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FDIC Proposes Stringent New Rules for Private Equity Investors in Failed Depository Institutions

At a meeting on July 2, 2009, the Federal Deposit Insurance Corporation (the “FDIC”) Board authorized publication for public comment of a Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (the “Proposed Policy Statement”). The Proposed Policy Statement is targeted at, and would establish standards for bidder eligibility for, private equity investors and similar nonbank investors seeking to acquire or invest in failed depository institutions through the FDIC resolution process.

The Proposed Policy Statement is remarkable not only for its vagueness and opacity with regard to the details of its material provisions and key terminology but also its surprisingly far-reaching policy prescriptions. As for the manner of its drafting, it is possible that the Proposed Policy Statement is intended by the FDIC primarily to generate public comments and start debate on the fundamental policy issues involved, which would be addressed with more precision and detail in whatever final policy statement the FDIC ultimately decides to adopt.

The Proposed Policy Statement is sufficiently clear, however, in its policy prescriptions, which would impose new regulatory requirements and restrictions—including extraordinary capitalization requirements for covered depository institutions, source of strength obligations and cross-guarantee liability for noncontrolling investor organizations, minimum holding periods for depository institution investments, and investor disclosure requirements—that are in some cases substantially more burdensome than those applicable to depository institutions owned by traditional holding companies and that go well beyond the requirements imposed by applicable law. If adopted in final form, these policy prescriptions would likely cause many private equity investors to reconsider their strategy of investing in failed depository institutions. The proposal also seems to infringe on the jurisdiction of the Federal Reserve Board, the Office of the Comptroller of the Currency (the “OCC”), and the Office of Thrift Supervision (the “OTS”) with respect to bank holding companies, state member banks, national banks and thrifts and thrift holding companies. FDIC Chair Sheila Bair, aware of the controversy that the Proposed Policy Statement will generate, has indicated that the FDIC expects substantial public comment and extensive debate regarding the proposed terms. She has also expressed a general openness to revisiting those terms in light of public comment and debate when the agency finalizes the policy.



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Background and Context of the Proposed Policy Statement

The Proposed Policy Statement comes at a time when the FDIC, as the receiver for insured depository institutions that have been closed by their primary regulators, is facing the daunting task of resolving an ever-increasing number of failed institutions. There were 45 depository institution closings in the first two quarters of 2009, nearly double the total for all of 2008. An additional seven depository institutions were closed on July 2, 2009, the same day that the FDIC adopted the Proposed Policy Statement. The FDIC's Quarterly Banking Profile for the first quarter of 2009 reported that the number of insured banks and thrifts on the FDIC's "Problem List" increased from 252 to 305 during that quarter, and total assets of "problem" institutions rose from US\$159 billion to US\$220 billion.

Faced with this task, the FDIC and the other federal banking agencies have sought to enlist nontraditional bank investors such as private equity firms to acquire closed or failing depository institutions. In particular, the FDIC has expanded its bidding procedures for troubled institutions to allow participation by parties currently without a bank charter in bidding for troubled institutions and deposits and assets of institutions in receivership. This has led to some significant acquisitions of failed depository institutions by consortia of private equity investors, including IndyMac Federal Bank, F.S.B. (acquired in March of this year by a thrift holding company owned by a consortium including JC Flowers & Co., Paulson & Co., Dune Capital Management L.P., MSD Capital L.P., Stone Point Capital, and other investors) and BankUnited, FSB (acquired in May by a thrift holding company owned by a consortium including WL Ross & Co. LLC, Carlyle Investment Management L.L.C., Blackstone Management Partners, L.L.C., and other investors).

In each of the IndyMac and BankUnited transactions, the FDIC and the acquirers entered into loss-sharing arrangements of a type that the FDIC has traditionally entered into with banks acquiring failed depository institutions, with the FDIC generally absorbing 80 percent of losses on acquired assets above a first-loss tranche and up to a specified threshold and 95 percent of losses thereafter. The large number of failed and failing depository institutions, along with the potential availability of loss-sharing arrangements with the FDIC, have piqued the interest of private equity investors. In its May 21, 2009 press release announcing the BankUnited acquisition, the FDIC stated that "due to the interest of private equity firms in the purchase of depository institutions in receivership, the FDIC has been evaluating the appropriate terms for such investments" and that the FDIC would in the near future provide "generally applicable policy guidance on eligibility and other terms and conditions for such investments to guide potential investors."

The Proposed Policy Statement appears to have been precipitated also by the concerns raised recently by Senator Reed of Rhode Island with the federal bank regulators and Treasury Secretary Timothy Geithner regarding investments by private equity firms in depository institutions—in particular, such firms' lack of transparency—and the possibility of regulatory arbitrage due to a lack of uniform standards among the various regulators for such transactions.

FDIC Policy Concerns Cited in the Proposed Policy Statement

In the preamble to the Proposed Policy Statement, the FDIC states that it is "particularly concerned that owners of banks and thrifts, whether they are individuals, partnerships, limited liability companies, or corporations, have the experience, competence, and willingness to run the bank in a prudent manner, and accept the responsibility to support their banks when they face difficulties and protect them from insider transactions." The FDIC states further that it has "reviewed various elements of private capital investment structures and considers that some of these investment structures raise potential safety and soundness considerations and risks to the Deposit Insurance Fund (DIF) as well as important issues with respect to their compliance with the requirements applied by the FDIC in its decision on the granting of deposit insurance." The specific concerns cited by the FDIC are the need for fully adequate capital, a source of financial and managerial strength for the depository institution and the potential adverse effects of extensions of credit to affiliates. The FDIC seems to be concerned that the failed depository institution (or one that has assumed its liabilities and purchased its assets) will fail a second time.

The FDIC does not, however, cite any actual instances in which private equity ownership of depository institutions has led to losses by or risks to the DIF or unsafe and unsound conditions at the depository institutions in question.

Details of the Proposed Policy Statement

Investors Covered

The Proposed Policy Statement states that it would be applicable to:

- private capital investors in a company (other than a bank holding company or thrift holding company that has come into existence or has been acquired by such investors at least three years prior to the date of the final policy statement) that is proposing to directly or indirectly acquire a failed depository institution in FDIC receivership; and

- applicants for FDIC deposit insurance for a de novo depository institution being chartered in connection with an acquisition of a failed insured depository institution in FDIC receivership (collectively, “Investors”).¹

The Proposed Policy Statement states that the scope of its coverage is intended to address “concerns raised mainly by ownership structures involving more than *de minimis* investments that typically involve a shell holding company owned by another entity or other entities that avoid certain of the responsibilities of bank and thrift ownership.” Although the Proposed Policy Statement takes pains to avoid stating it directly, it appears to be targeted primarily at private equity investors and consortia of such investors (commonly referred to as “club deals”) seeking to participate in the FDIC bidding process for failed depository institutions through newly-formed holding companies or newly-chartered or recently-acquired depository institutions, in which the private equity investors have not taken controlling equity stakes so as to avoid becoming subject to regulation as bank holding companies or thrift holding companies under applicable federal banking laws. Ownership structures of those types were involved in the IndyMac and BankUnited transactions as well as in other private equity investment transactions involving depository institutions that were not in FDIC receivership. The Proposed Policy Statement presumably would also apply if there is only one private equity investor involved in a transaction, as long as its ownership stake is above the *de minimis* threshold. It is not clear, however, whether one or more individuals acquiring or chartering a depository institution to acquire a failed bank in the FDIC receivership process would be considered to be Investors covered by the Proposed Policy Statement. Investors J.C. Flowers and Wilbur Ross have made equity investments in open depository institutions (i.e., not in FDIC receivership) in their individual capacities.

There are a number of substantial issues raised as to the coverage of the Proposed Policy Statement. What level of equity ownership by a private equity investor would be considered “more than *de minimis*” and trigger the application of the policy to a potential bidder? Presumably the level would be below the 10 percent rebuttable presumption of control threshold of the Change in Bank Control Act that has been a guidepost for private equity and other nonbank investments in depository institutions. Additionally, as drafted, the Proposed Policy Statement would appear to exclude a private equity-owned bank holding company or thrift holding company that **either** has been in existence for, or was acquired by

the private equity investors, at least three years prior to the date of the FDIC’s final policy statement. This suggests that private equity investors could avoid coming within the coverage of the Proposed Policy Statement simply by selecting as an acquisition vehicle a bank holding company or thrift holding company that has been in existence for at least three years.

The Proposed Policy Statement also provides that it will not apply “to individuals, partnerships, limited liability companies, or corporations, which accept the responsibilities under existing law to serve as responsible custodians of the public interest that is inherent in insured depository institutions.” Presumably, this is intended to refer to investors that agree to become regulated as bank holding companies or thrift holding companies (as in the case of a number of specialized bank investment funds, such as CapGen Capital Group and Belvedere Capital), but like much of the Proposed Policy Statement it is strikingly vague, most likely intentionally so.

It is not clear why the Proposed Policy Statement should apply to an existing bank holding company that charters a de novo bank to purchase assets and assume liabilities of a failed bank, regardless of the nature of the investors in that bank holding company. Presumably the Federal Reserve Board has the requisite expertise to carry out its supervisory responsibilities relating to the managerial and financial condition of the bank holding company.

Capital Commitment

In the provision likely to be of greatest concern to many private equity investors interested in bidding on failed depository institutions, the Proposed Policy Statement provides that Investors would be required to commit to the FDIC that they would cause the depository institution acquiring the banking operations of a failed depository institution in receivership to be initially capitalized at a minimum 15 percent Tier 1 leverage ratio² for a period of three years, subject to possible extension by the FDIC. After the initial three-year period, the Investors would be required to maintain the depository institution at a level of capital adequacy no lower than “well capitalized”³ throughout the remainder of their ownership. If at any time the depository institution’s capital

2 A depository institution’s Tier 1 leverage ratio is calculated by dividing its Tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). Tier 1 capital consists of common stock, perpetual preferred stock, and minority interest in the equity accounts of consolidated subsidiaries, less goodwill and certain other deducted items. Under generally applicable bank capital regulations, depository institutions with the highest examination ratings are subject to a minimum Tier 1 leverage ratio requirement of 3 percent, with the minimum for all other banks being 4 percent. The Tier 1 leverage ratio requirement for a depository institution to be considered “well capitalized” is 5 percent.

3 To be well capitalized under the federal Prompt Corrective Action regulations, a depository institution must have a ratio of Tier 1 capital to total consolidated risk-weighted assets of at least 6 percent, a ratio of total capital to total consolidated risk-weighted assets of at least 10 percent, and a Tier 1 leverage ratio of at least 5 percent.

1 Unless otherwise provided, the provisions of the Proposed Policy Statement would apply to a covered Investor throughout the entire period during which the Investor maintained an ownership interest in the depository institution acquired from the FDIC. However, the FDIC has specifically requested public comment as to whether some or all of the Proposed Policy Statement’s provisions should be lifted after a certain number of years of successful operation of a bank or thrift holding company, and if so in what timeframe and subject to what criteria.

were to fall below the well capitalized level, the Investors would have to “immediately facilitate restoring” the institution to well capitalized status. Any failure to maintain the required capital level would result in the institution being treated as “undercapitalized” for purposes of the federal Prompt Corrective Action regulations, which would (among other things) trigger restrictions on the payment of dividends and management fees by the institution and on the growth of the institution’s assets, require the submission to the institution’s primary federal regulator of a capital restoration plan and impose prior regulatory approval requirements on certain expansion proposals by the institution.

Notwithstanding the absence of any Congressional authorization, this provision would have the effect of creating a completely separate set of capital standards, perhaps unprecedented in their stringency, for depository institutions with private equity ownership that acquire failed banks in FDIC receivership. The 15 percent Tier 1 leverage ratio requirement applicable to the initial three-year ownership period after the FDIC receivership transaction would be almost double the 8 percent level imposed by the FDIC in granting deposit insurance for de novo institutions generally, three times greater than the level required for an existing depository institution to be considered well capitalized and nearly four times greater than the minimum level generally required of most depository institutions on an ongoing basis. It is also more stringent by a good measure than the 15 percent total risk-weighted capital ratio requirement imposed by the FDIC in certain cases under capital maintenance agreements with the largely unregulated parent companies of newly-chartered, FDIC-insured industrial banks and industrial loan companies. The FDIC specifically requests public comment as to whether this level of initial capital would have the effect of “making investments in the assets and liabilities of failed banks and thrifts uncompetitive and uneconomic,” but it is difficult to see how it could fail to do so.

A private equity firm considering participating in the bidding for failed depository institutions in FDIC receivership through an ownership structure that would be subject to the Proposed Policy Statement would need to evaluate whether and how it could provide the FDIC with the required commitments to make additional capital available to the covered depository institution on an ongoing basis under the provisions of its fund’s governing documents, which ordinarily do not provide for open-ended capital commitments from the investing limited partners. It should also be noted in this regard that the need to avoid ongoing regulatory capital commitments as well as the source of strength requirement discussed below is a principal reason why private equity investors have traditionally structured their depository institution investments to be non-controlling in nature, which preserves the investors’ unregulated status under the Bank Holding Company Act (the “BHC Act”) and the Savings and Loan Holding Company Act (the “SLHC Act”).

It is not clear that this FDIC definition of “undercapitalized”— i.e., a depository institution that ceases to be “well capitalized”— would apply to a national bank, a state member bank or a thrift that in practice meets the criteria for “adequately capitalized” rather than “undercapitalized” status under the federal Prompt Corrective Action regulations,⁴ unless the OCC, the Federal Reserve Board or the OTS were to adopt the FDIC’s proposed definition.

For a private equity firm or consortium that holds an equity stake in a depository institution that was not acquired from the FDIC in the receivership process and that seeks also to bid on failed depository institutions, it should be possible to insulate the first depository institution from the capital commitment requirements of the Proposed Policy Statement by not using it as the acquirer of the banking operations of the failed bank. Such a strategy, however, could deprive the private equity firm or consortium of the efficiencies and synergies that might be available if the operations of the two institutions could be combined.

Source of Strength⁵

The Proposed Policy Statement provides that “Investors organizational structures subject to the measures provided for in this policy statement would be expected to agree to serve as a source of strength for their subsidiary depository institutions.” These source of strength commitments “are to be supported by the agreement of the depository institution holding company in which the Investors have invested that holds the stock of such depository institutions to sell equity or engage in capital qualifying borrowing.”

As drafted, this provision of the Proposed Policy Statement would impose the source of strength obligation at the level of the depository institution holding company in which the private equity investor or consortium holds its equity investments. Such an

4 Under the Prompt Corrective Action regulations, a depository institution is “adequately capitalized” if it has a Tier 1 risk-weighted capital ratio of 4 percent or greater, a total risk-weighted capital ratio of 8 percent or greater, a Tier 1 leverage ratio of 4 percent or greater (or 3 percent or greater if the institution has the highest examination rating and is not experiencing or anticipating significant growth), and the institution does not meet the criteria for well-capitalized status. A depository institution is “undercapitalized” if it has a Tier 1 risk-weighted capital ratio of less than 4 percent, a total risk-weighted capital ratio of less than 8 percent, and a Tier 1 leverage ratio of less than 4 percent (or less than 3 percent if the institution has the highest examination rating and is not experiencing or anticipating significant growth).

5 The term “source of strength” comes from a Federal Reserve Board policy applicable to its supervision and regulation of bank holding companies, which requires that a bank holding company serve as “sources of financial and managerial strength” to its subsidiary banks. The Federal Reserve Board expects that a bank holding company, in serving as a source of strength to its subsidiary banks, would stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks.

approach would essentially be a reiteration of existing regulation, particularly in the case of bank holding companies. The FDIC specifically requests public comment, however, as to whether the source of strength commitment should be “enhanced to require from the shell holding company *and/or the Investors* a broader obligation than only a commitment to raise additional equity or engage in capital qualifying borrowing.” (emphasis added) This indicates that the FDIC is at least considering imposing a source of strength commitment directly on the noncontrolling private equity investors holding equity stakes in the depository institution holding company, and that it is also considering expanding the obligations under that commitment beyond what is required of bank holding companies under Federal Reserve Board policy.

Such an approach would present the same type of concerns for private equity firms about ongoing regulatory capital commitment obligations that are discussed above in connection with the Capital Commitment provisions of the Proposed Policy Statement. It is also fair to say that imposing such an obligation on an indirect, noncontrolling stockholder would be highly unusual if not unprecedented as both a bank regulatory and general corporate law matter. In addition, the Proposed Policy Statement provides no details as to how such an obligation would operate in practice.

Cross Guarantees

The Proposed Policy Statement provides that:

Investors whose investments, individually or collectively, constitute a majority of the direct or indirect investments in more than one insured depository institution would be expected to pledge to the FDIC their proportionate interests in each such institution to pay for any losses to the deposit insurance fund resulting from the failure of, or assistance provided to, any other such institution.

The FDIC also specifically requests comment as to whether the cross guarantee provision, if retained in the final FDIC policy statement, should “be enhanced by requiring a direct obligation of the Investors.” This presumably refers to a commitment of the Investor to make a direct payment to the FDIC in reimbursement of the losses to the deposit insurance fund rather than merely pledging the Investor’s shares in the commonly controlled depository institutions to the FDIC.

This provision appears to represent a draconian extension of the cross-guarantee provisions of the Federal Deposit Insurance Act to noncontrolling private equity investors. That Act provides that an insured depository institution is liable for any loss incurred by or anticipated for the FDIC’s Deposit Insurance Fund in connection with the default of a commonly-controlled insured

depository institution or any assistance provided by the FDIC to any commonly-controlled insured depository institution in danger of default. “Control” for purposes of that statutory provision has the same meaning as under the BHC Act, which means direct or indirect ownership or control of or power to vote 25 percent or more of a class of voting securities, control over the election of a majority of directors, or the power to exercise a controlling influence over management or policies.

As in the case of other provisions of the Proposed Policy Statement, the cross guarantee provision does not contain any details as to how the provision would be applied in practice. However, the provision does not appear to be focused on situations in which a private equity organization holds majority ownership stakes in two or more depository institution investments through one or more investment funds, as such funds would be regulated as bank holding companies or thrift holding companies and therefore not covered by the Proposed Policy Statement. Rather, the provision appears aimed at the members of overlapping private equity consortia investing in depository institutions, and as drafted would seem to apply to any such member regardless of the size of its ownership stake (although perhaps subject to the *de minimis* threshold referred to above in connection with the general scope of the Proposed Policy Statement). Under this approach, a private equity investor participating in two depository institution club deals (at least one of which involved an acquisition of a failed depository institution) and holding more than a *de minimis* equity stake in each of the two depository institutions could in theory become subject to the cross guarantee requirement if the combined direct or indirect ownership stake in each of the underlying depository institutions of at least some of the common members in the two consortia represented at least 50.1 percent. For the private equity investor holding such small equity stakes, this would be akin to a nightmare version of the “drag along” rights often contained in shareholder agreements.

This provision, if retained by the FDIC in the final policy and applied in this manner, would likely lead private equity investors to avoid entering into more than one depository institution club deal with any other private equity firm, at least in cases where an existing or proposed common depository institution investment involves the acquisition of a failed bank in the FDIC receivership process. Additionally, a private equity firm considering club deal transactions that might subject it to the cross-guarantee provision would need to evaluate whether the requirement to pledge the depository institutions’ shares to the FDIC would be permissible as a contractual matter.

Continuity of Ownership

Investors subject to the Proposed Policy Statement would be prohibited from selling or otherwise transferring securities of the Investors' holding company or depository institution for three years after the acquisition of the failed depository institution from the FDIC, unless otherwise approved in advance by the FDIC. The Proposed Policy Statement provides that "the FDIC does not expect to approve any sale to a private capital investor during such 3 year period unless the buyer agrees to be subject to the same conditions that are applicable under this policy statement to the selling Investor."⁶

The FDIC seeks to justify this three-year minimum ownership period, which has no basis in applicable law, by comparing it to the requirement commonly contained in FDIC Deposit Insurance Orders for de novo depository institutions to obtain prior FDIC approval to make a change in their business plan during their first three years of operations. However, while a regulatory agency can be expected to impose a prior approval requirement on a temporary basis for a departure from the depository institution's business plan approved as part of the chartering process, it is very unusual to seek to restrict the ability of the institution's direct or indirect owners to sell their ownership interests. Moreover, it is unclear how this three-year minimum ownership period would affect the ability of private equity investors to take the depository institution or its holding company public during that time frame.

Investor Disclosure

The Proposed Policy Statement provides that covered Investors

would be expected to submit to the FDIC information about the Investors and all entities in the ownership chain including such information as the size of the capital fund or funds, its diversification, the return profile, the marketing documents, the management team and the business model. In addition, Investors and all entities in the ownership chain will be required to provide to the FDIC such other information as is determined to be necessary to assure compliance with this policy statement.

It is not clear how extensive the required disclosure would be, and in particular whether a private equity firm would be required to disclose the identities of limited partners in its investment fund. Such a disclosure requirement, particularly if applied to limited partners holding relatively small equity positions, would be very problematic for most private equity firms.

⁶ If a private equity investor were to sell its ownership stake in the covered depository institution after the initial three-year period, that investor should no longer be subject to the ongoing capital commitment obligations and other requirements of the Proposed Policy Statement.

Transactions with Affiliates

The Proposed Policy Statement would prohibit "all extensions of credit to Investors, their investment funds if any, any affiliates of either, and any portfolio companies (i.e., companies in which the Investors or affiliates invest) by an insured depository institution acquired or controlled by such Investors under this policy statement." The Proposed Policy Statement incorporates the expansive definition of the term "extension of credit" in Federal Reserve Board Regulation W (Transactions Between Member Banks and Their Affiliates), and defines "affiliate" as any company in which an Investor owns 10 percent or more of the equity.

This provision's flat prohibition on extensions of credit and the definition of "affiliates" within its scope represent a substantial expansion of existing regulatory restrictions on affiliate transactions by insured depository institutions.⁷ The FDIC justifies that expansion on the basis that private capital investors are not subject to the regulatory restrictions on nonbanking activities that are applicable to bank holding companies and thrift holding companies. However, the FDIC has not sought to impose a similar expansion of existing affiliate transaction restrictions on other insured depository institutions that are controlled by largely unregulated parent companies, such as industrial bank and industrial loan company subsidiaries of commercial or industrial companies.

As in the case of other provisions, this affiliate transaction provision would appear to apply to transactions between the depository institution and an Investor or its related interests regardless of the size of the Investor's direct or indirect ownership stake in the institution. The provision would also require the Investor to share information with the depository institution as to the Investor's portfolio holdings down to the 10 percent ownership level in order to avoid violations of the prohibition.

Use of "Silo" Structures

The Proposed Policy Statement provides that some private capital investment structures,

such as those involving complex and functionally opaque ownership structures, typified by so-called "silo" organizational arrangements, in which the beneficial ownership cannot be ascertained, the responsible parties for

⁷ Under Federal Reserve Act Section 23A and Regulation W thereunder, an insured depository institution is permitted to extend credit to affiliates, subject to quantitative restrictions, collateralization requirements and certain other prudential requirements. Federal Reserve Act Section 23B and Regulation W also subject such transactions to the requirement that they be on arm's length, market terms. To be an affiliate of the depository institution for purposes of those statutes and Regulation W, the entity would have to control, be controlled by, or be under common control with, the depository institution, with control being defined as in the BHC Act (which provides for a 25 percent voting ownership threshold, as discussed above).

making decisions are not clearly identified, and/or ownership and control are separated, would be so substantially inconsistent with these principles as not to be considered as appropriate for approval for ownership of insured depository institutions.

The Proposed Policy Statement does not contain a definition of the term “‘silo’ organizational arrangements.” However, in connection with private equity investments in depository institutions, the term “silo structure” is commonly used to refer to an acquisition structure that is designed to allow an investing private equity organization to make a controlling investment in the institution without becoming (and without the private equity organization’s others funds and their portfolio investments becoming) subject to the nonbanking prohibitions and other regulatory restrictions and requirements of the BHC Act or the SLHC Act.⁸

Although the use of silo structures by private equity firms making investments in depository institutions has been controversial, the issues in controversy have related to whether the structures allow for an impermissible evasion of the control provisions of the BHC Act and the SLHC Act, rather than any question as to the identity of beneficial owners or responsible parties. The Federal Reserve Board no longer allows any transactions potentially subject to the BHC Act and that would employ a silo structure to proceed, whereas the OTS allowed private equity firm MatlinPatterson to make a controlling investment in the thrift holding company Flagstar Bancorp, Inc. in December of 2008 utilizing a silo structure to allow MatlinPatterson to avoid becoming a thrift holding company itself. That OTS approval was the main example of “regulatory arbitrage” cited by Senator Reed in his recent letters to the federal bank regulatory agencies and Treasury Secretary Geithner, as noted above, and it appears that this provision in the Proposed Policy Statement is primarily intended to address that concern.

Secrecy Law Jurisdictions

The Proposed Policy Statement provides that Investors employing ownership structures utilizing entities domiciled in bank secrecy jurisdictions would not be eligible to own a direct or indirect interest in an insured depository institution unless:

- the Investors are subsidiaries of companies that are subject to “comprehensive consolidated supervision” as recognized by the Federal Reserve Board; and

⁸ In a silo structure, the private equity organization creates a mirror fund (to be capitalized by the investors in the organization’s existing fund or funds) with its own new general partner that would acquire up to 100 percent of the voting equity of a depository institution or its holding company. The new general partner is controlled by an individual partner or partners in the private equity organization, and no legal entity controls both the bank fund and any other fund in the organization. Although the new fund and the new general partner become subject to regulation as bank holding companies or thrift holding companies, depending upon the type of depository institution acquired, the rest of the private equity organization avoids regulated status.

- the Investors (i) execute agreements to provide the depository institution’s primary federal regulator with information regarding the Investors’ operations and activities; (ii) maintain business books and records (or copies) in the United States; (iii) consent to the disclosure of information that might be covered by confidentiality or privacy laws in their home country 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 US federal banking agencies.

The requirement that the Investors be subsidiaries of companies that are subject to “comprehensive consolidated supervision” limits the universe of permissible Investors domiciled in bank secrecy jurisdictions to those that are controlled by bank holding companies or foreign banking organizations based in countries whose bank supervisory systems have been reviewed by the Federal Reserve Board and determined to be consistent with international standards.

It is not specified which jurisdictions would be treated as “bank secrecy jurisdictions” for purposes of this provision; however, for purposes of branch or subsidiary applications by insured state nonmember banks, the FDIC treats the Cayman Islands and the Bahamas, among others, as within that category, and presumably that same approach would be taken in this context as well. This would negatively affect the ability of private equity organizations to utilize offshore funds in connection with investments in failed depository institutions.

Special Owner Bid Limitation

The Proposed Policy Statement provides that an Investor that directly or indirectly holds 10 percent or more of the equity of a depository institution would not be permitted to bid in the FDIC receivership process on that institution if it were subsequently to fail. This provision is intended to avoid providing an incentive for such an Investor to seek to take advantage of any loss sharing arrangements that might be entered into by the FDIC as part of the resolution of the failed institution.

Additional Regulatory Issues Raised

The Proposed Policy Statement provides that its requirements are intended to be in addition to, rather than a substitution for, the requirements of the primary federal regulator of the bank, thrift or holding company participating in a particular acquisition transaction, such as with respect to matters of general character, fitness and expertise of the management being proposed by investors, the need for a satisfactory business plan and a satisfactory corporate governance structure and other supervisory matters. However, the Proposed Policy Statement raises a number

of jurisdictional issues with regard to the authority of the FDIC, in its capacity as deposit insurer and receiver of failed institutions, to impose such additional restrictions, requirements and policies on depository institutions and their holding companies, particularly to the extent that they may be in conflict with those of the primary federal bank regulators for the depository institutions or holding companies in question. The Proposed Policy Statement could therefore be viewed as a substantial proposed expansion by the FDIC of its regulatory authority and powers, in apparent conflict with the allocation of regulatory and supervisory responsibilities adopted by Congress in the federal banking laws.

Of greater import, not merely for private equity investors seeking to acquire failed banks in FDIC receivership but for investors in depository institutions generally, the Proposed Policy Statement would overturn basic principles relating to the role, responsibilities and obligations of noncontrolling investors. As discussed above, noncontrolling investors would become subject to a number of regulatory restrictions and requirements that equal or even go beyond those imposed currently on controlling shareholders. Noncontrolling investors would also be required to take coordinated action on an ongoing basis with regard to the depository institution or holding company in question, in potential conflict with the provisions of the passivity agreement or rebuttal of control agreement that each investor would have been required to enter into with the Federal Reserve Board or the OTS in connection with making its equity investment. Moreover, the possibility that the concepts embodied in the Proposed Policy Statement might be extended in the future to apply in contexts other than the acquisition of failed banks in the FDIC receivership process could give would-be investors pause when evaluating the risks and benefits of an equity investment in any type of depository institution.

Proposed Policy Statement Fails to Strike Sought-After Balance of Conflicting Goals

FDIC Chair Sheila Bair emphasized at the July 2, 2009 FDIC Board meeting that the Proposed Policy Statement was intended to strike a balance between, on the one hand, accommodating investments in depository institutions from nontraditional sources in order to assist the FDIC in resolving the large number of failed and troubled depository institutions, and imposing new prudential requirements intended to address the perceived risks associated with ownership in depository institutions by largely unregulated investors, on the other. However, many observers, including prominent private equity investors actively involved in investing in failed or troubled depository institutions, have been taken aback by the largely unprecedented nature of a number of the Proposed

Policy Statement's leading prescriptions, which, as discussed above, would subject depository institutions acquired or formed by private equity investors in connection with the FDIC resolution process to requirements that are in some cases substantially more burdensome than those applicable to depository institutions owned by traditional holding companies and that go well beyond the requirements imposed by applicable law.

Investor Wilbur Ross, whose firm was a member of the private equity consortium in the recent BankUnited transaction, has been quoted as warning of the likely chilling effect of the Proposed Policy Statement on private equity firms bidding on failed banks, including even before the policy is finalized.⁹ The Private Equity Council, a trade association for private equity firms, has gone on record with a similar view.¹⁰ Mr. Ross has stated further that his firm would not have participated in the BankUnited acquisition under the terms of the Proposed Policy Statement, and that his firm will stop working on new deals involving investments in failed depository institutions until the matter is resolved.¹¹

The Proposed Policy Statement has also been the subject of criticism by some of the other federal bank regulatory agencies. At the July 2, 2009 FDIC Board meeting, Comptroller of the Currency, John Dugan and Acting Director of the OTS John Bowman, both members of the five-member FDIC Board, expressed the view that the Proposed Policy Statement's prescriptions were overreaching and likely to deter private equity investors from seeking to invest in failed depository institutions, which would ultimately increase the FDIC's bank resolution costs. Acting Director Bowman also noted the lack of clarity for certain key terms and provisions in the Proposed Policy Statement.

The Proposed Policy Statement calls for a relatively short 30-day public comment period from the date that the document is published in the Federal Register, which means that the comment period would end in early or mid-August and a final policy could be adopted soon thereafter. It is not known at this time whether the FDIC will defer action on any bid proposals for failed or failing banks involving private equity investors until the Proposed Policy Statement becomes effective.

9 "FDIC Failed-Bank Bid Plan Blasted by OCC, Investors," *American Banker* (July 2, 2009).

10 "U.S. Gets Tough on Funds Trying to Buy Failed Banks," *New York Times* (July 3, 2009).

11 *American Banker*, *supra*.

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