The New Rules of Private Equity Investments & Acquisitions
in U.S. Financial Institutions

By

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Unlike prior M&A binges, the 2007 acquisition market is marked not by companies buying companies, but by private equity and hedge fund acquisitions of companies. This trend is increasingly bumping up against federal and potentially state banking laws as acquisitions are attempted of companies that directly or indirectly control or want to control regulated financial institutions *(i.e.,* commercial banks, thrift institutions, CEBA banks, trust banks, credit card banks and industrial loan companies ("ILCs")), often because they really want to control the companies that control those institutions.

Interestingly, there have been some recent private equity acquisitions where financial institutions have participated in three distinct and very different ways: (i) as lenders; (ii) as equity investors; and (iii) as targets of private equity investments. Some transactions may actually put some institutions in the unique position of being the lender, investor and target (e.g., through the sale or investment in an affiliate) all at the same time, raising issues regarding compliance with bank investment, affiliate transaction and holding company rules. Finally, the fact that it is no longer readily apparent from a company's name whether it is or owns a financial institution or financial institution holding company, requires that there be a careful analysis under federal and state banking laws of all investments before they are made. For example, in the recent acquisitions of GMAC by Cerberus, and First Data Corp. by KKR, their FDIC-insured Utah and Colorado industrial loan company subsidiaries were not really the targets, but their existence triggered substantive bank control rules requiring prior approval by the FDIC.

Where the control of any FDIC-insured financial institution that will remain in existence is in question, it will trigger prior approvals required under the federal Change in Bank Control Act ("CIBCA"), Bank Holding Company Act ("BHCA"), and/or Savings & Loan Holding Company Act ("SLHCA") Act as well as potentially under state law. Typically, commercial companies have not been able or willing to acquire or take controlling interests in banks. The aggregate effect of activity, investment, capital, examination and federal enforcement restraints have been enough to convince most companies that life as a regulated bank holding company ("BHC"), savings and loan holding company ("SLHC"), or ILC holding company ("IHC") is not very attractive. Indeed, a type of "poison pill" exists for those companies that acquired thrift institutions prior to 1999 when the Gramm-Leach-Bliley Act ("GLB Act") leveled the playing field with respect to commercial banks and thrift institutions and prohibited non-financial companies from buying thrift institutions. Companies like American Express Company, E*TRADE, Federated Department Stores, GE, General Motors, John Deere, Lehman Brothers,

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Morgan Stanley, Nordstrom, Inc. and Allstate are all registered SLHCs, and BMW, Franklin Templeton Credit, Sallie Mae, Pitney Bowes, UBS and Volkswagen are IHCs and own FDIC-insured ILCs in Utah. That means that, as a general matter, no one can acquire 10% or more of a class of the voting stock of these parent entities, and in some cases 5% or more, without getting prior federal and/or state regulatory approval.

Getting the Deal Done

A number of creative ways exist to structure an investment in or acquisition of a regulated financial institution and/or the companies that control them (*e.g.*, BHCs and SLHCs) without triggering either control or holding company requirements. They include: (i) dispersing ownership among equity holders and ensuring that they do not act in concert so that their shares are not aggregated for the purposes of determining control; (ii) executing passivity agreements that give up the right to have representatives on the Board of Directors, conduct proxy contests or otherwise influence the management of the company; (iii) using non-voting and other convertible securities; and (iv) nominating voting trustees who can step in the shoes of an equity holder and shield the holder from the consequences of control.

Dispersed Ownership and Disaggregated Investors

Investors seeking to invest in a financial institution or its intermediate and/or ultimate holding company can unwittingly find themselves in a control position under the CIBCA, the BHCA or the SLHCA if their investment is aggregated with other investors under the acting in concert rules. Conscious parallel behavior with regard to the control of voting securities in the same financial institution or its holding company may result in the stock of each of those persons or entities being attributed to each other and aggregated for purposes of determining the existence of control and the need for control filings to be made. Where such filings have not already been made before the investment or acquisition, an enforcement action may be brought by the appropriate federal or state banking agency imposing divestiture, other remedial actions and significant fines. In some cases, criminal prosecution can ensue.

However, changing the typical acquisition structure or reconstructing the relationship between investors, partners and related parties can provide a workable means of avoiding such control and potential holding company status. Parties that normally might have invested as one private equity group may segregate their interests and form separate entities or trusts to control the investment target and/or execute passivity agreements to avoid triggering control and holding company requirements.

Several recent transactions have demonstrated how the chain of control can be broken, and the aggregation of voting stock by individuals or companies acting in concert avoided. For example, separate trusts among a number of equity investors each controlling less than 9.9% of the voting stock were used in the purchase of 26.58% of the shares of HSH Nordbank AG, to whom the BHCA is applicable because of the bank's maintenance of a branch in New York City. In the recently proposed recapitalization of Doral Financial Corporation in Puerto Rico, a number of private equity investors invested as limited partners in a limited partnership ("LP") that owned substantially all of the limited liability corporation ("LLC") that is to serve as the acquisition entity. The limited partners would each own less than 9.9% of the voting interests and 9.9% of the equity of the LP. Several of the limited partners will be entitled to designate a representative to serve as one of the directors of the general partner ("GP") of the limited

partnership. The proposed transaction is conditioned upon Federal Reserve Board confirmation that the equity investors will not be deemed to control Doral Financial, the LLC, LP or GP.

Using Non-Voting and Convertible Securities as Investment Vehicles

Voting stock may trigger control and holding company issues. Therefore, non-voting securities, such as preferred stock, convertible debt, warrants and options, may be employed in an acquisition structure to isolate and protect certain investors from control and holding company issues. Where preferred stock, options, rights and warrants include a future convertibility feature into voting securities, in determining whether the instruments will be treated as non-voting for banking law purposes, various federal rules may, however, look to whether the instrument that carries potential voting rights, is immediately convertible at the time it is issued, or whether the holder is vested with the preponderant economic risk in the underlying voting stock. Generally speaking, an investor may be permitted to acquire preferred stock and avoid control and holding company status as long as the preferred stock: (i) does not provide the holder with the ability to vote for or otherwise affect the selection of the issuer's board of directors; (ii) constitutes a passive investment or financing device that does not provide the holder the ability to direct the issuer's management or policies or with a significant equity interest in the issuer (generally greater than 25%); and (iii) limits voting rights to the type of rights ordinarily provided by state law with regard to matters that adversely affect the rights of the stockholder.

Instruments that are immediately convertible into voting stock are generally viewed by the regulators as tantamount to the ownership of the underlying securities. However, the Office of Thrift Supervision, for example, would not consider the preponderant economic risk of an instrument as vested in the holder (meaning that the ownership of the underlying stock would not be attributed to the holder) if the holder has paid less than 50% of the amount required to directly acquire the underlying stock and has no other economic interest in it. Thus, if structured properly, the combination of voting securities, non-voting securities and convertible instruments may be used to satisfy both the investment profile desired and avoid a finding of control under applicable federal control regulations. Each of the federal banking agencies have a set of criteria that differ from each other regarding the various characteristics used in determining whether and when convertible instruments may trigger control filings.

Voting Trust Arrangements

A voting trust may allow an investor or group of investors to complete an acquisition without being subject to the restrictions that may normally apply in a traditional controlling investment or acquisition. A voting trust can be most helpful to facilitate a transaction where a regulated institution is a subsidiary of a larger company being acquired. Generally, a voting trust arrangement would provide the trustee with the authority on voting issues affecting the financial institution or a company that controls the financial institution. Such an arrangement would preclude any voting influence by the beneficiaries and would not allow the beneficiaries to remove the voting trustee, except for cause, or to dissolve the voting trust. Thus, from a regulatory perspective, the owners of the stock would not control the bank or thrift, and therefore may negotiate an arrangement with the regulators that will provide for a quicker prior approval (or non-disapproval of the notice) and less substantive restrictions on the owners. Only the trustee would need to file the CIBCA notice, submit personal biographical and financial information and undergo the CIBCA process.

In cases where voting trustees have been used, they have tended to be persons very familiar to the regulators, and in many cases, former regulators themselves.

Conclusion

Investments in and acquisitions of financial institutions are changing, much as the M&A market is changing in this country. The fact that there are large amounts of investing funds looking for good investments means that creative structures will continue to evolve to provide those funds access to investments in companies that may control financial institutions and in financial institutions themselves.