Texas Department of Banking

Randall S. James
Banking Commissioner

October 18, 2002

Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

RE: Insurance of State Banks Chartered as Limited Liability Companies

Dear Mr. Feldman:

I am writing in my capacity as Banking Commissioner of Texas to comment in support of the regulation proposed by the Federal Deposit Insurance Corporation ("FDIC"), to be codified at 12 C.F.R. § 303.15, "Certain limited liability companies deemed incorporated under State law". However, as further described below, the rationale for our support differs somewhat from the FDIC's rationale as stated in its Notice of Proposed Rulemaking, 67 Fed. Reg. 48054 (July 23, 2002) ("Notice").

This letter responds, in the order presented, to the three questions raised in the Notice. However, in response to the question not asked, we believe the FDIC should act to authorize insurance for an LLC bank without regard to the current federal income tax treatment accorded an LLC bank or prospects for changes in tax treatment. With respect to a particular application, we believe the FDIC should evaluate the substantive effects of the then-prevailing federal tax treatment accorded an LLC bank, just as it should evaluate effects of other entity attributes, to the extent relevant to analysis of the evaluative factors required to be considered by the FDIC in acting on applications for insurance of accounts. As set forth in 12 U.S.C. § 1816, the FDIC must consider:

(1) The financial history and condition of the depository institution.
(2) The adequacy of the depository institution's capital structure.
(3) The future earnings prospects of the depository institution.
(4) The general character and fitness of the management of the depository institution.
(5) The risk presented by such depository institution to the Bank Insurance Fund or the Savings Association Insurance fund.
(6) The convenience and needs of the community to be served by such depository institution.
(7) Whether the depository institution's corporate powers are consistent with the purposes of this chapter.

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Questions Presented

1. **Should the FDIC permit a State bank that is organized as an LLC to obtain Federal deposit insurance?**

The FDIC should permit a State bank that is organized as an LLC to obtain Federal deposit insurance without pre-determining eligibility based on entity structural issues. If the relevant chartering authority is empowered under applicable law to issue a charter that is an LLC or similar entity (*e.g.*, the Limited Banking Association ("LBA") charter for a Texas state bank), the FDIC should entertain applications for insurance of accounts from such charters and grant insurance coverage as appropriate, without regard to entity attributes that do not adversely affect safety and soundness or increase risk to the pertinent federal deposit insurance fund.

The choices available to organizers for forming a business entity have increased and diversified in recent years. Businesses today can conduct operations not only as proprietorships, general partnerships, and corporations, but in hybrid entities created under state laws. These hybrid statutory entities include, among others, limited partnerships, limited liability companies, limited liability partnerships, and close corporations. Banks have been precluded from utilizing a number of these entities by antiquated banking statutes from another era, restrictions that do not necessarily relate to safety and soundness or risk to the federal deposit insurance fund. Indeed, we would argue these restrictions arose inadvertently with the mere passage of time.

If a chartering authority has modernized its laws and regulations to permit banks to use a hybrid form of business entity, the FDIC should honor that statutory construct and grant or deny insurance of the bank's accounts based on evaluation of the effects of the chosen entity form on the statutory factors listed in 12 U.S.C. § 1816, set forth on the first page of this letter.

2. **If so, should the FDIC interpret the term "incorporated" utilizing some, all or none of "the traditional four corporate attributes"?**

We do not believe the FDIC must necessarily utilize "the traditional four corporate attributes" except to the extent such categorization assists in understanding the risk profile of the bank with respect to the deposit insurance fund.

The "four traditional corporate characteristics" are not among the factors required for consideration by the FDIC. The factor in 12 U.S.C. § 1816 (7) uses the word "corporate" but refers to powers and not "characteristics or features". In practice, until the issue of limited liability entities as banks was raised by the FDIC, the FDIC does not appear to have historically considered perpetual existence, limited liability, free transferability of interests, and centralized

management as factors necessary or even relevant to its overall review of insurance applications filed under 12 U.S.C. § 1815.

Perpetual Existence

We know from experience that the FDIC has historically insured banks without perpetual existence. Prior to 1995, a number of Texas state bank charters had a limited period of existence under their organizational documents and were nonetheless insured by the FDIC. In 1995 we sought and obtained statutory language that had the effect of creating perpetual existence for all Texas state banks, although the reason we did so was to eliminate an annoying "trap for the unwary" and not because of safety and soundness concerns.

The FDIC appropriately states in the Notice that it is charged with promoting the safety and soundness of banking institutions and with the duty of resolving failed institutions. However, no evidence exists that lack of perpetual succession in a bank charter would inhibit FDIC authority or interfere with FDIC duties and responsibilities, as suggested by the Notice. Means are available to obtain extensions of existence and these means have been used in the past to re-authorize and extend charters having limited existence. We fail to see why the FDIC should start requiring perpetual existence as a corporate attribute when it has not done so historically.

Free Transferability

We are not aware that the FDIC has historically considered whether the stock of a depository institution was freely transferable in considering its application for insurance of accounts. A number of state banks under our supervision have both FDIC insurance and agreements restricting the transferability of bank stock. LLC restrictions on transferability are similarly imposed by means of a restrictive shareholder agreement.

We understand the FDIC is charged to consider the adequacy of a depository institution's capital structure and risk to the insurance fund under 12 U.S.C. § 1816. However, we believe that the theoretical connection between "free transferability" and any of these statutory factors is tenuous at best. Considering the number of insured, closely-held banks and other insured banks we supervise that have restrictive shareholder agreements in place, at the very least it would be inconsistent for the FDIC to require free transferability of interests as a pre-condition to a future application for insurance of accounts.

If the FDIC is merely inexperienced with institutions organized as LLCs, as its Notice states, until it gains experience it could institute a more measured approach. For example, the FDIC's policy statement on insurance of accounts states, regarding stock benefit plans, that such plans must contain a provision permitting the primary federal regulator to direct the plan participants to exercise or forfeit their stock rights if capital becomes inadequate. Similarly, until the FDIC achieves experience, the terms of an LLC bank's documents could be required to say that if a capital is determined to be inadequate by the primary regulator, that the current owners be directed to replenish capital or waive the transferability restrictions. The FDIC could thus address its concern about capital adequacy without unduly interfering in owners' rights.

Centralized Management

We fundamentally agree with the FDIC that management of an institution is key to its success, and the FDIC is appropriately charged under 12 U.S.C. § 1816 to assess the "general character and fitness of management of the depository institution". A chartering authority also conducts reviews of management. For example, in order to grant a bank charter under the Texas Finance Code, the Department is required to determine, among other things, that the banking experience, ability, standing, competence, trustworthiness and integrity of officers, directors (and their equivalent under the limited banking association structure) are sufficient to support the bank [Tex. Fin. Code Ann. § 32.003 (West 2002)]. This same review would be required if the bank were managed by a board of directors of a traditional bank or by members of an LLC bank.

Concerns can arise in the theoretical instance of an LLC bank proposed to be managed by its members collectively if the bank will have a large number of members. Texas law specifically addresses this concern with respect to both conventional banks and LBAs. In a traditional Texas bank a board of directors cannot exceed 25 in number, *see* Finance Code § 33.103(a). A Texas LBA must elect a board of managers that does not exceed 25 in number if it has more than 25 members, *see* Finance Code § 32.003(d). The FDIC should address its concerns with a similar provision to conform the remedy more closely to the evil sought to be addressed.

Limited Liability

By 1937 amendment, personal liability of bank stockholders (i.e., assessable stock) was deleted from Article XVI, Section 16, of the Texas Constitution an attribute deemed no longer necessary because of federal deposit insurance. We found no record indicating that the FDIC ever objected to or raised questions regarding liability of shareholders in approving insurance of accounts of Texas state banks prior to 1937. We submit that this evident lack of concern was and remains appropriate in light of the statutory factors governing applications for insurance of accounts.

If an LLC bank charter is structured to impose unlimited liability on one or more members, the FDIC should evaluate the substantive effect of this legal parameter on the statutory factors the FDIC must consider. Based on the particular facts of a specific application, the FDIC could well conclude that unlimited liability of one or more of the bank's equity owners actually reduces potential risk to the deposit insurance fund. In practical terms, we believe such a finding actually seems to be a more likely result than a finding that risk is enhanced by these shareholder liability issues.

However, we do not think limited liability is a significant factor with respect to raising capital in the LLC structure. Limited liability can exist in an LLC just as in a traditional charter, and a conscious choice to create unlimited liability will be both rare and thoughtfully made. In addition, the chartering authority will have evaluated the appropriateness of optionally chosen entity attributes with respect to the business of banking and regulatory oversight. The FDIC should at the very least allow the bank organizers to articulate the rationale for structural choices made and how those choices impact the bank's risk profile for insurance of accounts.

3. If the FDIC should not utilize any of the four corporate attributes, how should it interpret the term "incorporated"?

We believe the FDIC should consider the term "incorporated" to be synonymous with "chartered and regulated" in this context, as the best means of focusing on Congressional intent. Congress' objective could not have been to exclude banks existing at the time from deposit insurance coverage; yet many of those banks, whether state or federally chartered, did not exhibit "the four corporate attributes."

The FDIC should focus on risk to the deposit insurance fund by evaluating the facts of each application, including entity attributes, in light of the statutory factors the FDIC is directed to consider. Whether a bank is "incorporated" in the modern sense of the term is irrelevant.

We previously submitted a thorough analysis of the term "incorporated" as used in 12 U.S.C. § 1813(a)(2). As we there stated:

> "The analysis must ... center on what the 'incorporated' requirement means in the context of the purposes of the FDI Act. In our view, the term 'incorporated' is primarily of historical interest and originally used to distinguish state chartered and regulated banks from private banks." *Letter from Everette D. Jobe, General Counsel to the Department,* (copy attached as Exhibit A) *to Douglas H. Jones, Esq., then Acting General Counsel of the FDIC dated October 26, 1994.*

Our view, as expressed in the attached exhibit, is consistent with our previous observation that the FDI Act does not address or require consideration of any "four corporate characteristics" for a national bank or other bank to be eligible for insurance. A charter from a recognized bank regulatory authority is all that should be required for a depository institution to be eligible to apply for insurance of accounts.

Summary

In any particular situation, important business and policy considerations may support variances in entity structure and operation. In the modern era, choice of entity structure has become an element of the business plan. Insisting that all state banks utilize the same entity structure is inherently no more valid than insisting that all banks use the same business plan.

We believe that any state-chartered and regulated entity authorized by state law to engage in the business of receiving deposits should be eligible to apply to the FDIC for insurance of accounts. The FDIC should not create a pre-condition to eligibility for insurance of accounts by rule unless

it can persuasively argue that under no circumstances can a specific statutory factor in 12 U.S.C. § 1816 be satisfied if the proscribed entity attribute exists with respect to any applicant.

Until the FDIC gains experience, a more measured approach is appropriate. Rather than prohibit entity attributes that the FDIC "suspects" might impact insurability of accounts, the FDIC should evaluate the substantive effects of entity attributes possessed by the applicant in the context of a specific application and how such effects specifically relate to satisfaction of the statutory factors the FDIC must consider. Further, we believe this approach is consistent with historical FDIC practice and more faithfully implements the public policy considerations underlying insurance of depository accounts.

Thank you for this opportunity to comment. Please do not hesitate to contact this Department if the FDIC needs additional information or has questions.

Respectfully,

Randall S. James
Banking Commissioner

Cc:

Exhibit A

to Comments of Randall S. James, Banking Commissioner of Texas

Letter dated October 26, 1994, from Everette D. Jobe, General Counsel to the Texas Department of Banking, to Douglas H. Jones, Esq., then Acting General Counsel to the Federal Deposit Insurance Corporation

Texas Department of Banking

Everette D. Jobe
General Counsel

October 26, 1994

Douglas H. Jones, Esq.
Acting General Counsel
Federal Deposit Insurance Corporation
Washington, D.C. 20429

RE: Whether Texas Limited Banking Associations are Incorporated under State Law for Purposes of 12 U.S.C. § 1813(a)(2) and Eligibility for Federal Deposit Insurance (OP94-72).

Dear Mr. Jones:

By letter dated July 28, 1994, you requested our analysis regarding whether a Texas limited banking association is incorporated under the laws of the State of Texas.

The Federal Deposit Insurance Act (the "FDI Act")[1] defines a "State bank" as:

> any bank, banking association, trust company, savings bank, industrial bank ... or other banking institution which —
>
> (A) is engaged in the business of receiving deposits, other than trust funds (as defined in this section); and
>
> (B) is incorporated under the laws of any State ...,
>
> including any cooperative bank or other unincorporated bank the deposits of which were insured by the Corporation on the day before August 9, 1989.[2]

A limited banking association is a bank chartered and fully regulated by the State of Texas and is engaged in the business of receiving deposits. The analysis must therefore center on what the "incorporated" requirement means in the context of the purposes of the FDI Act. In our view, the term "incorporated" is primarily of historical interest and originally used to distinguish state chartered and regulated banks from private banks.

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[1]Federal Deposit Insurance Act, Pub. L. No. 81-797, 64 Stat. 873 (1950) (codified as amended at 12 U.S.C.A. § 1811, *et seq.* (1989 and Supp. 1994)).

[2]12 U.S.C.A. § 1813(a)(2) (1989).

History of Banking in Texas

For present purposes, history begins during the era of Reconstruction following the Civil War. The first Constitution of the State of Texas in 1845 provided that "[n]o corporate body shall hereafter be created, renewed, or extended, with banking or discounting privileges,"[3] and this prohibition against the chartering of banks was carried forward into the Constitutions of 1861 and 1866, deleted in the Constitution of 1869, and added back into the Constitution of 1876 as Article XVI, § 16. Thus, from 1865 through 1904, state chartered banks, or "corporate" bodies with banking and discounting privileges, were prohibited in Texas. Congress passed the National Bank Act of 1863[4] that permitted national banks to operate within the borders of Texas, but the scarcity of capital in the post-Civil War era made it extremely difficult to raise $50,000, the minimum capital required. As a result, the establishment of private banks was encouraged and the private banking system developed in Texas simultaneously with the growth of national banks. By 1905, at least 197 private banks were operating in Texas.[5]

In 1904, the Texas Constitution was amended to permit state chartered banking, and the first sentence of Article XVI, § 16 stated that "[t]he Legislature shall by general laws, authorize the incorporation of corporate bodies with banking and discounting privileges, and shall provide for a system of State supervision, regulation and control of such bodies which will adequately protect and secure the depositors and creditors thereof."[6] However, the 1905 banking laws did not bring private banks under supervision because of constitutional questions, and private banks were permitted to exist alongside state and national banks.[7] By 1914, over 1,000 state banks had been chartered.[8]

This then was the scenario at the time of the enactment of the Federal Reserve Act,[9] the predecessor statute to the FDI Act. However, as the preceding discussion and the discussion below regarding the nature of an "incorporated" entity demonstrate, a limited banking association would clearly have been considered a "corporate body" with banking and discounting

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[3]TEX. CONST. of 1845, art. VII, § 30, *reprinted in* TEX. CONST. app. 502, 518 (Vernon 1993).

[4]Act of June 3, 1864, ch. 106, 13 Stat. 99 (codified as amended at 12 U.S.C. § 21, *et seq.*).

[5]J. GRANT AND L. CRUM, THE DEVELOPMENT OF STATE-CHARTERED BANKING IN TEXAS, 31 (Bureau of Business Research, University of Texas at Austin ed. 1978).

[6]The provision today reads "[t]he Legislature shall by general laws, authorize the incorporation of state banks and savings and loan associations and shall provide for a system of State supervision, regulation and control of such bodies which will adequately protect and secure the depositors and creditors thereof." TEX. CONST. art. XVI, § 16(a) (Vernon 1993).

[7]J. GRANT AND L. CRUM, *supra* at 43-44.

[8]*Id.* at 49.

[9]The Federal Reserve Act was originally adopted by Pub. L. No. 63-42, ch. 6, 38 Stat. 251 (1913) (codified at 12 U.S.C.A. § 221, *et seq.* (1989 and Supp. 1994)).

privileges as was prohibited by the Texas Constitutions of 1845, 1861, 1866, and 1876, and authorized by the 1904 amendment to the Texas Constitution of 1876.

History of Federal "Incorporation" Requirements

The Federal Reserve Act sets forth entities which are eligible to make application for membership in the Federal Reserve:

> Any bank incorporated by special law of any state, or organized under the general laws of any state or of the United States, including Morris Plan banks and other incorporated banking institutions engaged in similar business, desiring to become a member of the Federal Reserve System, may make application to the Board of Governors of the Federal Reserve System ....
>
> Upon the conversion of a national bank into a State bank, or the merger or consolidation of a national bank with a State bank which is not a member of the Federal Reserve System, the resulting or continuing State bank may be admitted to membership in the Federal Reserve System ... in accordance with the provisions of this section, but, otherwise, the Federal Reserve bank stock owned by the national bank shall be canceled and paid for as provided in § 287 of this title ....[10]

If the term "incorporated" in the above statute were read strictly, it would refer to a bank which is a corporation and has a corporate charter; however, the statute also clearly states that a bank which is "organized under the general laws of the state" would also qualify to apply for membership. The term "organized" does not necessarily refer to a corporate body, but rather could be applied to any business organization such as a partnership, a limited partnership, a limited liability company, or joint stock association.[11] The term "special law" refers to the granting of corporate charters under special acts of state legislatures, as opposed to "general laws" which are general corporate statutes providing for incorporation without special legislative favor.[12] The Texas Constitution contains provisions which effectively prohibit special laws.[13] With the state's movement toward codification, this distinction in modern business law does not seem to have much, if any, significance. Reference to such terms in the Federal Reserve Act likewise does not seem to have any particular significance, and the statute could easily be read to mean "any bank incorporated or organized under the laws of any state ...."

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[10]Federal Reserve Act, Pub. L. No. 63-42, ch. 6, § 9, 38 Stat. 251, 259 (1913) (codified as amended at 12 U.S.C.A. § 321 (1989)).

[11]H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES, ch. 1, §§ 16-17 (West 3rd ed. 1983).

[12]*Id.* at ch. 1, § 12.

[13]TEX. CONST. art. III, § 56 (Vernon 1984).

The principal focus of the statute seems to be that in order to be eligible for membership, the entity must be a "bank," which is defined to include "State bank, banking association and trust company, except where national banks or Federal Reserve banks are specifically referred to."[14] The term "State bank" is defined for purposes of the Federal Reserve Act as:

> [A]ny bank, banking association, trust company, savings bank (other than a mutual savings bank), or other banking institution which is engaged in the business of receiving deposits and which is incorporated under the laws of any State ... or which is operating under the Code of Law for the District of Columbia (except a national banking association).[15]

This definition is made specifically applicable to the merger and conversion provisions (Subchapter XV) of the National Bank Act and § 321, which establishes the banking entities that are eligible for membership in the Federal Reserve.

We have reviewed the Congressional Record, which contains the legislative history of the Federal Reserve Act, and find no references that provide any further insight into the background or intent behind the foregoing provisions. The historical intent of the Federal Reserve Act was to establish a system of federal regulation to provide greater governmental participation in the banking system, among other purposes, in contrast to the system of private banking which existed at the time.[16] Private banking, as the preceding discussion demonstrates, refers to privately held business organizations which had not received any charter, franchise, or other state or federal approval to conduct banking activities.[17] The roots of this system reach to 19th century commercial banking when the powers of incorporated banks were generally limited to "core" banking activities[18] and when "corporate bodies" with banking and discounting privileges were prohibited in Texas. Nationally, the growth of private banking empires which were permitted to engage in securities and other "non-core" banking activities, such as established by J.P. Morgan & Co. (which apparently operated without a charter or other state or federal authorization), led the populists to seek to curtail this activity by requiring state authorization.[19] Therefore, the reference to a bank being incorporated or organized under a special or general

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[14]Federal Reserve Act, Pub. L. No. 63-42, ch. 6, § 1, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C.A. § 221 (1989)).

[15]12 U.S.C.A. § 214 (1989).

[16]E. SYMONS, JR., J. WHITE, BANKING LAW, ch. 1, § 1 (West 2d ed. 1984). *See also*, 79 Cong. Rec. 6657-6658 (1935).

[17]*Id.*, *See also*, TEX. CONST. art. XVI, § 16, interp. commentary (Vernon 1993).

[18]*Id.*

[19]*See, e.g.*, 79 Cong. Rec. 6578-6579 (1935).

law of a state relates more to a state or federally approved, organized, chartered, or incorporated bank, as opposed to the "private bank" which was unregulated and viewed negatively by many.[20]

The system of federal deposit insurance was instituted on a temporary basis in 1933 with the creation of the Federal Deposit Insurance Corporation ("FDIC").[21] Historically, all banks which were members of the Federal Reserve System on or before July 1, 1934 were required to become stockholders of the FDIC by such date.[22] No state bank was eligible for membership in the Federal Reserve System until it became a stockholder of the FDIC, and thereby became an insured institution.[23] The system was later changed in 1935 to provide for a permanent insurance fund; the stock of the FDIC was purchased by the Secretary of the Treasury on behalf of the United States, and the deposit insurance system was maintained through assessments directly on the insured institutions.[24] In addition, the definition of "State bank" was expanded to include any unincorporated bank that had insured deposits on the effective date.[25]

The federal deposit insurance provisions continued as a part of the Federal Reserve Act until September 21, 1950, when Congress passed the FDI Act. With this FDI Act, the definition of "State bank" was changed slightly to effectively provide that institutions which were only accepting trust funds did not meet the deposit recovery test for insurance.[26] An additional modification to the definition of "State bank" was made in connection with the FIRREA amendments adopted in 1989 wherein the definition was amended to include "any cooperative bank or other unincorporated bank, the deposits of which were insured by the Corporation on the day before August 9, 1989."[27] The definition of state bank for purposes of the Federal Reserve Act is nearly identical to the definition of state bank in the FDI Act at 12 U.S.C.A. § 1813(a)(2), except that the latter seems to clarify that the conditions described (in (a)(2)(A) of receiving deposits and in (a)(2)(B) of being incorporated under the laws of any state) refer to "bank, banking association, trust company" and not just "other banking institution" under the definition. This distinction is not so clear in the Federal Reserve Act definition contained in the original language under the National Bank Act, quoted above as § 214.

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[20] *Id.* *See also* SYMONS AND WHITE, *supra*.

[21] Act of June 16, 1933 (Banking Act of 1933), Pub. L. No. 73-66, 48 Stat. 162.

[22] *Id.* at § 12A(c).

[23] *Id.* at § 12A(f).

[24] Act of August 3, 1935 (Banking Act of 1935), Pub. L. No. 74-305, 49 Stat. 708.

[25] *Id.* at § 101[12B(c)(1)].

[26] *Id.* at § 2[3] (codified as amended at 12 U.S.C.A. § 1813 (1989)).

[27] Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989).

for federal deposit insurance, they must be incorporated in the State of Texas and be engaged in the business of receiving deposits, other than trust funds." However, Mr. Hove further stated:

> We have reviewed HB 1212, enacted by the Texas Legislature, which provides for the creation of state limited banking associations. Assuming that pursuant to HB 1212 such institutions would be organized under Texas law, and may elect to receive deposits other than trust funds, we conclude that Texas limited banking associations could be eligible for federal deposit insurance (emphasis added).

Nature of an Incorporated Entity

The foregoing discussion suggests that the use of the word "incorporated" should be read synonymously with "chartered" or "organized" rather than as describing a type of legal entity eligible for insurance coverage. The following discussion focuses on use of the term in the latter sense, if it is perceived necessary.

The three basic types of business organizations at common law were proprietorships, general partnerships, and corporations. Proprietorships and general partnerships required no grant of authority by the sovereign because they had no existence separate and apart from that of their owners. By contrast, a corporation required that a sovereign power bring it into existence and imbue it with whatever attributes it might possess. It is the grant of authority from, and sanction by, the sovereign which is at the essence of the act of "incorporation." Legal scholars have not been able to agree on a perfect definition of the term "corporation" and, in fact, volumes have been written on the subject.[32] Some early definitions of a corporation include:

> Bouvier: "A body, consisting of one or more natural persons, established by law, usually for some specific purpose, and continued by a succession of members."[33]
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> Chief Justice Marshall: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created ...."[34]
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> Chief Justice Baldwin of Connecticut defined a corporation as "an association of persons to whom the sovereign has offered a franchise to become an artificial, juridical person, with a name of its own, under which they can act and contract,

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[32] *See, e.g.*, 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 3 (rev. perm. ed. 1990).

[33] *Id.*

[34] *Id.* (quoting *Dartmouth College v. Woodward*, 17 U.S. 518, 636 (4 Wheat), 4 L. Ed. 629 (1819)).

> and sue and be sued, and who have ... accepted the offer and effected an organization in substantial conformity with its terms."[35]
>
> A corporation cannot be created by a mere agreement of the associates, but it is necessary to obtain sovereign sanction, for corporations today can be created only by or under legislative authority. A corporation cannot exist without the consent or grant of the sovereign; this power to create a corporation is one of the attributes of the sovereign.[36]

At one time the term "incorporated" could be read as signifying a corporation, as distinct from a proprietorship or general partnership. However, as state legislatures and the Congress have expanded upon the types of entities existing at common law, this is no longer the case.

Responsive to the needs of modern commerce, a number of hybrid entities with characteristics of both partnerships and corporations have been created by statute. Among these hybrid entities that have been authorized by the Texas Legislature are limited partnerships, limited liability companies, limited liability partnerships, close corporations, banking associations,[37] and limited banking associations. Each of these entities has some attributes common to corporations and others common to partnerships. Each receives a charter from the state that empowers it, to a greater or lesser extent, to exist independently of its owners, and act and be responsible for its actions independently of its owners. In this sense, each of these organizations is "incorporated" under the laws of the State of Texas.

A limited banking association could not exist without specific approval of the Texas State Banking Board. TEX. REV. CIV. STAT. ANN. art. 342-310 (Vernon Supp. 1994) provides that a certificate of incorporation will be issued to a limited banking association upon conversion from a national bank or, as provided by rule 3.38,[38] from a state bank. This does not change the fact that a limited banking association has certain basic characteristics which enable it to be treated as a partnership under Subchapter "K" of the Internal Revenue Code. The prospect that a limited banking association may be eligible for partnership tax treatment under Subchapter K does not mean that it cannot be considered to be an incorporated entity, chartered and organized under the laws of the State of Texas as a state bank, and, therefore, eligible for membership in the Federal Reserve System or accepted by the FDIC as an insured bank. A limited banking association is a new form of banking association that is modeled after a limited liability company. The limited liability company has certain characteristics which, for state law purposes, make it similar to a corporation; however, for purposes of the Internal Revenue Code,

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[35] *Id.* (quoting *Mackay v. New York, N.H. & H.R. Co.*, 72 A. 583, 82 Conn. 73 (1909)).

[36] *Id.* at § 15 (quoting *Airvator, Inc., v. Turtle Mountain Mfg. Co.*, 329 N.W.2d 596 (N.D. 1983)).

[37] State banking associations formed from 1905 to 1937 did not have the corporate characteristic of limited liability, and state banking associations formed from 1905 to 1963 did not have the corporate characteristic of perpetual life.

[38] 7 TEX. ADMIN. CODE § 3.38 (West 1994).

a limited liability company may be eligible for partnership tax treatment.[39] So too, the limited banking association has various characteristics which would qualify it for different treatment depending on the statute and the policy reasons embodied in the statute.

The FDIC and other regulatory authorities have recognized that an entity can be treated as incorporated for banking and state law purposes even though taxed as a partnership. Significantly, the FDIC and the other regulators have reached such conclusion in the case of limited liability companies. In other words, the FDIC concluded that a limited liability company is incorporated under the banking laws even though it is taxed as a partnership. Nothing about the legislation facilitating Texas limited banking associations suggests that they be treated differently.

The FDIC, the Comptroller of the Currency and the Board of Governors of the Federal Reserve System have permitted banks (including state nonmember banks) located in East Texas to form and invest in a bank service corporation organized as a Texas limited liability company, despite the fact that a "bank service corporation" is defined in 12 U.S.C.A. § 1861(b)(1) as "a corporation organized to perform services ..." (emphasis added). Implicitly, then, the FDIC must have reached the conclusion that the limited liability company was sufficiently a "corporation" to satisfy the purposes of the Bank Service Corporation Act. The limited liability company is a state-chartered and state-regulated entity that, like a limited banking association, is taxed as a partnership for Federal income tax purposes.

This concept was recognized as early as 1930 in a case involving a Lloyd's plan insurance organization under the Texas Insurance Code.[40] The Lloyd's plan organization under the Texas statute is an association of individuals and partnerships joined together under articles of agreement to provide a specific type of insurance. The articles of agreement must be filed and approved by the Texas Insurance Commissioner. Nevertheless, a federal court held that the Lloyd's plan organization was an "insurance corporation" for purposes of the federal bankruptcy laws as they then existed, and as such, it was specifically excluded from protection under the bankruptcy laws.[41] In finding certain corporate attributes, the court stated:

> [T]hat the sovereignty authorized the creation of the Lloyd's; that it provided for the transaction of business through an agent; that it might sue and be sued; that there would be succession. These are the marks of a corporation .... For purposes of administration, the national government may denominate certain associations as corporations. That seems to be what Congress has done in the Bankruptcy Act.[42]

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[39]Rev. Rul. 88-76, 1988-2 C.B. 360.

[40]*In Re Lloyd's of Texas*, 43 F. 2d 383 (D.C. Tex. 1930).

[41]*Id.*

[42]*Id.*

Corporate Characteristics Relevant to Federal Income Tax Status

In telephone conversations last June, FDIC employees expressed concern regarding certain corporate characteristics that must be lacking for a limited banking association to be taxed as a partnership for federal income tax purposes, and whether the absence of those factors must preclude FDIC insurance. As you by now are aware, an entity must lack at least two of the following four corporate characteristics to be classified for federal income tax purposes as a partnership: (i) perpetual life, (ii) centralization of management, (iii) limited liability, and (iv) free transferability of interests.[43] The Internal Revenue Service focuses on these characteristics solely to determine how an entity should be taxed. The characteristics are not meant to dictate how an entity should be treated for non-tax purposes. However, while we believe based on recent conversations that the safety and soundness issues have been satisfactorily resolved by the FDIC, we will address these corporate characteristics as requested. As discussed below, the lack of some of these characteristics would actually have a favorable effect on the safety and soundness of a limited banking association as compared to a conventional bank.

Perpetual Life. The FDIC has expressed a concern that a limited banking association may cease to remain in existence if it does not have a perpetual life. At last count, over 100 conventional state banks in Texas did not have a provision for perpetual existence in their Articles of Association. In fact, numerous Texas state banks have experienced technical dissolutions by reason of the expiration of their terms of existence, and were permitted by the FDIC and this Department to amend their Articles of Association to extend their lives, without any threatened loss of deposit insurance.

Although a limited banking association can technically dissolve (as can a conventional state bank), the shareholders of a limited banking association can elect to continue operations[44] and can extend the period of duration of a limited banking association by amendment to the limited banking association's Articles of Association. This power is completely analogous to the practice of the FDIC and the Department to permit conventional state banks that have dissolved to vote to continue operations and to ratify their past actions. A lack of the "perpetual life" factor is therefore not relevant in the context of insurability.

Centralization of Management. As a practical matter, a limited banking association will have centralization of management in a board of directors. This corporate characteristic may be lacking if a limited banking association has a small group of shareholders who reserve management authority to the participants in their membership capacities. State banking law treats these shareholders (or "participants" as they are so labeled) as the board of directors for all purposes.[45] The lack of centralization of management would, however, be favorable to the FDIC in its corporate capacity. If such a limited banking association were to fail, unlike conventional banks, the FDIC could pursue director liability claims against all of the

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[43] 26 C.F.R. § 301.7701-2 (1994).

[44] TEX. REV. CIV. STAT. ANN. art. 342-371 (Vernon Supp. 1994).

[45] TEX. REV. CIV. STAT. ANN. art. 342-372 (Vernon Supp. 1994).

shareholders of the limited banking association because they would also be the managers of the limited banking association. In contrast, the FDIC cannot pursue claims against the shareholders of a failed conventional bank.

Limited Liability. As you are aware, the shareholders of conventional banks have limited liability, meaning that such shareholders are only subject to the loss of their investment in a conventional bank. However one or more participants of a limited banking association may elect to be fully liable for the entire amount of any debt, obligation, or liability of the limited banking association.[46] Full liability of some or all of the shareholders of a limited banking association is favorable to the FDIC because it provides an additional party that the FDIC may pursue for claims it may have against the bank. As to the viability of this factor as a determining "corporate" factor, one must bear in mind that shareholders of banks did not always have limited liability,[47] and the lack of this "corporate" characteristic is therefore not relevant in the context of insurability.

Free Transferability of Interests. Limitations on the transferability of ownership interests in a limited banking association do not differ in substance from transfer restriction agreements routinely entered into by the shareholders of closely held banks. The FDIC is protected by 12 U.S.C.A. § 1817(j) and 12 C.F.R. § 5.50, which govern changes in ownership of insured financial institutions. In fact, limited transferability of ownership interests would have a positive effect on the FDIC as it provides an additional check on the ownership of limited banking associations.

Conclusion

In conclusion, we believe that the limited banking association should be considered to be incorporated under Texas law in the sense that it is a "corporate body" as contemplated by the Texas Constitutions of 1845, 1861, 1866, 1876, and as amended in 1904; that it is a creation of statute and has a separate existence apart from its owners; and that it is required to undergo the rigorous regulatory scrutiny, capital requirements, and other supervisory analysis that any other state bank charter must undergo. Finally, it can be created only upon the act of the State Banking Board and the Banking Commissioner. For purposes of the FDI Act and the Federal Reserve Act, this entity may be said to be "incorporated" while at the same time maintaining its characteristics as an entity which would be taxed pursuant to the provisions of Subchapter K of the Internal Revenue Code.

We recognize that the limited banking association is unique in the banking industry. However, we have monitored the development of the statutory provisions authorizing this new form of state bank, and are confident that this Department can exercise the degree of regulatory and

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[46] TEX. REV. CIV. STAT. ANN. arts. 342-361 and 342-364(b) (Vernon Supp. 1994).

[47] *See* 12 U.S.C. §§ 63-64 (repealed 1959); TEXAS CONST. art. XVI, § 16 (1904, before amendment in 1937).

supervisory authority necessary to ensure the safe and sound operation of limited banking associations.

Please feel free to call or write me if you have any questions or comments.

Sincerely,

Everette D. Jobe
General Counsel

cc: Catherine A. Ghiglieri
Banking Commissioner of Texas

Kenneth L. Walker, Regional Director
Dallas Regional Office
Federal Deposit Insurance Corporation

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A national bank converting into a state bank appears to be automatically insured pursuant to the conversion provisions of the FDI Act:

> Subject to § 1815(d) of this title -
>
> (1) any State depository institution which results from the conversion of any insured Federal depository institution; and
>
> (2) any Federal depository institution which results from the conversion of any insured State depository institution, shall continue as an insured depository institution.[28]

We can think of no discernable policy reason to treat an insured state bank differently if it converts into another form of state charter. In fact, Federal Reserve Regulation H governing membership of state banking institutions in the Federal Reserve System can be read to support the point that a state bank, engaged in the business of receiving deposits and not already insured under the FDI Act, that becomes a member of the Federal Reserve System will become an insured bank automatically.[29] In the case of an insured bank which is admitted to membership in the Federal Reserve System, the bank will continue to be an insured bank. No application for federal deposit insurance is required of a national bank converting to a state bank and no application should be required of a state bank converting into another form of state bank.

The emphasis in the FDI Act is clearly not on whether a bank is incorporated, but rather whether it is a bank, as defined by a state banking authority or other federal authority. The suggestion that only "incorporated" state banks are eligible seems misguided since no such distinction is made for national banks. A national bank, which is clearly entitled to be a member of the Federal Reserve and automatically insured by the FDIC, is not described anywhere in the National Bank Act as being incorporated, but rather organized as an association.[30] The term "association" has historically been used to refer to state and national banks by statute and common usage. This terminology likely resulted from the fact that historically bank stockholders were subject to personal liability for actions of the bank and losses incurred by the bank.[31]

The FDIC itself has used the terms "incorporated" and "organized" synonymously in the specific context of limited banking associations. On July 28, 1993, Andrew C. Hove, Jr., Acting Chairman of the FDIC, in response to an inquiry from this office, stated (as quoted in your letter of July 28, 1994) that "in order for Texas limited banking associations to be eligible

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[28] 12 U.S.C.A. § 1814(c) (1989).

[29] 12 C.F.R. § 208.3 (1963).

[30] Act of June 3, 1864 (National Bank Act), Rev. Stat. § 5133, 13 Stat. 100 (codified as amended at 12 U.S.C.A. §§ 21, *et seq.*).

[31] *See* 12 U.S.C. §§ 63-64 (repealed 1959); TEXAS CONST. art. XVI, § 16 (1904, before amendment in 1937).