File

94/CS-02

Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6000

February 14, 1994

[redacted]

Re: Proposed Option Agreement Between [redacted]

Dear [redacted]

This is in response to your letters of March 8, 1993 and August 17, 1993, to James H. Underwood, Special Counsel, Office of Thrift Supervision ("OTS"), on behalf of [redacted] (the "Holding Company" or the "Optionor"), a registered unitary savings and loan company which owns 100% of the outstanding common stock of [redacted] (the "Bank"). Your letters seek certain interpretative advice under the Savings and Loan Holding Company Act and regulations (the "Control Regulations") promulgated thereunder[1], and under the OTS's regulations defining "affiliate" (for purposes of transactions with affiliates)[2] and "controlling person"[3], in connection with the proposed granting of an option (the "Option") to [redacted] (the "Optionee" or "[redacted]") to acquire common stock of the Holding Company. I apologize for the delay in responding to your inquiry.

You have requested confirmation that, based on the facts and representations made in your letters, the granting of the Option to [redacted] will not cause [redacted] to be deemed to have acquired control of the Holding Company. You have specifically requested confirmation that:

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1. 12 U.S.C. §1467a; 12 C.F.R. Part 574 (1993).

2. 12 C.F.R. § 563.41 (1993).

3. 12 C.F.R. § 561.14 (1993).

(i) the Option to be granted by the option agreement (the "Option Agreement") attached as an exhibit to your letter of August 17, 1993, will not constitute "voting stock" of the Holding Company under 12 C.F.R. § 574.2(u)(1) or (3), or "stock" as defined in 12 C.F.R. § 574.2(s) such that its acquisition might be deemed acquisition of more than 25% of any class of voting stock under 12 C.F.R. § 574.4(b)(1)(ii);

(ii) that the Optionee would not be considered an "affiliate" of the Bank for purposes of the OTS's transactions with affiliate regulation, 12 C.F.R. § 563.41(b)(1); and

(iii) that the Optionee would not be considered to be a "controlling person" of the Holding Company or the Bank under 12 C.F.R. § 561.14 solely on the basis of the acquisition of the Option.

On the basis of the facts presented and representations made in your letters and the Option Agreement, and subject to the caveats noted herein, we concur that the Option to be granted to the Optionee under the Option Agreement would not constitute "voting stock" or "stock" of the Holding Company as defined under the Control Regulations and that the granting of the Option would not cause the Optionee to be deemed to be an "affiliate" under 12 C.F.R. § 563.41 or a "controlling person" of the Holding Company or the Bank under 12 C.F.R. § 561.14.

I. BACKGROUND

You have advised us that the Holding Company intends to grant an option to acquire 50% of its common stock to a third party corporation, [redacted], that is owned by persons not affiliated with the Holding Company or its stockholders. Since 1990, the Bank has engaged in single-family mortgage banking activities with nonaffiliated mortgage banking entities. Typically, these third party mortgage bankers act as secondary marketing agents for the Bank by purchasing loans originated by the Bank that are not eligible to be purchased by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association and reselling them to investors in the national secondary market for such loans. You have advised us that these activities have been conducted in accordance with the Bank's business plan that was approved by the OTS.

The Bank intends to enter into a similar arrangement with [redacted]. According to your letter, the Bank believes that that [redacted] offers expanded opportunities for the Bank to increase its origination of non-conforming mortgage loans and will provide a more favorable array of

loan products and prices than other mortgage banking entities that are willing to contract with the Bank. In order to induce [redacted] to enter into this arrangement with the Bank, you have stated that the Holding Company intends to grant an Option to [redacted] to purchase 50% of the Holding Company that is conditioned upon [redacted] having purchased at least $500 million of mortgage loans from the Bank on terms and conditions that are acceptable to the Bank during the term of the Option Agreement. The Option is proposed to be issued pursuant to an option agreement with the following material terms:

(i) consideration for the Option will be $25,000;

(ii) the Option will have a term of seven years;

(iii) exercise of the Option will be conditioned upon the Optionee having met specified mortgage loan purchase requirements; provided, that the failure of the Optionee to purchase mortgages due to the failure of the Bank to originate a sufficient volume of mortgages will not be deemed a default under the Option Agreement;

(iv) the exercise price for the Option will be $350,000;

(v) in the event that the Option is exercised and there is a subsequent sale of the Holding Company or the Bank, the parties to the Option Agreement agree, notwithstanding the ownership interests of the parties, to divide up the proceeds of the sale in accordance with the terms of the Option Agreement;

(vi) in the event that the Optionee is unable to obtain required regulatory approvals to exercise the Option, the Optionee has the right to assign the Option to a third party, subject to a right of first refusal in favor of the Holding Company;

(vii) the Optionor agrees to (a) limit executive compensation to a percentage of its taxable income, (b) not issue additional shares of its common stock or preferred stock or authorize another class of stock without making appropriate adjustments in the number of shares subject to the Option, or (c) conclude any sale of its common stock without accomplishing a sale of all of its common stock, including shares issuable pursuant to the Option;

(viii) in the event the Optionee or its assignee exercise the Option, then such party will enter into and become a party to the existing Stock Restriction

and Purchase Agreement applicable to the current stockholders of the Optionor;

(ix) the Option can not be exercised unless all prior required regulatory approvals have been obtained;

(x) the Optionee will not have any voting rights or other rights to control the Optionor or the Bank and the Optionee affirmatively agrees not to attempt to influence the management, policies, or decisions of the Optionor or the Bank, including the appointment of any officers or directors; and

(xi) any provision of the Option Agreement that is to be performed by the Optionor shall be deemed unenforceable to the extent that it is determined by any regulatory authority of either the Optionor or the Bank to constitute an unsafe or unsound practice.

II. DISCUSSION

The primary issue in determining whether [redacted] will acquire a controlling interest in the Holding Company or the Bank is to determine whether the Option will constitute "voting stock" under the Control Regulations. In pertinent part, the definition of voting stock under Part 574 provides that:

> (u)(1) Voting stock means common or preferred stock, general or limited partnership shares or interests, or similar interests if the shares or interests, by statute, charter, or in any manner, entitle the holder:
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> (i) To vote for or to select directors, trustees, or partners (or persons exercising similar functions of the issuing savings association or company); or
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> (ii) To vote or to direct the conduct of the operations or other significant policies of the issuer:
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> (3) Notwithstanding anything in paragraphs (u)(1) and (u)(2) of this section, "voting stock" shall be deemed to include stock and other securities that, upon transfer or otherwise, are convertible into voting stock or exercisable to acquire voting stock where the holder of the stock, convertible security or right to acquire voting stock has the preponderant economic risk in the underlying voting stock. Securities immediately

> convertible into voting stock at the option of the holder without payment of additional consideration shall be deemed to constitute the voting stock into which they are convertible; other convertible securities and rights to acquire voting stock shall not be deemed to vest the holder with preponderant economic risk in the underlying voting stock if the holder has paid less than 50% of the consideration required to directly acquire the voting stock and has no other economic interest in the underlying voting stock.[4]

Under the terms of the Option, it is clear that the Optionee will have paid less than 50% of the consideration required to directly acquire the voting stock of the Holding Company. Thus, unless it is determined that the Optionee has some other economic interest in the underlying stock that is the subject of the Option, the Optionee should not be deemed to have acquired "voting stock" under the Control Regulations by acquiring the Option. Although there will be an ongoing business relationship between the Bank and the Optionee, you have advised us that the terms of that relationship will be usual and customary for transactions of that type and consistent with other arms-length arrangements that the Bank has with other mortgage banking entities. Based upon those representations and the other restrictions set forth in the Option Agreement prohibiting the Optionee from attempting to influence the policies or management of the Bank and the Holding Company, we concur with your view that the Optionee will not not have an economic interest in the underlying stock for purposes of § 574.2(u)(3) and with your view that the Option does not constitute voting stock of the Holding Company.

Similarly, we concur with your view that Option does not constitute "stock" as is defined in the Control Regulations[5] such that its acquisition might be considered acquisition of more than 25% of a class of stock under 12 C.F.R. § 574.4(b)(1)(ii). As defined in § 574.2(s), "stock" "means common or preferred stock, general or limited partnership shares or similar interests." Based on the facts described in your letter, the Option to acquire common stock of the Holding Company should not be deemed to be common stock for

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4. 12 C.F.R. § 574.2(u) (1993).

5. See 12 C.F.R. § 574.2(s) (1993).

purposes of § 574.2(s) since the holder of the Option will not have the preponderant economic risk in the underlying common stock.[6]

Finally, we also concur with your view that the Optionee should not deemed to be an "affiliate" of the Bank as defined in 12 C.F.R. §563.41(b)(1) or a "controlling person" of the Holding Company or the Bank as defined in 12 C.F.R. § 561.14 solely by reason of Optionee's acquisition of the Option under the circumstances described in your correspondence. As you note in your letter, you understand that there are other grounds for a determination that the Optionee might be found to be either a "controlling person" or an "affiliate" of the Holding Company or the Bank and your request is limited to the impact of the granting of the Option.

With respect to the issue of the Optionee being an "affiliate" of the Bank, the only provision of § 563.41(b)(1) that would be applicable to the facts described in your correspondence would be subsection (b)(1)(i). Subsection (b)(1)(i) provides that an affiliate of a savings association shall include "[a]ny company that controls the savings association...." Under § 563.41(b)(3)(i), a company shall be deemed to have control over another company if that company, "directly or indirectly, or acting through one or more persons owns, controls, or has the power to vote 25 per centum or more of any class of voting securities of the other company" or if the company would be deemed to control another company under § 574.4(a) or (b).[7]

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6. An option to acquire "voting" stock, whether common or preferred, is not considered to have the same attributes of control that the underlying stock possesses unless the holder of the option has the preponderant economic risk in the underlying voting stock. See subsection 574.2(u)(3) and the discussion in the preamble in the release adopting the Control Regulations, 50 Fed. Reg. 48686, 48691-48692 (Nov. 26, 1985). It would be incongruent with the regulatory scheme set forth in the Control Regulations to conclude that an option to acquire common stock would trigger a requirement to rebut the presumption of control under § 574.4(b)(1)(ii) but would not trigger it under § 574.4(b)(1)(i). Thus, absent other facts that would indicate the ability to exercise control, the acquisition of an option to acquire common stock where the holder is not subject to the preponderant economic risk of the underlying common stock will not result in the holder of the option having to rebut the presumption of control under § 574.4(b)(1)(ii).

7. 12 C.F.R. § 563.41(b)(3)(i).

Based on the facts described in your correspondence, the Optionee will not have the power to vote 25% or more of any class of voting securities of either the Bank or the Holding Company. As discussed above, it is also clear that the Optionee will not have acquired control under § 574.4(a) or (b) since the Optionee will not have acquired "voting stock" or "stock" for purposes of those sections. Therefore, the Optionee should not be deemed to control the Bank or the Holding Company under § 563.41(b)(1)(i) and would not be an "affiliate" of the Bank.

The Optionee should also not be deemed to be a "controlling person" under § 561.14. Section 561.14 defines controlling person of a savings association to mean "any person or entity which, either directly or indirectly, or acting in concert with one or more other persons or entities, owns, controls or holds with power to vote, or holds proxies representing, ten percent or more of the voting shares or rights of such savings association; or controls in any manner the election or appointment of a majority of the directors of the savings association." As in the case of the definition of "voting stock", the granting of an option under circumstances where the Optionee does not have the preponderant economic risk in the underlying stock should not result in the Optionee being deemed to have acquired voting shares for purposes of § 561.14.[8] Assuming that the Optionee does not otherwise have the ability to control the election or appointment of a majority of the directors of the Bank, we concur with your view that the Optionee is not a "controlling shareholder" under § 561.14.

In reaching the foregoing conclusions, we have relied upon the factual representations contained in the materials presented to us. The positions set forth herein therefore depend upon the accuracy and completeness of those representations. Moreover, any change in circumstances from those set forth in your submissions could result in conclusions different from those expressed herein.

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8. As noted in the preamble to the release adopting the Control Regulations, 50 Fed. Reg. 48686, 48691 (Nov. 26, 1985), the definition of "controlling person" in the Control Regulations was derived from § 561.14. Based on the facts in this case, it would be inconsistent to treat an option to acquire common stock under § 561.14 in a manner different than the treatment afforded under the Control Regulations.

If you have any questions regarding the foregoing, please contact James H. Underwood, Special Counsel, at (202) 906-7354.

Sincerely,

Carolyn Lieberman
Acting Chief Counsel

cc: Regional Director
Regional Counsel
Midwest Region