Davis Polk

PRIVATE EQUITY NEWSLETTER

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Structuring Private Equity Investments in FDIC "Problem" Institutions

The number of insured institutions on the FDIC's "troubled bank" list grew to over 700 at the end of 2009 (nearly three times the number of banks on the list at the end of 2008), representing nearly $403 billion in total assets (up from $159 billion at the end of 2008).[1] Although opportunities abound for private investments in these banks, a private equity fund must take great care when structuring its investment to ensure that it satisfies the requirements of the applicable regulators as well as the needs of the fund and its investors.

The well-publicized requirements regarding private capital investments in failed banks released by the FDIC last summer (the "Policy Statement")[2] are not the only limitations. In addition, a private equity fund must consider other relevant banking laws such as the U.S. Bank Holding Company Act, S&L Holding Company Act and Change in Bank Control Act. These requirements may (and likely, will) continue to evolve as the market for private capital investments in failed banks develops, and the FDIC, as the gatekeeper for failed bank investments, continues to assess the benefits and risks of these investments.

Drawing on our experience in representing acquirers, investors, financial institutions and placement agents in many of the significant private equity investments in financial institutions, we describe the current lay of the land for private equity investors seeking to meet these regulatory challenges.

Control Considerations as the Overriding Concern Under the Bank and S&L Holding Company Acts

Virtually all private equity firms that have participated in failed bank acquisitions have structured their investments to be non-controlling. This is because a controlling investment in a target bank or bank holding company will cause the private equity fund and its general partner to become bank holding companies and subject them to Federal Reserve regulation. Similarly, a controlling investment in a thrift or thrift holding company will cause the private equity fund and its general partner to become thrift holding companies and subject them to OTS regulation. The resulting activities limitations, regulatory supervision and likely requirement that the private equity firm serve as a "source of strength" for the bank or thrift have generally led private equity funds to conclude that a controlling investment would be unpalatable.

When evaluating whether an investment is "non-controlling," the regulators will consider a number of factors, such as the amount of voting and total equity interests owned by the private equity fund and what rights and restrictions apply with respect to governance and share transfers.

In general, a private equity investor can own up to 24.9% of the voting shares of the target and have the right to appoint one representative to the target's board and still be deemed "non-controlling." Under the Federal Reserve's rules and policy, a non-controlling private equity investor in a bank or bank holding company may own up to 33.3% of the total equity of a target, as long as no more than 14.9% of the equity is voting, and may appoint one director to the target's board. In contrast, the OTS rules limit the non-controlling investor's investment to 25% of the voting stock and 25% of the capital of a thrift or thrift holding company, and may require an investor to enter into a rebuttal of control agreement if certain control factors—such as being one of the two largest voting shareholders—are present. These

[1] See FDIC's Quarterly Banking Profile, http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP.

[2] For a detailed description of the Policy Statement and subsequent "Questions and Answers" released by the FDIC, see our Davis Polk Memoranda describing the Policy Statement and subsequent related Q&As.

percentages are not calculated on a fully diluted basis, with any convertible securities, options or warrants held by an investor generally treated as if converted or exercised solely by that investor.

Under the Federal Reserve's rules and policy, although a non-controlling investor in a bank or bank holding company may appoint a board representative, the representative cannot serve as the chair of the board of directors or any board committee, make up more than 25% of the board or any committee or have the authority or practical ability to make or block any policy decisions. With respect to banks or bank holding companies capitalized by private equity investments, the Federal Reserve has recently indicated that if the board has fewer than nine directors, at least 50% of the directors must be independent of management and of the private equity investors, and if the board has nine or more directors, at least 40% of the directors must meet this independence standard.

For "non-controlling" investments in banks, thrifts or bank and thrift holding companies, the investor's governance rights must be limited. Any "veto" rights generally should be limited to fundamental decisions such as dissolution and materially adverse changes to the rights and preferences of the investor's interest, and should not give the investor veto powers over particular investments or management decisions.

A non-controlling investor's right to compel or prohibit transfers by other shareholders must also be limited. For example, the presence of drag-along rights or rights to prohibit transfer can preclude a determination that an investment is "non-controlling" by giving the investor control over the shares subject to the drag or transfer restrictions, although tag-along rights, rights of first offer, preemptive rights and registration rights are generally permissible.

In addition, investors in banks and bank holding companies are required to execute the Federal Reserve's standard passivity commitments if they hold 10% or more of the voting shares, and are often required to do so if they hold 5% or more of voting shares. The passivity commitments generally circumscribe an investor's influence on the board of directors and operations of the company and restrict transactions between the investor and the target, absent Federal Reserve approval.

Timing and Disclosure Considerations Under the Change in Bank Control Act

For investments in banks and bank holding companies, a fund may want to structure its investment to avoid a required filing under the federal Change in Bank Control Act. Under this statute, acquisitions of a 10% or greater voting interest in a bank or bank holding company may require the fund to make a "control" filing, even though the investment is deemed to be "non-controlling" under the Bank Holding Company Act. Such a filing could delay the closing of the transaction and potentially require the disclosure of confidential personal information regarding the individuals that "control" the fund and other sensitive information to the regulators. Although such information is generally confidential under the Freedom of Information Act, a private equity investor may prefer to avoid a filing altogether by limiting its voting interest to 9.9% and electing to receive additional interests in non-voting stock. However, even under these circumstances, in the case of state member banks and bank holding companies, the Federal Reserve may in practice request information about the investor analogous to that required in a Change in Bank Control Act notice.

Concerted Action – Anti-Association Commitments

Under the Bank Holding Company Act, S&L Holding Company Act and Change in Bank Control Act, the regulators may find the existence of a "company" or "association" if investors are considered to be "acting in concert"—that is, not acting independently with respect to their investment in the bank, thrift, or bank or thrift holding company. In this case, an investor's shares may be aggregated with those of other investors when determining the relevant percentage ownership limits.

The S&L Holding Company Act and Change in Bank Control Act regulations define "acting in concert," and the Federal Reserve's Legal Division has traditionally formulated a principle of an "association" under the Bank Holding Company Act. Because an "acting in concert" or "association" determination will result in the attribution to an investor of other investors' shares, it is advisable in "club deals" for each investor to use separate counsel, approach the applicable banking regulator independently and document its own independent investment decision.

Moreover, in certain deals involving investments in banks or bank holding companies, the Federal Reserve has recently requested that investors that are seeking to contribute capital concurrently with contributions by other investors make so-called "anti-association" commitments. The most significant of these commitments requires an affirmation from each investor that it will not engage as part of a similar group with substantially the same combination of interests in any additional U.S. banking or non-banking activities without prior consultation with the Federal Reserve.

Interpreting the FDIC Policy Statement

In addition to the holding company statutes and Change in Bank Control Act, a private equity investor (and any investors in its group) must also reckon with the FDIC's Policy Statement as it has been interpreted in its first six months of life.

The Policy Statement reflects the FDIC's concern that private investors serve as "responsible custodians" for a failed institution and devote efforts to ensure that the institution does not fail again. If a private investor covered by the Policy Statement makes an investment in a failed bank or thrift, the post-acquisition financial institution must maintain at least a 10% Tier 1 common equity ratio throughout the first three years, generally remain well-capitalized thereafter and be subject to firewalls with respect to any investment funds controlled by the private investor. In addition, the private investor will be subject to a three-year lock-up on the shares it acquires absent FDIC approval, whether in the bank or thrift itself or a holding company formed for purposes of making failed bank investments.

The Policy Statement exempts two types of investors from its requirements: an investor with less than 5% of the total voting power when there is no evidence of "concerted action," and an investor that enters into a partnership with or invests directly in an existing bank or thrift holding company where the holding company has a "strong majority interest"[3] in the failed bank and has an established record for successful operation of insured banks or thrifts. These exemptions have helped shape the landscape of current investment opportunities.

Sub 5% Pools

Following the adoption of the Policy Statement, several large pools were formed to acquire failed banks. Initially, these investments were structured so that every investor was below the 5% voting threshold, thus avoiding the Policy Statement. Influenced by these structures, the FDIC released a set of Q&As in January 2010 that presumed 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. This effectively required investors holding at least one-third of the voting equity to be subject to the Policy Statement in order for the investment pool to bid on a failed bank.

[3] The Revised Q&A defines a "strong majority interest" in two ways, depending on whether the private investor invests in a failed bank through a partnership with an established bank or thrift holding company or whether the private investor invests directly in an established bank or thrift holding company that intends to acquire a failed bank. When a private investor enters into a partnership with an existing bank or thrift holding company, the existing holding company has a "strong majority interest" so long as the private investors own one-third or less of both the total equity and the voting equity of the partnership. When a private investor invests directly in an established bank or thrift holding company, the existing holding company has a "strong majority interest" so long as the private investors own less than one-third of the total equity of the resulting holding company after the capital raise.

Various large investment pools have been required to restructure their investments to achieve this objective. Such restructurings can be quite difficult, as investors that may be willing to accept additional restrictions typically wish to be compensated through warrants or other economic incentives, which may require re-solicitation or give rise to rescission rights.

Community & Southern ("C&S") is a recent transaction that was structured with over one-third of the voting equity held by a number of investors that had stakes over the 5% threshold and the rest held by investors with smaller stakes. As of March 29, C&S had acquired two failed institutions with almost $2 billion in assets.

Existing Bank Holding Companies

Investing in existing bank holding companies permits investors to take larger-than-5% stakes in failed banks but avoid application of the Policy Statement. As modified by the Q&A, the Policy Statement does not apply to investors that invest directly in an existing bank or thrift holding company where new private investors own no more than one-third of the total equity of the holding company on a *pro forma* basis, and the holding company has an established record for successful operation of insured banks or thrifts. Many investors also favor this structure, as the infrastructure and management of the existing bank holding company may make it a superior bidder for a failed bank although it does mean that the investor is not making a "pure play" investment in the failed bank transaction.

An example of an investment in an existing bank holding company was Corsair Capital's December 2009 acquisition of a 9.9% equity stake in an existing bank holding company, East West Bancorp Inc., in connection with the acquisition of the failed United Commercial Bank by East West Bancorp's subsidiary bank. The transaction raised questions of the applicability of the Policy Statement as a substantial amount of new equity was raised from private investors to fund the acquisition. However, the FDIC determined that the Policy Statement would not be applied since much of the new capital came from existing shareholders of East West Bancorp so that after the transaction the new investors held less than one-third of the total equity.

Platform Banks

Despite application of the Policy Statement, various investors believe that acquiring an existing small institution and significantly overcapitalizing it represents a superior structure for acquiring failed banks. An existing bank has its own developed infrastructure as well as management in place, which may make it an attractive bidder for a failed bank. In addition, the acquisition of a controlling interest in an existing bank provides a mechanism for regulatory review of the investors and clearance in the context of a real transaction.

Questions Unanswered by the Policy Statement and Q&As

Although the Policy Statement and Q&As have provided some guidance, the FDIC has left some important questions unanswered. For example:

- How irrevocable must a private investor's capital commitment in a potential failed bank buyer be for the FDIC to take the investment into account in determining whether to give the potential buyer access to the FDIC bidding process? Private equity firms are reluctant to relinquish control of their capital without knowing the terms or reviewing the diligence materials for an investment. Regulators strongly prefer that investors irrevocably contribute or commit capital so that the investors are identified and the amount of firmly committed capital available to the potential buyer is known. As a middle ground, investors are considering structures whereby capital is irrevocably committed, but a supermajority of the target bank or bank holding company's board is required to approve a capital call. We have also seen this issue arise with other bank regulators, who have shown reluctance to process the necessary regulatory applications if they see the investment as "contingent."

- Under what circumstances may non-voting shares become voting shares? As noted above, the allocation of voting and non-voting shares may be used to avoid application of the Change in Bank Control Act. Often, investments are structured to allow the non-voting shares to become voting shares in certain limited circumstances, such as upon a transfer of shares in a public offering, which the Federal Reserve and OTS have permitted as consistent with a "non-voting share."
- How does the FDIC define "concerted action" and what will the standards and procedures be for rebutting the presumption? The FDIC has listed a series of information-related "factors" it will take into consideration, but it has not publicly indicated whether it will adopt other regulators' views of what is required for a finding or rebuttal of "acting in concert."
- Although the Q&A indicates that at least one-third of the voting equity must be held by investors subject to the Policy Statement in order to avoid applicability of the Policy Statement to all investors, will the FDIC nonetheless allow the test to be satisfied through both voting and non-voting shares? We believe, based on recent experience, that the FDIC will adopt a dual test: either one-third of the voting equity must be held by investors subject to the Policy Statement or one-third of the total equity (both voting and non-voting shares) must be held by investors subject to the Policy Statement.
- Once the one-third test has been satisfied, will the FDIC essentially presume that "concerted action" issues among less-than-5% holders have effectively been rebutted? Again, we believe, based on recent experience, that unless the one-third test is satisfied, it is extremely difficult to rebut the concerted action test; once satisfied, the FDIC takes a more traditional view of concerted action issues, evaluating contractual and business affiliations among the smaller investors.
- Can an investor subject a portion of its investment to the Policy Statement and have the remainder not so subject? Will an investor holding less than 5% of the voting shares nonetheless be subject to the Policy Statement if the investor has the right to a board seat? While the Policy Statement does not answer these points, we believe the answer to each of these questions is likely "yes," although the FDIC has yet to issue public clarifications.
- When does the three year holding period begin, and when does it end? Does it re-start each time a bank does another failed bank acquisition?
- How will changes in share ownership percentages resulting from sales of stock or from exercises of stock options post-transaction affect the exemptions under the Policy Statement?

Confronting the Ambiguity

To confront these ambiguities and others, investors should plan to approach the FDIC, along with other relevant banking supervisors, in the early stages of their investment process to discuss their specific circumstances. Our experience in one transaction provides an example of the FDIC's willingness to work with investors to improve their investment structure to resolve regulatory issues. When the Policy Statement was first announced, but before it was adopted, its application to pending transactions was uncertain. In the State Bank & Trust transaction, an investor group led by banker Joe Evans successfully recapitalized State Bank & Trust Company and simultaneously acquired six related failed banks with approximately $2.5 billion in assets. The FDIC approved the investment structure, even though the Policy Statement had not been finalized, but required the investor group to comply with many of the requirements of the Policy Statement.

We are hopeful that the FDIC will show similar creativity in connection with the recapitalizations of large, troubled banks. Private investors have expressed interest in putting substantial funds into larger institutions to bring them back to well-capitalized status. Naturally, these institutions, once recapitalized, are interested in participating in FDIC auctions. In these circumstances, because of the significant amount of new capital, the Policy Statement would literally apply, requiring higher capital levels and one-third of the equity being subject to the three-year holding period. Understandably, this has the effect of discouraging the very type of recapitalization the FDIC would like to encourage. Flexibility in applying the Policy Statement under such circumstances would serve an important policy goal.

For more resources on this topic and information about our practice in this area, please visit our web site.

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