FDIC PROPOSED GUIDANCE ON PRIVATE EQUITY INVESTMENTS IN FAILED DEPOSITORY INSTITUTIONS

On July 2, 2009, the Federal Deposit Insurance Corporation (FDIC) released a Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (Proposed Policy Statement or Statement). According to FDIC Chairman Sheila Bair, the Proposed Policy Statement is intended to "provide guidance to private capital investors interested in acquiring or investing in failed banks or thrifts regarding the terms and conditions of the investments or acquisitions." This proposed guidance has been much anticipated since the FDIC stated on May 21, 2009 that it would provide such guidance in a press release announcing its sale of the failed BankUnited, FSB to a group of private equity investors. Earlier, the FDIC had sold IndyMac Federal Bank, which was operating in an FDIC conservatorship, to another group of private equity investors. Public comments on the Proposed Policy Statement are due within 30 days of its publication in the Federal Register. However, the Proposed Policy Statement, if finalized as issued, imposes very harsh requirements on private equity investors, and, thus, is not likely to facilitate many future transactions.

A summary of the Proposed Policy Statement follows.

I. TYPES OF INVESTMENT STRUCTURES THAT WOULD TRIGGER THE PROPOSED REQUIREMENTS

The Proposed Policy Statement first attempts to define the investment structures that the FDIC proposes to subject to the requirements of the Statement. The types of structures are those that are used to invest more than a *de minimis* amount in a shell holding company that proposes to acquire a failed bank or thrift, if the ownership structures are not themselves registered as bank or thrift holding companies. Such structures would presumably include investment funds that participate in a so called "club deal" to invest in a holding company that is set up to acquire a failed bank or thrift. These investment funds would not be acting in concert with other funds or individually acquiring a controlling interest in the holding company.

The Proposed Policy Statement specifically singles out what is characterized as "complex and functionally opaque" structures, "typified by so-called 'silo' organizational arrangements," as the type of investment structure the FDIC would consider unsuitable for investment in insured depository institutions. The FDIC

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believes that, under these structures, "beneficial ownership cannot be ascertained, the responsible parties for making decisions are not clearly identified, and/or ownership and control are separated." No reason is provided for its position and acceptable structures are not further defined.

Other than the "silo" and certain other undefined structures singled out as unsuitable for investment in the banking sector, the Proposed Policy Statement appears to allow private equity investment structures to bid for failed banks or thrifts, but it would impose the eligibility criteria set forth in the Proposed Policy Statement. Specifically, the requirements appear to apply to:

- Private equity investors that have applied for deposit insurance through the *de novo* charter process, through which a charter will be issued in connection with the resolution of a failed insured institution; and
- Private equity investors in a company (other than a bank or thrift holding company that has come into existence or has been acquired by an investor at least three years prior to the date of the final policy statement) that is proposing to directly or indirectly assume deposit liabilities or liabilities and assets from a failed insured depository institution in receivership.

In the first instance, the investors would have first applied for a shelf charter and deposit insurance through a banking agency's preclearance process to gain access to the FDIC operated bid process. If the FDIC approves the application for deposit insurance, it will apply the Statement's requirements to the private equity investors in the structures along the ownership chain of the newly chartered bank or thrift, unless such structures are registered as bank or thrift holding companies. In the second instance, if the private equity investors, through one or more ownership structures, invest in a holding company that already controls a bank or thrift, which is already regulated, the FDIC would still apply the proposed requirements to the private equity investors unless the holding company "has come into existence or has been acquired by [the investors] at least three years prior" to the date of the policy statement.

II. THE PROPOSED REQUIREMENTS FOR PRIVATE EQUITY INVESTMENTS

Private equity investors covered by the Proposed Policy Statement would be subject to the following requirements.

- **Capital Commitment:** The investors would be required to agree to cause the depository institution that they invest in and that acquires deposit liabilities, or both deposit liabilities and assets, from a failed bank or thrift to maintain a *Tier 1 leverage ratio* of 15% for three years (or longer if required by the FDIC), and then remain well capitalized as long as the investors own it. This requirement is almost punishingly high. Furthermore, if the depository institution should fail to maintain this capital level, it would be treated as "undercapitalized" for purposes of the Prompt Corrective Action provisions of the Federal Deposit Insurance Act, which would require the institution to file a capital restoration plan and come under increased regulatory scrutiny.
- **Source of Strength:** The ownership structures that may be used by investors to acquire a failed bank or thrift would be required to serve as a source of strength for the bank or thrift subsidiary of the holding company. The bank or thrift holding company also would be required to agree to raise equity or debt capital, if necessary, to support the investors' source of strength commitment. The Statement notes that this requirement would be documented in an agreement, likely a capital maintenance agreement between the FDIC and the investors. To date, the source of strength doctrine has been applied only to "companies" that control a bank and are thus bank holding companies or financial holding companies, as defined in the Bank Holding Company Act. The Proposed Policy Statement arguably would apply the doctrine by contract more broadly to investors or groups of investors that do not constitute a "company" under the Bank Holding Company Act, and equity interests that do not give the investors "control" over a bank or thrift.

- **Cross Guarantees:** If investors, individually or collectively, own a majority of the direct *or indirect* investments in more than one insured depository institution, then those investors will be expected to pledge by contract to the FDIC their proportionate interest in each institution to pay for any loss to the Deposit Insurance Fund resulting from the failure of, or assistance provided to, the other institution. As with the source of strength doctrine, cross guarantee liability by statute has been limited to depository institutions that are controlled by the same bank or thrift holding company. The Proposed Policy Statement would apply such liability more broadly to a group of otherwise non-affiliated investors that do not constitute a "company" under applicable law.
- **Transactions with Affiliates:** If private equity investors invest in a depository institution that acquires a failed bank or thrift, that depository institution would be prohibited from extending any credit to the investors, or any company in which any of the investors owns 10% or more of the equity (which is considered an affiliate of an investor), or any company in which the investors or an affiliate of any of the investors invests. It would follow that any investor would be required to disclose the companies in which the investor holds 10% or more of the equity interests, and that the depository institution would be required to maintain records of such holdings in order to comply with this requirement.
- **Secrecy Law Jurisdictions:** The investors would not be able to use an entity domiciled in a bank secrecy jurisdiction (i.e., a jurisdiction with strict bank secrecy laws to protect the anonymity of bank accountholders) to invest in an insured depository institution, unless the investors are subsidiaries of companies that are subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board. Furthermore, the investors would be required to essentially forgo the bank secrecy protection afforded by the entity's jurisdiction of domicile.
- **Continuity of Ownership:** Investors investing in a depository institution that acquires a failed bank or thrift would not be able to sell or transfer their investments for the first three years after the acquisition, unless they obtain FDIC approval. The Proposed Policy Statement indicates that the FDIC does not expect to give such approval to any private equity investor purchaser unless such purchaser agrees to comply with the same requirements that apply to the sellers. It does not appear that similar requirements would be imposed on a bank or savings and loan holding company acquirer.
- **Special Owner Bid Limitation:** Investors that hold 10% or more of the equity of a bank or thrift when it fails would not be allowed to bid on that failed bank or thrift. This again appears unduly harsh, as many such investors are passive investors without any control over the institution, and thus no ability to control or influence management or the institution's activities.
- **Disclosure:** The investors would be required to provide the FDIC with information about themselves and all the entities in the ownership chain, including information regarding the size of the investment fund, its diversification, the return profile, the marketing documents, the management team, and the business model. The FDIC may also require other information.

As noted, these requirements overall are very harsh, and unless eased in the final policy statement, make it unlikely that most private equity investors will seek to participate in acquiring failed banks or thrifts, as the FDIC states is its goal. A concerted effort to comment on the Proposed Policy Statement may result in some easing, although that is not guaranteed. The Proposed Policy Statement, rather, appears to indicate a desire to steer private equity investors in the direction of acquiring assets from the FDIC as receiver for failed banks or thrifts, as opposed to seeking to acquire failing banks or thrifts through the FDIC bid process.

Arnold & Porter has been assisting numerous private equity firms and individual investors interested in navigating through the shelf charter process initiated by the Office of the Comptroller of the Currency and the Office of Thrift Supervision, and the non-controlling investment policy statement issued by the Federal Reserve in September 2008 and its implications. We would be pleased to assist you in considering the implications of this Proposed Policy Statement or in preparing comments on the Proposed Policy Statement. If you have questions or need further information, please contact your Arnold & Porter attorney or:

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