FDIC Issues Guidance on Policy Statement for Investments in Failed Banks

January 8, 2010

Yesterday the FDIC reissued a Q&A providing guidance on significant interpretation issues that have arisen with respect to the September 2009 Policy Statement on Qualifications for Failed Bank Acquisitions. (An earlier version of the Q&A had been posted on December 11 and then withdrawn on December 14.) The issues relate to two types of transactions that have occurred since the issuance of the Policy Statement: an existing bank raising significant amounts of new capital in order to bid for a failed bank, and a "blind pool" investment fund raising capital in Rule 144A or similar offerings in order to bid for failed banks.

BANK CAPITAL RAISES

The Policy Statement provides that it will not apply to private investors who bid for a failed bank through a partnership or venture with, or by means of an investment in, an established bank or thrift holding company, provided that the existing holding company has a "strong majority interest" in the resulting bank or thrift (as well as "an established record for successful operation of insured banks or thrifts").

The Q&A clarifies that "strong majority" means the private investors have no more than one-third of both the total equity and the voting equity of the partnership or joint venture post-acquisition of the failed bank. In the case of investments directly in an established bank or thrift holding company, the shareholders of the holding company prior to the acquisition of the failed bank must hold at least two-thirds of the total equity[1] of the holding company immediately following the acquisition (and related capital raise). In practice, the FDIC has treated additional investments by existing shareholders as counting toward meeting this two-thirds requirement.

In addition, the Q&A notes that the FDIC "will take into account the impact of any special rights provided to the private investor through covenants, agreements, special voting rights, or other such mechanisms." The Q&A does not give any examples of special rights that would be problematic. In most situations, private investors would not receive material special rights in order to avoid a control determination under the Bank Holding Company Act, the Change in Bank Control Act or corresponding thrift regulations.

"BLIND POOL" ISSUES

During the fourth quarter of 2009 a number of "blind pool" offerings were launched in which management teams sought to raise capital to be used for bids to purchase failed banks in the

[1] The Q&A limitation for direct investments refers only to ownership of "total equity", while the limitation for partnership and joint ventures refers to limits on both total equity and voting equity. It is not clear if that distinction is intentional.

future. Generally these capital raises were done as Rule 144A-type offerings in which investors committed to own less than 5% of the voting stock of the investment vehicle. In order to accommodate investor interest, investors were also allowed to purchase special non-voting shares in excess of the 5% limit; these non-voting shares could be converted into voting shares only following a broad distribution to unaffiliated third parties[2]. Under the Policy Statement, investors holding 5% or less of the voting power of a banking organization are exempt from all of the terms of the Policy Statement. If none of the investors in a banking organization are subject to the Policy Statement, then the banking organization itself would be exempt as well.

In order to utilize the 5% exemption for investors, however, there must be "no evidence of concerted action" among these investors. The Q&A notes that the FDIC generally will not consider the purchase of shares by investors in a Rule 144A or similar type offering (which the Q&A refers to as a "widespread offering") as evidence of concerted action. However, the FDIC indicated it was concerned with the capital and prudential risks of having a newly formed entity or recapitalized bank (often referred to as an "inflatable charter"), and all or most of the investors in that entity, exempt from all the provisions of the Policy Statement through the use of the 5% exemption. As a result, the Q&A outlines a bifurcated approach that the FDIC will use to assess transactions involving widespread offerings for evidence of concerted action:

- where 5%-and-under investors collectively own two-thirds or less of the total voting stock (and the remaining voting stock is held by investors who are subject to the Policy Statement, thereby making the institution also subject to the Policy Statement), the FDIC will not presume that the 5%-and-under investors who purchase in a widespread offering are acting in concert. Accordingly, offerings of this type can be completed without requiring any special certifications from investors, the issuer or the placement agents.
- where 5%-and-under investors collectively own more than two-thirds of the voting stock, the FDIC will presume concerted action among such investors. This presumption may be rebutted, however, if the investors or placement agents provide sufficient evidence to the FDIC that the investors are not participating in concerted action.

The Q&A does not outline any specific process to follow to rebut a presumption of concerted action[3], but notes that the FDIC will consider the following factors:

[2] The Q&A appears to confirm that these contingently convertible shares will be treated as non-voting securities for purposes of the Policy Statement. However, the language of the Q&A on this point is less specific than the version of the Q&A previously posted on the FDIC's website.

[3] The Q&A notes that the FDIC will "take into account" determinations by other banking agencies as to whether concerted action exists. In most capital raising transactions, non-control determinations (and therefore determinations as to no concerted action) would be sought under the control regulations only by large (e.g. 9.9% or greater) investors and not by smaller (e.g. under 5%) investors. Even if such a determination were obtained, however, the Q&A clearly indicates that the FDIC will make its own, separate determination on the subject.

- Whether each investor was among many potential investors contacted by the bank/thrift or its agent, and each investor reached an independent decision to invest in the bank/thrift;
- Whether an investor is managed or advised by an investment manager or investment advisor who performs the same services for another investor;
- Whether the investor has engaged, or anticipates engaging, as part of a group consisting of substantially the same entities as are shareholders of the bank/thrift, in substantially the same combination of interests, in any additional banking or non-banking activities in the United States;
- Whether an investor has any significant ownership interest in any other investor in the bank/thrift;
- Whether an investor is entitled to acquire any other investor's shares;
- Whether there are any agreements or understandings between any of the investors for the purpose of controlling the bank/thrift;
- Whether the investors (and each director representing each investor) will consult with other investors concerning the voting of bank/thrift shares; and
- Whether the directors representing the investors will represent only the particular investor which nominated him or her, and will not represent any combination of investors.

These factors are derived from the commitments typically provided to the Federal Reserve by investors seeking to rebut control in the context of large, concurrent voting investments. Obtaining these representations from numerous investors in connection with a widespread offering will require changes in customary securities offering practices, and obviously present informational challenges since, among other things, investors in widespread offerings will not normally know the identities of the other investors. Accordingly, structures in which one-third or more of the investors are subject to the Policy Statement may be easier to complete than structures which trigger a presumption of concerted action.

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