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WEATHERING THE STORM Guidelines Issued for Private Equity Investors Acquiring Failed Banks or Thrifts

The interest from the private equity community in filling the growing capital gaps that exist in the balance sheets of U.S. banks has spurred the FDIC Board to adopt a Final Statement of Policy on Qualifications for Failed Bank Acquisitions (the "**Policy Statement**"). The Policy Statement, published on September 2, 2009, provides private equity investors with guidelines for acquiring failed banks or thrifts. While the final Policy Statement is a more investor-friendly version of the proposed Policy Statement the FDIC published on July 9, 2009, for public comment (the "**Proposed Policy Statement**"), critics of the Policy Statement argue that the final form does not go far enough to attract much-needed private capital to the banking industry, and in some cases may even deter investors from pursuing the purchase of failed banks.

To view the full text of the Policy Statement, [click here](#).

Applicability. Notably, the Policy Statement incorporates public comments related to the ambiguous definition of "Investor" included in the Proposed Policy Statement. As adopted, the Policy Statement applies to (1) private investors in any company proposing to assume, directly or indirectly, the deposit liabilities or assets and deposit liabilities of a failed insured depository institution, and (2) applicants for insurance in the case of *de novo* charters issued in connection with the resolution of failed insured depository institutions (hereinafter, "**Investors**"). The Policy Statement does not apply to (1) investors in partnerships or similar ventures with bank or thrift holding companies, or in holding companies with a strong majority interest in the resulting bank or thrift and an established record for successful operation of insured banks or thrifts, or (2) 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 a group of such investors.

Capital Commitment. A significant divergence from the Proposed Policy Statement is the reduction in the minimum capital ratio required of Investors from 15% to 10%. A 10% ratio of Tier 1 common equity to total assets must be maintained for a period of three years from the time of acquisition of the failed institution. Thereafter, the depository institution must maintain a standard of capital adequacy that is at least "well capitalized" during the remaining period of ownership by the Investors.

Cross Guarantee. Another departure from the Proposed Policy Statement is the diluted cross-guarantee provision. The Policy Statement provides that if one or more Investors own 80% or more of multiple banks or thrifts, then the stock of the banks or thrifts commonly owned by these Investors shall be pledged to the FDIC. Upon the failure of any one of the banks or thrifts, the FDIC may exercise such pledges to the extent necessary to recoup any losses incurred by the FDIC as a result of the bank or thrift failure. The FDIC may waive this pledge requirement where enforcing the pledge obligation would not reduce the cost of the bank or thrift to the Deposit Insurance Fund (the "**DIF**").

Transactions with Affiliates. The Policy Statement prohibits extensions of credit to Investors, their investment funds and affiliates of either, by an insured depository institution acquired by such Investor pursuant to the Policy Statement. This prohibition does not apply to existing credit extensions made by a bank or thrift which is acquired by Investors. An "extension of credit" is as defined in 12 C.F.R. § 223.3(o). An "affiliate" is any company in which the Investor owns, directly or indirectly, at least 10% of such company and has maintained such ownership for at

least 30 days. Public criticism of the proposed transactions with affiliates provision resulted in the addition of the 30-day minimum ownership period in the definition of "affiliate," and the exemption for existing extensions of credit.

Secrecy Law Jurisdictions. One area almost entirely uninfluenced by public comment is the secrecy law jurisdiction provision. This restriction bans investors in entities domiciled in bank secrecy jurisdictions from investing in an insured depository institution unless the investors are subsidiaries of companies that are subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board and they consent to several regulatory oversight conditions. These conditions include: providing information about the non-domestic Investors' operations and activities, including consenting to the disclosure of potentially confidential or private information; maintaining their books and records in the U.S.; cooperating with the FDIC, if necessary, in obtaining information maintained by foreign government entities; consenting to jurisdiction and the designation of an agent for service of process; and agreeing to be bound by the statutes and regulations administered by the appropriate U.S. federal banking agencies.

The FDIC, in response to comments requesting clarification of the meaning of "secrecy law jurisdiction," defines the term in the Policy Statement as a country that applies a bank secrecy law that limits U.S. bank regulators from determining compliance with U.S. laws or prevents them from obtaining information on the competence, experience and financial condition of applicants and related parties, lacks authorization for exchange of information with U.S. regulatory authorities, does not provide for a minimum standard of transparency for financial activities, or permits off shore companies to operate shell companies without substantial activities within the host country.

Continuity of Ownership. Absent the FDIC's prior approval, Investors shall not sell or otherwise transfer their securities for three years following acquisition. FDIC approval will not be unreasonably withheld for transfers to affiliates which agree to be subject to the provisions of the Policy Statement applicable to the transferring Investor. Certain mutual funds are exempt from this requirement. This provision was left largely unchanged from the language in the Proposed Policy Statement, except for the addition of the conditions under which FDIC approval shall not be unreasonably withheld.

Prohibited Structures/Bid Limitations. Certain ownership structures are prohibited from bidding on failed banks or thrifts, including a single private equity fund seeking to acquire ownership of a depository institution through the creation of multiple investment vehicles, funded and effectively controlled by the parent fund. The FDIC reasons that the nature of these structures is such that it is difficult to ascertain beneficial ownership, the responsible parties for making decisions are not clearly identified, and ownership and control of the institution are separated. In addition, investors that directly or indirectly hold 10% or more of the equity of a bank or thrift in receivership are prohibited from bidding on that failed bank or thrift.

Disclosure. The Policy Statement imposes certain disclosure requirements on Investors. Investors are expected to submit to the FDIC information about the Investors and all entities in the ownership chain as well as such other information as the FDIC determines is necessary to ensure compliance with the Policy Statement. In response to public concern about the confidentiality of certain information, the Policy Statement provides that confidential business information will be treated as such and will not be disclosed except in accordance with law.

A provision was added to the final version of the Policy Statement to clarify that the FDIC Board of Directors may waive any of the provisions of the Policy Statement if the exemption is in the best interests of the DIF and the goals and objectives of the Policy Statement can be accomplished by other means. The Policy Statement will be reviewed in six months to gauge its impact on the banking industry.

The Bottom Line. The Policy Statement eased some of the restrictions and requirements related to private equity investment in failed financial institutions; however, hurdles remain. The FDIC may be forced back to the drawing board in six months if private investors determine that those hurdles were too high.

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