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# Bank Asset Acquisitions by Private Equity and Other Non-Bank Investors Navigating Federal Regulations and Policies in Structuring Transactions

**A Live 90-Minute Teleconference/Webinar with Interactive Q&A**

**Today's panel features:**

Daniel Keating, Partner, **Hogan & Hartson**, Washington, D.C.

Beth S. DeSimone, Counsel, **Arnold Porter**, Washington, D.C.

Kevin L. Petrasic, Of Counsel, **Paul Hastings**, Washington, D.C.

**Tuesday, December 1, 2009**

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**1 pm Eastern**

**12 pm Central**

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# **Acquisition of Bank Assets by Private Equity and Other Non-Bank Investors**

*Navigating Federal Regulations and Policies*

*In Structuring Transactions*

## **Strafford Publications Teleconference**

**December 1, 2009**

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# Current Environment for Non-Bank Investments in Depository Institutions

- Regulators have begun to relax some restrictions to encourage flow of private capital into banking system.
- At the same time, regulators continue to stress the need to ensure capital adequacy, management stability, and safe and sound banking practices, whether or not investors are themselves financial institutions.

# Recent Regulatory Guidance

- 2008 Fed Policy Statement
  - Eases certain restrictions on private equity firms' ability to invest in banks without becoming subject to the Bank Holding Company Act
- 2009 FDIC Policy Statement
  - Imposes certain restrictions on private equity firms' ability to invest in failed banks
  - However, final version of statement not as restrictive as proposed version

## 2008 Fed Policy Statement

- On September 22, 2008, the Federal Reserve Board issued its Policy Statement on Equity Investments in Banks and Bank Holding Companies (12 CFR 225.144).
- The Policy Statement facilitates, to some extent, the ability of private equity firms and other investors to make large investments in banks and bank holding companies without being deemed to control such entities under the Bank Holding Company Act.

# Bank Holding Company Act

- BHC Act requires any company that directly or indirectly controls a bank or a BHC to register as a BHC.
- BHCs are subject to:
  - Activity restrictions aimed at separating banking and commerce
  - Fed comprehensive regulation and supervision, including capital adequacy requirements, serving as a source of strength to the bank, and prior approval to make certain investments or engage in certain activities

## Definition of “Control”

- BHC Act defines “control” as any of the following:
  - Directly or indirectly owning, controlling or having the power to vote 25% or more of any class of voting securities of a bank or BHC;
  - Controlling in any manner the election of a majority of the directors or trustees of the bank or BHC; or
  - Directly or indirectly exercising a controlling influence over the management or policies of the bank or BHC that the Fed, after notice and opportunity for hearing, determines is control.
- The Fed has a great deal of discretion under the third prong of the control definition to determine whether the investor is in fact in control.

## Rebutting Presumptions of Control

- Companies making a 10% or greater but less than 15% investment in class of a banking organization's voting stock have typically entered into the so-called Lincoln National passivity commitments.
- Companies making a 15% or greater but less than 25% investment have typically entered into the so-called Crown-X commitments.

# Rebutting Presumptions of Control – Passivity Commitments

- Both Lincoln National and Crown-X commitments are similar. The investor must agree that it will not:
  - Propose a director or slate of directors in opposition to management or board proposed nominees
  - Solicit or participate in soliciting proxies
  - Attempt to influence the dividend policies; loan, credit, or investment decisions or policies; pricing of services; personnel decisions; operations activities (such as location and hours)
  - Dispose of, or threaten to dispose of, stock as a condition of specific action or non-action by the banking organization
  - Enter into any transactions with the bank (except for deposits with an aggregate balance not more than \$500,000 and on substantially the same terms as those prevailing for non-affiliates)

# New Fed Policy

- Three principal revisions to Federal Reserve precedent:
  - Ability for investors holding between 15% and 24.9% of a class of voting securities to have a representative on the bank's board of directors, and in some cases 2 representatives
  - Increased permissible levels of non-voting equity investments from 25% of the total equity to 33% in certain instances
  - Increased ability for a minority investor to communicate with management and advocate for specific policies

# New Fed Policy – Increased Representation on Board of Directors

The September 22, 2008 Policy Statement relaxes limitations on board representation by non-controlling investors.

- A minority investor, including those owning more than 15%, generally should be able to have a single representative on the board of directors
  - Fed: “In the absence of other indicia of control, it would be difficult for a minority investor with a single board seat to have a controlling influence over the management or policies of the banking organization.”

## New Fed Policy – Increased Representation on Board of Directors (cont'd)

- A minority investor can have up to 2 representatives on the board of directors if, absent other indicia of control:
  - The aggregate director representation is proportionate to its total interest;
  - The 2 representatives do not comprise more than 25% of the voting members of the board; and
  - Another shareholder is a bank holding company that controls the banking organization under the BHC Act.
- A minority investor's board representatives cannot serve as chair of the board or of a committee, nor occupy more than 25% of the seats on any committee.

## New Fed Policy – Increased Non-Voting Equity Stakes

The September 22, 2008 Policy Statement provides flexibility in the use of non-voting equity interests.

- A combination of voting and nonvoting shares that are less than one-third of total equity will not constitute “control” if the investor holds less than 15% of any class of voting securities.
- Non-voting shares convertible into voting shares at the election of the holder, or that mandatorily convert after passage of time are deemed voting.
- Non-voting, non-convertible shares are not deemed voting if transfers are subject to so-called dribble-out commitments to minimize ability to exercise a controlling influence or convey control. The shares may only be transferred:
  - To an affiliate of the investor or the banking organization
  - In a widespread public distribution
  - Where no transferee will receive 2% or more voting stock
  - Where the transferee will control more than 50% of the voting securities

## **New Fed Policy – Increased Communications**

The September 22, 2008 Policy Statement provides clarity and more flexibility for permissible communications with management and rest of board of directors

- Non-controlling minority investor, like any other shareholder, may communicate with management to advocate for changes in policies and operations, including dividend policy, mergers, and new or alternative management

## Case-by-Case Review

- Non-control determinations to be reviewed by Fed on a case-by-case basis.
- Investors holding more than 10% of the voting stock will continue to be required to enter into passivity commitments (reflecting the new positions in the Policy Statement)
  - Despite commentary and press reports that implied otherwise, there is no “safe harbor” for investments under 15%

## Review Focus – Business Relationships

- Business relationships between the investor and the banking organization will continue to be closely reviewed
  - The Fed believes that business relationships between an investor and the banking organization could result in a controlling influence
  - Business relationships need to be quantitatively and qualitatively limited for a non-control determination
  - The greater the investor's percentage holdings of voting securities holdings, the more concern the Fed will have with business relationships

## Review Focus – Restrictive Covenants

- Restrictive covenants in any agreements between the investor and the banking organization will continue to be closely reviewed.
- Covenants that substantially limit the discretion of management over major policies and decisions suggest control.
- Covenants limited to those that protect the rights of a particular class of security holder, such as limiting the issuance of additional senior securities or providing limited information and consultation rights, are generally consistent with non-control.

## Change in Bank Control Act Notice Requirements

The September 22, 2008 Policy Statement interprets “control” under the BHC Act. It does not change rebuttable presumptions of control and prior notice requirements under Change in Bank Control Act (CIBCA), which requires 60 days’ prior notice

- Under the Federal Reserve’s CIBCA regulations, any person with 10% or more of a class of voting securities is presumed to have control if no other person controls a greater percentage of that class of voting securities, or the banking organization has registered securities under section 12 of the Securities Exchange Act of 1934
- Therefore, investments of 10% or more will, in most cases, still require regulatory notice under CIBCA
- The case-by-case review process and entry into commitments will occur through the CIBCA filing

# Acquisition of Failed Banks – 2009 FDIC Policy Statement

- On August 26, 2009, FDIC issued its Statement of Policy (SOP) on Qualifications for Failed Bank Acquisitions.
- SOP applies to “Investors”
  - Private investors, including private equity firms, buying failed banks
  - Prohibits bids by investors that hold  $\geq 10\%$  of equity of the failed bank
- SOP does not apply to
  - Already completed acquisitions
  - Investment in institution with composite CAMELS rating of 1 or 2 for 7 consecutive years (with FDIC approval)
  - Investors in ventures with holding companies that have a “strong majority interest” in the bank and “an established record for successful operation” of banks
  - Investors with  $\leq 5\%$  of total voting power of the acquired bank or its holding company
- FDIC can waive any provision of SOP if in best interest of deposit insurance fund and goals of SOP can be accomplished by other means.

# Capital / Strength Requirements

- Acquired institution must maintain ratio of Tier 1 common equity to total assets of at least 10% for 3 years from acquisition date, remain “well-capitalized” thereafter
  - Failure to meet these levels will result in “undercapitalized” designation
  - Proposed SOP would have required 15%
- Deleted requirement from proposed SOP that acquirer must serve as “source of strength” via direct capital injections
- “Cross Support”: If one or more investors own 80% or more of 2 or more institutions, must pledge the commonly owned stock to FDIC
  - FDIC can waive where exercise of pledge would not decrease cost of failure to deposit insurance fund
- Prohibits new extensions of credit by acquired institution to investors, their investment funds, and/or any affiliate of either

## 3-Year Prohibition on Sales

- “Continuity of Ownership” provision reflects FDIC concerns regarding:
  - Ownership/management instability
  - Desire to ensure bank owners are invested in bank’s successful and prudent operation in the long term
- Provision prohibits investors from selling/transferring their interest in acquired bank for 3 years from acquisition without FDIC approval
  - FDIC shall not reasonably withhold approval for transfers to affiliates who agree to abide by SOP
  - Prohibition does not apply to mutual funds defined as open-end investment companies registered under the Investment Act of 1940 that issue securities redeemable on demand

# Structure/Transparency Requirements

- No “complex and functionally opaque ownership structures”
  - Difficult to ascertain beneficial ownership and decision-making parties; ownership/control separated
- Limitations on ownership by entities domiciled in “secrecy law jurisdictions”
  - Countries with laws that limit regulatory transparency
  - Investors must be subs of companies subject to comprehensive consolidated supervision as recognized by Fed, and must agree to disclose certain information on business activities to regulators
- Disclosures to FDIC required from all investors about investors and all entities in ownership chain
  - Size of capital fund(s), diversification, return profile, marketing documents, management team, business model

# FDIC Failed Institution Asset Sales

- Mix of loan types – mortgage, commercial, consumer
- Loan portfolios of distressed/troubled loans, but portfolios may include both performing and nonperforming loans
- Others asset types include securities and mortgage servicing
- 3 Major Programs:
- Loan Portfolio Sales: Loans are pooled and packaged for bid based on their common characteristics
- Structured Loan Transaction Program: Public-private partnership involving LLC created by FDIC as receiver
- Legacy Loans Program: Joint FDIC-Treasury pilot incorporating public-private investment funds to buy/sell bank loans and other assets

# FDIC Loan Sales

- Loans with similar characteristics, such as size, quality, type and collateral, are pooled and bid out
- Bidders must contact the FDIC to schedule a due diligence appointment to review the loan files
- FDIC storeroom provides all information required to qualify and submit a bid
- Bidders must make an initial deposit to bid; winning bidder must make a 10% deposit within one day after winning bid
- Sale usually closes within 20 days
- FDIC markets loans through – First Financial Network; DebtX, The Debt Exchange; Eastdil Secured; Garnet Capital Advisors; and Mission Capital Advisors ([www.missioncap.com](http://www.missioncap.com))

# FDIC Structured Loan Sales Program

- Structured Loan Sale Transaction involving Public-Private Partnerships
- Each transaction includes specific bid parameters and qualification criteria
- Recent example is Starwood consortium purchase of 40% interest in CRE pool of Corus Bank – included 1-to-1 debt-to-equity match from FDIC on the total equity that FDIC (\$832M) and Starwood (\$554M) put into the deal. Leverage of \$1.39B produced total purchase price of approximately \$2.77B, or roughly 60% of the \$4.5B book value of the troubled assets in the pool
- Additional \$1B advance funding facility available for 3 to 5 years to fund future unfunded commitments and overages on existing construction loans, REO costs, and working capital needs
- Advance and term funding must be repaid before any distributions to equity holders; automatic equity kicker for FDIC if distributions to Starwood exceed certain thresholds
- Business plan requirement for each of the loans in the portfolio.
- FDIC retained ability to sell term note into the market at a market yield at a later date, and to syndicate up to 51 percent of the advance funding

# FDIC Legacy Loans Program

- Variation of Structured Loan Sale
- First and only pilot sale announced 9/16/09 – Residential Credit Solutions' (RCS) purchased ownership interest in LLC holding \$1.3B principal balance portfolio of Franklin Bank residential mortgage loans
- Terms allowed for FDIC receivership to provide leverage to the LLC with an FDIC-guaranteed amortizing note
- Bidders could bid at either 6-1 or 4-1 debt-to-equity ... or a cash bid for a 20% ownership interest in the LLC
- RCS bid 6-1 and paid \$64.2M for 50% equity stake in LLC; matched by FDIC equity investment and levered so FDIC issued a note valued at roughly \$728M

## Eligibility Requirements to Purchase Loans Through FDIC

- Purchaser Eligibility Certification – e.g., no officers/directors of failed institutions
- Confidentiality Agreement required before reviewing loan files in order to decide whether to purchase
- Bid Instructions specific to each loan sale
- Earnest Money Deposit/Final Deposit in amounts that vary by loan sale
- FDIC website has detailed information on bidding process, specific terms for each loan sale
  - Anyone may sign up for FDIC email notification of asset sales

# Outlook for Non-Bank Equity Investments in Banks

- Numerous opportunities for investments.
- Structured loan sales and LLP likely to continue to evolve.
- Regulators will continue to balance need for increased capital in banking system against supervisory concerns raised by allowing non-bank entities to invest in banks.

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