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FDIC and Private Capital: Moving the Goal Lines

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For the second time since adopting its Final Statement of Policy for Failed Bank Acquisitions (the "**Policy Statement**"), the FDIC has issued "Questions and Answers" (the "**Revised Q&As**") about the Policy Statement that appear to make it more difficult for private investors to avoid the onerous standards and requirements of the Policy Statement.[1] The FDIC will now presume that, if more than two-thirds of the total voting stock of an insured depository institution or its holding company that acquires a failed bank or thrift is held by private investors that each own 5% or less of the voting stock, the private investors are acting in concert as a single investor group. The private investors will be subject to the requirements of the Policy Statement unless they can satisfy the FDIC that the presumption has been rebutted. This position seems to confirm the FDIC's preference for transactions in which an existing bank holding company owns at least two-thirds of the voting stock of the acquiring depository institution or its holding company or is itself the acquirer (with new private investors limited to no more than one-third of the existing bank holding company's total equity).

The Policy Statement and the 5 Percent-or-Less Investor

In the Policy Statement, the FDIC took the position that it would not apply the Policy Statement to private investors with 5 percent or less of the total voting power of a depository institution or its holding company that participates in the acquisition of a failed institution, provided there was no evidence of concerted action by the private investors.

As a result, many investment vehicles created after the Policy Statement came into effect were structured in such a way as to keep every investor below the 5% threshold, on the theory that the FDIC was obviously trying to encourage arrangements where capital was being provided by smaller, passive investors that were not in a position to control the management or policies of the institution. This was particularly true of "blind pools," which have been structured so that no investor owns more than 4.9% of the voting stock, and no more than 9.9% of the total equity, of the company that will acquire a failed bank or thrift.[2]

[1] The Revised Q&As were posted on the FDIC's website on January 6, 2010, and can be found at http://www.fdic.gov/regulations/laws/faqfbqual.html. The FDIC had released some "Frequently Asked Questions" about the Policy Statement on December 11, 2009, but these were removed from its website without explanation after two days. The Policy Statement itself, promulgated last August, imposed more onerous standards and requirements for private investors in failed depository institutions than those applicable to existing banks, thrifts or their respective holding companies. The Davis Polk Client Memorandum on the Policy Statement can be found here.

[2] Another example approved by the FDIC shortly before its adoption of the Policy Statement was the State Bank/Security Bank transaction in August 2009. This transaction was structured with voting common stock only, no investor having more than 10% of such stock, and no investor having rights to a board seat or other preferences.

It has been apparent in a number of transactions before the FDIC that the agency is struggling with how to apply the Policy Statement. On the one hand, the FDIC seems receptive to the idea of structures led by new management teams in which numerous new private investors are limited to relatively small voting equity stakes, presumably because these structures look more like the traditional bank ownership model than those structures — such as "club deals" — in which a smaller number of private equity funds or other private investors hold relatively larger voting stakes. On the other hand, the FDIC seems distinctly uncomfortable with the idea that private investors, taking note of the 5%-or-less-of-voting-power safe harbor, would structure investments so that none of the private investors or the institution in which they are investing is subject to the Policy Statement. This discomfort has been reflected in the FDIC's often skeptical questioning of the degree to which private investors in transactions involving "blind pools" or other structures not involving existing bank holding companies acted independently.

In the Revised Q&As, the FDIC now states that it will presume concerted action among private investors making contemporaneous investments of 5% or less of the total voting stock of a depository institution or its holding company that acquires a failed bank or thrift where, in the aggregate, such investors hold more than two-thirds of the total voting power. As a result, in any such transaction structure, each private investor at or below the 5% of voting stock threshold will have to go through some form of rebuttal process with the FDIC, either directly or through the placement agent for the structure, if it wishes to avoid being subject to the Policy Statement.

The Revised Q&As do contain guidance on the factors that the FDIC will consider in evaluating whether the private investors have acted in concert, many of which are similar to those that the various bank supervisory agencies have traditionally used in making "acting in concert" determinations. However, one of the factors — "whether the [investor] has engaged, or anticipates engaging, as part of a group consisting of substantially the same entities as are shareholders of [the] bank/thrift, in substantially the same combination of interests, in any additional banking or non-banking activities in the United States" — is new and is very similar to the text of one of the certifications of "non-collusion" that the Federal Reserve Board has indicated it will require, together with passivity commitments, from certain investors in club deals and similar transaction structures.

The creation of this presumption of acting in concert may create a conundrum for potential private investors. If a private investor is willing to hold more than 5% of the voting stock and thereby become subject to the Policy Statement, it will be required to provide substantial information to the FDIC, agree to a three-year holding period on the investment and prohibitions on loans to affiliated companies, become subject to potential

cross-guarantee liability if there is sufficient common ownership of another insured depository institution, and comply with other restrictions.[3] However, unless there are sufficient investors willing to become subject to the Policy Statement, all of the private investors will need to go through some form of rebuttal process to address a presumption of concerted action, with the risk that the FDIC will ultimately conclude that the presumption has not been rebutted and therefore that the Policy Statement applies to all of the investors.

Ultimately, it appears that to avoid both the application of the Policy Statement to any private investor and the presumption of concerted action, an investment in a failed institution must be structured in one of the following ways:

- An existing bank or thrift holding company holds at least two-thirds of the voting stock and total equity of the company acquiring the failed institution, with private investors holding in the aggregate the remaining one-third or less (but not subject to an individual limit of 5% or less of voting stock). This is the structure envisioned by the Policy Statement's first exemption from its applicability, and is "strongly encouraged by the FDIC." *See* 74 Fed. Reg. 45, 446 (Sept. 2, 2009).
- Private investors invest in an existing bank or thrift holding company that acquires the failed institution. In this structure, the private investors are limited in the aggregate to a maximum of one-third of the total equity of the existing holding company (but not subject to an individual limit of 5% or less of voting stock) with the holding company's shareholders prior to the date of acquisition owning at least two-thirds of its total equity. This is the structure envisioned in the Revised Q&As relating to a direct investment in an established bank or thrift holding company.
- Private investors each hold no more than 5% of the voting stock of a company that acquires a failed institution, and in the aggregate hold two-thirds or less of the company's total voting stock, with an existing bank or thrift holding company owning the remaining one-third or more. (In the absence of a definition of "private investor" in the Policy Statement or the Revised Q&As, it is unclear whether any investor other than an existing bank or thrift holding company would qualify for such a structure.) Although this structure seems less practical, as it would require an existing bank holding company to control the depository institution resulting from the acquisition for purposes of the Bank Holding Company Act of 1956 and act as its source of financial strength while holding potentially less than a

[3] The Policy Statement, if applicable, also requires the depository institution resulting from the acquisition of a failed institution to maintain a 10% common equity to assets ratio for three years. However, in light of the FDIC's decision, as set forth in Financial Institution Letter FIL-50-2009 dated August 28, 2009, to extend the period in which *de novo* insured depository institutions are subject to higher capital requirements (including a Tier 1 leverage ratio of 8%) from three to seven years, we believe that, even if the Policy Statement is ultimately found to be inapplicable to private investors in a company that acquires a failed bank or thrift, the FDIC is nonetheless going to impose equivalent capital levels on any institution funded substantially by new private capital.

majority of its total voting stock, it would be consistent with the Policy Statement's second exemption from its applicability, as modified by the Revised Q&A.

One can certainly question the logic behind the FDIC's new position. Whatever its merits, it seems clear that the FDIC is trying to ensure, in every failed bank transaction, that there is either a sufficiently large, controlling stake held by an existing bank or thrift holding company or else a sufficient number of private investors that are committed to the investment for at least three years and are willing to undergo the regulatory scrutiny inherent in the application of the Policy Statement.

Convertible Securities and the 5% or Less Threshold

The Revised Q&As are more ambiguous regarding the circumstances under which non-voting equity may be used to allow private investors greater economic positions while still not being subject to the Policy Statement. In the December 2009 Frequently Asked Questions, the FDIC seemed to align itself with the other federal banking agencies in determining the acceptable bounds of non-voting equity, and in particular the circumstances in which such equity could convert to voting equity. The FDIC indicated that non-voting shares could become voting in the hands of a subsequent transferee from the private investor if the transfer was in a widespread public distribution; in transfers in which no transferee or associated group would receive 2% or more of any class of voting securities; or to a transferee that would control more than 50% of the voting securities not counting the private investor's transfer.

In the Revised Q&As, the FDIC is less specific, referring only to conversions "under certain circumstances" and immediate transfers from the control of an investor, without specifying any transfer restrictions. This raises the prospect that the FDIC may not defer to the established rules of the other banking agencies, but may instead insist on a case-by-case approach to non-voting shares – which in turn means that additional structuring efforts and engagement with the FDIC may be required for a private investor to hold an economic position larger than its voting position.

Investments in Existing Bank and Thrift Holding Companies

Although the FDIC has clearly indicated its preference for structures involving existing bank or thrift holding companies, the Revised Q&As would also seem to impose additional burdens even in this "strongly encouraged" context.

Partnerships with Existing Holding Companies

The Policy Statement contains an exemption for "investors in partnerships or similar ventures with bank or thrift holding companies or in such holding companies . . . where the holding company has a strong majority interest in the ***resulting bank or thrift*** and an established record for successful operation of insured banks or thrifts." (Emphasis added.) The Revised Q&As seek to clarify this exemption.

With respect to partnerships with existing holding companies, the Revised Q&As state that if the new private investors hold no more than one-third of

the total equity and voting equity in any partnership or joint venture with an existing bank holding company, and there are no special rights provided through covenants, agreements or similar mechanisms that the FDIC finds troubling, the FDIC will deem the existing bank holding company to have the "strong majority interest" contemplated by the Policy Statement.

Direct Investments in Existing Holding Companies

The Revised Q&As impose a similar test for direct investments in existing holding companies. They state that the Policy Statement will not apply, "provided that the shareholders in the established bank or thrift holding company pre-dating the proposed acquisition have at least two-thirds of the total equity of the ***resulting bank or thrift holding company***" (emphasis added), subject to exceptions for covenants and special voting rights. This publicly confirms the position the FDIC took in East West Bancorp, Inc.'s ("**East West**") acquisition of the failed United Commercial Bank in November 2009, in which new private investors made a substantial investment in East West to facilitate the acquisition, but shareholders who were shareholders of East West prior to the acquisition contributed the predominant amount of additional capital.

It is difficult to understand treating partnerships with and direct investments in existing holding companies in exactly the same way. In the first instance, the FDIC is giving effect to its concern that the institution that is managing the bank or thrift whose assets are acquired with FDIC assistance be the bank or thrift holding company with a proven track record – that is, that the private investor partner should not have undue influence via the partnership vehicle. It is not clear that the same concerns apply when there is a direct investment in an existing bank or thrift holding company by multiple independent private investors. In the absence of special rights – which could independently violate the Federal Reserve Board's rules and guidance on non-controlling investments – the existing holding company has the same obligations to all its shareholders. In addition, there may be circumstances in which a holding company with a proven track record can raise capital more efficiently from new private investors instead of existing shareholders.

Conclusion

As we indicated in our Client Memorandum dated August 31, 2009, the FDIC has positioned itself as the gatekeeper of private capital investments in failed banks and thrifts. The Revised Q&As show continued discomfort at the FDIC with such investments, even when made through existing holding companies. The Revised Q&As, however, should not be read as the final word from the FDIC on the subject, particularly as the FDIC has undertaken to revisit the Policy Statement less than two months from now. Regardless of how investments in failed banks are structured, however, and whether or not the Policy Statement ultimately applies, the FDIC is likely to be exacting in its approval process. To be successful, investors in any failed bank transaction will be required to engage the FDIC early, keep it apprised of important structural issues, and provide it with as much information as possible during its review.

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