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Private Equity Investment in U.S. Financial Institutions: Promise and Challenges

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Financial institutions in the United States and elsewhere continue to struggle with losses in their loan portfolios and write-downs in their investment portfolios. Governments have stepped in to bolster bank capital and liquidity, and to encourage sales of non-performing assets and the issuance of new loans. For example, in the United States over the past six months, the Department of the Treasury has proposed or implemented several programs to bolster bank capital and liquidity. These include:

- The Capital Purchase Program under the Troubled Assets Relief Program, under which the Treasury Department has invested over US $350 billion in senior preferred stock (plus warrants) of eligible financial institutions and their holding companies (including U.S. financial institutions or holding companies in which foreign banks or non-U.S. investors hold minority investments (i.e., less than 25% of the equity)) that apply for such funds;[1]

[1] A description of the program is available at http://www.treas.gov/initiatives/eesa/.

- The Capital Assistance Program, under which the Treasury Department proposes to invest in mandatorily convertible preferred stock (plus warrants) of eligible financial institutions and their holding companies that apply for such funds and undertake a forward-looking assessment of its balance sheet risk and capital needs (a so-called stress test) indicating the need for such capital;[2]
- The Term Asset-Backed Loan Facility or TALF, under which the Federal Reserve will use up to US $1 trillion to extend credit to eligible lenders, fully secured by highly rated securities backed by auto loans, education loans or credit card loans made by such lenders to businesses and consumers, thus making funding more available for such loans;[3] and
- The Public-Private Investment Fund, under which the Federal Reserve and the FDIC will establish a series of funds, capitalized by private funds and up to U.S.$500 billion to US$ 1 trillion in public financing, which will then purchase underperforming assets on bank balance sheets.[4]

To fully recapitalize the financial services industry in the United States, however, private equity investment in financial institutions almost certainly will need to occur. To that end, in the past six months, the U.S. federal bank regulatory agencies also have promulgated new policies designed to encourage private equity investment in the financial services industry in the United States. As discussed further below, overall, these policies, while innovative, do not resolve many of the control issues that confront private equity funds (including those with non-U.S. investors) wishing to make investments in U.S. financial institutions. Thus, it remains to be seen

[2] A description of this program is available at http://www.treas.gov/initiatives/eesa/.

[3] A description of this program is available at http://www.newyorkfed.org/markets/talf.html.

[4] A description of this proposal is available at http://www.financialstability.gov/.

whether these new policies will spur the needed private investment as the environment for such investment improves.

A. OCC, FDIC and OTS Proposals: "Shelf" and "Inflatable" Charters

The Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") each announced new policies in November 2008 designed to facilitate new private equity investments in troubled U.S. depository institutions. The OCC was the first to issue such a policy, announcing a "shelf" charter program on November 21, 2008, under which it described a process under which the agency could grant preliminary approval to an investor group for a new national bank charter that would remain inactive or "on the shelf" until such time as the investor group is in a position to acquire a failing or failed institution.[5] The process for regular new national bank charters requires the organizational group to propose a geographical place for the new bank, detail the names and qualifications of a local board and management group (including completing detailed financial and biographical reports), the funds that are being raised for capital, and submit a detailed business plan. In contrast, the "shelf" charter process allows an investor group to submit a more general proposal of the size and type of troubled institutions in which the group may be interested in acquiring, the dollar amount of the capital immediately available for such acquisition (i.e., the cash already raised), the qualifications of the proposed management team (including required background information), and a streamlined business plan that describes how the acquired bank will be operated. If the proposal is acceptable, the OCC would issue a preliminary approval of a charter, subject to certain conditions and requirements that a more detailed business plan, satisfactory to the OCC, be submitted if the group bids on a specific institution for acquisition.

5 The OCC's statement on "shelf" charters is available at http://www.occ.treas.gov/ftp/release/2008-137.htm.

The granting of this preliminary approval allows an investor group (which may include one or more non-U.S. investors) that is not already a financial institution or a bank or savings and loan holding company to be eligible to view the FDIC's list of failing or troubled banks and thrifts, and to bid on troubled U.S. financial institutions in which it is interested. If a bid is submitted by the investor group, the OCC then will evaluate the specific proposal, and if acceptable and the FDIC approves the bid, issue a final charter approval. If the bid is not accepted by the FDIC, then the preliminary approval remains on the shelf and is good for up to 18 months.

Another initiative that the OCC has commenced is the "inflatable" charter, under which an investor group applies to acquire a small national bank, on the understanding that in the next year, the acquirer group will expand the business, asset size and geographical reach of the charter by acquiring failing or failed financial institutions or assets and liabilities of such institutions. The expansion of the business of the acquired institution is subject to submission of an acceptable business plan, and agreeing to certain conditions relating to capital and liquidity maintenance of the institution.

To date, the OCC has issued one approval for a "shelf" charter,[6] and one approval for an "inflatable" charter.[7] To date, however, the "shelf" charter has not been used, and the bank acquired by J.C. Flowers has not acquired any failing bank assets.

The Office of Thrift Supervision (the primary federal bank regulator for savings institutions - i.e., savings and loan associations and savings banks - and savings and loan holding

6 Ford Group Bank, N.A., OCC Conditional Approval (Nov. 17, 2008), *available at* http://www.occ.treas.gov/ftp/release/2008-137a.pdf.

7 First National Bank of Cainesville, Missouri, OCC Conditional Approval (Aug. 27, 2008), *available at* http://www.occ.gov/interp/aug08/ca872.pdf.

companies), while not announcing its own a formal "shelf" charter process, appears to be allowing investor groups to file applications on an informal basis to become savings and loan holding companies upon the acquisition of a failed savings bank. The applications require information similar to that being required by the OCC for "shelf" bank charters. To date, however, no such applications have been acted upon.

At about the same time as the OCC issued its "shelf" charter policy statement, the FDIC issued a statement modifying its bidder qualifications to expand the pool of bidders of failing financial institutions by allowing groups that have obtained a preliminary charter (such as the OCC's "shelf" charter) to participate in the bid process.[8] The FDIC also said it would modify its requirements for obtaining federal deposit insurance for such preliminary charters and may issue conditional approvals for deposit insurance to facilitate the ability of investor groups to participate in the process. However, to date, it does not appear that the FDIC has approved any deposit insurance applications for this purpose.

B. Federal Reserve Policy Statement on Minority Investments in Banks

The "shelf" bank charter concept of the OCC, and its equivalent concept being used by the OTS, while innovative, do not address any of the complicated control issues that may arise in connection with private equity fund investments in or acquisitions of any financial institution in the United States. Indeed, each of these proposals assume that a private investor group would acquire control over the new bank, and thus require, as a condition to obtaining a final approval to take the charter "off the shelf" that a private equity investor group obtain approval either from

[8] Press Release, FDIC Expands Bidder List For Troubled Institutions (Nov. 26, 2008), *available at* http://www.fdic.gov/news/news/press/2008/pr08127.html.

the Federal Reserve to become a bank holding company (if the proposed target institution is a bank), or from the OTS to become a savings and loan holding company (if the proposed target institution is a savings institution).

The Federal Reserve in September 2008 issued a new policy statement on minority equity investments in banks and bank holding companies that it hoped would address some of these issues.[9] 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% 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% or more of any class of voting securities, The policy statement also allows 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% than to 25% of the total voting securities of the target.

The Federal Reserve's relaxation of these policies on non-controlling investments, while welcome, did not address most of the fundamental questions that private equity firms have with respect to controlling investments in financial institutions. In particular, the policy statement did not address any issues relating to alternative investment vehicles within private equity funds,

[9] Policy Statement on Equity Investments in Banks and Bank Holding Companies, (Sept. 22, 2008) (to be codified at 12 C.F.R. § 225.144), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf.

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 did not address the relationships among private equity firms that may jointly invest in one target bank or bank holding company in a "club" deal. Indeed, the Federal Reserve has not yet interpreted 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. The Federal Reserve also seems to be taking the position that certain precedents it had in this area prior to the issuance of the policy statement have been superseded by the policy statement, making it more difficult to structure transactions based on prior transactions.

C. Issues Not Addressed in the Regulatory Statements

Indeed, 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 U.S. financial services law. The laws and regulations governing control in the United States 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 U.S. 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.[10]

A similar definition of control is found in the U.S. 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.[11]

Furthermore, 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

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[10] 12 U.S.C. § 1841(a)(2) (2000).

[11] 12 U.S.C. § 1467a(a)(2)(B) (2000).

(2) no other shareholder will own a greater percentage of voting securities immediately after the transaction.[12]

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.

Furthermore, for investments between five and 25 percent of a banking organization's voting securities, there are a variety of tests and presumptions related to determining whether ”control” is deemed to exist under these federal banking laws. These tests and presumptions must be evaluated in structuring any investment, as well as discussed with the appropriate U.S. federal bank regulatory agency.. For example, under the Federal Reserve's control rules, there is a rebuttable presumption of control if a company owns five percent or more of a class of voting shares of a banking organization and shares a director or officers with the organization, and no other investor owns five percent or more of that class of that banking organization's voting shares.[13] Both the terms “class” and “voting shares” have specialized definitions in U.S. federal banking law that are very different than commonly understood by corporate lawyers and investors. There also are presumptions of control based on warrants and options that may be held, convertibility features that may apply to non-voting stock, the nature and amount of business done between two companies, the amount of total capital or equity (including non-voting capital and junior or subordinated debt) held, and a variety of other factors.

[12] 12 C.F.R. § 224.141(2008).

[13] 12 C.F.R. § 225.31(d)(2)(iii) (2008).

A determination of whether "control" exists under these rules and presumptions determines what applications must be filed and approvals obtained, whether a passivity agreement may rebut the presumption of control that may be deemed to exist, whether "cross-guarantee" liability applies between two or more depository institutions that may be deemed to be affiliated, as well as the regulatory requirements, capital standards, supervisory framework and other restrictions that may apply to the investments and activities of affiliated companies. These rules and presumptions also may determine whether an investor group may be even permitted to make the investment in the banking organization.

Furthermore, in the private equity fund context, under all of these laws and rules, 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, whether U.S. or non-U.S.-based). Thus, the breadth of the law can be wide, and this potential breadth is not generally addressed in the September 2008 Federal Reserve policy statement.

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 of 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 September 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 are 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 (whether or not U.S. based). 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 coincidental, might in the past in some circumstances have been considered acting in concert by a regulator. While these are areas where the Federal Reserve and the OTS should be flexible, depending on the facts and circumstances, to date there has not been any indication as to whether such flexibility will be shown.

Furthermore, depending on how these alternatives are structured, they 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.

Thus, while the U.S. federal bank regulators have shown some innovation and flexibility designed to encourage the needed private equity investment in troubled financial institutions in the U.S., the unique control issues involved in many private equity fund investment proposals continue to act as countervailing weights in this area. Such control issues will need to be overcome to realize increased participation by private equity firms in the recapitalization of the U.S. financial services industry.

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