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Private Equity Investments in Financial Institutions

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Over the last 15 years, the relatively high valuations in banking, coupled with leverage limitations and other regulatory restrictions, discouraged private equity investments in financial institutions. The credit crunch and subsequent recession have marked a new era. The resulting decline in bank stock prices has sparked new interest in financials by private equity funds. The challenge is to make such investments while avoiding regulatory land mines.

Most private equity firms' investments across industries have been made to acquire control of the target. In banking, however, most transactions involve the acquisition of a minority interest to avoid the ramifications of "control" of a financial institution. Set forth below are the regulatory issues that must be addressed if a company is in "control" of a financial institution, the definitions of control, and then some circumstances that have allowed ownership and influence without a finding of control for regulatory purposes.

Ramifications of Control. An entity that controls a financial institution or financial institution holding company is deemed to be a bank or thrift holding company. Such holding companies are subject to significant rules and restrictions. The principal ones are:

- *Limitations on Leverage*. Bank holding companies with total assets of $500 million or more are required to meet consolidated capital guidelines. These guidelines include a leverage ratio (core capital divided by average assets) of at least 4 percent (and generally at least 5 percent) and a total risk-based capital ratio (all sources of capital, including certain hybrid capital elements divided by risk-weighted assets) of 10 percent. If the bank holding company has less than $500 million in total assets, then below this threshold there is a debt-to-equity-ratio limitation for a bank holding company. Thrift holding companies do not have quantitative capital requirements, but they do have qualitative limitations on the amount of leverage.
- *Activity Restrictions*. Generally, financial institution holding companies are restricted to activities that are financial in nature. Nonqualifying investments must be divested.
- *Affiliate Restrictions*. Transactions between a financial institution and its affiliated parties (entities under common control or which control the financial institution) must be on arm's-length terms. Certain types of

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transactions are subject to high collateral requirements and are limited as a percentage of the financial institution's capital.

- *Source of Strength Doctrine*. The Federal Reserve Board requires a bank holding company to serve as a "source of strength" to a bank it controls. If any financial institution becomes undercapitalized, the holding company must guarantee a capital restoration plan for such a plan to be acceptable.

- *Oversight*. Bank holding companies are subject to examination and supervision by the Federal Reserve Board. Thrift holding companies may be examined by the Office of Thrift Supervision ("OTS") in certain circumstances. Entities seeking to acquire control of any financial institution or holding company must obtain the prior approval of the Federal Reserve or the OTS, as the case may be.

- *Nonbanking Acquisitions*. Bank holding companies and thrift holding companies must seek prior approval of the Federal Reserve Board or the OTS, as the case may be, to acquire control of a nonbanking entity.

- *Cross-guarantees Liability*. Financial institutions that are controlled by the same holding company are potentially liable for the obligations incurred by their sister financial institutions in the event the FDIC is called upon to render government assistance to avoid or resolve an insolvency.

The key to determining whether these restrictions are applicable is whether the private equity fund "controls" the financial institution for regulatory purposes.

Control. The bank regulatory authorities deem control to exist at much lower ownership percentages than actual control or even practical control, for that matter. A "company controls" an entity if:

- the company, directly or indirectly or acting through one or more persons, owns, controls or has the power to vote 25 percent or more of any class of the entity's voting stock;

- the company has the ability to appoint a majority of the entity's directors; or

- the company has the ability to exercise a controlling influence over the management or policies of the entity.

For regulatory purposes, the term "company" is expansively defined to include any type of entity. The regulators also will evaluate the quality of the security. A security, such as a preferred stock, still may be determined to be voting. The key factors are whether the security holder has the authority to appoint directors, vote on the entity's operations or steer significant policies. The regulatory authorities also have factors that they evaluate to determine whether a company exercises a "controlling influence" over another entity.

The regulatory authorities presume control to exist at lower ownership thresholds than even the 25 percent bright-line test. Traditionally, for a nonbanking company, control of a bank or bank holding company was presumed to exist at 10 percent of the outstanding shares unless the nonbanking entity made certain passivity commitments to the Federal Reserve Board in the case of a bank or bank holding company. In September 2008, the Federal Reserve Board relaxed the thresholds and softened certain restrictions that had been used for a presumption of control. The Federal Reserve Board changes include:

- A minority shareholder may own up to 33 percent of the total equity of a bank or bank holding company provided that it does not own, control or have power to vote more than 15 percent of any class of voting securities. Again, the 25 percent of any class of voting securities threshold is still a bright-line test for control, and, thus, for bank holding company status.

- A minority shareholder that is above the 10 percent threshold may have at least one board seat. A second board seat is permissible if the minority shareholder's board representation is proportionate to its ownership interest in the bank and another shareholder is a bank holding company. Nonetheless, the minority shareholder may not have a second board seat if such representation would give it 25 percent of the board. The representative cannot be the chairman of the board or chair of any committee.

- A minority shareholder can now seek to influence policy in the same manner as any other shareholder.

- A minority shareholder may now engage in business relationships with a bank or bank holding company on a case-by-case basis. The Federal Reserve Board will pay particular attention to the size of the relationships and whether transactions are on market terms, nonexclusive and may be terminated without penalty.

- A minority shareholder may require, as part of a shareholders' agreement, covenants, such as those prohibiting the issuance of senior

- securities or senior borrowings, consultation rights and rights to financial information. More extensive covenants, such as limitations on hiring, firing, increasing compensation, raising additional debt or capital, or engaging in new lines of business, may be deemed to represent a controlling influence.

These tests were applied when the Federal Reserve Board approved the applications of GMAC LLC and IB Finance Holding Company LLC (collectively, "GMAC") to become bank holding companies and GMAC bank to convert from a Utah industrial loan company to a commercial bank. Cerberus Capital Management, L.P. ("Cerberus") agreed to distribute shares to its respective investors to reduce its ownership of GMAC from a majority of the shares to less than 14.9 percent of the voting shares and 33 percent of the total equity. General Motors ("GM") agreed to reduce its ownership to less than 10 percent of the voting and total equity of GMAC. The remainder of GM's ownership in GMAC was transferred to a blind trust to be disposed of within three years. GM agreed to comply with restrictions on transactions with affiliates.

For federal savings banks, the tests are similar but not the same. The OTS also will evaluate the circumstances to determine whether to rebut a presumption of control for a 10 percent or more owner of voting shares. The OTS has shown flexibility in allowing investments for thrifts and thrift holding companies of less than 25 percent of the equity and less than 35 percent of total equity and debt of a thrift.

The bank regulators will carefully consider convertible securities. The Federal Reserve Board generally deems such securities as having been converted for purposes of analyzing whether a change in control would occur.

When is Control not Control? The bank regulatory authorities are well aware that the banking industry is short of capital. The Federal Reserve Board and the Department of the Treasury have been pushing banking organizations to raise more capital to minimize the prospects of financial institutions curtailing their lending. The result of these economic factors may be to allow greater flexibility in structuring private equity investments that have led to significant influence without necessarily a finding of control for regulatory purposes. There have been a number of notable transactions that have walked the tightrope of avoiding control while maintaining sufficient economic and operational advantages to be acceptable to the private equity fund.

→ *Doral Financial Corporation*. Perhaps the transaction that signaled the most flexibility in the Federal Reserve Board's approach to private equity investments in bank holding companies concerned Doral Financial Corporation ("Doral"). The Bear Stearns Companies Inc. ("Bear Stearns") led a group of investors that acquired virtually all the San Juan, Puerto Rico-based Doral. Essentially, Bear Stearns arranged side-by-side investments that kept any entity controlled by Bear Stearns below 5 percent of the common stock of Doral or any entity that was deemed to control Doral. No individual investor acquired more than 10 percent of Doral's common stock. The transaction was structured by Bear Stearns and Bear Stearns found all the investors. Bear Stearns was provided a carried interest on the individual investments. Nonetheless, the Federal Reserve Board did not deem Bear Stearns to be a bank holding company with respect to Doral because Bear Stearns's ownership and voting rights, as an entity, were less than 5 percent and although Bear Stearns had the ability to influence the election of Doral's directors, it could not make the determination itself.

→ *National City Corporation*. Corsair Capital LLC ("Corsair Capital") led a group that invested $7 billion in National City Corporation ("Nat City"). Corsair Capital contributed a little less than $1 billion of the $7 billion, while other investors purchased the remaining $6 billion. Corsair Capital purchased shares of common stock at $5 per share and preferred stock convertible upon shareholder approval of an increase in authorized shares. In addition, Corsair Capital received warrants with an exercise price of $7.10 per share subject to adjustment. Corsair also added one director to the Nat City board. Corsair Capital would own 8.8 percent of Nat City after giving effect to conversion of all the preferred stock and exercise of the warrants. For regulatory purposes, Corsair Capital acquired more than 10 percent of Nat City's outstanding shares. Corsair Capital and the investors it brought to the table would own 69.74 percent of Nat City upon conversion of the preferred stock and the exercise of the warrants.

→ *E*TRADE FINANCIAL Corporation*. The OTS permitted the Citadel Investment Group, L.L.C.; its controlling member, Kenneth Griffin; and certain affiliated entities (collectively, the "Citadel Group") to acquire 25 percent of E*TRADE FINANCIAL Corporation ("E*TRADE"). Nonetheless, the OTS did not deem the Citadel Group to acquire control. The

Citadel Group filed a rebuttal of control agreement (an OTS requirement for those seeking to rebut the presumption of control). The rebuttal of control agreement provides a standard paragraph prohibiting intercompany transactions between the thrift institution and the party seeking to rebut the presumption of control. The OTS, however, allowed the Citadel Group to acquire millions of dollars of problem assets because such acquisitions did not give the Citadel Group the ability to influence or control E*TRADE. Presumably, the OTS was heavily influenced by the effect of such transactions in removing problem assets from E*TRADE's balance sheet.

→ *Washington Mutual*. Private equity firm TPG (formerly Texas Pacific Group), and certain other investors, provided Washington Mutual, Inc., with $5 billion equity capital. The transaction was structured as the acquisition of both common and preferred stock. The preferred stock was convertible into common shares in the future, subject to a shareholder vote. TPG also received one seat on WAMU's 14-member board of directors. TPG itself received less than 25 percent of the common stock and less than 35 percent of the overall equity of WAMU. The OTS allowed TPG to rebut the presumption of control. WAMU sold 176 million shares at $8.75 each (a 26 percent discount to market), preferred stock convertible at $8.75, and WAMU issued five-year warrants to the investors, exercisable into 68.2 million shares of WAMU stock at $10.06 each. Collectively, the investors acquired ownership, including warrants, representing 50.2 percent of WAMU's outstanding stock.

Alternatives. These transactions and others indicate a few alternatives for private equity firms.

→ *Passive Investments*. Assuming no other investors are acting in concert, a private equity fund could seek a minority investment subject to the 33⅓ percent and 15 percent thresholds. In the case of a thrift holding company, an ownership percentage of up to 25 percent is permissible as long as other indicia of control are not present.

→ *Side-by-Side Investing*. A private equity fund could seek to orchestrate a transaction that results in an acquisition of up to 100 percent of the stock of a bank or bank holding company. In such a transaction, individual investors in the fund would invest on a side-by-side basis with the private equity fund itself. Such investors cannot be voting in concert with the fund. The Federal Reserve Board has determined that a carried interest (as long as there is no clawback against other funds) would not in and of itself result in investors acting in concert.

→ *Accept Holding Company Status*. Certain private equity funds have accepted holding company status, with its regulatory ramifications. It is possible to structure a fund as a silo so that sister funds are not deemed affiliates of a silo fund that is a bank holding company. Because control continues up the chain, it is important to structure the silo fund to avoid treating partnerships over sister funds as bank holding companies. Structures can be developed that would prevent the completion of the loop of control over the election of the board of directors or the financial institution's operations. Moreover, economic linkage between funds, such as cross-fund clawbacks, should be avoided.

Conclusion. Private equity investments in banks or bank holding companies (other than those that clearly do not represent control) must be addressed by Federal Reserve Board staff in Washington, DC. There is no delegated authority. Similarly, the Washington, DC, staff of the OTS would make any decision on whether a presumption of control may be overcome for a thrift or thrift holding company. A private equity fund that is considering an investment in financial institutions should evaluate its investment specifications. The bank regulatory authorities are willing to work with counsel on appropriate structures consistent with such investment intentions. A change-in-control transaction requires prior regulatory approval and is generally on at least a 60-day time frame for a private equity fund. Accordingly, a private equity fund that desires to invest in the banking space should not wait until it has identified a target before it engages in the preparatory work of structuring an acquisition.

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