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FDIC to Private Equity: Thanks but (Maybe) No Thanks

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On July 2, 2009, the Board of Directors of the Federal Deposit Insurance Corporation ("FDIC") issued for public comment a proposed Statement of Policy that sets forth the qualifications expected of private equity investors for failed bank acquisitions ("Proposal").[1] The purpose of the Proposal is to provide guidance to private equity investors that are interested in acquiring or investing in assets and liabilities from failed insured depository institutions ("Failed Banks") by setting forth the terms and conditions for such investments or acquisitions.

While the FDIC is currently seeking comment on all aspects of the Proposal, the implications of the Proposal, if adopted in final form, would significantly impact – and potentially derail – the considerations of private equity firms looking to invest in Failed Banks through various investment structures previously contemplated and, in many cases, approved by the federal banking agencies.

The Proposal describes the terms and conditions that private equity investors would be expected to satisfy to obtain eligibility for a proposed acquisition structure. The terms and conditions generally cover: (1) minimum capital support requirements; (2) source of strength commitments; (3) cross guarantee liability; (4) restrictions on transactions with affiliates; (5) restrictions on secrecy jurisdiction investors; (6) ownership transfer restrictions, *i.e.*, minimum hold periods; (7) special bid limitations on certain existing investors of Failed Banks by restricting the ability of such investors to bid on the bank if it failed; and (8) disclosure requirements. The terms and conditions addressed in the Proposal are not intended to replace or substitute the relevant considerations and requirements imposed by a bank's primary regulator in determining the adequacy of an investor's proposed acquisition structure by the investor's holding company regulator.

I. Background

Until recently, only existing depository institutions and their holding companies were deemed qualified bidders for Failed Banks in the FDIC resolution process. In an effort to increase the pool of eligible bidders, and thereby expand access to new sources of capital, federal banking regulators, including the FDIC, now permit pre-cleared non-banks to participate in the bidding process.[2] In May 2009, the FDIC accepted the bid of a consortium of private investment firms for BankUnited, FSB, Coral Gables, Florida, at which time the FDIC indicated its plan to issue further guidance, *i.e.,* the current Proposal, to private equity firms looking to invest in Failed Banks.[3] Previously, the FDIC approved the bid for the acquisition of IndyMac Federal Bank, FSB, Pasadena, California, to OneWest Bank, FSB, a newly formed federal savings bank controlled by IMB Management Holdings LP, which was funded by a consortium of private equity investors.[4]

Private equity investors have generally sought to avoid acquiring "control" of banks in which they invest due to the significant burdens and obligations that accompany such control, *e.g.*, compliance with the activities restrictions imposed under the Bank Holding Company Act ("BHCA") and Home Owners' Loan Act ("HOLA"). A notable exception was Matlin Paterson's acquisition of control of Flagstar Bank, FSB, Troy, Michigan, in a so-called "silo structure" transaction approved by the Office of Thrift Supervision ("OTS") in January 2009.[5] The Federal Reserve Board ("FRB") has not approved silo structure arrangements since its approval of an investment by CapGen Capital Group LLC in September 2007.[6]

To address the challenge of structuring a transaction in compliance with the activities restrictions inherent in the BHCA and HOLA, as applicable, consortiums of private equity firms have been pooling their funds together in so-called "club deals." Under these transactions, no one private equity firm is deemed to control a newly formed holding company or its subsidiary bank that has assumed the liabilities and acquired the assets of a Failed Bank. A common practice in such transactions is for the private equity firms involved to affirmatively file either passivity commitments with the FRB or Rebuttals of Control with the OTS,[7] so as to confirm they are not holding companies and, thus, are not subject to the activities restrictions of the BHCA or HOLA and the FRB's source of strength doctrine. As a result, other than the explicit commitments of non-control given to a bank's primary regulator or holding company regulator, such passive investors generally did not assume any greater obligations with regard to their investments. One significant feature of the Proposal is the manner in which it alters the role – along with the associated duties and responsibilities – of an investor looking to acquire a non-controlling interest in a Failed Bank.

In issuing the Proposal, the FDIC established a 30-day comment period and seeks public comment on the following nine topic areas:[8]

1. **Scope**. Development of a proper definition of private capital investors to whom the Proposal should be applied.

2. **Silo Structures**. Whether there are any reasons why entities comprising a silo structure should be considered eligible bidders for Failed Bank assets in light of concerns that (i) under these structures beneficial ownership cannot be ascertained, (ii) the parties responsible for making decisions are not clearly identified, and/or (iii) ownership and control are separated.

3. **Capital Requirements**. Whether is it necessary to require each acquired depository institution to remain "very well capitalized," *i.e.*, at a 15% Tier 1 leverage ratio, for three years following the acquisition and "well capitalized" thereafter and, if the institution fails to do so, to automatically treat it as "undercapitalized" for purposes of the prompt corrective action ("PCA") requirements.

4. **Source of Strength**. Whether shell holding companies and/or investors should be required to commit to serve as a source of strength for the acquired institution and, if so, whether the proposed commitment should be enhanced to go beyond requiring that such entities raise additional capital or engage in capital borrowing.

5. **Cross Guarantee Liability**. Whether those investors whose investments, individually or collectively, constitute the majority investment in more than one insured depository institution should be required to pledge such ownership interests to the FDIC to pay for

any losses to the FDIC's Deposit Insurance Fund ("DIF") which might result from the failure of, or assistance provided to, any such other institution.

6. **Entities from Bank Secrecy Jurisdictions**. Whether entities domiciled in bank secrecy jurisdictions should be barred from being eligible bidders on a Failed Bank unless the investors are subsidiaries of companies subject to comprehensive consolidated supervision recognized by the FRB.

7. **Re-sale Prohibitions**. Whether an imposed prohibition on an investor selling or otherwise transferring securities of the investor's holding company or the depository institution should, in the absence of the FDIC's approval, be for a period of less than three years, equal to three years, or longer than three years.

8. **Ten Percent Equity Holders as Purchasers of Assets or Liabilities**. Whether an investor that holds 10% or more of the equity of an institution in receivership should be ineligible to acquire the deposit liabilities or assets of such institution.

9. **Application of Limitations**. Whether the limitations imposed by the Proposal should be lifted after the acquired institution has successfully operated for a certain period following the acquisition and, if so, whether any other criteria should apply.

II. Discussion

If adopted as currently proposed, the Proposal would impose on private equity investors significant requirements, restrictions and limitations with respect to their investments in Failed Banks. While the FDIC Board of Directors recognized the need to strike the correct balance between encouraging and shunning private equity investment for Failed Banks, the Proposal has a number of troubling aspects that likely could tilt the balance away from Failed Bank acquisitions by private equity firms and ultimately produce greater losses to the DIF.

In addition to the chilling effect on private equity capital, perhaps the most notable aspect of the Proposal's potential impact is the extent to which it appears to override current laws and policies. For example, unilaterally imposing a 15% Tier 1 leverage ratio on banks formed to purchase assets and assume liabilities out of receivership ("Acquired Bank") is entirely inconsistent with existing capital rules and PCA regulatory requirements. In effect, this subjects a private equity owned bank that holds 14.9% Tier 1 capital to the same activities and other restrictions and limitations as an undercapitalized bank that holds only 4.9% Tier 1 capital. Aside from the inequities of this approach, the merits of imposing this type of super-capital requirement are unclear.

The Proposal also strikes at the established concepts of control under the federal banking laws by subjecting an otherwise passive private equity investor to certain requirements, including a source of strength provision and cross guarantee liability, that are inconsistent with a non-controlling ownership investment. It is unclear whether a private equity investor actually could execute a passivity agreement with its primary federal regulator where the FDIC is imposing certain expectations and ongoing obligations suggesting control by such investor.

In many respects, the Proposal also usurps the FDIC's own *de novo* policy statement[9] by establishing special rules that apply to private equity investors seeking to charter a *de novo* bank. Perhaps most important in this regard is that the FDIC has already approved a number of transactions involving private equity investments in *de novo* banks acquiring assets out of an FDIC receivership.

The potentially retroactive application of the Proposal also draws into question, once again, the federal government's ability to abide by its end of a contract entered into with its citizens. There are a number of private equity deals that have been done by the FDIC over the past several months of the current financial crisis, and this language certainly raises the issue about whether the policy statement could be imposed on holding companies acquired or established by private equity investors in the last three years.

Finally, it is worth highlighting the fundamental nature in which the Proposal alters the relationship between the deposit insurer and the primary federal regulator. Numerous features set forth in the Proposal are clearly within the jurisdiction of the primary federal bank regulators, including the application of capital standards and PCA requirements, holding company control determinations, holding company source of strength requirements, supervision of affiliate transactions, and decisions/determinations regarding the financial and managerial resources of a private equity investor in an institution. While the FDIC may determine which entity is the winning bidder of an institution in receivership, it does not have the statutory authority to dictate terms and issues that are subject to the jurisdiction of the primary federal regulator. More importantly, this aspect of the proposal has significant implications for private equity investments in non-failing banks, as well as the potential – or at least the perception – of a new paradigm for the FDIC's role in the chartering of banks, analyzing control relationships and exercising supervisory oversight over certain matters going forward.

A. Capital Commitment

If adopted as proposed, the Proposal would require private equity investors to agree to cause an Acquired Bank to maintain a minimum 15% Tier 1 capital leverage ratio for a period of three years, *unless* the period is *extended* by the FDIC (emphasis added). Thereafter, the capital level of the Acquired Bank will be required to be maintained at no lower than "well capitalized" status during the remaining period of a private equity firm's ownership. Such extraordinary amount of capital is intended to address the operational uncertainties facing new entrants in the banking industry and, as FDIC Chairman Bair indicated at the FDIC Board of Directors open meeting, the uncertainties facing federal banking agencies trying to enforce source of strength commitments from shell holding companies.

> *Commentary:* The proposed capital requirements impose significant risk to private equity investors who will have exceptionally high capital requirements to enter the banking industry, ongoing commitments to maintain an Acquired Bank's capital, and the risk of enforcement for a violation of a written agreement with federal banking agencies for failing to satisfy these requirements. The capital requirements also place an Acquired Bank at an extreme competitive disadvantage to ongoing banks that can operate at lower capital ratios.
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> The FDIC already imposes higher capital requirements in connection with the formation of *de novo* institutions – requiring capital on day one equal to 8% of Tier 1 assets at the end of the third year of operations. However, a 15% Tier 1 ratio for an Acquired Bank's first three years of operations reflects a significantly outsized and virtually unprecedented up-front capital commitment. The impact of this requirement is further magnified when juxtaposed to the Proposal's proposed source of strength commitment and cross-guarantee requirements.

B. Source of Strength

The Proposal, if adopted as currently proposed, would require private equity firms to enter into written agreements with Acquired Banks mandating that the private equity firms would serve as a source of strength for the Acquired Bank.

> *Commentary:* Source of strength agreements would mandate ongoing relations even between non-controlling shareholders of the Acquired Bank and such requirement could be viewed as an indicia of control by holding company regulators. Accordingly, such agreements would create unique challenges to investors subject to passivity agreements with the FRB or rebuttals of control with the OTS. Imposing a source of strength requirement could also be viewed by the FRB and OTS as a potential indicia of control as it imposes ongoing requirements on shareholders beyond their initial investment.
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> Imposing a source of strength obligation on shareholders that do not formally control a bank is a novel and radical departure from traditional shareholder liability, as non-controlling shareholders' liability is generally limited to the amount of their investment. This requirement expands the statutorily-mandated cross-guarantee obligation for commonly controlled institutions, imposing obligations on commonly controlled banks for losses incurred by the FDIC caused by an affiliate.[10] As defined under the Federal Deposit Insurance Act ("FDIA"), "common control" is when an institution is controlled by the same company or one depository institution controls another depository institution.[11] Finally, the statutory cross-guarantee obligation applies at the depository institution level,[12] while the Proposal appears to apply at the shareholder level. In effect, the Proposal turns such statutory mandate on its head by imposing a capital call on non-controlling shareholders of banks merely because of a perceived access to additional capital.

C. Cross-Guarantee Liability

The Proposal, if adopted as currently proposed, would require investors in more than one Failed Bank to pledge to the FDIC their proportionate interests in each such institution to pay for any losses to the DIF resulting from the failure of, or assistance provided to, any other such institution.

> *Commentary*: Private equity firms willing to accept the other requirements of the Proposal will likely not be willing to say "thank you sir, may I have some more" by placing one investment in peril for a second investment they have no control over. Pledging their shares to the FDIC also could violate the fundamental fund documents, which may restrict hypothecation of portfolio company shares. Cross guarantee obligations for multiple institutions also could lead to adverse consequences on private equity firms, including activities limitations if multiple private equity firms are found to be acting in concert with respect to multiple investments.

D. Mandatory Holding Period

The FDIC seeks to require that private equity firms maintain their respective investments in an Acquired Bank for at least three years, unless FDIC approval is obtained.

> *Commentary*: Although the holding period mitigates the possibility that an acquirer can quickly "flip" an Acquired Bank receiving FDIC assistance and reap a handsome profit – avoiding criticism that the FDIC bid process did not generate appropriate bids – the FDIC should be encouraging a vibrant free-market economy without re-sale restrictions. Nonetheless, given

that typical bank sale transactions can take over a year from start-to-finish, a three-year hold period may not be perceived as a significant burden.

Implementation of this requirement of the Proposal, however, imposes new regulatory burdens and requirements for bank acquisitions. In addition to an acquirer seeking FRB or OTS approval for an acquisition, a selling entity now will be required to seek FDIC approval, a process not subject to any formal or informal timeframes.

E. Transactions with Affiliates Restrictions

The Proposal supersedes the long-standing statutory framework imposed on transactions with affiliates of insured depository institutions by prohibiting extensions of credit to private equity firms, their investment funds, affiliates of either, or portfolio companies.

Commentary: Barring extensions by any Acquired Bank to its private equity investors, their investment funds, affiliates of either, and any companies in which the investors or affiliates invest, in effect deems a control relationship to exist and expands upon the definition of "affiliate" contained in sections 23A and 23B of the Federal Reserve Act ("FRA") and the FRB's Regulation W.[13] Rather than requiring compliance with the existing quantitative and qualitative limitations of section 23A and the market terms requirement of Section 23B of the FRA and Regulation W, which apply to all institutions and their affiliates, the Proposal prohibits an Acquired Bank from extending credit to investors, their investment funds, affiliates of either, and any companies in which the investors or affiliates invest.

Finally, this provision creates significant compliance challenges since, if a private equity firm owns greater than 10% of a company, the Acquired Bank would be prohibited from engaging in any transactions with that company. Compliance with this requirement would require the non-controlling private equity firm to provide the Acquired Bank a likely confidential and proprietary list of its 10% or greater holdings so that the Acquired Bank would not inadvertently extend credit to a prohibited borrower.

F. Secrecy Law Jurisdictions

The Proposal provides that investors utilizing entities that are domiciled in bank secrecy jurisdictions as part of their acquisition structure would not be eligible to own a direct or indirect interest in an insured depository institution unless the investors: (i) are subsidiaries of companies that are subject to comprehensive consolidated supervision as recognized by the FRB and execute agreements on the provision of information to the primary federal regulator about the investor's non-domestic operation and activities; (ii) maintain their business books and records (or a duplicate) in the United States; (iii) consent to the disclosure of information that might be covered by confidentiality or privacy laws and to cooperate with the FDIC, if necessary, in obtaining information maintained by foreign government entities; (iv) consent to jurisdiction and designation of an agent for service of process; and (v) consent to be bound by the statutes and regulations administered by the appropriate U.S. federal banking agencies.

G. Special Owner Bid Limitation

The Proposal prohibits any investor that directly or indirectly holds 10% or more of the equity of an institution in receivership from being eligible to bid on the deposit liabilities, or such liabilities and the assets, of such Failed Bank.

III. Action Plan

Implementation of the Proposal will clearly impact the willingness and ability of private equity firms to acquire Failed Banks from the FDIC. Simultaneously, the failure to attract private equity funds into the industry – particularly at a time when capital is most needed – will likely increase the cost of bank resolutions, ultimately impacting all industry participants. The statutory underpinning for the exercise of this authority is clearly questionable, and the application of certain provisions under the Proposal may even be at odds with the FDIC's own "least cost" requirement under the FDIA.[14]

The public comment period on the Proposal will run until August 10, 2009, providing ample time for private equity firms and banks to advise the FDIC of their concerns. Paul Hastings' attorneys are available to assist you in structuring comments to present your views and concerns to the FDIC regarding this significant Proposal.

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1 *See* 74 Fed. Reg. 32931 (July 9, 2009). A copy of the proposed Policy Statement also is available at: http://www.fdic.gov/news/board/jul2sop.pdf; and a copy of the FDIC staff Memorandum is available at: http://www.fdic.gov/news/board/jul2memo.pdf.

2 The Office of the Comptroller of the Currency has a "shelf-charter" process; information is available at: http://www.occ.treas.gov/ftp/release/2008-137.html.

The Office of Thrift Supervision has a pre-clearance process; information is available at: http://www.ots.treas.gov/?p=PreclearanceProgram.

The FDIC expanded its bidder list eligibility; see FDIC press release available at: http://www.fdic.gov/news/news/press/2008/pr08127.html.

To date, the Federal Reserve Board has not established a pre-clearance process, but has approved bank holding company formation on an expedited basis when needed.

3 See FDIC News Release, May 21, 2009, available at: http://www.fdic.gov/news/news/press/2009/pr09072.html.

4 See OTS approval of OneWest Bank Group, LLC, available at: http://files.ots.treas.gov/690014.pdf.

5 See OTS approval of Matlin Paterson's acquisition of Flagstar Bank, FSB at: http://files.ots.treas.gov/690006.pdf.

6 See the Federal Reserve's notice of the approval under delegated authority at: http://www.federalreserve.gov/releases/h2/20070915/delactions.htm.

7 See OTS orders concerning BankUnited at: http://files.ots.treas.gov/690022.pdf; and IndyMac at: http://files.ots.treas.gov/690014.pdf; see also Federal Reserve approval of a club transaction involving Doral Financial, available at: http://www.federalreserve.gov/BoardDocs/LegalInt/BHC_ChangeInControl/2007/20070718.pdf.

8 The 30-day comment period will run from the date of publication of the Proposal in the Federal Register, which is anticipated to be some time this week.

9 FDIC Statement of Policy on Applications for Deposit Insurance, 63 Fed. Reg. 44756 (Aug. 20, 1998), effective Oct. 1, 1998; amended at 67 Fed. Reg. 79278 (Dec. 27, 2002), available at: http://www.fdic.gov/regulations/laws/rules/5000-3000.html#5000applicationsfd.

10 12 USC § 1815(e).

11 12 USC § 1815(e)(8).

12 Pursuant to the statutory provision, "any insured depository shall be liable for any loss incurred by the [FDIC] … in connection with the default of a commonly controlled insured depository institution." 12 USC § 1815(e)(1).

13 See 12 USC §§ 371c(b)(1) and 371c-1(d)(1); see also 12 CFR § 223.2.

14 Pursuant to 12 USC § 1823(c)(4)(A)(ii), the FDIC must, in connection with the exercise of its resolution authority, ensure that a resolution of an institution is the least costly to the DIF of all possible methods for meeting the FDIC's obligation under the FDIA.