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FDIC Private Equity Policy Evolves

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On a day in which the Federal Deposit Insurance Corporation ("FDIC") closed seven Illinois banks with total assets of approximately $6.3 billion—selling all of the failed banks to other bank acquirers[1]—the agency also issued additional guidance on its August 26, 2009 policy statement governing private equity investments in failed banks ("Policy Statement").[2] The Policy Statement, which generally imposes restrictions on private investors and the activities of failed banks acquired from the FDIC by such investors,[3] is intended to provide stability and continuity to banks resulting from failed banks acquired by private equity investors. This is effected by a concept of imputed control to certain investors, even when such investors do not necessarily exhibit the typical characteristics of control under existing banking laws.

In guidance issued by the FDIC in January of this year, the agency set forth three important concepts triggering control and the applicability of the Policy Statement. First, private investors will not be subject to the Policy Statement where they own less than one-third of the total equity and voting equity in a partnership or joint venture with, or directly in, an established bank/thrift holding company investing in (or acquiring) the resulting bank acquired from the FDIC. Second, if private investors exceed the one-third threshold ("One-Third Test"), any private investors owning more than five percent of the total voting power of the acquired bank or its holding company will be subject to the Policy Statement. Third, where the One-Third Test is exceeded, investors holding five percent or less of the total voting power of the acquired bank or its holding company will be presumed to be acting in concert for purposes of the Policy Statement where they own, in the aggregate, more than two-thirds of the total voting power of the resulting institution or its holding company.

The January guidance contained significant ambiguities regarding the applicability and operation of the One-Third Test. In addition, the Policy Statement and previous guidance did not sufficiently address requirements for offshore investors, informational disclosure requirements applicable to less-than-five-percent investors, and the extent to which the Policy Statement applies during a recapitalization. The recent April 23, 2010 guidance from the FDIC provides additional clarity on these and other issues. Following is a synopsis of that guidance.

Strong Majority Interest

As noted above, a key aspect of the Policy Statement is the concept of assigning accountability to an existing holding company with a "strong majority interest" in a resulting bank, which allows private investors partnering with (or investing in) such an entity generally to avoid the Policy Statement. The FDIC further clarified this concept as follows:

- *Preexisting Holding Company Investors*. Existing investors in an established holding company are not subject to a holding period requirement in determining the applicability of the Policy Statement to such investors. In this regard, the FDIC provides that it will consider whether a "significant portion" of the holding company shares held by investors prior to the proposed failed bank acquisition was "recently acquired" or "part of a recapitalization" of the existing institution.

- *Recapitalizations of Existing Banks*. Recapitalizations of existing banks are generally not subject to the Policy Statement. However, where new investors recently recapitalized an institution that seeks to acquire a failing bank, the agency indicated that it will review whether the additional capital was provided contingent on completion of the failed bank acquisition. In any event, the Policy Statement will apply in connection with the acquisition of one or more failed banks that exceed 100 percent of a recapitalized bank's total assets within 18 months after its recapitalization.

De Minimis Investors

The application of the Policy Statement to "*de minimis*" (five percent or less) investors and the issue of concerted action are the subjects on which the FDIC provided the most guidance. In this regard, the agency noted:

- *One-Third Test Requirement*. In order to ensure the stability and continuity of an acquired failed bank, the FDIC requires that investors holding a minimum of one-third of the "total voting equity shares or total equity shares" of an acquired bank or its holding company must be subject to the Policy Statement.

- *Anchor Group Solution*. Investors may satisfy the One-Third Test through an "anchor group" of investors that comply with the terms of the Policy Statement. The anchor group may consist of "one-third or more of the total voting equity shares or one-third or more of a combination of total voting equity shares and total equity shares as a proportion of total equity shares." An anchor group must include greater-than-five-percent investors and any additional "five-percent-or-less" investors who agree to be bound to meet the test.

- *One-Third Test Timing*. The One-Third Test only needs to be met at the time of the failed bank acquisition, but investors subject to the Policy Statement pursuant to the test may not sell their interest for three years following the acquisition (absent FDIC prior approval).

- *Board Member Designation*. Any investor having the right to designate a board member will be subject to the Policy Statement (i.e., regardless of their ownership interest).

- *Senior Management*. Senior management will be subject to the Policy Statement based on the same standards applicable to other investors (e.g., equity ownership, ability to designate a board member, concerted action, etc.).

- *Right of First Refusal*. A right of first refusal to purchase another investor's interest will not make an investor outside the anchor group subject to the Policy Statement; however, if a purchase causes an investor to exceed the five percent voting share threshold, the investor will become subject to the Policy Statement.

- <u>De Minimis *Investor Information Requirement*</u>. Investors holding five percent or less of voting equity are not required to submit the same detailed FDIC questionnaires required of anchor group members; but *de-minimis* investors are included on the "List of Investors" provided to the FDIC.[4]

Secrecy Law Jurisdiction

Finally, the FDIC provided the following additional guidance on investors in secrecy law jurisdictions:

- <u>*Domestic Subsidiary Requirement*</u>. While the FDIC will not determine whether investors are in compliance with relevant tax laws, offshore investors who are part of the anchor group must make their investment in the bank or its holding company through at least one wholly-owned domestic subsidiary (i.e., established under state law in the U.S.).

- <u>*Books and Records*</u>. Each offshore investor must: (1) maintain with its domestic subsidiary its business books and records (or duplicates thereof) and an exact duplicate of the books and records of the offshore investor; (2) maintain with its domestic subsidiary a current list of all investors in the offshore investor; and (3) make all such required information available to the FDIC upon its request.

- <u>*U.S. Income Tax*</u>. An offshore investor must pay U.S. federal income tax on the income from its ownership, including dividends and capital gains, as if it had made its investment directly in the bank or holding company.

Overview and Analysis

The FDIC's recent additions to its guidance on the Policy Statement highlight important refinements with respect to the "anchor group" concept and underlying issues related to the One-Third Test, as well as the treatment of *de minimis* investors and the presumption of "concerted action" among such investors in the absence of an anchor group of more-than-five-percent investors that satisfies the One-Third Test. Since the recent guidance is purposely flexible to accommodate the FDIC's objectives in structuring an anchor group to achieve its goals of stability and continuity, this provides new opportunities to work with the agency to structure workable private equity investments in failed bank situations. While challenges remain with respect to the Policy Statement for private equity investors, this is certainly a step in the right direction for a more workable framework. A related challenge is achieving a more cohesive and coordinated framework among all of the federal banking agencies with respect to control and concerted action issues involving private equity investors. These are issues that appear to be evolving as the FDIC and other federal banking agencies continue to work through the backlog of troubled and failing banks.

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The Paul Hastings Global Banking practice will continue to monitor these issues in the weeks and months ahead. Please feel free to contact the following Paul Hastings Washington, D.C. lawyers with any questions.

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1 *See* FDIC Press Releases PR-84-2010 through PR-90-2010 (April 23, 2010).

2 FDIC Policy Statement for Failed Bank Acquisitions (August 26, 2009).

3 Generally, the Policy Statement imposes a 10% Tier 1 capital commitment on a resulting bank the first three years after its acquisitions and a "well-capitalized" capital requirement thereafter while the bank is owned by investors subject to the Policy Statement; imposes a cross-support requirement on investor groups owning 80% or more of two or more banks; restricts extensions of credit from the resulting bank to investors covered by the Policy Statement; restricts the ability of investors domiciled in secrecy law jurisdictions to invest in a bank under the Policy Statement; and, most importantly, prohibits investors subject to the Policy Statement from selling their ownership interest for a three-year period following the acquisition (absent prior FDIC approval).

4 The "List of Investors" provides the following information for each investor: name; type of investor (e.g., individual, mutual fund, etc.); domicile; number of shares of voting stock and total equity held before and after the capital raise; options, warrants, and interests convertible into voting stock, and rights to control voting stock owned by others; and shares held by affiliates or immediate family members.