"Anchors," Recaps and *De Minimis* Investors: New FDIC FAQs on Qualifications for Acquiring Failed Banks

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The Federal Deposit Insurance Corporation has released additional guidance regarding qualifications for failed bank acquisitions by private investors.

This Advisory provides guidance to private equity investors interested in acquiring or investing in failed banks in light of the FDIC's recently released FAQs relating to its Final Statement of Policy on Qualifications for Failed Bank Acquisitions. For an overview of the Final Statement and key issues facing private equity investors in financial institutions (including potential transaction structures and certain regulatory considerations), please see our earlier Client Alerts of July 10, 2009 and September 8, 2009.

The Final Statement

The Final Statement outlines certain requirements for private investors in companies that acquire failed insured depository institutions from the FDIC. These requirements include capital commitments, continuity of ownership requirements, source of strength requirements, cross support requirements, restrictions on transactions with affiliates, and secrecy law jurisdiction considerations.

Since the Final Statement was adopted in August of 2009, private equity firms have explored various avenues to invest in failed depository institutions. Of particular importance to private equity investors are two exemptions from the requirements of the Final Statement. First, the Final Statement exempts investors in partnerships or similar ventures with bank or thrift holding companies or in such holding companies (excluding shell holding companies) where the holding company has a "strong majority interest" in the acquired bank or thrift and an established record for successful operation of insured banks or thrifts (the "strong majority interest exemption"). Second, the Final Statement exempts investors with 5% or less of the total voting power of an acquired depository institution or its bank or thrift holding company, provided there is no evidence of concerted action by these investors (the "*de minimis* investor exemption"). The FAQs clarify these two exemptions as well as provide additional guidance on the application of the Final Statement to recapitalization transactions, requirements for offshore investors and information requirements applicable to investors holding 5% or less of voting equity.

The "Strong Majority Interest" Exemption

The "strong majority interest" exemption is of particular interest to private equity firms that invest in existing banks with an eye toward using such banks as vehicles for the acquisition of failed banks. Several private equity firms are pursuing or contemplating this approach.[1]

To clarify the "strong majority interest" exemption, the FDIC stated in the FAQs that it would generally not apply the Final Statement to investments by private investors, through a partnership or venture with an established bank or thrift holding company, unless the private investors have more than one-third of either the total equity or the voting equity of the partnership or venture post-acquisition. This one-third of total equity or voting equity standard applies to direct investments in an established bank or thrift holding company as well. In keeping with its approach in the Final Statement, the FDIC stated that in making the determination of whether this exemption from the Final Statement is applicable, the FDIC will take into account the impact of any special rights provided to the private investors through covenants, agreements, special voting rights, or other such mechanisms.

The FDIC stated in the FAQs that the "strong majority interest" exemption would apply regardless of the amount of time that pre-existing investors have held their ownership interests. However, the FDIC will take into consideration whether a significant portion of the total equity shares or voting equity shares held by investors in the established bank or thrift holding company pre-dating the proposed failed institution acquisition was recently acquired or was part of a recapitalization of the existing institution.

The *De Minimis* Investor Exemption

The FAQs also addressed the *de minimis* investor exemption, particularly the method that the FDIC will use to determine "concerted action" among investors and the percentage of investors, *de minimis* or otherwise, that must be bound by the Final Statement. In general, the Final Statement does not apply to any investor with 5% or less of the total voting power of an acquired depository institution or its bank or thrift holding company, provided there is no evidence of concerted action among investors.

While participation in widespread offerings will not generally be considered evidence of concerted action among participating investors, the FDIC in the FAQs expressed its concerns with ownership structures in which all or substantially all of the investors own 5% or less of the voting stock of the institution. This concern arises from the FDIC's disapproval of so-called "silo" ownership structures in which an investor creates and funds multiple investment vehicles to acquire ownership of an insolvent depository institution in order to avoid regulation as a bank or thrift holding company or being subject to the requirements of the Final Statement. The FDIC has stated that "silo" structures raise serious concerns about the sufficiency of financial and managerial support to the acquired institution. Consequently, the FDIC will presume concerted action among such 5% or less investors where, in the aggregate, they hold more than two-thirds of the total voting power. This presumption may be rebutted, however, if the investors or placement agent provide sufficient evidence to the FDIC that the investors are not acting in concert. In evaluating whether this presumption has been rebutted, the FDIC will consider the following factors:

- 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 or thrift;

[1] FDIC 'Balancing Act' Addresses New Approach To Bank Deals, Sasha Dai, *Wall Street Journal*, *http://blogs.wsj.com/privateequity/2010/05/18/fdic-balancing-act-addresses-new-approach-to-bank-deals/?blog_id=107&post_id=9539*, last visited June 8, 2010.

- 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 or 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 or 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 or thrift;
- Whether the investors (and each director representing each investor) will consult with other investors concerning the voting of bank or 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.

The FDIC will also take into account a primary federal banking regulator's evaluation of whether the investors are acting in concert for purposes of applying the Bank Holding Company Act and the Change in Bank Control Act as part of the FDIC's assessment of the facts and circumstances of the proposed investment in determining, for the purpose of applying the Final Statement, whether there is "no evidence of concerted action" by the investors.

Recapitalizations

The FAQs also directly addressed the recapitalization of existing banks by private investors, stating that while recapitalizations of existing institutions are not subject to the Final Statement, where new investors have recently recapitalized an institution and the institution seeks to acquire a failing bank, the FDIC will review whether the additional capital was provided contingent on completion of failing bank acquisitions. The Final Statement will apply if any acquisition of one or more failed institutions occurs that in combination exceed 100% of the recapitalized institution's total assets within an 18-month period following the recapitalization.

"Anchor Groups"

The FDIC also introduced the concept of "anchor group" investors in the FAQs. Investors holding a minimum of one-third of the total voting equity shares or total equity shares of an acquired institution or its bank or thrift holding company must be bound by the terms of the Final Statement in order for the less-than-5% investors outside of this "anchor group" to be exempted. The FAQs clarify that this "anchor group" may consist of one-third or more of the total voting equity shares or one-third or more of a combination of total voting equity shares and total equity shares as a proportion of total equity shares. The "anchor group" includes investors who must comply with the terms of the Final Statement (i.e., investors with more than 5% of the total voting power) and any additional investors who agree to comply in order to meet the one-third test. Investors with 5% or less of voting equity shares and therefore not subject to the Final Statement may elect to be subject to the Final Statement in order to contribute towards satisfying the one-third "anchor" investment.

The one-third ownership test only needs to be met at the time of the failed bank acquisition. However, as provided in the Final Statement, investors subject to it are prohibited from selling or otherwise transferring their securities for a three-year period of time following the acquisition absent the FDIC's prior approval.

Others Subject to the Final Statement

The FDIC also clarified that certain investors holding 5% or less of the voting equity shares would still be subject to the Final Statement. Investors that have the right to designate a board member are subject to the Final Statement even if they hold 5% or less of the voting equity shares. Senior management is not automatically subject to the Final Statement simply due to their positions as senior management. However, they may be subject to the Final Statement if they would otherwise be subject to its provisions by virtue of their equity share ownership, ability to designate a board member, some combination of such rights, or evidence of concerted action.

Rights of First Refusal

Rights of first refusal are permitted for those investors who do not make up the one-third “anchor group.” However, if the purchase results in the investor holding more than 5% of the voting equity shares, the investor would become subject to the Final Statement.

Additional Considerations—Required Information, Secrecy Law Jurisdictions

The FAQs clarified what information is required from investors who hold 5% or less of the voting equity. Investors holding 5% or less of the voting equity are not subject to detailed questionnaires such as those requested of the investors who are subject to the Final Statement or who are otherwise included in the one-third “anchor group.” However, investors holding 5% or less of the voting equity are subject to being included on the list of investors provided to the FDIC. This list provides: each investor’s name; type of investor (i.e., mutual fund, hedge fund, individual); domicile; the number of shares of voting stock and total equity held by the investor both prior to the capital raise and subsequent to the capital raise; options, warrants, interests convertible into voting stock, and rights to control voting stock owned by others; and shares held by affiliates or immediate family members.

In response to the question of whether the FDIC will review tax information from investors operating through U.S. subsidiaries, but whose parent company operates through or is domiciled in secrecy law jurisdictions for compliance with tax laws, the FDIC stated that it will not make determinations as to whether an investor is in compliance with all relevant tax laws. In applying the Final Statement's secrecy law jurisdiction requirements to “anchor” investors utilizing entities domiciled in bank secrecy jurisdictions (Offshore Investors), the FDIC will consider those entities to be in compliance with the Final Statement as long as each Offshore Investor makes its investment in the bank or the bank or thrift holding company through at least one wholly owned subsidiary established under the laws of any state of the United States (Domestic Subsidiary).

Under the Final Statement, each Offshore Investor and its Domestic Subsidiary must agree: (1) to maintain in the United States at the offices of its subsidiary or subsidiaries (i) its business books and records (or duplicates thereof) and (ii) an exact duplicate of the books and records of the Offshore Investor; (2) to maintain in the United States at the offices of its Domestic Subsidiary a current list of all investors in the Offshore Investor; and (3) to make the required books, records, and lists identified in (1) and (2) above available to the FDIC upon request as may be necessary to implement and enforce the provisions of the Final Statement or the FDIC's supervisory, deposit insurance or receivership obligations.

The FDIC stated that it is expected that any Offshore Investor will pay U.S. federal income tax on the income from its ownership, including dividends and capital gains, at the same time, at the same tax rate, and to the same extent as if it had made its investment directly in the acquired institution or its bank or thrift holding company.

Conclusion

While the FDIC, in its recently released FAQs, has provided some additional guidance to private equity investors interested in acquiring or investing in failed banks, ambiguities regarding the application of the Final Statement remain, and private equity investors contemplating any such investment transaction should consult with legal counsel and FDIC staff concerning the structure, feasibility and implications of their proposed investment in an FDIC-assisted transaction.

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work or the attorneys below.

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