

BL-057

Use of State-Chartered Business Entities to Hold Acquired Property

To: Chairman, Board of Directors
Each Farm Credit Bank and Association

From: Leland A. Strom
Chairman and Chief Executive Officer

Subject: Use of State-Chartered Business Entities to Hold Acquired Property

Non-Farm Credit System lenders, such as commercial banks, make use of business entities organized under state law (state-chartered), primarily limited liability companies (LLCs), when managing acquired property in complex and unusual situations that may expose the lender to risks beyond those commonly associated with loans. LLCs or other state-chartered business entities are formed, for example, to hold acquired industrial or manufacturing properties (such as ethanol plants) where a lender is concerned about incurring potential environmental or other liabilities that may accrue to an owner of these types of properties. Multi-lender participation and syndication agreements may also provide for creation of an LLC to hold acquired property as a means of distributing *pro rata* interests in recovered collateral to lenders who participate in the loan transaction.

A “limited liability company” (sometimes—incorrectly—referred to as a limited liability “corporation”) is a state-chartered business entity that combines certain characteristics of a corporation and a partnership. Like a traditional corporation, the LLC form limits the liability of its owners; like a partnership, it provides for pass-through income taxation. Ownership in an LLC is usually evidenced by membership interests.

Section 4.25 of the Farm Credit Act of 1971, as amended, authorizes Farm Credit System (System) institutions to form service corporations to conduct statutorily authorized activities (other than extending credit or selling insurance). System institutions may also work together through unincorporated service organizations, including joint ventures and partnerships, to engage in authorized activities. Farm Credit Administration (FCA) rules do not authorize System institutions to form or hold interests in any other type of state-chartered business entity, such as an LLC. The FCA is reviewing regulatory requirements to determine if revisions are needed to address use of LLCs or other state-chartered business entities for the limited purpose of acquiring and managing property of distressed loans that involve unusual or complex collateral.

However, as part of their statutory lending powers, System institutions clearly have the authority and the obligation to seek collection of debts from property held as collateral for defaulted loan obligations. Therefore, FCA believes that System institutions have the concomitant legal authority to take the same commercially reasonable and accepted measures as non-System lenders when acquiring and holding property as a result of a defaulted loan, including the use of tools, such as LLCs, to limit liabilities under appropriately narrow circumstances.

Therefore, FCA will not object if a System institution, acting in good faith, forms or acquires an interest in one or more LLCs or other state-chartered business entities for the limited purpose of carrying out the following activities: 1) making credit bids at a foreclosure sale or other court-approved auction of property collateralizing System institutions’ loans that are in default; and

2) holding and managing acquired property to minimize losses, protect the property's value, and limit potential liability, including taking appropriate actions to limit the potential for liability under applicable environmental law and regulations.

A System institution that acquires an interest in an LLC or other state-chartered business entity for these purposes must:

1. Provide timely and early notice before acquiring any interest to FCA's Examiner-in-Charge (EIC) and provide the EIC the LLC charter or agreement upon formation of the LLC or other state-chartered business entity;
2. Ensure that any interest acquired in an LLC or other state-chartered business entity is solely for the purposes specified above and complies with all legal documentation requirements applicable to the form of the entity, as supported by opinion of outside counsel;
3. Maintain, or maintain access to, all books, papers, records, agreements, reports and other documents of each LLC or other state-chartered business entity necessary to document and protect its interest in each entity;
4. Provide FCA examiners with full access to all documents within the institution's control or access relating to its interest in an LLC or other state-chartered business entity;
5. Divest, as soon as practicable, ownership interest in (or withdraw membership from) any LLC or other state-chartered business entity that conducts activities beyond those needed to carry out the purposes specified above or conducts new business activities that the institution does not have the authority to conduct under the Farm Credit Act of 1971, as amended, (Act).
6. Report any interest in an LLC or other state-chartered business entity as acquired property on reports to its board of directors and reflect this acquired property in Call Reports as FCA directs;
7. Appropriately value acquired property pursuant to FCA regulations and Generally Accepted Accounting Principles and in consultation with the institution's EIC;
8. Dispose of the acquired property and divest its interest in an LLC or other state-chartered business entity at the earliest possible time or as directed by the FCA.

System institutions must make an independent determination regarding how and whether to acquire or manage collateral for distressed loans, including the use of LLCs or other state-chartered entities. We believe that it is generally inappropriate for FCA to provide prior approval or concurrence for these decisions. It is the responsibility of a System institution, acting in concert with any lending partners, to determine, after exercising proper due diligence and performing a comprehensive least-cost analysis, whether a bid should be made or how to acquire property. The existence of an LLC or other entity does not mitigate in any way prudent and conservative oversight and management of acquired property, including the realistic recognition of holding costs, specific allowance provisions, and establishing realistic exit strategies to dispose of the acquired property in a timely manner.

The use of an LLC or other entity is not a factor in determining the level of losses that a System institution may need to recognize on a defaulted loan and any related acquired property. The FCA will continue to exercise its full authority under the Act and its regulations to ensure that the risk in these distressed credits and any resulting acquired property is fully recognized. The FCA will be conservative and cautious in evaluating the value placed on the collateral and any related acquired property for risk and loss identification purposes. FCA's Office of Examination will closely review acquired property

situations and provide any supervisory oversight and required actions that might be necessary.

The position expressed by FCA in this booklet applies only to acquisition of an interest in an LLC or other state-chartered entity for the limited purposes specified above. A System institution acquiring an ownership interest in an LLC or other business entity under these circumstances does not provide a System institution with any authority or justification for acquiring an interest in an LLC or any other business entity for any other purpose or to perform any other activities through an established LLC or other entity.

Please contact Charles Rawls, General Counsel, or Howard Rubin, Senior Counsel, at (703) 883-4020, if you have any questions regarding this booklet.

Copy to: Chief Executive Officer
 Each Farm Credit Bank and Association