SO YOU THINK YOU WANT TO BUY A BANK?

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I. INTRODUCTION

Among the fallout of the recent financial crisis has been something of a fire sale on weak or failing banks. During 2009, the number of problem banks on the "watch list" maintained by the Federal Deposit Insurance Corporation ("FDIC") reached 552 by September 2009—up from 416 only three months earlier—with some $346 billion in assets, the largest numbers since 1993.[1] With its insurance fund already seriously depleted by resolutions of failing banks,[2] it is no secret that the FDIC is eager to have private investors take some of the remaining ones off its—and, potentially, the taxpayers'—hands. Given the magnitude of the problem, the agency has sought to encourage entities that traditionally have not invested in banks—private equity funds, real estate developers, sovereign wealth funds, and others—to step up to the plate. And in turn, these entities have perceived an opportunity to enter the banking business—which offers, through its base of FDIC-insured deposits, the cheapest and most reliable source of funding available—at bargain basement prices.

While the FDIC is self-funding through assessments made against insured deposits, the losses sustained on failing bank resolutions since the crisis began have plunged its insurance fund $8.2 billion into the red (including a provision of $21.7 billion for

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1 David Ellis, *Bank 'Problem' List Climbs to 552*, CNNMONEY.COM, Nov. 24, 2009, http://money.cnn.com/2009/11/24/news/companies/fdic_list/index.htm. The FDIC does not disclose the names of the troubled banks in order to prevent a run on their deposits.

2 Fifty insured institutions (banks and savings and loans associations) with total assets of $69 billion failed in the third quarter of 2009 alone, the largest number in any quarter since 1990. Kevin Brown, *Insurance Fund Indicators*, *in* FDIC QUARTERLY BANKING PROFILE: THIRD QUARTER 2009 28 (2009), http://www2.fdic/gov/qbp/2009sep/qbp.pdf.

expected losses)[3]—the first time it has been underwater since 1991. Furthermore, the temporary increase from $100,000 to $250,000 per insured account (other than retirement accounts, which are fully insured) adopted by the FDIC as an emergency measure in 2008 was extended through 2013 by the Helping Families Save Their Homes Act, signed into law by President Obama last May,[4] significantly increasing the agency's potential exposure. Beginning September 30, 2009, the FDIC has been permitted by law to base its insurance assessments on the $250,000 figure, and has taken other measures, such as requiring banks to prepay their premiums, in an attempt to ameliorate a funding crisis.[5]

All of this would suggest that the agency is paving the way for prospective investors to beat a path to its door. To date, however, the path remains relatively untrodden. The reason lies in the thicket of regulation that surrounds any entity that would presume to own or invest in a bank, not to mention the uncertainty surrounding the current legislative climate. Specifically, the objectives of private investors on the one hand, and bank regulators and the laws they administer on the other, are fundamentally at odds. Private equity firms typically seek to obtain a controlling position in struggling or undervalued companies, then "fix them, grow them, and sell them," usually in a period of three to five years.[6] The conundrum is that bank regulatory laws place severe restrictions on entities that control banks—restrictions that are anathema, unless the entity's fundamental business purpose is to operate banks rather than to invest in undervalued companies. Still, for certain classes of investors, the current crisis may represent a historic opportunity that should not be overlooked.

This article reviews the legal impediments to investing in a bank or thrift institution[7] by a non-banking investor, and the efforts to

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[3] *Id.*

[4] Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1633 (2009) (codified in scattered sections of 12, 15, 31, 38, and 42 U.S.C.); Brown, *supra* note 2, at 14.

[5] Brown, *supra* note 2, at 14–15.

[6] Ravi R. Desai, Comment, *Private Equity Investment in Financial Institutions and How to Avoid Becoming a Bank Holding Company*, 13 N.C. BANKING INST. 385, 386 (2009) (citation omitted).

[7] Thrift institutions include savings and loan associations, savings banks, and similar institutions. Although thrift institutions are under a different regulatory regime (the Office of Thrift Supervision, or OTS) than commercial banks, for purposes of the issues discussed in this article their treatment is similar. For clarity, the article will use the word "banks" with the understanding that, except as otherwise stated, similar considerations apply to thrift institutions.

date by the Federal Reserve ("Fed"), which has authority over all acquisitions of a bank by any company, as well as the FDIC to facilitate such investments. The article concludes by outlining some of the issues such an investor should consider in determining whether to pursue such an investment at this time.

II. BACKGROUND: THE BANK HOLDING COMPANY ACT

The starting point in the analysis is the Bank Holding Company Act of 1956, as amended ("BHCA").[8] The BHCA was enacted with the primary objective of separating banking from "commerce"—defined broadly to include basically, any and all non-financial activities.[9] Under the BHCA, any company that controls one or more banks is deemed to be a bank holding company ("BHC") and, as such, cannot engage in any activity other than banking, or a list of activities determined by the Fed to be "so closely related to banking as to be a proper incident thereto."[10] The Gramm-Leach-Bliley Financial Modernization Act of 1999 ("GLBA")[11]—infamously, if erroneously, referred to as the "repeal of the Glass-Steagall Act"[12]—liberalized the activities permissible for BHCs, if they could

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[8] 12 U.S.C. §§ 1841–50 (2006).

[9] *Turmoil in the U.S. Credit Markets: Examining the U.S. Regulatory Framework for Assessing Sovereign Investments: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (Apr. 24, 2008), *available at* www.federalreserve.gov/newsevents/testimony/alvarez20080424a.htm (statement of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System).

[10] 12 U.S.C. § 1843(c)(8) (2006). The list of activities determined to meet this test, known as the "laundry list," is found in the Fed's List of Permissible Non-Banking Activities, 12 C.F.R. § 225.28(b) (2010). Under the Gramm-Leach-Bliley Act of 1999, this list was essentially frozen in place as of November 12, 1999, the date of its enactment; henceforth the Fed may not approve any non-banking activities not on the list for a BHC unless it qualifies as a financial holding company ("FHC") thereunder.

[11] Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 and 15 U.S.C.).

[12] The Depression-era Glass-Steagall Act was aimed at separating commercial banking and the securities business. But the regulators and the courts long ago established that agency-only brokerage of securities was permitted. The key prohibitions in the Act, which forbid banks (as distinguished from their securities affiliates) from trading and underwriting securities remain in place. *See* 12 U.S.C. § 24 para. Seventh (2006) (providing that the business of trading in securities and stock by a national bank is limited to agency-only activities); 12 U.S.C. § 378(a)(1) (2006) (providing that companies that underwrite securities are prohibited from taking deposits). These key provisions were left undisturbed by the GLBA. The repealed portions of the Act were section 32 (12 U.S.C § 78 (repealed 1999)), an archaic and ineffective provision that prohibited a person sitting on the board of directors of a bank from also sitting on the board of a securities company, and section 20 (12 U.S.C. § 377 (repealed 1999)), which prohibited affiliations between a bank and a company "engaged principally" in underwriting securities. *See* 113 Stat. at 1341. Prior to the GLBA the Fed had allowed limited underwriting, up to 25% of the affiliate's revenues, as not violating the "engaged principally" standard. As a practical matter, since the GLBA froze the "laundry

meet certain criteria relating to capital adequacy, management, and service to their local communities. A BHC that meets these criteria can elect to be treated as a "financial holding company," and as such can engage in financial activities, including selling insurance and securities, without limitation through subsidiary companies subject to regulation based upon their function (i.e., securities subsidiaries are regulated by the SEC and insurance subsidiaries by the insurance department of the state in which they are located).[13]

In enacting the GLBA, the Congress rejected a provision which would have allowed FHCs to engage more broadly in non-financial activities—with a narrow exception for activities determined by the Fed to be "complementary" to an existing financial activity, provided the proposed complementary activity does not pose a significant risk to the "financial system generally."[14] The concept of "complementary" means that the FHC already is engaged in a financial activity, to which the proposed non-financial activity is merely complementary.[15] To date, the primary use that has been made of the "complementary" exception is in the area of physical commodities trading. While banks and BHCs are generally prohibited from trading physical commodities, an FHC can do so if it is already engaged in a related financial activity, such as trading derivatives based on that commodity, as long as the FHC receives prior approval from the Fed. As noted in the Fed's Orders approving this activity for certain FHCs, the exception is narrow and is discretionary with the Fed; among other things, the FHC applying for the exception must make the case that it has the infrastructure to manage the activity.[16] Also, the word "complementary" implies that the volume of the commercial activity is not large in relation to the underlying financial activity.

It should be noted that, apart from the BHC Act, changes in control of an insured bank are subject to the Change in Bank Control Act ("CBC Act").[17] The CBC Act essentially requires prior notice to the bank's regulator if 10% or more of the bank changes

list" of permitted non-banking activities, unless the BHC qualifies as an FHC it will still be bound by this standard, notwithstanding the repeal of section 20. *See* 12 C.F.R. § 225.28(b).

[13] 12 U.S.C. § 1843(k)(1) (2006).

[14] § 1843(k)(1)(B).

[15] § 1843(k)(1)(A), (B).

[16] *See, e.g.*, JP Morgan Chase, 92 FED. RES. BULL. C57 (2006), *available at* http://www.federalreserve.gov/pubs/bulletin/2006/legal06-508.pdf; Barclays Bank PLC, 90 FED. RES. BULL. 511 (2004), *available at* http://www.federalreserve.gov/pubs/bulletin/2004/autumn04_legal.pdf.

[17] 12 U.S.C. § 1817(j) (2006 & Supp. 2010).

hands.[18] Unlike the BHC Act, however, the CBC Act does not impose any activity restrictions or ongoing regulatory requirements, once the initial notice is given. The CBC Act specifically exempts transactions that are subject to other laws, such as the BHC Act or the Bank Merger Act.[19] Thus, it would pick up an acquisition not covered by these laws—for example, the purchase of a bank by an individual or group of individuals, since the BHC Act applies only to control of bank by a "company." Care must be taken, however; if a group of individuals are acting in concert, there is ample precedent for the Fed to determine that they have formed an association which is a de facto "company." Thus, the essential dilemma for investors such as private equity or sovereign wealth funds[20] is that if they become BHCs, they will be precluded from investing in assets and industries that stray from the financial field. Furthermore, they will be required to register with and be regulated by the Fed. It follows that investing in a bank generally is only feasible if the fund can avoid becoming a BHC in the process. To do so, it must avoid taking "control" of the bank, directly or indirectly.[21]

The BHC Act defines "control" in three ways. A company "controls" a bank or a BHC if it: (i) owns 25% or more of any class of voting equity; (ii) has the power to appoint a majority of the board of directors; or (iii) if the Fed determines, under all the facts and circumstances, that it exercises a "controlling influence" over the management and policies of the bank or company.[22] The first two definitions in effect are irrebuttable presumptions—no state of facts can be adduced to rebut the presumption of control if either of these two things are shown. The third definition comes into play only if neither of the first two conditions is met. It can be seen immediately that a company can be deemed to "control" a bank even if, as a practical matter, its ability to control the bank's day-to-day activities is minimal. For example, imagine that the investor owns 25% of the voting equity, while a giant BHC such as Citigroup or

[18] 12 C.F.R. § 225.41 (2010).

[19] 12 U.S.C. § 1817(j)(17).

[20] The Fed has made clear that, while foreign governments are not themselves "companies" and thus cannot become BHCs, a sovereign wealth fund is a "company" for this purpose. Alvarez, *supra* note 9.

[21] "Indirectly" in this context refers to controlling a bank by controlling a company that in turn controls a bank—i.e., a BHC. 12 C.F.R. § 225.2(c)(1) (2010). It should be noted that "control" is tested separately at each level. Thus, if A owns 25% of B, which in turn owns 25% of the bank, A cannot argue that it does not control the bank because its interest is actually only 6.25% (.25 times .25). Control is conclusively presumed at each level.

[22] 12 U.S.C. § 1841(a)(2) (2006); *see generally* PAULINE B. HELLER & MELANIE L. FEIN, FEDERAL BANK HOLDING COMPANY LAW § 2.05 (2006).

BankAmerica owns the remainder. In the real world, control of the bank will be dominated by the 75% owner. Nonetheless, under the law both will be deemed to be BHCs (because they are deemed to be in control as a matter of law) and thus subject to all the restrictions and regulatory requirements of the BHC Act.

Under the "controlling influence" prong, by contrast, the presumption is one of non-control. In principle, at least, the burden is on the Fed to rebut the presumption that the investor does not control the bank, if the Fed believes this to be the case. In that event, the Fed must provide the investor with notice and an opportunity for a hearing.[23] But the shifting of the burden may be more theoretical than actual; as long as the Fed's interpretation of the statute is reasonable, as a matter of administrative law it will be upheld by the courts. Applying its *Chevron* doctrine,[24] the Supreme Court repeatedly has made clear that an interpretation of a regulatory statute by the bank regulatory agency charged with its enforcement will not be overturned by a court unless it is found to be arbitrary and capricious, with no rational basis in the underlying statute.[25] And as a practical matter, an enforcement proceeding is not a happy way to start life as a BHC.

III. What Constitutes a "Controlling Influence?"

Thus, the threshold inquiry for an investor contemplating an investment in a bank or BHC is whether, and how, the investment can be structured to avoid a determination of "control." At the outset, for the reasons noted, we assume that the investment stops short of 25% of any class of voting equity and that the investor cannot control a majority of the board of the target bank or BHC—otherwise, game over. At the other end of the spectrum, the Fed generally has treated equity interests of less than 5% as de minimis and presumptively non-controlling. So the area between 5% and

[23] Alvarez, *supra* note 9.

[24] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–44 (1984).

[25] In the 1990s the Supreme Court unanimously applied this principle in three separate cases. Though all three involved interpretations of the National Bank Act by the Office of the Comptroller of the Currency, the same principle applies to the Fed or any other agency interpreting a statute which it is charged to interpret and enforce. *See* NationsBank of N.C. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 264 (1995) (upholding as reasonable the Comptroller's ruling that annuities are a banking product rather than a form of insurance); Smiley v. Citibank, 517 U.S. 735, 744–46 (1996) (holding that the Comptroller reasonably determined what charges were and were not "interest" for purposes of applying state usury laws to national banks); Barnett Bank of Marion County v. Nelson, 517 U.S. 25, 27–28 (1996) (holding that state infringement on national bank insurance agency activities is permitted under federal law).

25% is where the inquiry lies.

In 1982, in an attempt to clarify and provide some certainty regarding the basis for a "controlling influence" determination, the Fed issued a "Statement of policy on non-voting equity investments by Bank Holding Companies" ("1982 Policy").[26] The 1982 Policy responded to a wave of "stakeout" investments, in which BHCs would purchase a substantial interest in an out-of-state bank or BHC with the manifest intent, usually stated as such in the deal documents, of acquiring the remaining shares if and when interstate acquisitions were permitted.[27] These interests would be structured to fall just below the irrebuttable presumptions noted above. Nonetheless, they typically had numerous features aimed at effectively controlling the investment, such as "covenants or options that, among other things . . . limit the discretion of the bank's management over major policies and decisions," allow the investor to block acquisitions by other parties, and the like.[28]

The 1982 Policy was, therefore, aimed at reining in the unfettered use of these devices to evade the BHC Act. Although the Fed recognize that "the complexity of legitimate business arrangements precludes rigid rules," and that the "circumstances of each case" are unique and must be taken into account, the Fed also laid out guidance regarding provisions that could be included to negate a finding of controlling influence.[29] Examples were giving the bank a right of first refusal, if the investor wished to sell its interest, leaving management free to carry out all permissible activities without interference, and limiting the aggregate ownership of voting and non-voting stock.

Over the years, investors falling into the gray area between 5% and 25% developed a mechanism to rebut a Fed finding of

[26] Bank Holding Companies and Change in Bank Control, 47 Fed. Reg. 30,965, 30,965 (July 16, 1982) (codified at 12 C.F.R. § 225.143 (2010)).

[27] 12 C.F.R. § 225.143(a)(1). At that time, the so-called Douglas Amendment to the BHC Act prohibited acquisitions of a bank in one state by a BHC in another state unless the statute law of the first state explicitly allowed such acquisitions, "by language to that effect and not merely by implication." 12 U.S.C. § 1842(d) (2006). In the early 1980s certain states began to enact laws that were reciprocal with those of selected neighboring states, creating "regional compacts" in which interstate bank ownership would be permitted. Such compacts were upheld by the Supreme Court in *Northeast Bancorp v. Board of Governors of the Federal Reserve System*, 472 U.S. 159, 162 (1985). The Douglas Amendment was repealed by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Pub. L. No. 103-328, 108 Stat. 2338, 2339 (current version at 12 U.S.C. § 1842(d) (2006)). Today there are no restrictions on such interstate acquisitions, but Fed Board approval is required as is the case for all BHC acquisitions.

[28] Desai, *supra* note 6, at 393.

[29] 12 C.F.R. § 225.143(a)(2).

controlling influence by entering into a passivity agreement with the regulator. These agreements were focused on provisions prohibiting investors from seeking or exercising a controlling influence over the management, and from seeking or accepting representation on the bank's board. In this manner the Fed would be assured that unregulated investors were not, in fact, controlling the bank. These agreements evolved into two distinct forms, based on the percentage of voting shares held by the investor. The first, referred to as the "Lincoln" commitment, would be used if the investor acquired between 10% and 14.9% of a class of voting stock, and was not thereby the largest shareholder.[30] The second, referred to as the "Crown X" commitment, was used when the percentage of voting stock was 15 to 24.9% (or 10 to 14.9% if the investor was the largest shareholder).[31]

Under the Lincoln commitment, the investor was limited to appointing one member of the bank's board of directors, and even that seat would have to be relinquished if the investor subsequently passed the 15% barrier or became the largest shareholder.[32] It precluded appointing management of the bank or its subsidiaries; proposing a director in opposition to one proposed by management; attempting to influence the operating policies of the bank; soliciting proxies; disposing or threatening to dispose of stock because of some action taken by management; and engaging in transactions with the bank, other than placing a deposit of not more than $500,000.[33] The Crown X commitment included all of the above, and further precluded even a single director to represent the investor.[34]

It is apparent that both sets of commitments are inimical to the way private equity firms normally operate. As a consequence, investments in banks simply were not attractive to private equity funds and similar investors, whose focus was on taking control, turning around the bank, and ultimately selling it at a profit. By 2008, however, with the crisis in the banking industry spreading rapidly, it had become evident that additional sources of capital were necessary, and a group of private equity funds and hedge funds petitioned the Fed to reconsider its criteria for controlling influence.[35]

[30] Desai, *supra* note 6, at 394
[31] *Id.* at 395.
[32] *Id.* at 394.
[33] *Id.* at 394–95.
[34] *Id.* at 395.
[35] *See* GIBSON DUNN, FINANCIAL MARKETS CRISIS: ISSUES FOR HEDGE FUNDS AND PRIVATE EQUITY FUNDS (2008), http://www.gibsondunn.com/Publications/Pages/FinancialMarketsCrisi

Accordingly, the Fed issued a new "Policy statement on equity investments in banks and bank holding companies" ("2008 Policy").[36] Whether coincidentally or not, the 2008 Policy was issued as the financial panic of 2008 hit full stride, a week after the failure of Lehman Brothers and just one day after the Fed Board approved the shotgun conversion of Morgan Stanley and Goldman Sachs to BHCs (on a Sunday, no less), in an attempt to stave off panic that they, too, were on the verge of imminent failure.[37]

Still, the changes made are significant, and fell into three broad areas: (1) appointment of board members; (2) communication with management; and (3) total permissible equity holding.

First, the 2008 Policy addressed the concern about not being able to appoint even a single board member—which for many private equity firms is a non-starter.[38] Recognizing that banking organizations typically have nine or ten member boards, the Fed concluded that a single board member was unlikely to give the investor a controlling influence. Furthermore, the 2008 Policy allows a second board member, if the bank is otherwise controlled by a registered BHC and the investor's two appointees do not exceed 25% of the total board members.[39] These board members may serve on board committees, subject to the 25% test, if they "do not have the authority or practical ability unilaterally to make (or block the making of) policy or other decisions that bind the board or management of the bank[] . . . ."[40] The investor's board representatives may not, however, serve as chair of the board or of a committee.

A second notable change is in the ability of the investor to communicate with management.[41] Previously there was little guidance in this regard, but the 2008 Policy makes clear that the investor may voice its opinion about the bank's dividend policy, capital raising plans, mergers and acquisitions, entering or leaving

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s-HedgeFunds-PrivateFunds.aspx.

[36] BD. OF GOVERNORS OF THE FED. RESERVE SYS., POLICY STATEMENT ON EQUITY INVESTMENTS IN BANKS AND BANK HOLDING COMPANIES 1 (Sept. 22, 2008), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf. Although the Board of Governors refers to this source as a provision in the C.F.R., it was never published as a proposed or adopted regulation in the Federal Register, and therefore has never been formally adopted as a regulation in the C.F.R.

[37] *Id.*

[38] *Id.* at 6.

[39] *Id.* at 7.

[40] *Id.* at 8.

[41] *Id.* at 11.

particular lines of business, and the general role of management.[42] In effect, the Fed is recognizing that, absent other indicia of control, the BHC Act is not seeking to prevent discussions with management. The investor's formal role is still, after all, limited to a minority investment and minority board representation. Nonetheless, the investor or its representative still may not threaten to disinvest as a means of expressing dissatisfaction with management policy.

Third, and perhaps most significantly, the Fed has relaxed its view of the total investment that may be made, combining voting and non-voting securities.[43] Under the 2008 Policy, the investor may acquire up to a 33% combined equity position in the bank, as long as it has no more than 15% of any class of voting security.[44] Previously, the Fed had taken the view that the mere fact of owning an equity position as large as 25%, even if entirely non-voting, would per se enable the investor to influence the management.[45]

While the 2008 Policy was a step forward, it disappointed the funds that had requested it because it does not get these investors all the way to the desired state of control. But the story may not be over; the Fed tends to move cautiously in making major supervisory policy changes. For example, when the Fed first allowed bank-affiliated broker dealer firms to underwrite securities, it initially restricted the underwriting activity to no more than 5% of the affiliate's revenues.[46] Over a matter of years the Fed then raised the limit incrementally to 25%, as it gained comfort that these affiliates did not pose a significant threat to the safety and soundness of the financial system.[47]

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[42] *Id.* at 11–12.

[43] *Id.* at 8.

[44] *Id.* at 7.

[45] *See supra* note 12. Indeed, when Sumitomo Trust & Banking Corp., a foreign bank that is a BHC under the law, sought to acquire a 25% in Goldman Sachs, the Fed was concerned about a controlling influence even though the proposed investment was to be in the form of subordinated debt, with no voting equity at all (a control position would have violated the Glass-Steagall Act at that time). *See* David L. Glass, *The Sumitomo-Goldman Sachs Partnership*, 3 REV. FIN. SERVS. REGULATION 11 (1987).

[46] *See* Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys., 807 F.2d 1052 (D.C. Cir. 1986).

[47] *See* Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities 61 Fed. Reg 68,750 (Dec. 20, 1996), *available at* http://www.federalreserve.gov/boarddocs/press/boardacts/1996/19961220/R-0841.pdf.

IV. THE FDIC: SEEKING BUYERS FOR FAILED BANKS

At the same time that the Fed was rethinking the rules for "controlling influence," the FDIC was seeking a means to expand the list of potential buyers for failed banks. Generally, the FDIC is required to pursue the lowest-cost solution to resolving a failing bank.[48] Selling the bank to a prospective buyer often will result in lower costs than liquidating the bank, because liquidation destroys any enterprise or goodwill value associated with the institution's franchise. But the problem is that there are too few potential buyers that are already BHCs, or that are otherwise experienced in managing banks. Thus, the agency has attempted to reach out to a broader range of investors.

In July 2009 the FDIC published for comment a proposed Statement of policy on qualifications for failed bank acquisitions ("Proposed SOP").[49] The preamble makes clear that the FDIC continues to prefer that banks be sold to existing BHCs, since they have a "well developed prudential framework" that included minimum capital requirements; support for banks that experience difficulties (i.e., the "source of strength" doctrine that the Fed historically has applied to BHCs);[50] and protection against insider transactions.[51] Accordingly, in allowing new classes of investors to purchase banks, the agency took the initial approach of imposing similar requirements. The requirements in the Proposed SOP, however, were draconian, and regarded as unworkable by the majority of commenters.[52]

In September 2009 the FDIC released its final Statement of Policy on qualifications for failed bank acquisitions ("SOP").[53] The SOP attempted to accommodate some of the principal concerns

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[48] 12 U.S.C. § 1823(c)(4) (2006).

[49] Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 32,931, 32,931 (July 9, 2009) [hereinafter Proposed Statement].

[50] Although it is not articulated therein, the Fed has interpreted the BHCA as mandating that BHCs serve as a "source of strength" to their subsidiary banks. Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Bank, 52 Fed. Reg. 15,707, 15,707 (Apr. 24, 1987). The Fed explicitly incorporated the doctrine in its Regulation Y, which governs BHCs generally. 12 C.F.R. § 225.4(a)(1) (2010). The doctrine has been controversial, in that its application could be deemed to violate the general principle that a corporation's liability is limited. *See* HELLER & FEIN, *supra* note 22, at §3.02–.03.

[51] Proposed Statement, 74 Fed. Reg. at 32,932–33.

[52] *See* Final Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45,440, 45,440–42 (Sept. 2, 2009) [hereinafter Final Statement].

[53] *Id.*

expressed about the Proposed SOP.[54] Nonetheless, it still left private investors facing more onerous requirements than those that would apply to an existing bank or BHC.[55] The agency thus continues to leave no doubt that its preferred buyers are institutions already subject to the bank regulatory regime, and with a track record for compliance with those regulations.

By its terms, the SOP applies to two broad classes of persons, referred to as "investors" in the regulation: (i) private investors in a company, including any company acquired to facilitate bidding on a failed bank or thrift, that is proposing—directly or indirectly, including through a shelf charter—to assume deposit liabilities, or both deposit liabilities and assets, from the resolution of a failed bank; and (ii) applicants for deposit insurance to establish a de novo charter in connection with the resolution of a failed bank.[56] The FDIC declined to define "investors" more precisely; since the SOP is, after all, a policy and not a statute, the agency wanted to retain the flexibility of defining this term in relation to actual agreements it is able to reach with investors. Also, a more precise definition would be difficult to craft, given the variety of capital structures that could be formed by consortia of private investors, each of whom would hold less than a 25% interest (which, as discussed above, is the level at which the irrebuttable presumption of control would kick in under the BHC Act).

The following reviews the principal aspects of the final SOP.

Applicability

The SOP creates a de minimus exemption for Investors with less than 5% of the bank's equity, provided such investors are not acting in concert. It also would not apply to minority investors in a bank controlled by a BHC with a strong majority interest and a track record for successful operation of banks. Finally, if the bank maintains a composite CAMELS rating[57] of 1 or 2 for at least seven years, the investor can apply for exemption.[58]

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[54] *Id.*
[55] *Id.*
[56] *Id.* at 45,441.
[57] CAMELS is the basic system for examination of banks (Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk). The bank receives a rating from 1 (highest) to 5 (lowest) in each category, and a composite rating. A composite rating of 3 or lower generally indicates significant weaknesses in one or more areas. *See* Uniform Financial Institutions Rating System, 61 Fed. Reg. 67,021, 67,022, 67,025 (Dec. 19, 1996).
[58] *See* Final Statement, 74 Fed. Reg. at 45,446.

Minimum Capital

Since capital represents the bank owner's "skin in the game" and acts as a cushion against losses, regulators are obsessive about the importance of maintaining a strong ratio of capital to assets. In the Proposed SOP an unworkably high 15% capital ratio was proposed. The commenters noted that placing the requirement so much higher than required for traditional owners such as BHCs—three times the minimum requirement for "well capitalized" and twice the industry average—would place private investors at a competitive disadvantage, make it difficult to earn a reasonable rate of return, and encourage risky post-acquisition strategies (i.e., in an effort to generate a better return on investment).[59] The SOP reduces the requirement to 10%, but mandates that it be comprised of Tier One capital—the preferred form, since it consists of common equity that has no claim against the assets of the bank until all other claims are satisfied.[60]

Affiliate Transactions

BHCs are subject to Section 23A of the Federal Reserve Act[61] and its implementing regulation, Federal Reserve Regulation W.[62] Section 23A restricts transactions between a bank and its affiliates—for example, a loan to an affiliate is limited to 10% of the bank's capital, and must be fully secured. The SOP is even more restrictive; it essentially prohibits all such loans.[63]

Cross-Support

In the Proposed SOP, the FDIC proposed a cross-guarantee provision, whereby investors with interests in more than one bank would have to commit each such bank to support another if it got in trouble. The commenters stressed that this would deter private investment, since it would place legally separate investments at risk. The SOP scaled back the circumstances in which such cross-guarantees, now euphemistically softened as "cross-support," would be required. It would now apply only if at least 80% of each bank was owned by common investors. Further, the FDIC could waive

[59] *Id.* at 45,442.
[60] *Id.* at 45,446.
[61] 12 U.S.C. §§ 226, 371c (2006).
[62] 12 C.F.R. § 223.1–.71 (2010).
[63] Final Statement, 74 Fed. Reg. at 45,441, 45,444.

the cross-support obligation if enforcing it would not reduce the cost to the FDIC of resolving the bank failure.[64]

It might be noted that cross-guarantee is an idea with which the FDIC has been enamored for some time, going back to the rash of bank and thrift failures in the 1980s—and, in particular, the failure of individual banks that were part of holding company structures in which there were other banks that remained healthy, but could not be compelled to support their weaker sisters.[65] This was the case in several states—most notably, Texas—that historically had prohibited branch banking. As a consequence, the state had a large number of small community banks—more than two thousand at one time—which were overly vulnerable to economic conditions in their local communities. The agency felt, not unreasonably, that where a number of such banks were affiliated through a holding company structure, they should be required to cross-guarantee each others' deposits, in effect making them de facto branches. It attempted to achieve this in the 1989 FIRREA legislation[66] but the practical problems with its implementation resulted in only a watered down version.[67]

Continuity of Ownership

The Proposed SOP would require investors to maintain their investments for a minimum of three years. The SOP adopted this without change.[68]

Prohibited Structures

Noting its concern with "complex and functionally opaque" arrangements such as silo structures, the FDIC retained a general prohibition on investments by funds that are part of a group—in particular, structures whereby a private equity firm (or its sponsor) that controls multiple investment vehicles that would be used for

[64] *Id.* at 45441, 45443–44, 45446–47.

[65] One prominent example was MCorp, a BHC that filed for bankruptcy that owned a number of Texas banks. *See* Bd. of Governors of the Fed. Reserve Sys. v. MCorp Fin., Inc., 502 U.S. 32 (1991).

[66] Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, Pub. L. 101-73, 103 Stat. 183 (codified as amended in scattered sections of 12 U.S.C.); *see* Jeffery M. Cooper, Note, *Out on a Limb: FIRREA's Cross-Guarantee Provision "Takes" Root in* Branch v. United States, 33 HOUS. L. REV. 299, 313–15 (1996).

[67] David L. Glass, *"Cross-Guarantee": A Threat to Bank Creditors?*, BANK ANALYST, May/June, 1990, at 5.

[68] Proposed Statement, 74 Fed. Reg. 32,932, 32,934 (July 9, 2009); Final Statement, 74 Fed. Reg. at 45,449.

bank acquisitions. The underlying concern is that the objective of these arrangements is to evade the prohibitions of the BHC Act on non-financial investments by artificially isolating the bank investment from the rest of the group.[69]

Source of Strength

The Fed historically has indicated that it expects BHCs to be a "source of strength" to their subsidiary banks. This requirement is inimical to private equity investors, who would view their investments as legally separate. The FDIC had proposed source of strength in the Proposed SOP but dropped it from the SOP.[70]

Secrecy Jurisdictions

Investors organized in designated secrecy jurisdictions would be prohibited from bidding on failed banks, unless they were subsidiaries of companies determined by the Fed to be subject to "comprehensive consolidated supervision" ("CCS").[71] In essence, this would preclude all entities from such jurisdictions, except for foreign banks approved by the Fed, to engage in banking in the US.[72]

Bid Limitation

The Proposed SOP would not allow an owner of 10% or more of a failed bank to bid on it in receivership. This was unchanged in the SOP.[73]

Disclosure

The SOP mandates disclosure of extensive information about entities in the chain of ownership, analogous to the BHC Act. While this is of great concern to private investors, the FDIC noted that confidential information would be protected in accordance with

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[69] Final Statement, 74 Fed. Reg. at 45,442, 45,447, 45,449.

[70] Proposed Statement, 74 Fed. Reg. at 32,933; Final Statement, 74 Fed. Reg. at 45,443.

[71] The CCS standard was adopted into the law in the Foreign Bank Supervision Enhancement Act of 1991, in response to scandals involving certain foreign banks. In essence, it mandates the Fed to determine that any foreign bank seeking to enter the U.S. is subject to comprehensive supervision on a consolidated worldwide basis by its home country regulator. 12 U.S.C. § 3105(d)(2)(A) (2006).

[72] Final Statement, 74 Fed. Reg. at 45,449.

[73] *Id.* at 45,449.

applicable law.[74] In this regard, one area of concern would be the intention of Attorney General Holder, stated on behalf of the Obama Administration, that the current Administration would take a much narrower view of exemptions from disclosure under the Freedom of Information Act.[75]

V. THE STATE OF PLAY

So where does all this leave the prospective investor? While it is obviously too early to draw any definitive conclusions, some preliminary observations are in order.

First, for investors who are satisfied with passive interests of less than 10%, it is still possible to avoid regulation and regulatory scrutiny. This is apparently the preferred approach of sovereign wealth funds, no doubt for this reason.[76]

Second, investors have greater latitude than in the past with respect to the use of non-voting securities, such as preferred stock, as long as such stock does not allow them to vote for or influence the board of directors; is a passive investment that does not enable the investor to influence the management or policies of the bank; and limits voting rights to those given shareholders whose interests have been adversely affected.[77] It must be recognized, however, that under long-standing Fed policy, securities convertible into voting stock at the instance of the investor will be counted as if they are already voting.

Third, investors can avoid a control determination by acting individually as part of a consortium. The problem is that, if the investors consciously act in parallel, they may be deemed to be acting "in concert" and, as such, becoming a de facto BHC. The risks and uncertainty of this approach will generally preclude it from being used to evade the restrictions on control.

Fourth, a private equity fund can use the "silo" approach—i.e., creating a bank-focused fund that is separate from its other non-banking funds. A number of funds have in fact been created with

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[74] *Id.*

[75] 5 U.S.C. § 552(b)(4) (2006). The Freedom of Information Act contains an exemption for trade secrets and confidential information. Under the Bush Administration, requests for confidential treatment generally were granted almost pro forma; under the new policy there is a "clear presumption of disclosure," so that the case for non-disclosure must be pleaded with greater particularity. *See* OFFICE OF INFO. POLICY, U.S. DEP'T OF JUSTICE, PRESIDENT OBAMA'S FOIA MEMORANDUM AND ATTORNEY GENERAL HOLDER'S FOIA GUIDELINES (2009), *available at* http://www.justice.gov/oip/obama_holder_foia_memo_march2009.pdf.

[76] Alvarez, *supra* note 9.

[77] Desai, *supra* note 6, at 399–400.

the objective of acquiring banks. Such funds will, of course, be BHCs if they purchase controlling interests, but presumptively will be BHC Act-compliant by remaining separate from other investment funds. The problem is that common control of the funds will defeat this objective; the BHC Act requires the Fed to look to the "ultimate parent" in making a BHC determination.

Fifth, in the failed bank world, the FDIC's SOP does not provide adequate comfort to private investors to assure their participation. Still, there are indications that they are ready to buy if the price is right.[78]

VI. Conclusion

The unprecedented situation in the financial markets over the past few years has created a unique challenge for the bank regulators. In attempting to find new sources of capital for the banking industry, they have been able to re-think, to some extent, their traditional aversion to the control of banks by investors lacking a proven track record of banking. But the fundamental underlying tension is still there; the American obsession with separating banking and "commerce," which finds its expression in the BHC Act, makes the regulators wary of erring on the side of being too inclusive in the quest for new investors.

On the investor side, these considerations create a conundrum as well. For private equity investors, the preferred business model is to take control of a weak or failing company, straighten it around, and sell it at a profit in a comparatively short time frame. These objectives are inherently at odds with banking law and regulatory policy, which are aimed at precluding engagement in non-banking activities and maintaining continuity of management. Such investors also are unused to a culture of full disclosure and the "source of strength" concept—which implicitly commits them to "throw good money after bad" if the bank continues to struggle.

Seen in this light, the policy changes by the Fed and the FDIC are no more than hesitant first steps. In turn, the private equity market thus far has tiptoed gingerly around the idea of bank investment, as they weigh the potential for superior returns—with many banks available at bargain basement prices—against the many pitfalls in the Fed and FDIC policies. The next few years will tell whether the agencies are willing to liberalize further as they

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[78] *See* Paul Davis, *Field of Failed-Bank Suitors Getting Crowded*, AM. BANKER, Mar. 1, 2010, at 1.

gain experience with private equity investors.