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THE EVOLUTION OF PRIVATE EQUITY INVESTMENT IN FAILED INSTITUTIONS

Private equity investors purchasing the assets of failed banks usually seek ownership without a "control" status that would require registration as a bank holding company. A 2008 FRB policy statement relaxed certain requirements, but a 2009 FDIC policy statement significantly tightened the rules, with a chilling effect on the market. The way forward for buyers may be the so-called "blind pool" structure.

By Todd W. Beauchamp *

The ongoing financial crisis renewed an intense desire on the part of private equity firms to participate in the significant profit opportunities inherent in the acquisition of failed financial institutions by other banks, thrifts, bank holding companies, and savings and loan holding companies (each, a "banking organization"). However, this desire has been significantly tempered as investors not typically used to banking regulation learned that structuring investments in a manner acceptable to regulators can be a challenging, and often frustrating, exercise, due to the persistent evolution of the rules and guidance applied by regulators to such investments. This dynamic regulatory landscape leaves many open questions, resulting in a great deal of uncertainty for investors and a corresponding hesitance to move forward.

The confusion associated with these investments by private equity firms revolves primarily around the issue of "control" – namely, whether the investment will cause the investors to be viewed as control parties, such that they must either (i) register as a bank holding company ("BHC") or savings and loan holding company ("SHLC"), thus becoming subject to the significant obligations, including restrictions on non-banking activities, imposed upon the same under the Bank Holding Company Act of 1956 ("BHCA") or the Home Owners' Loan Act ("HOLA"), or (ii) successfully rebut a presumption of control by demonstrating passive ownership, a position which is often viewed with great suspicion by regulators.

MURKY WATERS: THE ISSUE OF "CONTROL"

As a threshold matter, it is important to note that any acquisition of a failed institution is really a purchase of assets (*i.e.,* loans, branches, etc.) and assumption of liabilities (*i.e.,* deposits) from the Federal Deposit Insurance Corporation ("FDIC"), the appointed receiver of failed banks, as the actual charter of the failed institution is not transferred to the acquirer.[1] Therefore,

[1] Once an institution is placed into receivership, the receivership becomes the corporate successor-in-interest to the failed institution and transfers the assets and liabilities directly to the purchaser, or, in the event that a purchaser is not identified at the time the failed institution is placed into receivership, into a bridge bank. Note that the receivership often retains some

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as a bank or thrift charter is ultimately required to acquire such assets and liabilities, it is necessary for investors to either establish a *de novo* entity that obtains a "shelf charter" or other pre-approval (depending upon the type of institution it seeks to become) from a chartering agency,[2] purchase an open institution (either directly or through the acquisition of a holding company that owns an institution), or partner with an open institution to form a *de novo* entity for purposes of acquiring the assets and liabilities. In doing so, the investors would then be eligible, through such entity, to participate in the bidding process conducted by the FDIC in its capacity as receiver for failed institutions.

However, when making such investments, investors must be mindful of the requirements that apply to those deemed to control any banking organization. As under the control regulations promulgated by the Board of Governors of the Federal Reserve System ("FRB") and the U.S. Department of Treasury's Office of Thrift Supervision ("OTS"), if an entity is deemed to "control" a banking organization, it will itself be required to register as a BHC or SLHC. As such, the entity would be subject to several significant requirements, which include:

(i) having to comply with significant restrictions on non-banking activities;

(ii) becoming subject to the jurisdiction of the FRB or OTS, having to file quarterly reports detailing financial data and other matters, and being regularly examined by them;

(iii) potentially serving as a "source of strength" or "source of support" for the controlled institution; and

(iv) having to file biographical and financial information with the FRB or the OTS, as applicable.

The holding company control rules do not apply to individuals, meaning that an individual would not be required to register as a BHC or SLHC, as applicable, by virtue of exceeding the stated thresholds or meeting the other criteria.[3] However, as a "controlling" shareholder under the Change in Bank Control Act of 1978,[4] he or she would become an "institution-affiliated party" ("IAP"),[5] a class which includes officers and directors of a banking organization, and would thus be required to submit biographical and financial data to the relevant regulator(s) as well as become subject to their jurisdiction and continued oversight.

Each of these requirements have been of significant concern for investors, as they are often:
(i) uncomfortable with the level of disclosure and ongoing scrutiny involved; (ii) involved in a wide range of enterprises (which could necessitate divestitures of those non-financial investments that are otherwise impermissible for BHCs or SLHCs if the investor is

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portion of the assets (*e.g.* loans that the purchaser does not wish to acquire) for later disposition, such as through the loan sales programs discussed below.

[2] The Office of the Comptroller of the Currency has a "shelf-charter" process (further information is *available at* http://www.occ.treas.gov/ftp/release/2008-137.html), while the OTS has a "pre-clearance" process (further information is *available at* http://www.ots.treas.gov/?p=PreclearanceProgram). These processes generally require investors to provide certain elements of the standard charter application, such as details regarding the proposed management team (including all required biographical information), the sources and amount of capital that would be available to the new institution, and a streamlined business plan that describes how the acquired bank will operate, with a more detailed plan to be provided after a target institution is identified. Once preliminary approval is granted, the investors are permitted to view the FDIC's list of failing institutions and participate in the bidding process.

[3] If an acquisition would result in the individual acquiring "control" of the banking organization, he or she would be required to submit a notice under the Change in Bank Control Act of 1978 and receive the non-objection of the appropriate federal banking agency prior to completing the acquisition (12 U.S.C. § 1817(j)).

[4] 12 U.S.C. § 1817(j).

[5] As defined under 12 U.S.C. § 1813(u).

deemed to be in control); and (iii) wary of the potential losses in the event that they are called upon to serve as a "source of strength" or "source of support" for the controlled institution and thus required to infuse additional capital into the same. Therefore, it has been paramount for private equity firms to develop investment structures which provide them with the desired level of ownership yet avoid placing them in "control." However, this effort has proved to be a daunting task as the relevant rules have been in a state of flux.

TRADITIONAL CONTROL RULES

Generally speaking, the traditional control rules promulgated by the FRB provide for a conclusive finding of control where a "company" (either a business entity or any group of individuals or entities that "act in concert" or are presumed to "act in concert"[6]) acquires 25 percent or more of any class of voting stock of a bank or BHC, and a presumptive finding of control where a company:

(i) acquires between 10% and 24.9% of any class of voting stock of a bank or BHC;

(ii) controls in any manner the election of a majority of directors of a bank or BHC; or

(iii) has the power to exercise, directly or indirectly, a controlling influence over the management or policies of a bank or BHC.[7]

However, a presumptive finding of control may be overcome by filing passivity commitments or making some other acceptable showing (depending upon the grounds for finding control) to the FRB.[8] The OTS has promulgated control rules which do vary slightly in certain instances, but are overall substantially similar to those of the FRB.[9]

ONE STEP FORWARD: THE FRB REVISED POLICY STATEMENT ON MINORITY INVESTMENTS

To further facilitate non-controlling capital infusions by private investors, the FRB clarified its position regarding minority equity investment in banks and BHCs with a September 2008 issuance of a policy statement ("FRB Policy Statement") that altered the traditional control rules by setting forth certain actions which the FRB felt were consistent with a finding that the investor is not in control of a banking organization.[10] In particular, the FRB Policy Statement provides as follows:

- An investor may own up to one-third of the total equity of a banking organization so long as the investor does not own, hold, or vote 15 percent or more of any class of voting securities of such organization (an increase from the 10 percent threshold set forth under the traditional control rules), and, assuming conversion of all convertible non-voting shares held by the investor, the investor does not own more than one-third of any class of voting securities of the organization. Further, the FRB modified its long-standing position to provide that convertible non-voting shares are generally now *not* included[11] for purposes of a control determination so long as the non-voting shares may not be converted into voting shares in the hands of the investor and many only be transferred by the investor: (i) to an affiliate of the investor or the bank or BHC, (ii) in a widespread public distribution, or (iii) in transfers in which no transferee (or group of associated transferees) would receive two percent or more of any class of voting securities of the bank or BHC, or to a transferee that would control more than 50 percent of the voting

[6] The FRB and OTS have each set forth definitions of what constitutes "acting in concert," found at 12 C.F.R. § 225.4(d) and 12 C.F.R. § 574.2(c), respectively. However, this has been the subject of various interpretations by regulators and courts alike, and is therefore very much based upon individual facts and circumstances.

[7] 12 C.F.R. § 225.2(e)(1). Certain other rebuttable presumptions of control are set forth in 12 C.F.R. § 225.31(d).

[8] *See* 12 C.F.R. § 225.41. In the event that a presumption of control exists with respect to a proposed investment, the investor must submit a letter to the FRB setting forth justification for a finding that the investor will not control the banking organization upon completion of the investment, which may require the investor to make certain commitments demonstrating its status as a passive investor.

[9] The OTS control rules are set forth in 12 C.F.R. § 574.4.

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

[11] As with many of the rules, this determination is highly dependant upon individual facts and circumstances, and therefore is made on a case-by-case basis.

securities of the bank or BHC without any transfer from the investor.[12]

- An investor may have one board seat without being deemed to exercise a controlling influence over the policies or management of the bank or BHC, and may have two board seats absent other indicia of control where (i) the investor's aggregate representation is proportionate to its equity ownership, but does not exceed 25 percent of the voting members of the board, and (ii) another shareholder is a BHC that controls the organization under the BHCA.[13] An investor may also have non-voting observers that sit in on board meetings so long as they do not have any right to vote. The FRB Policy Statement does reiterate the FRB's earlier position that a representative of the investor may not serve as the chairman of the board or of any committee of the board of the organization, but may serve as a member of a board committee where such representative(s) do not comprise more than 25 percent of the total committee membership and do not have the authority or practical ability to unilaterally make (or veto) policy or other decisions that bind the board or management of the bank or holding company.

- In a departure from the long-standing prohibitions on transactions between non-controlling investors and the banking organization(s) in which they have invested, the FRB Policy Statement also provided that the FRB will now review and possibly approve business transactions or other relationships between such parties which are quantitatively limited and qualitatively non-material, particularly where the investor's percentage of voting equity is closer to ten percent than 25 percent.

The OTS, which oversees investments in savings associations, is unable to adopt any guidance similar to that of the FRB permitting the expanded total ownership percentage of up to 33 percent due to the statutory limitations in the HOLA, which provide that conclusive control is found where a company has contributed more than 25 percent of the capital of any other company.[14]

Viewed by many as a highly encouraging step, the FRB Policy Statement initiated a wave of attempts by private equity firms to develop new investment structures that avoided subjecting their investors to the control requirements.

Silo Structures

One significant transaction structure is the so-called "silo structure," which has been utilized where a single private equity firm seeks to make a majority investment in a banking organization. A silo structure can be thought of as a duplication of a private equity firm's existing fund structure (*i.e.,* same managers, same investor base) through a separate set of new legal entities that by themselves engage in no impermissible activities, whose sole purpose is to invest in one or more banking organizations, which become control parties (and thus register as BHCs or SLHCs, as applicable) and are controlled by individual managers of the private equity firm, and which permit the majority of investors to avoid becoming subject to the control rules.

The structure generally involves the use of limited partnerships ("LPs") as the investment vehicles, limited liability companies ("LLCs") which serve as the general partner(s) of the LPs, and individuals associated with the sponsoring fund as managers of the LLCs. While each of the LPs and LLCs would become BHCs or SLHCs by virtue of their direct or indirect controlling ownership of the banking organization, no other party would be required to register as a BHC or SHLC as a result of the transaction. To explain, in order for the private equity firm to actually control the investment vehicles, it would need to either serve as the general partner or manager of the investment vehicle, or own a majority of its voting equity. However, if the fund itself were to do either of these, it would become subject to the control rules, be required to register as a BHC or SLHC, and therefore subject the fund's other investments to regulatory restrictions and itself to regulatory oversight. Therefore, the fund inserts an individual, to whom the control rules do not apply, as the manager of the LLC serving as the general partner of the investment vehicle, and limits each individual investor to owning 9.9% or less of one of the LPs.[15]

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[12] Convertible non-voting shares were formerly included as part of the control determination where conversion into voting shares would occur either at the election of the holder or automatically after the passage of time.

[13] Previously, the FRB would not permit a non-controlling investor to have board representation unless the investor owned 15 percent or less of the voting shares of the relevant bank or BHC, and another person or group owned a larger portion of the voting shares of the same.

[14] 12 U.S.C. § 1467a(a)(2).

[15] In an effort to avoid any presumption of control, these investments have been limited to 9.9% of one of the limited

Use of silo structures has been very limited primarily due to the challenges relating to concerted action, particularly where there are multiple connections between the silo fund and a private equity firm's other funds. For example, if shared profits or losses resulting from the failure or success of the banking organization owned by the silo fund would be used by its investors or fund managers to offset losses or gains flowing from another fund, such shared economic treatment would likely give rise to a finding of concerted action.

A significant example of a silo structure is found in the January 2009 acquisition of 70 percent of the common stock of Flagstar Bancorp, Inc., parent of Flagstar Bank, FSB, by affiliates of MatlinPatterson Global Advisors LLC.[16] This transaction involved an investment structure similar to that described above, and was approved by the OTS after affiliates of the two individual fund managers involved provided written commitments that they would not exercise any control over the thrift or its holding company, acquire any of the securities of the same, or engage in any transactions with either entity. Although the Flagstar transaction did not involve investment by a banking organization for purposes of acquiring the assets and liabilities of a failed institution, the same structure has been proposed for such purposes.

It is important to note that regulators have raised serious concerns regarding silo structures based on the notion that they artificially separate the non-financial activities of the funds from its investment in the banking organization for purposes of avoiding a control determination, prevent the regulators from ascertaining the beneficial owners of the banking organization, and may present issues relating to the sufficiency of financial and managerial support for the banking organization. While the FRB has previously approved of this structure,[17] it has since indicated that it would no longer be receptive to the same, and, as further discussed below, the FDIC has conclusively rejected the use of such structures.[18] Therefore, absent a significant shift in policy, it is highly unlikely that we will see any further transactions involving silo structures.

Club Deals

As a result of the regulators' increasing dislike for silo structures and the decreased financial appetite to attempt a controlling investment alone because of the various activities restrictions imposed on a private equity firm's non-banking activities, private equity firms began to get comfortable with taking a smaller piece of a potential acquisition by joining together to form "club deals." In these deals, each private equity firm acquired no more than 24.9% of the voting stock of the acquired banking organization, and filed either passivity commitments with the FRB or Rebuttals of Control with the OTS restricting their interactions with the banking organization, so as to confirm they were not holding companies.[19] As a result, other than the explicit commitments of non-control given to the banking organization's primary regulator, the investors generally did not assume any greater obligations with regard to their investments.

An example of a club deal is the January 2009 acquisition of the assets and operations of IndyMac Federal Bank FSB by OneWest Bank, FSB, a newly formed federal savings bank controlled by IMB

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partnerships. No single investor or group of affiliated investors would own more than this amount, nor be permitted to invest in more than one limited partnership, as the interests would be aggregated (*i.e.*, if two limited partnerships were used, and a single investor owned 9.9% of each, the investor would be viewed as owning 19.8% and thus be subject to a rebuttable presumption of control under the FRB or OTS control rules).

[16] OTS, *Approval of Holding Company Application*, Order No. 2009-06, Docket Nos. 8412 and H-4586 (January 29, 2009), *available at* http://files.ots.treas.gov/690006.pdf.

[17] The FRB has not approved a silo structure arrangement since its approval of an investment by CapGen Capital Group LLC in September 2007. *See* the FRB's notice of approval under

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delegated authority, *available at* http://www.federalreserve.gov/releases/h2/20070915/delactions.htm.

[18] FDIC, *Final Statement of Policy on Qualification for Failed Bank Acquisitions*, at 30 (August 26, 2009) ("In the Final Statement, the FDIC has clarified that it would not approve ownership structures that typically involve a private equity firm (or its sponsor) that create multiple investment vehicles funded and apparently controlled by the private equity firm (or its sponsor) to acquire ownership of an insured depository institution.").

[19] OTS, *Approval of Permission to Organize, Holding Company, and Bank Merger Act Application, and Related Filings, and Acceptance of Control Rebuttals*, Order No. 2009-13, Docket Nos. 18129 and H-4585 (March 4, 2009), *available at* http://files.ots.treas.gov/690014.pdf; and OTS, *Approval of Permission to Organize, Holding Company, and Bank Merger Act Application, and Related Filings, and Acceptance of Control Rebuttals and Rebuttal of Concerted Action*, Order No. 2009-31, Docket Nos. H-4625, H-4626 and 18132 (May 21, 2009), *available at* http://files.ots.treas.gov/690022.pdf.

Management Holdings LP.[20] Another is the May 2009 acquisition of all of the deposits and assets of BankUnited, FSB by a consortium of investors with a management team led by John Kanas, the former Chairman and Chief Executive Officer of North Fork Bancorporation.[21]

One interesting difference between the IndyMac and BankUnited deals is that in the IndyMac deal, none of the investors were deemed to be in control of the newly formed banking organization, while in the BankUnited deal, one of the investors, John Kanas, also served as the banking organization's Chairman and Chief Executive Officer. This made him an IAP, thus providing regulators with an equity owner that was explicitly subject to their jurisdiction and oversight. As reflected in the FDIC's private equity policy statement (further discussed below), which was promised at the time the FDIC issued its approval for the BankUnited transaction, it seems that this is a critical difference.

TEN STEPS BACK: THE FDIC POLICY STATEMENT

The FDIC delivered on its promise of policy guidance for private equity investors with its issuance of a proposed statement of policy on July 2, 2009, issued in final form on August 26, 2009 ("SOP").[22] On its face, the SOP focuses strictly on investments involving the acquisition of failed institutions, as compared to the traditional control rules and the FRB Policy Statement which apply to investments in any banking organization. The SOP drastically altered the requirements and prohibitions associated with such investments, thereby eliminating the forward momentum generated by the FRB Policy Statement by causing investors to freeze all potential investments as they struggled to find new acceptable structures. The FDIC followed this issuance in January 2010 by publishing a short list of frequently asked questions[23] in an attempt to clarify several points contained in the SOP; however, there remain a myriad of unanswered questions and inconsistencies with the applicable control regulatory regimes implemented by the FRB and OTS.

The SOP applies to investors acquiring five percent or more of the voting stock of a banking organization in connection with the acquisition of the assets and liabilities of a failed institution, as well as to the banking organization itself, and may apply to lesser investments where there is evidence that the investor is acting in concert with other shareholders of the banking organization. Consistent with the position set forth in the FRB Policy Statement, the SOP provides that convertible non-voting equity interests will not be aggregated with voting shares for purposes of determining whether the SOP applies where such interests are not convertible in the hands of the investor or its affiliate.[24]

Excluded from the SOP's coverage, however, are (i) investments made prior to the effective date of the final version of the SOP, (ii) co-investments with a banking organization that will have a "strong majority interest" in the resulting banking organization and "a strong track record in successfully operating depository institutions, and (iii) investments, following approval by the FDIC, in a banking organization that has had a composite CAMELS rating of "1" or "2" for the past seven years.[25]

"Acting in concert"

As previously noted, the determination whether an investor is acting in concert with others is highly dependant upon individual facts and circumstances. However, the FAQs do state that the FDIC will generally not find concerted action where multiple investors make

[20] OTS, *Approval of Permission to Organize, Holding Company, and Bank Merger Act Application, and Related Filings, and Acceptance of Control Rebuttals*, Order No. 2009-13, Docket Nos. 18129 and H-4585 (March 4, 2009), *available at* http://files.ots.treas.gov/690014.pdf. IMB was funded by a consortium of investors including Dune Capital Management LP's chairman Steve Mnuchin, J.C. Flowers & Co. LLC, Paulson & Co., MSD Capital LP, Stone Point Capital, SSP Offshore LLC, and Silar Advisors LP.

[21] OTS, *Approval of Permission to Organize, Holding Company, and Bank Merger Act Application, and Related Filings, and Acceptance of Control Rebuttals and Rebuttal of Concerted Action*, Order No. 2009-31, Docket Nos. H-4625, H-4626 and 18132 (May 21, 2009), *available at* http://files.ots.treas.gov/690022.pdf. The investors included W.L. Ross & Co. LLC, Carlyle Investment Management L.L.C., Blackstone Capital Partners V L.P., Centerbridge Capital Partners, L.P., LeFrak Organization, Inc., The Wellcome Trust, Greenaap Investments Ltd., and East Rock Endowment Fund.

[22] FDIC, *Final Statement of Policy on Qualification for Failed Bank Acquisitions* (August 26, 2009), *available at* http://www.fdic.gov/news/board/Aug26no2.pdf.

[23] FDIC, *Statement of Policy on Qualification for Failed Bank Acquisitions – Questions and Answers* (January 7, 2010), *available at* http://www.fdic.gov/regulations/laws/faqfbqual.html.

[24] As with the FRB Policy Statement, this determination is made on a case-by-case basis.

[25] FDIC, *supra* note 22, at 36.

contemporaneous share purchases as part of a widespread offering in which the investors each acquire not more than five percent, and collectively not more than two-thirds, of the total voting power of the banking organization.

Conversely, the FDIC will presume that concerted action exists in the case of ownership structures where all or substantially all of the investors each own five percent or less, and collectively own more than two-thirds, of the total voting power of the banking organization, which may be rebutted upon a showing of sufficient evidence that no concerted action exists. In evaluating possible concerted action, the FDIC (as well as other regulators) will consider various elements, which are as follows:

- *Facts supporting a finding of concerted action*:

  (i) an investor is managed or advised by an investment manager or investment advisor who performs the same services for another investor;

  (ii) an investor has engaged, or anticipates engaging, as part of a group consisting of substantially the same entities as are shareholders of banking organizations, in substantially the same combination of interests, in any additional banking or non-banking activities in the United States;

  (iii) an investor has significant ownership interest in another investor in the banking organization;

  (iv) an investor is entitled to acquire any other investor's shares;

  (v) existence of agreements or understandings between any of the investors for the purpose of controlling bank or thrift; and

  (vi) the investors (and each director representing each investor) will consult with other investors concerning the voting of the banking organization's shares.

- *Facts supporting a finding that concerted action does not exist:*

  (i) investors were among many potential investors contacted by the banking organization or its agent, and each investor reached an independent decision to invest in the banking organization; and

  (ii) directors representing the investors will represent only the particular investor which nominated him or her, and will not represent any combination of investors.

With respect to the structures discussed above, although the SOP explicitly reinforces the FDIC's adverse position to silo structures, it may leave the door open for club deals involving otherwise independent private equity firms, particularly where the groups have not participated in previous investments together and manage their investment separately from the other group members.

"Strong majority interest"

An important exclusion from the SOP exists for partnerships or joint ventures between investors and existing banking organizations to acquire the assets and liabilities of failed institutions, in which the partner banking organization maintains a "strong majority interest." The FDIC FAQs have clarified that such an interest would generally be two-thirds or more of both the voting equity and total equity of any *de novo* banking organization formed for purposes of the failed-institution acquisition, and note that any special rights provided to investors through covenants, agreements, or otherwise, will be considered in any determination regarding the sufficiency of the partner banking organization's interest for purposes of the exclusion.

Likewise, in instances where the co-investment takes the form of a direct investment in the partner banking organization itself, which would then proceed to acquire the assets and liabilities of the failed institution, the SOP will not apply so long as the investors collectively do not hold more than one-third of the banking organization's total equity following the investment. Of course, the FDIC will consider any special rights granted to the investors in this scenario as well.

Requirements and Prohibitions Imposed by the FDIC SOP

The requirements and prohibitions imposed by the SOP are as follows:

- *No silo structures* – no single firm/group may establish multiple entities to avoid having any single investor "control" the institution (*i.e.,* Flagstar).

- *Increased capital requirement* – the acquired banking organization must maintain a Tier 1 common equity[26] to total assets ratio of at least 10 percent for the first three years following the acquisition,[27] and must remain "well-capitalized" (as defined under the Prompt Corrective Action ("PCA") provisions[28]) thereafter. Any failure to maintain the same will result in the banking organization being deemed "undercapitalized" for PCA purposes, which ignores the intermediate step of "adequately capitalized." This effectively places the banking organization at a competitive disadvantage with respect to its peer institutions that are not subject to the SOP, as the acquired banking organization must maintain capital far in excess of its competitors, and would be subject to an enforcement action for far less than would otherwise be the case.

- *Cross-guarantee* – if two or more banking organizations share 80 percent or more common ownership, the investors (to whom the SOP applies) must pledge the ownership interests in each such banking organization to the FDIC as security for any losses to the FDIC's Deposit Insurance Fund ("DIF") which may result from the failure of such banking organizations.

- *Mandatory holding period* – the investor must maintain the investment in the banking organization for three years absent FDIC approval. However, FDIC approval of a transfer of the investment to an affiliate of the investor will not be unreasonably withheld if the affiliate agrees to comply with those terms of the SOP which are applicable to the investor.

- *Restrictions on transactions with affiliates* – the acquired banking organization may not extend credit to any "affiliate" of the investor (*i.e.,* any entity whose entity is owned, directly or indirectly, 10 percent or more by the investor), and each investor must provide the FDIC with periodic reports listing each of its "affiliates." However, this prohibition does not apply to extensions of credit pre-dating the investment.

- *Secrecy law jurisdictions* – the investor may not be domiciled in a bank secrecy jurisdiction (*i.e.*, one that limits U.S. regulators from determining compliance with U.S. laws, prevents U.S. regulators from obtaining information regarding the entity, does not provide minimum standards of transparency for financial activities, etc.).

- *Special Owner Bid Limitation* – an investor which owns 10 percent or more of the equity of a failed institution may not bid on the assets or liabilities of a failed institution.

- *Disclosures* – the investor must provide the FDIC with information on the size of the fund, diversification, return profile, marketing documents, management team, business plan, and such other information required by FDIC. However, this information is treated as confidential and not disclosed except in accordance with applicable law (as compared with filings by BHCs, which are publicly available).

Conflicts with Other Regulators

The FDIC has stated that it will take the primary regulator's control determination into account when making its own determination. However, various issues may arise where the primary regulator and the FDIC could take different views regarding certain actions. For example, the FDIC would view any right of an investor to acquire another investor's shares (which would be desirable in any closely held corporation) as indicative of concerted action. This, of course, is inconsistent with the FRB's Regulation Y, which expressly provides that an agreement between investors which grants a right of first refusal with respect to the shares held by an investor shall not give rise to any rebuttable presumption of control.[29] As a result, the FDIC's position would essentially trump the FRB's regulation in the context of a failed bank acquisition (but not in a transaction involving a healthy institution).

Next Steps

In adopting in its SOP, the FDIC committed to undertake a review of its operation and impact on or

[26] Tier 1 common equity" is defined as Tier 1 capital minus non-common equity elements, which are qualifying perpetual preferred stock, minority interests, and restricted core capital elements not already included.

[27] The FDIC's use of a tangible common equity ratio represents the use of a regulatory standard heretofore not used by regulatory agencies, other than in the stress tests applied to the nation's largest banks that were conducted in the spring of 2009.

[28] 12 U.S.C. § 1831o.

[29] *See* 12 C.F.R. § 225.31(d)(1)(ii)(a) (stating that a rebuttable presumption of control shall not arise based on any "mutual agreement among shareholders granting to each other a right of first refusal with respect to their shares").

before February 26, 2010[30] and to make such adjustments as it deems necessary. While the FDIC did hold a roundtable discussion on March 22, 2010 with a select group of investors and other interested parties to discuss the application of the SOP,[31] it has not yet issued any statements regarding any adjustments to be made. Given the chilling effect that the SOP has had on successful bids, it should be quite evident that the FDIC must either drastically revise the SOP or withdraw it and start anew, as any failure to do so is likely to cause the remaining interested private equity firms to focus their efforts elsewhere, something that the FDIC can ill-afford in this environment. To explain, with the number of small bank failures expected to spike over the next year as a result of increases in commercial real estate loan defaults, the FDIC will need a large pool of eager bidders to absorb the volume. However, by effectively eliminating private equity firms from the process, the FDIC will need to rely solely on healthy and interested strategic bidders, a group that is likely to be in relatively short supply, meaning fewer competitive bids, lower purchase premiums, and increased losses to the DIF. It is therefore vital for the FDIC to promptly reverse its course and move swiftly towards implementing policies that reignite the interests of private equity firms by striking a better balance between their concerns and desires and those of the FDIC.

THE CURRENT LANDSCAPE

While it is understood that a number of private equity firms have submitted sealed bids for proposed transactions since the issuance of the FDIC SOP, with all but two having been rejected, those that have been approved offer a glimmer of hope for investors as representing a structure palatable to investors and regulators alike - the so-called "blind pool" structure. Briefly, the "blind pool" structure involves the establishment of a new entity, which serves as the investment vehicle to acquire the assets and liabilities of failed institutions, generally offers a series of voting stock and a series of non-voting stock, is controlled by one or more individual fund managers, and will register as a BHC or SLHC upon acquiring a failed institution. Individual investors are generally limited to holding 4.9% of the voting shares of the fund, which, absent a finding of concerted action, ensures that they will avoid crossing the five percent control threshold established by the SOP and may own varied amounts of the non-voting shares so long as these are not convertible into voting shares in the hands of the original investor, as discussed above.

The first of the approved applications, made in January 2010 by Bond Street Holdings, LLC, involved a blind pool led by a group of former bank executives including Dan Healy, the former chief financial officer of North Fork Bank, and Vincent Tese, former New York State superintendant of banks. This application represented the first approval of the use of an OCC shelf charter to form a new national bank for purposes of acquiring a failed institution, in this case, the formation of Premier American Bank, N.A. to acquire Premier American Bank, a failed Florida state-chartered bank.[32] The second application, also in January 2010, involved the establishment of a new Georgia state-chartered bank, Community & Southern Bank, by a blind pool led by former bank regulator Patrick Frawley, to acquire the failed First National Bank of Georgia.[33]

Various other blind pools have been or are currently in the process of being established, including NBH Holdings Corp., formed by a group of former executives from Citizens Financial Group, a subsidiary of Royal Bank of Scotland Group plc, which raised $1.15 billion in October 2009 through a private placement arranged by FBR Capital Markets Corp,[34] and North American Financial Holdings, formed by former Bank of America executives, which raised $550 million in December 2009.

[30] The FDIC committed to do so within six months following the approval date of the FDIC SOP, which was August 26, 2009.

[31] FDIC Press Release, *FDIC Holds Roundtable With Private Investors of Failing Banks*, March 23, 2010, *available at* http://www.fdic.gov/news/news/press/2010/pr10063.html.

[32] The OCC's approval to establish a new national bank and acquire assets from the FDIC as receiver is *available at* http://www.occ.treas.gov/ftp/release/2010-8a.pdf. Interestingly, the week after being approved to acquire the failed Premier American Bank, Premier American Bank, N.A. was approved to acquire a second failed Florida-chartered institution, Florida Community Bank, which would seem to further support the notion that regulators are becoming comfortable with blind pool acquisition structures. The OCC's approval of the second acquisition is *available at* http://www.occ.treas.gov/ftp/release/2010-12a.pdf.

[33] FDIC Press Release, *Community & Southern Bank, Carrollton, Georgia, Assumes All of the Deposits of First National Bank of Georgia, Carrollton, Georgia*, January 29, 2010, *available at* http://www.fdic.gov/news/news/press/2010/pr10022.html.

[34] The OCC granted preliminary conditional approval on February 24, 2010 for NBH Holdings Corp. to establish a new national bank, NBH National Bank, but has not yet granted final approval. The OCC's preliminary approval is *available at* http://www.occ.treas.gov/interp/mar10/ca948.pdf.

As evidenced by the approved acquisitions discussed above, blind pools would appear to represent to most viable option currently available to private equity investors looking to invest in failed institutions, as they seem to address the primary concerns expressed by regulators in that they provide a relatively simple and straightforward structure, ensure that non-controlling ownership is adequately dispersed, and provide the ever-important control parties who are subject to regulatory oversight, disclosure requirements, and activities restrictions. However, as mentioned above, it is entirely possible that the regulators may also become comfortable with the club deal structure used in the BankUnited transaction, which includes management as part of the investor group, such that we may see more of the same.

OTHER WAYS TO PARTICIPATE

While the above discussion has focused on equity investments and the acquisition of essentially all of a failed institution's assets and liabilities, there are other ways that private investors may participate in the resolution of such institutions, namely, through the various loan sales programs conducted by the FDIC or its third-party brokers. These programs involve either the sale of individual loans, often through a registration and sale process conducted by third-party brokers such as DebtX, or the offering of securities as part of structured transaction involving large pools of loans, such as last year's disposition of approximately $4.5 billion in performing and non-performing construction loans and real estate owned assets previously held by Corus Bank, N.A.,[35] or the $1 billion sale in January of approximately 1200 distressed commercial real estate loans obtained from 22 failed institutions.[36] In general, each structured sale involves a private placement structure whereby instead of selling individual loans directly to investors, the FDIC: (i) contributes the subject assets (potentially comprised of performing and non-performing loans and real estate assets) to a newly established LLC; (ii) retains a large equity interest in the LLC (60% in the two transactions mentioned above); and (iii) sells the remaining membership interest in the LLC to a single investor or consortium of investors.

Another option for investors interested in such asset purchases is a pass-through investment with an open institution, whereby the investor would enter into an agreement with an institution that is bidding to acquire the assets and liabilities of a failed institution, pursuant to which the investor would subsequently purchase a portion of the acquired assets. However, it is important to note that interested investors may face a very short time period in which to conduct due diligence on the assets to be acquired, and, absent the prior agreement of the FDIC, would not benefit from any loss sharing agreement that the winning bidder may obtain from the FDIC as part of its overall bid for the failed institution.[37]

CONCLUSION

Investments in banking organizations can create significant upside potential for private sector investors. Private equity firms, however, are subjected to certain complexities and challenges that make such investments inhospitable to the impatient, uninformed, or those seeking overnight returns. Patience, relative flexibility, and experienced advisors are essential for the investor to succeed in this ever-changing space. ■

[35] FDIC Press Release, *Corus Bank Assets – Winning Bidder Announced*, October 6, 2009, *available at* http://www.fdic.gov/news/news/press/2009/pr09183.html.

[36] FDIC Press Release, *FDIC Announces Winning Bidder of $1 Billion in Loans,* January 8, 2010, *available at* http://www.fdic.gov/news/news/press/2010/pr10003.html.

[37] Loss sharing will only be offered to depository institutions and their subsidiaries, and will not be available to any asset purchaser that is not a financial institution.

CLE QUESTIONS on Beauchamp, *The Evolution of Private Equity Investment in Failed Institutions* (June 2, 2010). Please circle the correct answer to each of the questions below. If at least four questions are answered correctly, there is one credit for New York lawyers (nontransitional) for this article. Complete the affirmation and evaluation and return it by fax to RSCR-CLE, 212-876-3441, or by e-mail attachment to rscrpub@att.net. The cost is $40.00, which will be billed to your firm.

1. The holding company control rules issued by the FRB and OTS apply to individuals as well as business entities. **True** **False**

2. The FRB's 2008 policy statement modified its long-standing position to provide that convertible non-voting shares will generally not be included for purposes of a control determination, subject to certain conditions. **True** **False**

3. The FDIC's 2009 SOP applies to investors acquiring five percent or more of the voting stock of a banking organization in connection with the acquisition of the assets and liabilities of a failed institution. **True** **False**

4. The FDIC's 2009 SOP permits "Silo" structures under certain circumstances. **True** **False**

5. The FDIC has not as yet approved any applications involving a "blind pool" structure to acquire a failed institution. **True** **False**

A F F I R M A T I O N

____________________________, Esq., an attorney at law, affirms pursuant to CPLR
[Please Print]
2106 and under penalty of perjury that I have read the above article and have answered the above questions without the assistance of any person.

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