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SPECIAL EDITION

FDIC Releases Proposed Policy Statement On Private Equity Investments in Failed Banks or Thrifts

The Federal Deposit Insurance Corporation (the "FDIC") on July 2, 2009 released a Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (the "Proposed Policy Statement") that provides guidance to private equity investors interested in acquiring or investing in the assets and liabilities of failed banks or thrifts. If adopted, the Proposed Policy Statement would introduce significant additional complexity for private equity firms considering either an investment in a failed bank or thrift or an application for deposit insurance for a new institution that will acquire assets of failed institutions. Importantly, the Proposed Policy Statement does not apply to investments in healthy institutions or other institutions that have not been placed in receivership. Although it is conceivable that the principles in the Proposed Policy Statement could be applied by other banking regulators more generally, news reports indicate that both Comptroller of the Currency John Dugan and Acting Office of Thrift Supervision Director John Bowman oppose the proposal in its current form for fear it could have a chilling effect on private equity investments in failed banks and thrifts.

Under the Proposed Policy Statement, the FDIC would establish standards for bidder eligibility in connection with the resolution of failed insured depository institutions, which would:

- Require that private equity investors provide capital support to the acquired depository institution;
- Require that private equity investors provide cross guarantees to the FDIC with respect to substantially commonly owned depository institutions;
- Impose limits on transactions with affiliates;
- Require maintenance of continuity of ownership for a three year period;
- Impose clear limits on "secrecy law jurisdiction" vehicles as the channel for investments;
- Impose limitations on whether existing investors that directly or indirectly hold 10% or more of the equity of an institution could bid on that institution if it entered receivership; and
- Require disclosure commitments, including those related to the size of the investing fund or funds, the fund's diversification, and the "return profile," marketing documents, management team and business model.

"Silo" Structures. The FDIC noted in the Proposed Policy Statement that it has reviewed various private capital investment structures and considers that some common structures raise potential safety and soundness considerations and risks to the Deposit Insurance Fund (the "DIF") as well as important additional compliance issues. The Proposed Policy Statement states that "silo" structures would not be eligible bidders for failed bank assets and liabilities, although the Proposed Policy Statement does not explain with any specificity which types of structures the FDIC would treat as "silo" structures. The FDIC expressed its view that, under these structures, beneficial ownership cannot be ascertained, the parties responsible for making decisions are not clearly identified, and ownership and control are separated.

The proposed limitations on "silo" structures are particularly important for investors seeking to acquire an interest in a failing thrift institution (as opposed to a failing bank). There have been some notable private equity investments carefully structured to allow private equity sponsors to form bank-focused private equity funds that themselves will become bank holding companies, without subjecting the limited partners or related funds to the burdens of becoming bank holding companies (so-called "silo" structures). For example, certain principals of JLL Partners, a diversified private equity firm with interests across a spectrum of industries, created a new fund that became a registered bank holding company by acquiring control of a Texas-based bank holding company. Although the new fund registered as a bank holding company, the individual principals did not, and JLL's other private equity activities conducted outside the bank fund chain were unaffected. More recently, though, Federal Reserve Board staff have indicated a strong reluctance to approve any such silo structures, citing concerns about the potential mixing of commerce and finance presented by such structures. In contrast, the Office of Thrift Supervision has permitted investors to acquire a thrift institution through a silo structure, most notably in the acquisition of a controlling interest in Flagstar Bancorp Inc. by an entity related to Matlin Patterson Global Advisers LLC. We note, however, that the continued viability of the Office of Thrift Supervision and, perhaps, even the thrift charter, have been called into doubt by the Treasury's recently released white paper on financial regulatory reform.

Capital Commitment. The Proposed Policy Statement goes far beyond what current law and policy would require with respect to capital adequacy. It would require that an acquired depository institution be exceptionally well capitalized, with a Tier 1 leverage ratio of 15% to be maintained for a period of at least three years, and thereafter continue to operate at a "well capitalized" level. If at any time the depository institution fails to meet this standard, the private equity investors would have to immediately facilitate restoring the institution to the "well capitalized" level. Failure to maintain the required capital level would result in the institution being treated as "undercapitalized" for purposes of applicable Prompt Corrective Action guidelines, thereby triggering all of the measures that would be available to the institution's regulator in such a situation. In comparison, under current Prompt Corrective Action guidelines adopted by the federal banking agencies, an institution is considered "well capitalized" if it maintains a leverage ratio of not less than 5% and meets certain other tests. Historically, in the context of granting deposit insurance to a *de novo* charter, the FDIC has required that initial capital be sufficient to maintain an 8% leverage ratio for three years.

Source of Strength. The Proposed Policy Statement also would require "organizational structures" to agree to serve as a source of strength for their subsidiary depository institutions. This commitment must be supported by an agreement of the holding company of a subsidiary depository institution to sell equity or engage in borrowing that generates

regulatory capital if necessary to maintain the capital adequacy of the subsidiary. Under Federal Reserve Board policy, bank holding companies already are required to serve as a source of strength to their subsidiary banks, but the Proposed Policy Statement would have the effect of extending this doctrine to structures organized to acquire a thrift institution and turn it into a contractual obligation.

Cross Guarantees. The Proposed Policy Statement would require investors whose investments, individually or collectively, constitute a majority investment in more than one insured depository institution, 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. Currently, Federal banking law imposes so-called cross-guarantee liability on insured depository institutions that are controlled by the same company. Because many private equity investments in banks and thrifts involve groups of investors, each holding a noncontrolling investment, the Proposed Policy Statement could effectively extend cross-guarantee liability to situations where non-controlling investors own institutions in common, even if the investors are not acting as a group and would not be viewed as having control of the institution under applicable law. This is a real concern because in recent months a number of private equity firms have entered into so-called "club" deals, in which a number of private equity firms (and potentially other investors) each buy up to the legal limit of a bank, generally up to either one-third of the total equity of the bank (provided the investment does not allow the investor to own, control or hold with power to vote 15% or more of any class of voting securities) or up to 24.9% of any class of voting equity. For example, the FDIC sold IndyMac and BankUnited, both failed insured depository institutions, in club deals in the past six months. Under the Proposed Policy Statement, each member of a club would potentially be subject to cross-guarantee liability if the same group (or possibly some subset of the group) were to invest in another institution.

Other Requirements. The Proposed Policy Statement includes a requirement that investors agree to a three year holding period, unless a sale is approved by the FDIC to an investor who agrees to be bound to the requirements of the Proposed Policy Statement. Institutions subject to the Proposed Policy Statement would be prohibited from extending credit to investors, their investment funds, any affiliates of either and any of their portfolio companies, even if those transactions would be permitted under current rules that regulate transactions between an insured depository institution and its insiders and affiliates. In addition, investors would be expected to submit to the FDIC information about the investors and all entities in the ownership chain, including the size of the investing fund or funds, its diversification, the "return profile," the marketing documents, the management team and the business model, as well as any other information the FDIC determines to be necessary to assure compliance with the Proposed Policy Statement.

Comments. The FDIC is seeking comment on all aspects of the Proposed Policy Statement, including the views of commenters on the appropriate level of initial capital that will satisfy concerns relating to both safety and soundness and the economic viability of the terms of investment in insured depository institutions. Comments will be due 30 days from the date of publication in the *Federal Register*.

Conclusion. Private equity firms seeking to invest in banks and thrifts are already subject to several regulatory requirements, including, for noncontrolling investments, limitations on the percentage of voting and total equity an investor may acquire and the types of governance rights, including board seats, and other rights an investor may obtain without

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being considered to control an institution. Moreover, an investment vehicle formed to acquire control of a failed institution in most cases is currently required to obtain regulatory approval to become a bank holding company or thrift holding company, even if its investors hold non-controlling stakes. As noted above, if the Proposed Policy Statement is adopted in its current form, it would introduce significant additional barriers to private equity firms seeking to invest in a failed bank or thrift.

If you have any questions regarding this Special Edition, please call or email Robert M. Kurucza, Thomas J. LaFond, William E. Stern or your regular Goodwin Procter contact.