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PRIVATE EQUITY INVESTMENT IN BANKING INSTITUTIONS

Private equity investors historically have shied away from investments in banks, thrifts and their holding companies. Compared with the corporate sector, banking institutions have been seen as too highly regulated, and too leveraged, for traditional private equity investment. Even relatively small investments in this sector are rife with traps for the unwary. There recently has been something of a shift in this paradigm, however, as private equity players have become among the most active investors in this sector. Recently we have witnessed not only investments in banks and thrifts by private equity investors that have structured their investments so as to avoid “control” of the underlying portfolio institutions, but also controlling investments by bank-focused private equity groups that have become comfortable with the regulatory regime associated with status as a “bank holding company.”

In this special issue of the *Financial Services Alert*, we look first at the federal bank regulatory landscape (states also may have independent requirements) in which equity investments in banks and thrifts take place – that is, (I) the regulatory burdens that control can entail, and the need for prior regulatory approval of controlling investments, and (II) the types of investment that trigger “control.” Section III then looks at some of the innovative structures that we have seen, both in our own private equity and financial services practices and in other transactions, that have enabled private equity investors to participate in the economics of bank investments without themselves becoming regulated holding companies. In this article, we are focused principally on investments in commercial banks and their holding companies, although substantially similar rules apply to the acquisitions of thrifts and their holding companies. We also note that there are somewhat parallel, albeit different, so-called “change in control” requirements with respect to investment in specialty banks, such as Utah industrial banks, credit card banks and trust companies, and altogether different regulatory schemes for specialty finance companies such as mortgage lenders and consumer loan companies.

I. Consequences of “Control”

If an investment by a private equity fund in a commercial bank or bank holding company represents 25% or more of any class of voting shares, or if there is otherwise a regulatory presumption of control that the investor cannot rebut, then the investor must apply for and obtain the prior consent of the Board of Governors of the Federal Reserve System (the “Fed”) to become a bank holding company, and will thereafter be subject to a regime of extensive ongoing requirements. Importantly, an acquisition of control generally has implications beyond the immediate investor, flowing up the legal ownership chain to the ultimate parent entities that directly or indirectly control the investor.

A critical consideration for any private equity investor to bear in mind is that registration as a holding company under the Bank Holding Company Act (the “BHCA”) both requires that the investor meet the managerial, capital and other requirements necessary to become a bank holding company and, going forward, subjects the bank holding company (and its direct and indirect parents) to:

- ongoing Fed supervision, examination and regulation;
- significant restrictions on its direct and indirect activities and investments;
- leverage and risk-based capital adequacy requirements, including the requirement that the bank holding company stand as a “source of strength” to its subsidiary banks; and
- significant limitations on its ability to incur leverage to support acquisitions, ongoing operations or distributions.

Because of the regulatory consequences of being a bank holding company, and in particular because of the activity and capital restrictions imposed by bank holding company status, the private equity funds that have registered as bank holding companies have, at least to date, tended to be sponsored by banking industry veterans familiar with the regulatory regime rather than diversified private equity shops with significant other private equity investments. (However, as we note at the end of this article, there have been some recent exceptions to this rule.)

Given the burdensome consequences of bank holding company status, a key consideration is what type and level of investment constitutes legal “control.” In this regard, it comes as a surprise to many that legal “control” includes relatively small acquisitions that very likely are not sufficient to confer actual business control over the banking enterprise. As a practical matter, legal control can impose on an acquirer a level of responsibility (for compliance and financial support, among other things) that the acquirer lacks the ability to effect, due to a lack of real business control.

II. Bank Control Rules

Presumptive Control

As Section III below highlights, a BHCA control evaluation is a multi-faceted analysis. However, the Change in Bank Control Act (the “CIBCA”), which for many practical purposes parallels the BHCA and also must be considered in its own right, provides some useful guidance as to what level and type of investment may be treated as “controlling” for purposes of this analysis. Under the CIBCA, as interpreted by the federal banking agencies, an acquisition by any person or company, acting alone or in concert, of 10% or more of any class of voting stock of a bank or thrift is presumed to acquire “control” if there are any of certain other “control” factors at play. Because the different bank regulators have somewhat different interpretations of what constitutes a “control” factor, it is important in structuring any such investment to be very clear about the precise type of bank charter being directly or indirectly acquired. For example, under the rules of the Fed, which regulates commercial bank holding companies, a control factor is present if the target bank holding company has publicly registered securities or if, after the acquisition, the acquirer would become the largest holder of any class of the target’s voting securities. By contrast, under the rules of the Office of Thrift Supervision (the “OTS”), which regulates thrifts and their holding companies, a control factor is present if, among other things, the acquirer would become one of the two largest holders of any class of voting stock or if the acquirer would hold more than 25% of the target’s total equity or 35% of the target’s combined debt and equity. We reiterate, however, that while the CIBCA provides a useful reference point, ownership involving management rights, as well as ownership above 9.9% of a class of voting stock or of a significant percentage of the overall equity of a banking institution, always must be closely analyzed for bank regulatory “control” purposes.

Rebuttal of Control

If a proposed investment triggers a presumption of control, but represents less than 25% of any class of voting shares, then the investor has the opportunity, prior to the investment being made, to rebut the presumption and thus avoid bank or thrift holding company status. (If the proposed investment represents 25% or more of any class of voting shares, the investor will be treated as definitively controlling the underlying investment and will be regulated as a bank holding company or thrift holding company going forward.) A rebuttal of control typically involves the acquirer entering into an agreement with the relevant bank regulator in which the acquirer commits that it will be a so-called “passive” investor. Although these passivity commitments are fairly similar from one transaction to the next, depending on the facts and circumstances they can be the subject of limited negotiation with the regulators. The Fed typically requires that these commitments include, among others, an agreement not to seek to exercise a controlling influence over management or policies of the target, and an agreement not to seek or accept representation on the board of directors of the target institution (although the Fed commonly permits a nonvoting observer). Needless to say, passivity commitments limit the influence

that a private equity investor would otherwise typically seek to exercise over a portfolio company and are therefore at odds with the control investment philosophy of many buy-out fund managers. Moreover, the commitment to hold a private equity investment as a “passive” investment can conflict with tax, ERISA or other requirements, such as the requirement for a venture capital operating company (“VCOC”) to take an active role in the management of its portfolio companies. Moreover, the higher the percentage of voting stock or greater the other elements of control an investor has, the less likely the Fed is to find a passivity commitment sufficient to avoid control.

Finally, it is important to note that a structure that triggers a presumption of control – even if it is ultimately rebutted – necessitates the cooperation of the appropriate banking regulators and thus can affect the timetable of any proposed acquisition.

III. Different Structures for Investment in Banks

Against this background, it is clear that the threshold decision that a fund sponsor or other private equity investor seeking to invest in the banking sector must make is whether the level of investment it seeks to make in portfolio banks, or the degree of actual managerial control that it wishes to exercise, requires that it register as a bank holding company. If it wants to avoid such registration, there are a number of structures that provide some level of economics without conferring regulatory “control.” The first three structures described below result in no private equity or other investor being deemed to be a bank holding company. By contrast, in the fourth structure, there is a private equity fund investor that is a bank holding company (and which can thus exercise true managerial control over its portfolio banks), but its investors and other funds are protected from regulation under the BHCA.

A. *Limit the Voting Shares and/or Enter Into Passivity Commitments*

As discussed above, investments of 25% of any class of voting shares of a bank, thrift or holding company are definitively treated as “controlling” investments. At the lower end of the range, the regulators have tended to treat investments of less than 10% of voting shares presumptively as non-controlling, and many private equity investors simply limit their voting investment to 9.9% as a kind of de facto safe harbor. Investments between those two percentage thresholds, particularly when made with appropriate passivity commitments, like those described above, may also be non-controlling, although these determinations tend to be very fact-specific.

B. *Structure All or a Portion of the Investment as Nonvoting Shares*

Private equity investors seeking to avoid control issues can participate in significantly greater economics if they are prepared to take all or some portion of their investment as nonvoting common stock, preferred stock or subordinated securities. The Fed has permitted an investment of up to 24.9% of the equity of a bank or bank holding company, without requiring that the investor become a bank holding company, so long as the investment is nonvoting and otherwise passive. If any of the instruments are convertible into voting stock, particular attention must be paid to the terms of any covenants or conversion feature, since the federal bank regulators have somewhat different rules on when a nonvoting convertible instrument will be treated as a voting security. The Fed generally treats an instrument that is immediately convertible at the option of the holder into voting stock as if it is voting stock, for example, while the OTS also considers how much additional consideration the holder must pay in order to exercise its conversion rights.

In addition to bank regulatory requirements, private equity funds must also analyze the effects (*e.g.* tax and VCOC issues) that structuring an investment in nonvoting preferred stock or debt would have on the fund and its limited partners.

C. Disaggregate Investors

As noted above, the CIBCA expressly attributes to an investor the investments of any other entity with which the investor is acting “in concert,” and any BHCA analysis tends to involve a similar inquiry. The Fed’s rules provide some explicit examples of when investors are presumed to be acting “in concert” (for example, if they are part of a group making a Section 13 or 14 filing under the Securities Exchange Act), but such determinations are typically very fact-specific.

The recapitalization of Doral Financial Corporation (“Doral”), a bank holding company, is one recent example of a consortium of institutional private equity investors acquiring virtually complete economic and management control over a bank holding company without any one of them, or the investor group, being deemed to control the target. In the Doral investment, each investor owned less than 10% of the voting securities of each investment entity that indirectly acquired Doral, and made certain passivity commitments and representations as to its independence from the others. Notwithstanding that they were clearly acting at the same time, – and indeed had entered into a shareholders’ agreement giving them each the right to appoint a director of the general partner investment entity and of the target bank holding company -- the Fed agreed that neither any individual investor, nor the investors as a group, would be deemed to control Doral for purposes of the BHCA.

D. Silo the Bank Fund

Finally, private equity sponsors can, through careful structuring, form bank-focused private equity funds that themselves will become bank holding companies, but without imposing on the limited partners or other funds with which the sponsors are affiliated the burdens of themselves becoming bank holding companies. Because the BHCA does not reach individuals, individual control persons of a fund general partner are generally not themselves regulated under the BHCA, even if the fund and its general partner are regulated bank holding companies. Since the individual owners are not regulated bank holding companies, their other private equity activities and funds – so long as they are conducted outside the bank fund chain – are not affected by the bank fund’s status as a bank holding company. For example, JLL Partners, a diversified private equity firm with interests across a spectrum of industries, recently created a new fund which 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.

In reviewing affiliated funds, when reviewing whether the bank holding status of one fund also causes another fund to be so treated, the Fed has put particular emphasis on whether the two funds have sufficiently separate economics. In particular, in treating funds as distinct for bank regulatory purposes, the Fed has focused on the fact that in such arrangements there are:

- no common portfolio investments;
- no cross-investment or lending among the funds;
- no asset transfers among the funds; and
- no material economic linkages among the funds (*e.g.*, no cross-fund carried interest clawback).

These parallel structures should be of particular interest to diversified private equity groups that seek to sponsor a bank-focused private equity fund without “tainting” their other private equity activities, principals or investors.

Goodwin Procter’s Financial Services and Private Equity practices have teamed together to bring you this article. Our depth of experience in both of these areas is unique among law firms. In addition to

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having one of the largest and most highly regarded Financial Services regulatory and transactional practices in the country, consistently ranked by the American Banker as one of the top firms for banking M&A, the firm has also recently been ranked by *Private Equity Analyst* as the second most active firm for private equity/buyout deals. We also have extensive experience in structuring private equity transactions and other strategic transactions involving banks and other financial institutions.

Members of Goodwin Procter's Financial Services and Private Equity groups who participated in writing this article and are involved in this initiative include Jamie Hutchinson, Hovey Kemp, Satish Kini, John LeClaire, Greg Lyons, Robin Maxwell and Bill Stern. Goodwin Procter hosted a recent roundtable discussion on this subject, in which Satish Kini participated, a transcript of which will be published in the June 2008 issue of *Mergers & Acquisitions Journal*. Click here for a copy of the transcript of the roundtable discussion.

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