension of credit to the Company with payment to originate from proceeds received from the sale of power generated by the project. The Bank represents that the

decision whether to provide financing to the Company would be based upon a full credit review of the transaction made pursuant to the Bank's standard loan underwriting criteria. The Bank further represents that the Company's LLC agreement would contain many of the same terms, conditions, and covenants typically found in lending and lease financing transactions, including representation and warranties, conditions precedent to funding pertaining to the mitigation of risks, covenants requiring the Company and the other investors to provide the Bank with customary financial information, and covenants restricting the Company from taking certain actions.

In Corporate Decision 99-07 (May 26, 1999), we approved a national bank's provision of financing to an entity that owned and wished to rehabilitate several historic properties. The bank provided the financing in the form of an investment in the entity, which permitted the bank to receive the federal rehabilitation tax credits. We concluded that, in substance, the transaction was the provision of construction financing which would be repaid both from the rehabilitated properties' operating income and through the tax credits. By taking advantage of the tax credits, the bank was able to facilitate the financing by reducing the cost of borrowing while receiving an appropriate yield. For these reasons, it was proper to treat the transaction as an extension of credit that is permissible for national banks.

Similarly, in an Interpretive Letter, dated November 4, 1994 (available in Lexis-Nexis), we approved a national bank's provision of financing to owners of natural gas leases by acquiring an interest in a business trust that owned the working interests in the leases. By structuring the financing as an investment in the trust, the bank qualified to receive the federal tax credits, thereby permitting the bank to reduce the cost of the financing while assuring an appropriate return. The letter concluded that the transaction was the equivalent of an extension of credit and that the substance of the transaction should prevail over the form in which it had been cast.[3]

Based upon the information provided and the Bank's representations, the proposed financing transaction fits the definition of loan or other extension of credit in section 24(Seventh).

B. Transaction is not prohibited by 12 U.S.C. § 29

The structure of the proposed financing transaction – as an acquisition by the Bank of an interest in the Company – is customer-driven, requested by the Project's sponsors and managing members as an efficient and cost-effective means to provide financing for the Project. Notwithstanding this structure, the substance of the proposed transaction remains, as described above, the provision of financing for the Project.

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[3] *See also* Corporate Decision 98-17 (March 23, 1998) (approving as an extension of credit transaction that included bank's acquisition of working interests in natural gas leases operated by borrower).

The economic substance of a transaction, rather than its form, guides our analysis of whether a national bank is prohibited from engaging in a certain activity.[4] Here, the investment in the Company is a means to provide financing to the Project. As part of the proposed financing arrangement the Bank, through its acquisition of an interest in the Company, will acquire interests in the land and the wind turbines. Because the substance of the transaction guides our analysis, we look through the form of the proposed transaction and assess whether the indirect interests in the land and the wind turbines acquired by the Bank (through its investment in the Company) are interests in real estate subject to 12 U.S.C. § 29 ("section 29") and, if so, whether the Bank permissibly may acquire such interests as an integral part of the proposed transaction.

A national bank's authority to own real estate is governed by section 29, which provides that "[a] national banking association may purchase, hold, and convey real estate for the following purposes, and for no others:

> First. Such as shall be necessary for its accommodation in the transaction of its business.
>
> Second. Such as shall be mortgaged to it in good faith by way of security for debts previously contracted.
>
> Third. Such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings.
>
> Fourth. Such as it shall purchase at sales under judgments, decrees, or mortgages held by the association, or shall purchase to secure debts due to it."

Thus, section 29 grants national banks the authority to purchase, hold, and convey real estate only for certain specified purposes. Unless authorized by another statute, national banks may not acquire, own, or convey an interest in real estate for any purpose other than those specified in section 29.[5]

The critical determination is whether a certain property interest constitutes a section 29 interest in "real estate." Section 29 itself does not contain a definition of "real estate" and does not direct the OCC to consider state law definitions in applying the statute. Nonetheless, as a general matter, the OCC has in the past been guided by state law in determining whether

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[4] *E.g.*, Corporate Decision 99-07, *supra;* Corporate Decision 98-17, *supra*; Interpretive Letter, dated November 4, 1994, *supra*. *See also* Interpretive Letter No. 867, *reprinted in* [1999-2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-361 (June 1, 1999) (noting that OCC looks to substance of non-traditional financing arrangement to determine whether it is permissible part of business of banking).

[5] National banks may acquire a section 29 interest in real estate when doing so is an integral part of or incidental to an authorized banking activity, provided that doing so is not inconsistent with any of the purposes underlying the limitations of section 29. *See, e.g.*, Corporate Decision No. 99-07, *supra* (acquisition of interest in historic property permissible as integral to provision of construction financing); Interpretive Letter No. 966 (May 12, 2003) (acquisition of legal title to residential real estate for a period not to exceed ninety days, where bank divests itself of beneficial interests in real estate, permissible as incidental to package of finder and other bank permissible activities).

particular interests are subject to section 29.[6] More specifically, the OCC previously has looked to state law definitions of "real property," a term with a broader meaning than the language – "real estate" – used in section 29.[7]

In recent years, however, it has become increasingly apparent that market developments have created, and national banks' financial intermediation activities may involve, types of assets clearly distinguishable from the type of asset typically associated with the term "real estate," yet which come within state law definitions of "real property." Moreover state law definitions are not consistent and an asset may be within the definition of "real property" in one state, but not another. Using a different definition of "real estate" for purposes of section 29 in different states thus could result in national banks' permissibly acquiring certain interests in one state but being prohibited by section 29 from acquiring the same interest in another state. Such a result is illogical, inefficient, and is inconsistent with the authority of national banks to operate under uniform federal standards.

Accordingly, we have determined that in the future we will apply a federal definition of "real estate" to determine what constitutes real estate subject to the limitations of section 29.[8] In determining whether a property interest is subject to section 29, this federal definition will be guided by the purposes and principles underlying section 29. For example, soon after enactment of the Act, the Supreme Court in *Union National Bank v. Matthews*,[9] stated that the three purposes underlying section 29 were to keep the capital of the banks flowing in the daily channels of commerce; to deter national banks from embarking in hazardous real estate speculations; and to prevent the accumulation of large masses of such property in the banks' hands, to be held, as it were, in mortmain.[10] We also will consider the treatment accorded such interest under the laws of the various states, but the state law characterization of the interest will not, alone, be dispositive.

In this proposal the Bank would acquire, through its investment in the Company, an indirect interest in the land upon which the wind turbines would be affixed. This interest, whether a leasehold interest or an easement, clearly is an interest in real estate subject to section

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[6] As far back as 1982, the OCC acknowledged that reference to state law to determine the definition of "real estate" was not required by section 29. *See* Interpretive Letter (March 18, 1982) (published in Lexis-Nexis).

[7] Cunningham et al., *The Law of Property* § 14 (1984 ed.); Tiffany, *The Law of Real Property* § 1 (1970 ed.).

[8] This approach is consistent with the approach that the OCC has taken in defining other terms that appear in the National Bank Act ("Act"). The Act is a vehicle for the implementation of federal policy with regard to banking. Accordingly, the OCC generally has developed federal definitions for the crucial terms that appear in the Act. For example, the OCC has developed and continues to apply federal definitions of "interest" for purposes of 12 U.S.C. § 85 and "branch" for purposes of 12 U.S.C. § 36. There is nothing in the plain language or legislative history of section 29 that demands a different approach.

[9] 98 U.S. 621 (1878).

[10] *Id.* at 626.

29.[11] We further conclude that the Bank's acquisition of this interest is not prohibited by section 29.

Notwithstanding section 29, national banks may acquire an interest in real estate when doing so is an integral part of an authorized banking activity, provided that doing so is not inconsistent with any of the purposes underlying the limitations of section 29. This principle is well supported by OCC precedent. In Corporate Decision No. 98-17, *supra*, the OCC permitted a national bank to acquire working interests in natural gas leases in order to provide financing to the producer. In order to allow the bank to take advantage of available tax credits to reduce the cost of borrowing to the producer while ensuring the bank's return on its extension of credit, the bank acquired the working interests in the gas leases. The letter opined that because acquiring legal title was an integral step – undertaken to further the permissible financing transaction – acquisition of the working interests was not prohibited by section 29.[12]

Similarly, in Corporate Decision No. 99-07, *supra*, we approved the provision of financing to an entity that owned and wished to rehabilitate several historic properties. The bank provided the financing by acquiring an interest in the entity, thereby giving the bank an interest in the historic properties. Such an interest permitted the bank to receive the federal tax credits. The decision concluded the bank's acquisition of an interest in real estate was not prohibited by section 29 because such acquisition was an integral part of authorized financing activity.

A key element to each of these letters is that the interest in real estate must be acquired as an integral part of an authorized banking activity. In the case of the proposal here, the Bank would acquire its indirect interest in real estate as part of and in furtherance of its provision of financing for the project. By taking advantage of the tax credits, the Bank would be able to facilitate this financing by reducing the cost of borrowing while receiving an appropriate yield.

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[11] Through its investment in the Company, the Bank also would acquire an interest in the wind turbines. The states that have considered the character of wind turbines are split as to whether they are real property or personal property. For example, New York has characterized wind turbines as taxable real property, *see* 9 Op. Counsel S.B.R.P.S. No. 114 (Jan 27, 1993), while the Colorado, South Dakota, West Virginia, and Wyoming legislatures have characterized wind turbines as personal property, *see* Colo. Rev. Stat. § 25-6.5-201; S.D. Codified Laws Ann. § 10-4-36; W.Va. Code Ann. § 11-6A-5a; Wyo. Stat. Ann. §§ 39-15-105 and 39-16-105. In California, the courts have determined that wind turbines are personal property. *See In re Oak Creek Energy Farms, LTD*, 107 B.R. 266 (Bankr. E.D.Cal. 1989), *aff'd* 119 B.R. 739 (E.D.Cal. 1990), *aff'd* 956 F.2d 1167 (9th Cir.1992). However, because we conclude for the reasons below that section 29 does not preclude the Bank from holding interests in real estate as an integral part of this transaction, we need not decide the issue of whether the interests in the turbines are "real estate" under our federal definition of the term.

[12] *See also* Interpretive Letter, dated November 4, 1994, *supra* (acquisition of working interests in natural gas leases operated by borrower an integral part of provision of financing). We express no opinion whether working interests in natural gas leases are interests in "real estate" under the federal definition adopted in this letter.

Further, the acquisition of these indirect interests in real estate is not inconsistent with any of the purposes underlying the limitations in section 29.[13] The Bank's capital, far from being removed from the daily channels of commerce, would be put to productive use by the Company to finance the Project and would be repaid to the Bank in regular intervals. The Bank would not acquire large amounts of real estate to be held indefinitely; rather, the Bank's interests would be restricted both in scope and time. Under the LLC agreement, the Bank would have no responsibility or obligation to manage or operate the Project. Such responsibilities would be the obligation of the other members of the Company. And the Bank's interests would be held only for the statutory holding period required by the Internal Revenue Code. Promptly upon the expiration of this holding period, the Bank would sell its interest in the Company to the other members.

Finally, the acquisition of the interests in real estate is not speculative. Structuring the financing in the manner proposed is necessary for the Bank to remain competitive in the marketplace for financing renewable energy producing projects. The structure of the proposed financing is driven by the Project's sponsors, and if the Bank cannot provide the financing in the manner proposed, the borrower would look elsewhere. Moreover, the Bank would not share in the appreciation or depreciation in value of the land or turbines. When the Bank divests its interest in the Company at the end of the statutory holding period, it would sell its interest to the Company's other members. These members would continue to own and operate the project and, upon termination of the project, would recognize any change in value of the land and turbines.

III. Conclusion

For the reasons provided above, and provided the Bank's EIC is satisfied that the Bank has adequate risk management and measurement systems and controls to conduct the financing activity in a safe and sound manner, we conclude that the Bank may provide financing to the Company in the manner stated. Our conclusion is based upon the information and representations you have provided. A material change in the facts may result in a different conclusion. If you have any questions, please contact Steven Key, Senior Attorney, Bank Activities & Structure Division, at (202) 874-5300.

Sincerely,

/s/ *Julie L. Williams*

Julie L. Williams
First Senior Deputy Comptroller
and Chief Counsel

[13] *See* footnotes 9 and 10, *supra.*