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Private Equity Investments in Troubled Banks

July 15, 2009 There has been increasing pressure on banks to increase their equity capital levels (and decrease their leverage ratio) in response to losses caused by declines in asset values. Historically, U.S. bank regulatory policy has limited the sources of equity capital that were available to banks, as policymakers have considered it essential to maintain the separation between the activities of banking and of commerce, even if that meant depriving banks of the potential for raising equity from private institutional investors. Recently, this policy has come under scrutiny and the federal banking regulators have considered whether commercial investors, particularly private equity funds ("**PEFs**"), might be induced to contribute capital and management expertise to failing (and already failed) banks.

Notwithstanding the desire to encourage investment in banks, the banking regulators are demonstrating an ambivalence about private equity investments in failing banks. The "shelf charter" offered by the Office of the Comptroller of the Currency ("**OCC**") appeared inviting to non-bank investors that might seek to acquire the assets and deposit liabilities of failed institutions, but the private equity investment guidelines recently proposed by the Federal Deposit Insurance Corporation ("**FDIC**") would impose enhanced capital requirements and restrictive investment commitments likely to discourage PEF investment. Meanwhile, the Board of Governors of the Federal Reserve System ("**Board**") has struck somewhat of a middle ground, liberalizing the definition of "control" for Bank Holding Company Act "(**BHC Act**")[1] purposes, while affirming and increasing the burdens imposed on owners that do exercise control over a bank.

In sum, the regulators' responses to private equity proposals to invest in failing banks have been mixed, with the Board's Policy Statement seeking to facilitate passive investment in banks by PEFs, the OCC's Shelf Charter pre-approving PEFs to become BHCs, and the FDIC's Proposed Guidelines hesitantly welcoming "club" PEF acquisitions of the assets and liabilities of failed banks, while imposing capital and transfer restrictions that may make the welcome seem rather chill. An overview of each of these measures is provided below.

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[1] Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-50).

I. The Board's Policy Statement and The Bank Holding Company Act

Historically, the primary obstacle to a PEF taking a significant ownership interest in a bank has been the BHC Act and Regulation Y thereunder,[2] which restricts the activities of companies that "**control**" banks to activities that are either "**so closely related to banking as to be a proper incident thereto**" or, in the case of a PEF that has qualified as a financial holding company, "**financial in nature.**"[3] A PEF subject to the BHC Act would be deemed to be engaged in any activity carried out by the portfolio companies that the PEF controls. Thus, a PEF subject to the BHC Act would be prohibited from "controlling" any portfolio company engaged in any activity that is not "closely related to banking" or "financial in nature" within the meaning of the BHC Act.[4] In addition, all BHCs are themselves subject to capital requirements that might further restrict asset allocation at the holding company level.

Because the definition of "control" is key to application of the BHC Act, the Board has defined "control" very broadly to create broad coverage for the statute. The BHC Act defines "control" as direct or indirect ownership of, control of, or holding with power to vote, 25% or more of a class of voting securities of a commercial bank, or the ability to determine the election of a majority of directors.[5] In addition to these largely numeric tests, the Board has promulgated a more open-ended subjective test: an entity will be deemed to be a BHC if it can exercise a controlling influence over the management or policies of a bank.[6] The holder of securities is deemed to "control" anything that any firm it "controls" in turn "controls."[7]

Under this more subjective test, the Board in Regulation Y has indicated that "control" of a bank can be created with ownership of as little as 5% of a class of voting securities, at least where there

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2 12 C.F.R. 225.

3 *See* 12 U.S.C. § 1843(k). Generally, the activities of a BHC must be limited to those "so closely related to banking as to be a proper incident thereto." Engaging in activities that are "financial in nature" (which is a broader definition) is limited to those BHCs that have qualified to become financial holding companies ("**FHCs**") by (i) being well capitalized, (ii) being well managed, and (iii) having a satisfactory Community Reinvestment Act ("**CRA**") evaluation.

4 The BHC Act and Regulation Y define as a regulatable "bank holding company" ("**BHC**") any firm that "controls" a commercial bank. Similarly, the BHC Act deems any firm "controlled" by the BHC to be a subsidiary of the BHC and subject to BHC Act restrictions.

5 12 U.S.C. § 1841(a).

6 12 U.S.C. § 1841(a)(2)(B), (C).

7 Interestingly the Board has indicated that affiliated but distinct investors investing in the same bank target at a level beneath the "control" threshold may be deemed to have "control" by implied concerted action: "Contemporaneous minority investments in the same banking organization by multiple different investors also often raise questions about whether the multiple investors are a . . . single association for purposes of the BHC Act." Unfortunately, the Board did not expand upon this interpretation of "control." *See Policy Statement on Equity Investments in Banks and Bank Holding Companies*, 12 C.F.R. § 225.144(a), fn. 2.

are any management or director interlocks between the bank and the owner and no one else owns more than 5% of the bank. Further, in 1982, the Board issued a policy statement on nonvoting equity interests in BHCs that, in essence, suggested that control could arise through ownership of nonvoting securities if an investor owned or controlled nonvoting securities that represented 25% or more of the bank's equity.[8]

That said, it is certainly possible for a PEF to invest in a bank or BHC without triggering a determination of "control." Limiting the investment to preferred nonvoting shares that represent less than 25% of equity or less than 5% of a class of voting securities will avoid a finding of "control" unless other "indicia" of control exist.

In addition to "control" through ownership, "control" may also be found to arise from contracts that confer rights on the PEF that would normally accompany voting share ownership (e.g., a right to prohibit a merger without the PEF's approval) or that substantially limit the authority of the bank's management to make decisions (e.g., a right to prohibit the banking organization from entering into new activities). However, contracts with these provisions should not be deemed to give rise to "control" if the banking organization is given the right to call the investment and thus avoid the PEF's veto.

Acquisitions by a PEF of nonvoting securities with springing voting rights on transfer, including warrants and options, may be deemed to be acquisitions of voting securities. However, granting the issuer a right of first refusal and providing for a dispersed public offering in the event that right is not exercised generally avoids attendant "control" problems.

On September 22, 2008, the Board issued a new policy statement on equity investments in banks and BHCs ("**Board Policy Statement**").[9] The Board Policy Statement essentially provides that ownership of up to 33% of a bank's equity – so long as any voting interest is less than 15% – may not be deemed to constitute exercise of a controlling influence over the target bank. The Board Policy Statement also expresses the view that a minority investor should be permitted to have a single representative on the board of a bank without being deemed thereby to have acquired "control."[10]

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[8] *Policy Statement on Nonvoting Equity Investments by Bank Holding Companies*, 47 Fed. Reg. 30966 (July 16, 1982); 12 C.F.R. § 225.143.

[9] *Policy Statement on Equity Investments in Banks and Bank Holding Companies*, 12 C.F.R. § 225.144, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf.

[10] The board of directors of a national bank generally must have between 5 and 25 directors, while the board of a N.Y. state chartered bank of any appreciable size must have between 7 and 30 directors. *See* 12 U.S.C. § 71a (national banks); N.Y. Banking Law § 7002 (N.Y. state chartered bank).

While this is clearly a positive to PEFs that are considering acquiring relatively "passive" interests in banks, one should be mindful that, while the Board's new Policy Statement somewhat expands the permitted activities of non-control investors, investors that genuinely control a bank would still be subject to regulation as a BHC. This may leave PEFs with something of a "Hobson's" choice: is it better to be a passive investor,[11] even if less passive than before, or is it better to become a true "control" person to protect one's investment, but be deemed a BHC and thus be limited to activities that are "closely related to banking" or "financial in nature."

II. The OCC's Shelf Charter

Historically, when a bank fails, the FDIC is appointed receiver or conservator and usually tries quickly to sell the failed bank's assets and deposit liabilities to another bank. A buyer that wishes to "assume" the failed bank's deposits must itself already have a bank charter. Thus, a PEF that did not already own or control a bank would have been precluded from participating in the bidding for a failed bank.

On November 21, 2008, the OCC created the "shelf charter" to enable non-bank investors to bid for failing banks and thereby increase the flow of capital into the commercial banking industry.[12] In acting on applications for shelf charters, the OCC considers an applicant's proposed management team, the amount of capital the applicant would make available, and the applicant's proposed business plan. Applicants also are expected to apply simultaneously to the Board for preliminary approval to become a BHC. Shelf charter approvals expire in 18 months unless extended by the OCC.[13]

While this pre-clearance process is intended to increase the market for already failed banks, theoretically it might be used by a PEF to position itself as a serious bidder for a troubled bank that

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[11] Based on the "failed bank" announcements that are made almost every Saturday morning, the number of bank failures seems to be increasing, suggesting that there may be considerable risk to passive investments in commercial banks. In April of last year, Washington Mutual, F.S.B. ("WaMu") (which was a federal savings bank and therefore not governed by the BHC Act) raised $7 billion in capital, selling a 14% stake to 3 PEFs (managed by Texas Pacific Group) and a group of unnamed investors, who paid $8.75 a share at a time when market value was below $12 a share. The PEFs' investment amounted to $1.35 billion. Five months later, WaMu was closed by its regulator, and its assets were sold to J.P.Morgan Chase for $1.9 billion.

Even if the target bank does not fail, an investment today could be diluted if a government capital infusion later becomes necessary.

[12] *See* OCC Conditional Approval Letter No. 2008-137a, *available at* http://www.occ.gov/ftp/release/2008-137a.pdf. Of course, this also has the effect of increasing the universe of potential bidders for a failed bank, increasing competition for failed bank assets, thus potentially increasing the economic benefit to the FDIC.

[13] *See* Press Release, *OCC Conditionally Approves First National Bank "Shelf Charter" to Expand Pool of Qualified Bidders for Troubled Institutions* (Nov. 21, 2008), *available at* http://www.occ.gov/ftp/release/2008-137.htm.

has not already failed. Potentially, the shelf charter might be used even to acquire a healthy bank's assets and deposit liabilities.

Of course, any PEF that receives a shelf charter and later acquires a bank's assets and deposit liabilities would likely become a BHC by operation of the BHC Act and have to conform its own activities, **as well as those of firms it controls**, to those permitted under the BHC Act - i.e., the PEF would be forced to limit its activities to those that are "closely related to banking" or "financial in nature."

III. The FDIC's Proposed Policy Statement on Qualifications for Failed Bank Acquisitions

Late last year, the FDIC established a modified bidder process to expand the pool of qualified bidders for the assets and deposit liabilities of failed depository institutions.[14] The new process permits abbreviated information submissions and applications for deposit insurance in order to qualify parties for the FDIC's list of potential bidders. As is the case with the OCC shelf charter application, the modified bidder process requires bidder applications to include details regarding the proposed management team, capital availability, and a business plan.[15]

More recently, on July 2, 2009 the FDIC issued the proposed Policy Statement on Qualifications for Failed Bank Acquisitions ("**Proposed Guidelines**").[16] The Proposed Guidelines would refine the approach the FDIC took in the PEF acquisitions of IndyMac[17] and BankUnited Financial Corp.[18] and would lay ground rules for "club" private equity investments in failed banks.

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[14] *See* Press Release, *FDIC Expands Bidder List for Troubled Institutions: Plan Allows Those Without a Bank Charter to Participate in the Process* (Nov. 26, 2008), *available at* http://www.fdic.gov/news/news/press/2008/pr08127.html; *see also Statement of Policy on Applications for Deposit Insurance*, 63 Fed. Reg. 44756 (Aug. 20, 1998), *available at* http://www.fdic.gov/regulations/laws/federal/98applic.pdf.

[15] The FDIC also expects the business plan to indicate how the applicant would comply with the CRA, which requires banks to help meet the credit needs of low- and moderate- income households.

[16] *See* FDIC Board Approves Proposed Policy Statement on Qualifications for Failed Bank Acquisitions, PR-112-2009 (July 2, 2009), *available at* http://www.fdic.gov/news/news/press/2009/pr09112.html. The Proposed Guidelines are available at http://www.fdic.gov/regulations/laws/federal/2009/09policyJuly9.pdf. Comments must be received by August 10, 2009.

[17] *See* Press Release, Fact Sheet: FDIC Sale of IndyMac FSB (Jan. 29, 2009), *available at* http://www.fdic.gov/news/news/press/2009/pr09001a.html.

[18] *See* Press Release, BankUnited Acquires the Banking Operations of BankUnited, FSB, Coral Gables, Florida (May 21, 2009), *available at* http://www.fdic.gov/news/news/press/2009/pr09072.html.

A. Scope and Applicability of Proposed Guidelines

The Proposed Guidelines apply to (a) private capital investors in a company (other than a BHC or a savings & loan holding company that has come into existence or has been acquired by an Investor at least three years prior to the date of issuance of the Proposed Guidelines) that is proposing to directly or indirectly assume assets and/or deposit liabilities from failed depository institutions in receivership, and (b) applicants for insurance in the case of *de novo* charters issued in connection with the resolution of failed depository institutions (together, "**Investors**"). The Proposed Guidelines thus seem not to apply to Investors seeking to acquire failing, as opposed to failed, depository institutions.

The Proposed Guidelines do not restrict who *may* be an Investor, but rather outline what the FDIC will require of individuals and entities that seek to *become* Investors in failing banks. The scope of the definition of Investor appears to be very broad and the Guidelines could be applied to practically any party the FDIC feels is trying to avoid "the responsibilities of bank and thrift ownership." The FDIC is seeking comment on whether another definition is appropriate.

B. Requirements of Bidders Under the Proposed Guidelines

As discussed in greater detail below, the Proposed Guidelines would establish eight basic requirements of Investors: (1) maintaining **higher than normal capital levels** at the target institution; (2) acting as a **source of strength** to the target institution; (3) providing **cross-guarantees** where the Investor (either individually or collectively with other Investors) owns a majority interest in more than one depository institution; (4) **limiting extensions of credit** to the Investor or its affiliate by the target institution; (5) **excluding "secrecy law" jurisdictions** from the proposed ownership chain; (6) maintaining **three years of continuous ownership**; (7) **disclosing information** regarding all entities in the "ownership chain" of the Investor; and (8) prohibiting investment by Investors with a direct or indirect interest of 10% or more in a failed institution.

Increased Capital. The Proposed Guidelines would require Investors to maintain a minimum Tier 1 leverage ratio of 15% for three years. Normally, the minimum Tier 1 leverage ratio is 3% for the most highly rated institutions, 4% for all other institutions, and 5% to be deemed well-capitalized.[19] The FDIC's apparent concern is that new depository institutions usually suffer losses in their first years of operation and, therefore, it is appropriate to impose significantly heightened capital requirements to protect the deposit insurance fund. Failure to maintain this "very well-capitalized" Tier 1 leverage ratio would amount to "undercapitalization" of the institution for purposes of the

[19] *See* 12 C.F.R. § 325.3.

FDIC's prompt corrective action rules.[20] After the three-year "very well-capitalized" Tier 1 leverage ratio has passed, the FDIC will expect the institution to remain at normal "well capitalized" levels.

The FDIC is not completely committed to the proposed 15% ratio and is seeking comment on whether a lower, but still heightened, level could satisfy safety and soundness concerns without making PEF investments in failed banks unprofitable or uncompetitive.

Source of Strength. Investors would be expected to enter into commitments with the FDIC under which the holding company of the target institution would provide capital support. Such capital support could include debt or equity issued by the holding company.

Cross-Guarantees. Where an Investor owns a majority stake (directly or indirectly, and either individually or collectively with other Investors) in more than one depository institution, the Investor must "pledge" to the FDIC its proportionate interest in those depository institutions to secure losses to the FDIC deposit insurance fund resulting from the failure of any depository institution owned by the Investor. The Proposed Guidelines also request comment on whether the cross-guarantee should be treated as a direct obligation of the Investor, rather than a pledge of the assets of other depository institutions owned by the Investor.

No Affiliate Transactions. The Proposed Guidelines prohibit extensions of credit by the target depository institutions to Investors, their investment funds, any affiliates thereof, and any portfolio companies of the Investor or its affiliates.[21]

No "Secrecy Law" Jurisdictions. Investors may not utilize entities incorporated in bank secrecy jurisdictions in the ownership structure of the target institution, unless the Investors are subsidiaries of companies already subject to comprehensive consolidated supervision ("**CCS**"), as recognized by the Board. In addition, each Investor must: (1) agree to provide the target institution's primary federal regulator with information regarding the non-U.S. operations and activities of the Investor; (2) maintain books and records in the United States; (3) consent to disclosure of certain information that may be covered by such bank secrecy laws; (4) consent to jurisdiction and designate an agent for service of process; and (5) consent to be bound by the statutes and regulations administered by the appropriate U.S. federal banking agencies.

[20] Ordinarily, the prompt corrective action rules are triggered when an institution's capital falls below the top two capitalization categories. The capitalization categories are: well-capitalized; adequately capitalized; undercapitalized; significantly undercapitalized; and critically undercapitalized. 12 U.S.C. § 1831o(b); 12 C.F.R. § 325.103.

[21] "Extension of Credit" is defined by reference to 12 C.F.R. § 223.3(o). "Affiliate" is defined as any company in which the Investor holds a 10% or greater equity interest.

Three Year Holding Period. Unless FDIC approval is obtained, Investors may not sell or otherwise transfer their ownership interest in the target institution for three years following the acquisition.

No Second Chances. Investors that directly or indirectly hold 10% or more of the equity of a target institution would be ineligible to participate in bidding for the assets and liabilities of the institution, should it later fail.

Disclosure. An Investor would be required to submit to the FDIC information regarding its ownership structure, including details on its capital base and sources of capital, management team, business model, and marketing information. Other entities in the ownership chain may also be required to provide the FDIC the same information.

C. FDIC Request for Comment on the Proposed Guidelines

FDIC Chairman Sheila Bair expressed frustration at certain aspects of (unsuccessful) PEF proposals for acquisitions of failed banks, including opaque ownership structures and the desire to limit the term of the PEF's investment in the bank, while reiterating her support for recent PEF transaction structures.[22] In a fashion similar to the Board, the Proposed Guidelines single out "silos" as unacceptable holding structures for target institutions.[23] The Office of Thrift Supervision "(OTS"), in contrast, appears to be comfortable with the use of a "silo" – i.e., a distinct legal entity that holds the PEF's investment in the thrift such that the thrift investment is "walled off" from the PEF's other investments. OTS approved the use of a "silo" in the acquisition of Flagstar Bancorp, Inc. by a single PEF, MatlinPatterson, on January 29, 2009.[24]

In sum, the overall tone that the FDIC seems to strike in the Proposed Guidelines is rather cautious vis-à-vis the desire to encourage further investment by PEFs.

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[22] *See* Chairman Bair Statement on Proposed Statement of Policy, *available at* http://www.fdic.gov/news/news/press/2009/pr09112a.html.

[23] *See* Linda Shen & Jonathan Keener, *BankUnited Sale May Signal FDIC Shift in Buyout Rules*, Bloomberg.com, May 22, 2009, http://www.bloomberg.com/apps/news?pid=20601103&sid=azOHOtxuEFJY&dbk.

[24] *See* MP Thrift Investments, L.P., Holding Company Information, http://www.ots.gov/?p=InstitutionSearch&&iid=&hid=H4586.

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