

## A Nice Step Forward: New Q&As on the FDIC's Policy Statement for Failed Bank Acquisitions

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On April 23, 2010, the FDIC issued [new Q&As](#) (the "**April Q&As**") that clarify certain aspects of its Statement of Policy for Failed Bank Acquisitions (the "**Policy Statement**"), but leave the contours of the Policy Statement largely intact.<sup>1</sup>

While there are still ambiguities in the Policy Statement, it is fair to say that the FDIC is signaling a practical way forward for private investors to enter the queue for failed institutions. The April Q&As help clarify the so-called "one-third test," requirements for offshore investors, information requirements applicable to non-Policy Statement investors and the application of the Policy Statement to recapitalization transactions. It will remain extremely important for private investors to engage the FDIC staff, as every transaction will inevitably require some degree of judgment and discretion on the part of the FDIC on a variety of supervisory issues, including the Policy Statement.

### **Clarity Regarding Application of the Policy Statement and Less-Than-5% Investors**

The April Q&As address a number of outstanding questions regarding the application of the Policy Statement in circumstances in which a substantial number of less-than-5% investors seek to make capital contributions.

Although the Policy Statement exempts investors that own 5% or less of the total voting power when there is no evidence of "concerted action," the FDIC presumes concerted action among less-than-5% investors where, in the aggregate, these less-than-5% investors own more than two-thirds of the total voting power. As a result, other private investors whose interests constitute a minimum of one-third ownership and the insured depository institution itself must be bound by the Policy Statement in order for the less-than-5% investors outside of this "anchor group" to be exempted. This has been called the "one-third test."

#### **The one-third test may be satisfied through both voting and nonvoting shares**

The April Q&As clarify that the "anchor group" of investors subject to the Policy Statement may satisfy the one-third test with either one-third of an institution's voting shares or one-third of a combination of voting and non-voting shares.

#### **Less-than-5% investors may elect to be subject to the Policy Statement**

The April Q&As further clarify that less-than-5% investors not otherwise subject to the Policy Statement may elect to be part of the "anchor group" of investors subject to the Policy Statement in order to meet the one-third test. Although not explicitly stated in the April Q&As, it would also seem logical for the FDIC to permit a less-than-5% investor to subject a portion of its investment to the Policy Statement and be exempt from the Policy Statement for the remainder of its investment. In practice, this would allow such a less-than-5% investor to be exempt from the Policy Statement's minimum three-year holding period for the portion of its investment not subject to the Policy Statement.

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<sup>1</sup> For a detailed description of the [Policy Statement](#) and the initial "[Questions and Answers](#)" released by the FDIC, please see our Davis Polk Memoranda describing the [Policy Statement](#) and those [Q&As](#).

## When the one-third test must be met

The April Q&As provide that the one-third ownership test needs to be met only at the time of the failed bank acquisition. This implies that a less-than-5% investor does not become subject to the Policy Statement if its ownership percentage exceeds the 5% level as a result of stock purchases or exercises of stock options subsequent to a failed bank acquisition.

## Less-than-5% investors may have rights of first refusal

In addition, the FDIC has made clear that it will permit less-than-5% investors to have rights of first refusal without subjecting them to the Policy Statement. Such investors, however, would become subject to the Policy Statement if the right is exercised and “the purchase results in the Investor holding more than 5% of the voting equity shares” in the investee institution. While the April Q&As are not explicit on this point, we presume that the FDIC will look to the percentage of voting equity that is owned at a time *before* the investee institution engages in a failed bank acquisition.<sup>2</sup>

## Board seats and management positions

Consistent with the FDIC’s position in recent deals, the April Q&As provide that any investor, including a less-than-5% investor, that has the right to designate a board member will be subject to the Policy Statement.

By contrast, members of senior management are not automatically subject to the Policy Statement if they own less than 5% of the voting equity. However, senior management may be subject to the Policy Statement if they would otherwise be subject to its provisions by virtue of their equity share ownership, ability to designate a board member, some combination of such rights, or evidence of concerted action.

## Information from less-than-5% investors

After the release of the Q&As published in January 2010, it remained unclear whether less-than-5% investors would still be subject to the extensive information questionnaires required of investors that are subject to the Policy Statement. Consistent with recent FDIC practice, the April Q&As confirm that less-than-5% investors need only provide the following information:

- The investor's name;
- Type of investor (e.g., mutual fund, hedge fund, individual);
- Domicile;
- Number of shares of voting stock and total equity held by the investor both prior to the capital raise and subsequent to the capital raise; options, warrants, interests convertible into voting stock, and rights to control voting stock owned by others; and
- Shares held by affiliates or immediate family members.

## Clarity on Investments in Existing Bank Holding Companies: “Strong Majority Interest”

The Policy Statement exempts investors that invest directly in an existing bank or thrift holding company where the holding company has a “strong majority interest” in the failed bank and an established record for successful operation of insured banks or thrifts. The FDIC presumes that such an established bank or

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<sup>2</sup> Although the “right of first refusal” Q&A is phrased in terms of permissibility and contains a negative implication that such a right is not permissible for members of the “anchor group,” we do not believe this negative implication was intended.

thrift holding company does not have a “strong majority interest” if new private investors own more than one-third of the voting or total equity of the company on a pro forma basis.

The April Q&As provide additional guidance on this subject by:

- clarifying that there is no minimum holding period applicable to shares held by investors that were shareholders in the existing holding company prior to the injection of new private capital; and
- creating an exemption from the Policy Statement for “recapitalizations” of existing institutions, subject to a limit on the amount of total assets the recapitalized institution may acquire from failed insured depository institutions.

## Preexisting shareholders and holding period

One question left unanswered by prior FDIC guidance was whether the preexisting shareholders of an existing holding company, who were required to own at least two-thirds of the equity to avoid application of the Policy Statement to the new private investors, were required to hold that equity for a particular period of time. In the April Q&As, the FDIC has clarified that no specific holding period is required, but that the FDIC will “take into consideration” whether a “significant portion” of the voting or total equity shares held by preexisting investors was “recently acquired” or was “part of a recapitalization” of the existing institution. The April Q&As do not, however, define “significant portion,” “recently acquired” or “recapitalization,” and so private investors should consider conferring with the FDIC on this issue in transactions in which private investors seek to invest in an existing bank or thrift holding company that is or may in the future be pursuing a bank acquisition.

## Recapitalizations

The April Q&As clarify that “[r]ecapitalizations of existing institutions are not subject to the Policy Statement.” We read this to mean that the mere recapitalization of an existing institution, no matter how troubled, will not implicate the Policy Statement unless that institution thereafter acquires a failed bank. The April Q&As go on to provide some additional guidance regarding the application of the Policy Statement when a recapitalization is followed by a failed bank acquisition. Specifically, the April Q&As note that if new private investors have recently recapitalized an institution and the institution seeks to acquire a failing bank, the FDIC will review “whether the additional capital was provided contingent on completion of failing bank acquisitions.” The April Q&As also provide that the Policy Statement will apply if the recapitalized institution completes the acquisition of one or more failed institutions in an eighteen-month period following its recapitalization and the acquired assets in the aggregate exceed 100% of the recapitalized institution’s total assets.

We recognize that there are certain ambiguities regarding how this aspect of the Policy Statement will apply to recapitalizations. Even the terms “recapitalization” and “contingent” are subject to interpretation. The following examples illustrate how we believe the FDIC intends to approach recapitalizations.

Let’s consider the example of investors engaging in the recapitalization of a large institution in order to facilitate its compliance with regulatory requirements and not for the purpose of facilitating the acquisition of one or more failed banks. To the extent that the recapitalized institution later engages in acquisitions of failed banks, we anticipate that the FDIC will not apply the Policy Statement, provided that the institution complies with the total asset limit set forth in the April Q&As. We expect that bank holding companies and banks that seek to take advantage of the recapitalization exemption will need to commit to investors in the recapitalization that they will conduct their acquisition strategy so that the Policy Statement will not apply.

The example of recapitalizing a large, troubled institution should be contrasted with the “platform bank” or “inflatable charter.” These are smaller institutions, some of which are *de novo* banks, that are substantially overcapitalized with the intent to engage in acquisitions. We anticipate that to the extent such a bank engages in an acquisition of a failed bank, the FDIC will apply the Policy Statement.

A more ambiguous situation arises in connection with providing capital to an otherwise reasonably healthy, large existing institution for the express purpose of acquiring a failed bank. In such a situation, we anticipate that the FDIC will revert to its "strong majority" interest test, as discussed above. Accordingly, in such a case, the FDIC would evaluate the source of the funds for the acquisition. If two-thirds or more of the total equity is owned by the previously existing shareholder base, the Policy Statement will likely not apply; if more than one-third is owned by new investors, the FDIC will likely apply the Policy Statement.

Our sense is that the FDIC will be responsive in providing guidance in specific situations. As with other aspects of the Policy Statement, it will be important to engage the FDIC staff in connection with any transaction.

### Secrecy Law Jurisdiction Issues

The April Q&As clarify the FDIC's recent position that an anchor investor (*i.e.*, an investor that is part of the "anchor group" that is subject to the Policy Statement) may make use of an entity domiciled in a secrecy jurisdiction (an "Offshore Investor") so long as that Offshore Investor holds its investment in the failed bank or bank holding company directly through a wholly owned domestic subsidiary (presumably an entity that is disregarded for U.S. tax purposes), and the Offshore Investor and the domestic subsidiary agree to record maintenance and inspection standards. These standards include maintaining in the U.S. entity books and records of both the wholly owned subsidiary and the Offshore Investor; maintaining in the U.S. a current list of investors in the Offshore Investor; and providing the required books, records and lists to the FDIC upon request as may be necessary to implement and enforce the provisions of the Policy Statement or the FDIC's supervisory, deposit insurance or receivership obligations.

### Conclusion

With the April Q&As, the FDIC has opened a clearer path for private investors in a number of significant ways. It has given less-than-5% investors a better road map for avoiding application of the Policy Statement, while making it easier to form the necessary "anchor group" that must be subject to the Policy Statement for less-than-5% investors to be exempted. It has clarified, in connection with the "strong majority interest" requirement, that no specific holding period is necessary with respect to the shares acquired by preexisting investors. The FDIC has also provided a new exemption from the Policy Statement's application in the case of a recapitalization. Despite this additional clarity, each private investment transaction will raise its own issues, and it will continue to be necessary for private investors to consult with the FDIC when contributing capital in contemplation of an FDIC-assisted transaction.

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