September 21, 2000

James P. Moore, Vice President, Corporate Development
Ent Federal Credit Union
P.O. Box 15819
805 North Murray Boulevard
Colorado Springs, Colorado 80935

Re: Member Business Loan Security Requirements.

Dear Mr. Moore:

The Region V Director requested that we respond to your letter to Principal Examiner Beth DiNapoli. Your letter presents questions concerning NCUA's member business loan regulation. 12 C.F.R. Part 723. We note that Office of General Counsel staff have had conversations with Tom Young of your credit union that helped us refine and reformulate your questions. Your questions and our answers are as follows:

1) Who is a principal in regard to a corporation under §723.7 of NCUA's regulations? Can a credit union make a business loan to a publicly traded corporation without obtaining any personal guarantees?

Unless waived, a credit union cannot make a business loan to a corporation, including a publicly traded corporation, without obtaining the personal guarantee of the shareholder or shareholders holding a majority interest in the corporation.

Unless a regional director grants a waiver, the member business loan regulation requires a guarantee by a natural person for a loan to a business entity, such as a corporation; the regulation provides an exception from the guarantee requirement for certain not for profit organizations. 12 C.F.R. §§723.7(b), 723.10. The regulation identifies the natural person guarantors as "principals." 12 C.F.R. §723.7(b) ("Principals . . . must provide their personal liability and guarantee.")

The preamble to the final member business rule specifically addressed the requirement for a natural person guarantor.

One commenter requested that NCUA allow borrowers that are corporations and other business entities, such as limited liability companies, to borrow in the name of the corporation whereby the guarantor is the corporation. The NCUA Board does not agree with such a change because it would allow a corporation to be liable instead of the individual. Past experience with credit union losses with this type of loan structure indicates that such a change would not be in the best interest of credit unions or the National Credit Union Share Insurance Fund (NCUSIF).

64 F.R. 28721, 28724 (May 27, 1999). The requirement that principals provide a guarantee means the guarantee of one or more natural persons who have a

majority ownership interest in the business organization receiving the loan. For a corporation, this will be one or more shareholders having a majority ownership of the corporation.

This requirement has been part of NCUA's regulatory scheme since the first business loan regulation was amended in 1987. 52 F.R. 12365 (April 16, 1987). The requirement was not in the original business loan regulation itself, but contained in a standard bylaw amendment to the Federal Credit Union (FCU) bylaws, issued in conjunction with the first business loan regulation. *Id*. at 12368. The basic FCU Bylaw provision in effect at the time provided that a loan to other than a natural person could not exceed its shareholdings. The standard amendment permitted a loan to other than a natural person to exceed its shareholdings "if the loan is made jointly to one or more natural person members and a business organization in which they have a majority ownership interest." *Id*. While previously the requirement was for joint liability of a natural person or persons having a majority interest in the business organization, the purpose and effect were substantially the same as the current requirement for a personal guarantee.

2) Who is a principal with respect to a limited liability partnership or a limited liability corporation, where the managing partner usually has a minority ownership position but has the authority to borrow and pledge assets? You further ask whether the managing partner must guarantee the entire amount of the loan or just the managing partner's *pro rata* share?

Natural person partners having a majority ownership interest in a partnership must each guarantee the full amount of a loan to a partnership.

3) If a member applies for a loan to purchase an existing building, must the member have a 35% equity interest in the property? If the stockholders of ABC Company form a separate legal entity to buy a building and lease it to ABC Company, would the leasing entity have to have a 35% equity interest in the property?

The answer, in both cases, is no. The 35% equity requirement for construction and development loans only applies to loans involving the construction, development, improvement or change in use of a particular property. 12 C.F.R. §723.3. Whether a particular loan is a construction or development loan will generally depend on the particular facts surrounding the granting of that loan. For example, the purchase of a single family home with the intent of converting it into a multi-family residential unit to generate income for the borrower would constitute a development loan. If some of the proceeds of a loan will be used to refurbish or develop property, in addition to being used to purchase the property, then the loan will be treated as a construction and development loan and will have to meet the requirements of §723.3.

Sincerely,

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Associate General Counsel

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cc: Region V Director