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September 30, 2008

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NEWSLETTER OF THE BANKING AND SPECIALTY FINANCE PRACTICE GROUP OF MANATT, PHELPS & PHILLIPS, LLP

The Federal Reserve Posts "Capital Welcome!" Sign and Opens the Gate a Little Wider for Noncontrolling Investments in Banks by Private Equity Firms and Others

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Among the flurry of proposals and pronouncements by the banking and securities regulators intended to calm the troubled financial market waters and restore credibility and liquidity was the long-rumored, but modest relaxation by the Federal Reserve of its policy on equity and non-equity investments in banks that will not subject the investor to supervision, regulation and examination as a bank holding company. Whether and when the new Federal Reserve policy, which is likely to be followed by the other regulatory agencies, may result in significant new private equity investment in bank capital remains to be seen.

Since the 1980s the Federal Reserve has allowed combinations of voting equity and total capital investments between 10% and 15% and up to 24.9%[1], subject to restrictions on having a director on the board and otherwise avoiding several identified indices of control that may allow the investor to otherwise exercise a controlling influence over the management or policies of a banking organization (e.g. having executive management positions; seeking to influence lending practices, growth decisions or dividends; and opposing management's director nominee slate). Private equity investors who take more than 9.9% voting interest will generally need to receive nonobjections from the applicable bank regulatory agency by providing so-called "passivity commitments" or entering into a Rebuttal of Control Agreement.

This *BankingLaw@manatt* newsletter summarizes the basic issues and rules, identifies what has changed and what has

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not changed; and then offers some background history and perspective and comments on the potential impact of the new Federal Reserve policy statement.

WHAT HAVE BEEN THE BASIC RULES FOR NONCONTROLLING INVESTMENTS IN BANKS?

- The proposed acquisition of more than 10% but less than 25% of the voting power of a bank or bank holding company by private investor groups generally triggers a presumption of control by all banking agencies (Federal Reserve, OCC, FDIC[2], OTS[3] and state agencies) and requires either prior approval or filings of agreements or passivity commitments to avoid a need for prior regulatory approval.

- Passive investors owning less than 15% voting stock (including under 10%) generally may have a single director representative on the board, but otherwise may not attempt to influence the dividend policies; loans, credit, or investment decisions or policies; pricing of services; personnel decisions; or the operations activities of the bank or any of its subsidiaries.

- Investment combinations of voting equity and non-voting equity and/or debt are subject to rules and policies aggregating the total investment. Warrants and nonvoting preferred stock or debt which is "immediately convertible" into voting stock will be treated as converted and counted as voting equity.

Except as discussed below, these basic rules have not changed.

WHAT DOES THE NEW FEDERAL RESERVE POLICY STATEMENT CHANGE?

The new Federal Reserve Policy Statement (12 CFR 225.144) makes three principal modifications to the situations which the Federal Reserve previously viewed as evidencing a controlling influence:

- **Total Voting and Non-Voting Equity Investment**. The Federal Reserve upped the 24.9% total equity limit, stating that it now would not expect a minority investor to have a controlling influence over a banking organization if the investor owns a combination of voting and nonvoting shares together representing less than one-third of the total equity (and less than one-third of any class of voting securities assuming conversion of all convertible nonvoting shares),

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provided the voting stock held is less than 15%.

- **Director Representation**. Minority investors now generally may have at least one representative on the board of directors, and two under certain circumstances; however, Chairman of the Board and committee chairmanships and having more than 25% of a committee's membership would be considered evidence of a controlling influence.

- **Consultations with Management**. The Fed now recognizes that larger minority shareholders should have the same rights as any other shareholder to communicate with management and advocate for changes (e.g. changes in dividend policy, entering into new business lines, encouraging mergers and acquisitions and changes in management), provided that decisions remain with the banking organization's shareholders as a group, its board or management, as appropriate.

SOME HISTORICAL BACKGROUND AND PERSPECTIVE

The bank regulatory parameters on noncontrolling investments in banks and the origin of the passivity commitments dates back to the early 1980s concern over bank "stake out" investments in banks in other states prior to the fall of most of the barriers on interstate banking. However, the most well-known case setting the barriers on noncontrolling investments in banks involved the proposed investment by The Sumitomo Bank, Ltd. in Goldman, Sachs & Co. in 1986 that would have equaled 30% of Goldman Sachs' total equity capital. The control issue was addressed in the context of the separation of commercial banking from investment banking--barriers which mostly fell with the enactment of the Gramm-Leach-Bliley Act in 1999. What a difference two decades make as last week the financial markets were encouraged by the announcement that Warren Buffet's Berkshire Hathaway investment conglomerate will make a noncontrolling $5 billion investment in Goldman Sachs as a new bank holding company.

Most private equity, hedge and sovereign wealth funds will not or cannot seek control approval due to: (i) the regulatory effects of controlling an insured U.S. depository institution—including capital requirements, examination and supervision, the obligation to serve as a source of financial and managerial strength and limits on affiliate transactions with the bank; or (ii) the continued U.S. limits on mixing banking and commerce by prohibiting commercial (non-financial) firms from controlling commercial banks. Accordingly, private equity investments of 9.9% or less voting stock without other indices of control are common as a "safe harbor" to avoid a control determination inquiry by a banking agency. However, multiple contemporaneous investments by independent, nonaffiliated investors must be structured carefully to avoid inquiry as to whether multiple investors are a group acting in concert which requires prior approval under the Bank Holding Company Act or the Change in Bank Control Act.

Separate funds have been structured to seek approval to control a banking organization without the fund investors being deemed to be acting in concert and thus subject to regulation and supervision (e.g. the Federal Reserve's approvals of the Bear Stearns-arranged Doral Financial, Puerto Rico, recapitalization and the JLL Associates-coordinated acquisition of control of FC Holdings' banks in Texas).

The engagement of experienced bank counsel and early informal consultation with the appropriate state and federal banking agencies is imperative for both the private equity investor and the banking organization to avoid missteps in structuring deals and damage to regulatory relationships.

WHAT IS THE EXPECTED IMPACT OF THE NEW POLICY STATEMENT?

The Federal Reserve's more relaxed fit policy has been under consideration and discussions with private equity funds for two years or more. This means that the interest in larger equity plays in banks arose when bank earnings were stellar and M&A opportunities were plentiful. Banks were often viewed as new "portfolio company" investment opportunities that offered short term high returns without long term commitments. A different appetite is required now when bank earnings prospects are in the cellar and new capital is needed just to remain well or adequately capitalized. Some private funds have already watched their investments in banks decline dramatically in value. Other funds have kept their powder dry. Old terminology is resurfacing ("buyout firms" and "vulture funds"), along with the prospect of private equity investments riding the recovery upside as was the case for some investors after the late 80s and early 90s savings and loan industry debacle.

Banking organizations contemplating new capital offerings that might otherwise cap voting investments at 9.9% in order to avoid bank regulatory complications, may want to be more flexible on the amount of private equity capital they will accept from investors who may now be more comfortable with the new policy statement. Given the recent dizzying speed of developments, we may know soon whether the new Federal Reserve policy statement will accelerate capital investments in banks by private equity funds and other such investors and what strategies they will pursue.

Notes

[1] Under the Bank Holding Company Act, a company has control over a bank or a bank holding company if the company (i) directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25% or more of any class of voting securities; (ii) controls in any manner the election of a majority of the directors; or (iii) directly or indirectly exercises a controlling influence over the management or policies of a bank or bank holding company.

[2] Control of Utah and Nevada (but not California) industrial banks not considered commercial banks remains available for non-financial investors, subject to the FDIC's ability to retain jurisdiction over the last charter loophole allowing banking and commerce to mix.

[3] The OTS has separate but similar policies and procedures for acquiring control of savings banks or savings and loan holding companies since the unitary savings and loan holding company ownership of saving banks by non-financial firms was halted by the Gramm-Leach-Bliley Act.

Questions on the foregoing may be addressed to T.J. Grasmick at Manatt, Phelps & Phillips, LLP, in Los Angeles at 310-312-4369 and by email to mgrasmick@manatt.com. The firm website at www.manatt.com also has other Newsletters and White Papers on investments in U.S. banks, as well as a description of the breadth and special expertise of the many attorneys in the Banking & Specialty Finance Practice Area.

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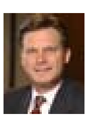

T.J. Mick Grasmick Mr. Grasmick's practice focuses on mergers and acquisitions, non-banking activities, formation of new banks, interstate and other expansion by banks, bank holding companies and other financial institutions and the requirements and restrictions on expansion of state and federal bank regulatory agencies; bank supervision and examination, and general banking corporate matters and regulatory and legislative developments.