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Private Equity Investment: Navigating The Mine Fields

Law360, New York (October 21, 2008) -- Facilitating private equity investment in financial institutions has become a top priority in Washington, as banks and thrifts continue to struggle with losses in their mortgage and commercial real estate portfolios.

In furtherance of that priority, on Sept. 22, 2008, the Federal Reserve issued a much anticipated policy statement on minority equity investments in banks and bank holding companies.

The policy statement relaxed some of its long-standing policies related to what constitutes control or controlling influence so that significant non-controlling investments could be made by private equity firms in banks and bank holding companies.

For example, the policy statement would allow a private equity firm to invest up to 33 percent of the total equity of a target bank or bank holding company, subject to certain conditions, including (but not limited to) that the investing firm does not acquire 15 percent or more of any class of voting securities.

The policy statement also would allow a private equity firm to name up to one director on the board of the target bank or bank holding company and up to two directors, subject to certain conditions.

Firms also can engage the management of the target bank or bank holding company in certain discussions about its business and operations, and may have some flexibility on business relationships with the target bank or bank holding company, if the investment is closer to 10 percent than to 25 percent of the total voting securities of the target.

The Federal Reserve's relaxation of these policies on non-controlling investments, while welcome, does not address some of the fundamental questions that private equity firms have with respect to controlling investments in financial institutions, and thus may not spur a large number of investments in institutions that may be seeking to bolster their capital.

In particular, the policy statement does not address any issues relating to alternative investment vehicles within a private equity funds, including what relationships among investors in a private equity fund would create a "group" whose investments are attributed to one another, and the entities to which the control rules should apply.

It also does not address the relationships among private equity firms that may jointly invest in one target bank or bank holding company in a "club" deal.

It remains to be seen whether the Federal Reserve will interpret its control rules, including the new policy statement to allow for private equity investments to be structured to allow for either such "club" deals, or a controlling investment by one fund or alternative investment vehicle in a private equity family, without affecting the ability of other funds with an affiliated investment manager to continue to make investments in a wide variety of areas.

Interestingly, there are indications that the Office of Thrift Supervision ("OTS"), which regulates savings banks, not commercial banks, may be willing to be more flexible in this area than the Federal Reserve.

What constitutes "control" over a bank or bank holding company (or a savings institution or a savings and loan holding company) is one of the more complicated areas in financial services law.

The laws and regulations governing control are complex and somewhat overlap, and the banking agencies, while having some "bright line" rules, have superimposed certain interpretations on those rules that are either unwritten or found only in interpretive letters or approval orders. In many cases a "facts and circumstances" approach is taken on the issue.

Generally, under the Bank Holding Company Act, an entity (including most private equity funds) is considered in control of a bank or bank holding company, if the entity, among other things:

(1) acquires direct or indirect control of 25 percent or more of any "class" of voting securities of that bank or bank holding company; or

(2) controls in any manner the election of a majority of the board of directors of the bank or bank holding company; or

(3) has the power to directly or indirectly exercise a controlling influence over the management or policies of the bank or bank holding company.

A similar definition of control is found in the Savings and Loan Holding Company Act and the OTS' Control Regulations, which govern any acquisition of control over savings institutions and their holding companies, although, unlike the Bank Holding Company Act, the Savings and Loan Company Act also defines control to include any contribution of more than 25 percent of the capital of a company.

Under the Change in Bank Control Act, the definition of control is the same, but the federal banking agencies (including the OTS for acquisitions of control of savings institutions) have each established a presumption of control for any acquisition of 10 percent or more of the voting securities of the bank or bank holding company if:

(1) the bank or bank holding company's securities are subject to registration under the Securities Act of 1934; or

(2) no other shareholder will own a greater percentage of voting securities immediately after the transaction.

This presumption of control can be rebutted by any entity deemed in control entering into a series of passivity commitments or a passivity agreement with the appropriate federal

regulator not to control the institution or exercise, or seek to exercise a controlling influence over the management or policies of the institution.

In the private equity context, under all of these laws, the entities deemed in control may include not just the fund itself, but any general partner or managing member of the fund, other persons or entities deemed to be acting in concert with them, including in some cases other funds and general partnerships, and any other person or entity that is deemed to contribute more than 25 percent of the capital of the fund (which may include investors).

Thus, the breadth of the law can be wide, and this potential breadth is not generally addressed in the recently issued policy statement.

Furthermore, if a private equity fund is considering acquiring control of a bank or bank holding company, then the fund itself (and any general partner, or managing member that controls the fund and perhaps others) must file for approval to become a bank holding company, and become subject to supervision and regulation by the Federal Reserve.

If the fund is acquiring control over a savings institution, it (and any general partner or managing member that controls the fund) must file for approval with the Office of Thrift Supervision to become a savings and loan holding company.

Once any of these entities are a holding company, they (and their subsidiaries) become subject to statutory and regulatory limits on their investments, and become subject to limits on their activities to those that are financial in nature or complementary to a financial activity.

Since most private equity firms make controlling investments in companies of all sorts, these limitations are unacceptable for most such entities.

The alternative is to limit the fund’s investment in the target bank or bank holding company to either below 10 percent (which is below the regulatory presumption of control) or between 10 percent and 24.99 percent or the voting stock, or potentially up to 33 percent of the equity (if the target is a bank or bank holding company and the private equity firm meets the conditions in the Federal Reserve’s Sep. 22, 2008 policy statement for investing that amount) or 24.99 percent of total equity (if the target is a savings institution or savings and loan holding company).

In each case, the private equity firm would need to enter into passivity commitments with the Federal Reserve (or if the target is a savings institution or its holding company, a rebuttal of control agreement with the OTS), which would limit the number of directors (up to 2 if the target is a bank or bank holding company, and one if the target is a savings institution or savings and loan holding company) limited or no influence over management, no ability to engage in proxy contests or other non-passive involvement with the target, and limited transactions with the target.

This alternative also can be unpalatable to a private equity firm used to active management of their investments, even under the terms of the Federal Reserve’s September 22 policy statement.

There are several alternative structures that the Federal Reserve and the OTS may be considering that would allow a private equity firm to make substantial investments in one or more financial institutions within the constraints of current law.

One alternative is to create one new alternative investment fund that would invest solely in a bank or its holding company (or a thrift and its holding companies).

Under this “silo” approach, only the fund, and any general partner or managing member, that proposes to invests in the financial institution would seek to become bank holding companies or control persons.

If properly structured, the other funds with an affiliate investment manager and their general partners or managing members, would not be subject to bank regulation and would continue to be free to conduct their investing activities.

A second alternative is for several private equity firms to invest in what are referred to as “club” deals, where each firm takes a non-controlling interest in a bank (or its holding company) or a thrift (or its holding company), and each company has the right to name one director.
The investing entities would rebut any presumption that they are acting in concert to control the bank or the thrift (or their respective holding companies).

In each case, one of the more important issues that must be considered is the extent to which the regulatory agencies will seek information on or commitments from the investors in the funds. This issue arises, for example, when one or more investors have contributed more than 25 percent of the capital of a fund.

The issue also can arise if many of the same investors in one fund also invest in another fund that in turn invests in a financial institution. Such parallel investing, even if co-incidental, might in the past in some circumstances have been considered acting in concert by a regulator.

These are areas where the Federal Reserve and the OTS may be willing to be flexible, depending on the facts and circumstances.

Depending on how they are structured, these alternatives may not be workable for all private equity fund families. These alternatives also raise other ancillary issues that would need to be resolved in each case for any proposal to move forward, including Investment Adviser Act issues, securities law issues, tax and ERISA issues, and other regulatory issues.

Additional issues will arise if a private equity firm wants to invest in more than one financial institution. But both the interest from various private equity firms and the signals from the regulators, particularly the Office of the Comptroller of the Currency and the Federal Reserve, indicate that such issues can be overcome to allow increased participation by the firms in the recapitalization of the financial services area.

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