

Economic Stabilization Advisory Group | February 4, 2010

## Structuring Private Equity Investments in Failed U.S. Banks Under New Guidance to the FDIC Policy Statement and the Bank Holding Company Act

The FDIC has issued interpretive guidance, in the form of questions and answers, concerning the standards that the FDIC applies in accepting bids from investment vehicles and other so called “private investors” to acquire failed banks and thrifts.<sup>1</sup> The guidance clarifies the eligibility criteria originally established in the FDIC’s policy statement on failed bank acquisitions (August 2009) for exclusions from the substantive requirements of the policy statement. The Q&As reflect the FDIC’s ongoing effort to strike a balance between the competing interests of attracting new potential investors in failed banks and creating eligibility standards for non-bank acquirors — including private equity firms — that will help ensure the long-term financial strength and prudential management of a bank or thrift emerging from receivership.

This Client Publication updates an earlier Client Publication, dated September 1, 2009 (the “September Client Publication”), addressing the FDIC’s “Final Statement of Policy on Qualifications for Failed Bank Acquisitions” (the “FDIC Statement”).<sup>2</sup> Since the issuance of the September Client Publication, the FDIC

has issued the Q&As and has attracted additional investor interest in failed bank sales by offering, in many cases, to enter into so-called “loss sharing” arrangements with the winning bidders.<sup>3</sup> Just in the past week, the FDIC has approved three transactions involving private equity firm (“PE Firm”) acquisitions of failed banks.

<sup>1</sup> A copy of the questions and answers (Q&As), which were posted on the FDIC’s website in January 2010, can be found at <http://www.fdic.gov/regulations/laws/faqfbqual.html>.

<sup>2</sup> A copy of the September Client Publication can be found at: [http://www.shearman.com/structuring\\_private-equity-investments-in-failed-us-banks-under-the-new-fdic-statement-and-the-bank-holding-company-act-09-01-2009/](http://www.shearman.com/structuring_private-equity-investments-in-failed-us-banks-under-the-new-fdic-statement-and-the-bank-holding-company-act-09-01-2009/).

The September Client Publication (i) described in detail the FDIC Statement, (ii) highlighted possible approaches to structuring private capital investments in failed banks in view of the interplay between the FDIC Statement and applicable Board of Governors of the Federal Reserve System interpretation of “control” of a bank or bank holding company for purposes of the Bank Holding Company

Act of 1956, and (iii) compared and contrasted four broad categories of investment structures available to private investors when considering investment in a failed bank or thrift.

A copy of the FDIC Statement can be found at <http://www.fdic.gov/regulations/laws/federal/2009/09FinalSOP92.pdf>.

<sup>3</sup> Very generally, under such arrangements, the FDIC reimburses the acquiror for a certain designated percentage of losses associated with “covered” assets of the failed bank. (In determining the winning bid for a failed bank, the FDIC will evaluate which bid represents the lowest cost to the FDIC.) The FDIC has issued Q&As regarding loss sharing arrangements which can be found at <http://www.fdic.gov/bank/individual/failed/lossshare/>.

As we described in September, the FDIC Statement establishes a regulatory framework for so-called “private investors” to qualify as eligible bidders for a failed U.S. bank or thrift. The FDIC Statement does not specifically define the term “private investors” but the term clearly applies to PE Firms and similar investment vehicles but not to established bank or thrift holding companies (which, in the context of a failed bank transaction, are frequently referred to as “strategic investors”).

In many cases, the FDIC Statement imposes on “private investor” acquirors of a failed bank certain financial support requirements, “insider lending” restrictions, a three-year minimum holding period, and disclosure requirements. As a general matter, the FDIC Statement’s requirements — including initial capitalization of the acquired bank sufficient to maintain a ratio of Tier 1 common equity to total assets of at least 10% — may exceed minimum standards that would ordinarily apply where the transaction is not subject to the FDIC Statement (i.e., specifically, in the case of an acquisition by (and only by) a “strategic investor” or in the case of an “excluded” acquisition involving one or more “private investors”).

There are two general categories of “private investor” structures that qualify for “exclusions” from application of the FDIC Statement requirements. The principal purpose of this Client Publication is to (i) briefly review these exclusions as clarified by the Q&As, and (ii) “update” the four investment structures to acquire a failed bank identified in our September Client Publication to reflect guidance included in the Q&As.

## Exclusions from the FDIC Statement

The FDIC Statement sets out the terms and conditions that “private investors” generally would be expected to satisfy to obtain bidding eligibility for a proposed

acquisition of a failed bank or thrift.<sup>4</sup> The FDIC Statement specifically provides for two exclusions from those terms and conditions:

### Exclusion #1: Investment Partnership with a Bank

*Private investors team up with a holding company of a U.S. depository institution (excluding “shell holding companies”), which will have a “strong majority interest” in the resulting bank or thrift and an established record for successful operation of insured banks or thrifts.*

This exclusion potentially covers different types of joint ventures between private investors and a strategic investor (i.e., a U.S. depository holding company). For example, transactions may be structured as (i) a co-investment by one or more PE Firms and a strategic investor or (ii) an investment by one or more PE Firms in a strategic investor, which, once recapitalized by the investment, will seek to acquire a failed bank.

### Exclusion #2: De Minimis Investment:

*Each private investor individually holds no more than 5% of the total voting power of an acquired bank or thrift (or its holding company) – provided there is no evidence of “concerted action” by such investors.*

There are different possible variations on the “De Minimis Investment” including the so-called “blind pool” investment fund structure. Under this structure, PE Firm investors in the fund have no role in selecting the target bank or in assembling the consortium of investors (thereby reducing the risk of a finding of “concerted

<sup>4</sup> An investor group that does not already control a U.S. depository institution would need to obtain a bank charter in order to be positioned to make proposals to acquire troubled institutions, and, in particular, to be cleared to view the FDIC’s list of failing or troubled institutions and to submit bids for those institutions. Two options available to private investors in this regard are: (i) acquire an existing bank (the so-called “inflatable charter” approach), or (ii) receive preliminary approval from a U.S. bank licensing authority for a de novo bank charter (the so-called “shelf charter” approach). For the first time, on January 22, 2010, a bidder (Bond Street Holdings) successfully acquired a failed bank from the FDIC using a “shelf charter” approach (i.e., a charter that remains “on the shelf” or inactive until a failed bank acquisition has been completed).

action”) — activities which are exclusively left up to the pool’s management.

The Q&As address certain interpretive issues relating to each of these exclusions.

What would the FDIC consider to be a “strong majority interest” for purposes of the “Investment Partnership with a Bank” Exclusion?

Whether a strategic investor is deemed to have a “strong majority interest” in the resulting depository institution is a determining factor for purposes of qualification for the “Investment Partnership with a Bank” exclusion. The particular structure being employed will bear on how the FDIC will make a determination in this regard.

*Structure #1: Co-Investment by Private Investors and a Strategic Investor in a Partnership or Joint Venture to Acquire a Failed Bank:*

According to the Q&As, the strategic investor will generally be viewed as having a “strong majority interest” in the resulting institution, so long as the private investors (collectively on an aggregate basis) have no more than one-third of the total equity and voting equity of the acquiring vehicle. Conformity with this limit, however, does not conclusively demonstrate that a “strong majority interest” exists. In reviewing structures, the FDIC will also consider whether the private investors receive any special rights through “covenants, agreements, special voting rights, or other such mechanisms” that are inconsistent with a “strong majority interest” finding.

*Structure #2: Direct Investment (or Recapitalization) by Private Investor(s) in a Strategic Investor:*

According to the Q&As, the strategic investor will generally be viewed as having a “strong majority interest” in the resulting institution so long as the shareholders in the strategic investor pre-dating the investment have at least two-thirds of the total equity of the resulting bank or thrift holding company. The same considerations concerning covenants, special voting rights, or other such mechanisms noted above (regarding “Structure #1”) apply in this case of a “Structure #2” investment as well.

How does the FDIC determine whether there is “no evidence of concerted action” among investors for purposes of the *De Minimis* Investment Exclusion?

If “private investors” are deemed to be “acting in concert” with one another, the FDIC can be expected to aggregate the holding of such investors for purposes of determining whether or not they hold, in the aggregate, greater than 5% of the total voting power of the acquired bank (in which case, the “*De Minimis* Investment” Exclusion would not be available).

According to the Q&As, participation in widespread offerings (where each investor will hold 5% or less of the total voting power of an acquired institution or holding company) will not generally be considered “concerted action” when such investors will hold two-thirds or less of the total voting power. On the other hand, the FDIC will require a formal “rebuttal of concerted action” presentation in cases where private investors hold in the aggregate more than two-thirds of the acquired company’s total voting power. In evaluating whether this presumption has been rebutted, the FDIC will take into account the following factors (which, as a general matter, have historically been taken into account by other U.S. federal banking authorities in making similar assessments relating to the existence of “concerted action”):

- Whether each investor was among many potential investors and each investor reached an independent decision to invest.
- Whether the same investment manager advises more than one of the investors.
- Whether a substantially similar group of investors, in substantially the same combination of interests, has invested in other banking or non-banking activities in the United States.
- Whether an investor has any significant ownership interest in any other investor in the bank.
- Whether an investor is entitled to acquire any other investor’s shares.

- Whether there are any agreements or understandings between any of the investors for the purpose of controlling the bank.
- Whether the investors (and each director representing each investor) will consult with other investors concerning the voting of the bank shares.
- Whether the directors representing the investors will represent only the particular investor which nominated him or her, and will not represent any combination of investors.

How will the FDIC treat investments of greater than 5% of total equity, but less than 5% of the voting power for purposes of the *De Minimis* Investment Exclusion?

The Q&As clarify that a private investor may hold greater than 5% of the resulting institution's equity (so long as it does not equate to holding 5% or more of the institution's voting securities) and still qualify for the *De Minimis* Investment Exclusion. In certain cases, however, non-voting equity interests convertible into voting interests may be treated as voting interests for these purposes. In particular, according to the Q&As, non-voting securities that are (i) convertible to voting at the election of the investor or any affiliate, and (ii) may continue to be held by the investor following such conversion, would be considered to be voting securities for these purposes.<sup>5</sup>

## Interplay of the Bank Holding Company Act and the FDIC Statement/Q&As

Under the existing U.S. bank regulatory scheme, private investors (e.g., PE Firm "consortiums") that intend to

acquire a failed bank generally need to secure clearance not only from the FDIC, but also from the Federal Reserve System to either (or both) (i) acquire "control" of the resulting bank and become a "bank holding company" under the Bank Holding Company Act (the "BHCA"), and/or (ii) especially in the context of a bank investment by a PE Firm, receive confirmation that the relationships between one or more individual PE Firms and the acquired entity do not involve "control" for purposes of the BHCA.

Private investors generally must limit their involvement to "passive" investment up to certain equity thresholds (generally less — and as a practical matter, frequently well less — than 25% of voting and/or 33% of total equity) in order to avoid becoming a bank holding company and thereby being subject to strict Federal Reserve supervision, regulation, reporting, capital requirements and limitations on non banking activities under the BHCA and regulations thereunder.

When viewed from a holistic perspective, together, the FDIC Statement and the Q&As suggest that the FDIC favors structures where either (i) the substantive requirements of the FDIC Statement apply (e.g., the resulting institution is subject to the Statement's Tier 1 common capital ratio requirement and the private investors are subject to a minimum three-year investment holding period), or (ii) a strategic investor (such as a bank holding company) with a proven track record has a large enough interest in the target to be deemed to "control" the failed bank for purposes of the BHCA. In this regard, the FDIC undoubtedly took into account that an investor with "control" over a bank is required to act as a "source of financial and managerial strength" to the institution.

## Structures for an Investment in a Failed Bank Following the FDIC Statement and the Q&As

The Annex to this Client Publication "updates" the four investment structures to acquire a failed bank identified in the September Client Publication to reflect guidance included in the Q&As.

<sup>5</sup> The principal concern in this regard is the potential for a private investor with such convertible securities to exert leverage over an entity by being able to convert such securities into "voting" securities of the institution.

While the Q&As are written in very general terms — and thus it is not entirely certain — it appears as though the FDIC's approach in this regard may be somewhat more flexible than the approach that the Federal Reserve staff has historically employed in evaluating whether a security is voting or "non voting" for purposes of the BHCA. See, e.g., 12 C.F.R. § 225.144(c)(2).

As shown by the Annex:

- The substantive requirements of the FDIC Statement should not apply to the first two investment structures (i.e., the “*De Minimis Investment*” and “Investment Partnership with a Bank” as addressed above).
- On the other hand, investors under the “Private Investor Club Deal” structure (i.e., the third investment structure covered in the Annex) would be subject to the requirements of the FDIC Statement.

Importantly, under the first three scenarios covered in the Annex, any PE Firm’s investment must effectively be passive in order to assure that it does not control the acquired depository institution and become subject to regulation and restriction under the BHCA. An active or controlling investment in a failed bank (i.e., the fourth investment structure covered in the Annex) can only be made if the investor is (or becomes) a bank holding company.

## Moving Forward

The Q&As effectively tighten the criteria originally established by the FDIC Statement for exclusions from the Statement’s substantive requirements. Nonetheless, PE Firm investors — drawn in certain cases by the prospect of FDIC “loss sharing” arrangements — appear willing to participate in bids for failed banks, and the FDIC remains amenable to various investment structures involving such investors, whether or not part of a co-investment with a strategic investor.

Given uncertain economic conditions and concentrations of troubled loans (particularly commercial real estate exposures) on bank books, it appears likely that bank failures will continue to occur in the coming months at above-normal rates. The FDIC will surely take these difficult circumstances into account when revisiting the FDIC Statement — which it has stated it intends to do. We will continue to monitor and report on additional developments in this evolving area of the law.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

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## ANNEX

| Nature of PE Firm's Investment in the Failed Bank   | Interplay Between the FDIC Statement and "Control"-Related Considerations  |
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| <p>Investment Structure Category #1</p> <p><u>"De Minimis Investment"</u></p> <ul style="list-style-type: none"> <li>▪ <u>No</u> investment by any individual "private investor" representing more than <u>5%</u> of the total <u>voting</u> power<sup>5</sup> of the acquired entity, and <i>provided that</i> there is no FDIC determination of "concerted action" among investors in the acquired entity.<sup>6</sup></li> </ul> | <ul style="list-style-type: none"> <li>▪ FDIC Statement requirements do <u>not</u> apply.</li> <li>▪ The FDIC would require a formal rebuttal of concerted action presentation where "private investors" hold in the aggregate more than two-thirds of the company's total voting power. "Anti-association" commitments are likely required under these circumstances.</li> <li>▪ "Non-Controlling" investment by the individual private investor (in almost all circumstances). <ul style="list-style-type: none"> <li>▪ It may be possible for a private investor to acquire up to <u>33%</u> of the total equity of the acquired institution.</li> <li>▪ A private investor should not typically be required to make "passivity commitments."</li> <li>▪ Private investor representation (e.g., one representative) on the board of directors of the acquired institution is generally possible.</li> </ul> </li> </ul> |

<sup>5</sup> The Q&As clarify that it is possible to structure an investment to fall into this category even where an individual "private investor" owns 5% or more of the target's equity. The FDIC, however, may treat non-voting equity interests as "voting" shares where: (i) the interests are convertible to voting shares under certain circumstances at the election of the investor or any affiliate of the investor, and (ii) following such conversion, the interests are not required to be transferred immediately from the control of the investor.

<sup>6</sup> The Q&As clarify that, as a general matter, the FDIC will apply a "facts and circumstances" analysis in determining whether or not "private investors" are acting in concert. The FDIC will rebuttably presume concerted action if the private investors will hold, in the aggregate, more than two-thirds of the total voting power of the acquired institution or the holding company thereof.

| Nature of PE Firm's<br>Investment in the Failed Bank   | Interplay Between the FDIC Statement<br>and "Control"-Related Considerations   |
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| <p>Investment Structure Category #2</p> <p><u>"Investment Partnership with a Bank"</u></p> <ul style="list-style-type: none"> <li>▪ One or more individual "private investors" each make an investment representing more than <u>5%</u> of the total voting power of the acquired entity (but <u>less</u> than <u>25%</u> of any class of voting securities of the entity) <i>provided that</i> another bank or thrift holding company with an established record for successful operation of insured banks or thrifts owns a "strong majority interest" in the acquired entity.<sup>7</sup></li> <li>▪ Investments that fall into this category may generally be structured as <u>either</u>: <ul style="list-style-type: none"> <li>▪ A partnership or venture with an established holding company where the "private investors" have no more than one-third of both the total and voting equity of the company (<u>i.e.</u>, the partnership or venture) acquiring the failed bank, or</li> <li>▪ An investment by private investors directly in an established bank or thrift holding company acquiring the assets and liabilities of a failed bank or thrift <i>provided that</i> the "private investors" have no more than one-third of the total equity of the resulting bank or thrift holding company.</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>▪ FDIC Statement requirements do <u>not</u> apply.</li> <li>▪ "Non-Controlling" investment by the individual private investor generally possible. <ul style="list-style-type: none"> <li>▪ It may be possible for the private investor to acquire up to <u>33%</u> of the total equity of the acquired institution so long as the investor does not own, hold or vote more than <u>14.9%</u> of any class of voting stock of the acquired entity.</li> <li>▪ In limited cases, the private investor may be required to make or offer to make "passivity" commitments.</li> <li>▪ Private investor representation (<u>e.g.</u>, one representative) on the board of directors of the acquired institution should generally be possible.</li> </ul> </li> </ul> |

<sup>7</sup> The Q&As clarify that (i) where the acquiring vehicle is a partnership or venture with an established bank or thrift holding company, generally, a "strong majority interest" will be found where the private investors (as a group on a post-acquisition basis) have no more than one-third of both the total and voting equity of the partnership or joint venture, and (ii) where the acquiring vehicle is an established bank or thrift holding company, generally, a "strong majority interest" will be found where the shareholders in the holding company (i.e., pre-dating the acquisition) retain at least two-thirds of the total equity of the resulting bank or thrift holding company. In making the determination of whether or not a "strong majority interest" exists, the FDIC will take into account whether the private investors receive any special rights through covenants, agreements, special voting rights or other mechanisms.

| Nature of PE Firm's<br>Investment in the Failed Bank   | Interplay Between the FDIC Statement<br>and "Control"-Related Considerations  |
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| <p>Investment Structure Category #3</p> <p><u>"Private Investor Club Deal"</u></p> <ul style="list-style-type: none"> <li>▪ One or more individual "private investors" each make an investment representing more than <u>5%</u> of the total voting power of the acquired entity (but <u>less</u> than <u>25%</u> of a class of voting securities of the entity).</li> </ul> | <ul style="list-style-type: none"> <li>▪ FDIC Statement requirements apply. <ul style="list-style-type: none"> <li>▪ Financial support requirements - capital maintenance/"cross support."</li> <li>▪ Prohibition on "insider lending."</li> <li>▪ Three-year minimum holding period by private investors.</li> <li>▪ Disclosure requirements relating to private investor ownership.</li> <li>▪ Restrictions on investment structure – no entities domiciled in a bank secrecy law jurisdiction and no "silo" structure.</li> </ul> </li> <li>▪ "Non-Controlling" investment by the private investor is generally possible. <ul style="list-style-type: none"> <li>▪ Possible in many cases for the private investor to acquire up to <u>33%</u> of the total equity of the acquired institution so long as the investor does not own, hold or vote more than <u>14.9%</u> of any class of voting stock of the acquired entity.</li> <li>▪ In certain cases the private investor (particularly if the investor acquires <u>10%</u> of more of a class of voting securities of the acquired entity) may be required to make or offer to make "passivity" commitments. "Anti-association" commitments may also be required.</li> <li>▪ Private investor representation (e.g., one representative) on the board of directors of the acquired institution should generally be possible.</li> </ul> </li> </ul> |

| Nature of PE Firm's<br><u>Investment in the Failed Bank</u>  | Interplay Between the FDIC Statement<br>and " <u>Control</u> "-Related Considerations  |
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| <p>Investment Structure Category #4</p> <p><u>"Controlling" Investment</u></p> <ul style="list-style-type: none"> <li>▪ Investment by a "private investor" representing <u>25%</u> or more of any class of voting securities, or <u>33%</u> or more of total equity of the acquired entity, or the right to elect a majority of directors of the acquired entity.</li> </ul> | <ul style="list-style-type: none"> <li>▪ FDIC Statement requirements may apply. <ul style="list-style-type: none"> <li>▪ Financial support requirements - capital maintenance/"cross support."</li> <li>▪ Prohibition on "insider lending."</li> <li>▪ Three-year minimum holding period by private investors.</li> <li>▪ Disclosure requirements relating to private investor ownership.</li> <li>▪ Restrictions on investment structure - no entities domiciled in a bank secrecy law jurisdiction and no "silo" structure.</li> </ul> </li> <li>▪ FDIC might not impose the FDIC Statement requirements due to the private investor having to become a bank holding company.</li> <li>▪ Automatic "controlling" investment by the private investor. <ul style="list-style-type: none"> <li>▪ Private investor becomes a bank holding company.</li> <li>▪ Private investor subject to Federal Reserve supervision, regulation, reporting, capital requirements, and limitation on non-banking activities.</li> </ul> </li> </ul> |