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Private Equity Investment in Financial Institutions and How to Avoid Becoming a Bank Holding Company

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Private Equity Investment in Financial Institutions and How to Avoid Becoming a Bank Holding Company

I. INTRODUCTION

Wachovia, Washington Mutual, IndyMac... Which bank will the credit crisis claim next? Could your bank face a similar fate as these and many other banks that underwent a forced sale or closure in 2008? As bank investments are written down, loan charge-offs are increasing and repeated losses are eroding bank capital, banks are being forced to raise additional capital or look for a buyer. Regulators require that banks be adequately capitalized so that they can absorb the potential losses that come from bad investments. The problem is that sources of additional capital have become scarce. There are two primary explanations for this: one, with so many banks in such a dire position, banks are unable to borrow from each other, and two, the early round investors have grown reluctant.

Congress responded to the need for a capital infusion into the financial system on October 3, 2008 with the Emergency Economic Stabilization Act (EESA) of 2008. The EESA authorizes the government to invest in the preferred stock of banks and bank holding companies. Furthermore, in an effort to

5. World on the Edge, supra note 4; Sisk, supra note 2.
7. See id. at § 113(d)(1).
attract greater private equity investment in banks, the Board of Governors of the Federal Reserve (Board) has issued a new Policy Statement. The Policy Statement provides greater clarity and guidance for investors on the limits of investing in a bank without exerting a "controlling influence" over the bank and being subjected to regulation as a bank holding company.

Some banks, such as Bank of America and Wells Fargo, have been successful in raising additional capital, but investment-related write downs continue to grow and with it the need for additional funds. Sovereign wealth funds, pension funds, and other institutional investors that were once a source of capital infusion are reluctant to commit additional funds to an industry mired in a crisis that seems to be continuing. As a result, private equity firms are one of the only remaining large sources of capital. Private equity firms have traditionally sought to buy or gain a controlling investment in struggling or undervalued companies, "fix them, grow them, and sell them" within a three- to five-year period. Holding periods can occasionally be as long as ten-years, but the ultimate goal for private equity investors is always to sell the company for a profit. Private equity firms are able to achieve quick turnarounds because management takes on an ownership mentality and prefers to operate in industries with

8. See infra Part II.D.
9. See id.
10. Sisk, supra note 2; see infra notes 174-176 and accompanying text.
15. Id. (Some investments are less than a year.)
fewer regulatory restraints than banking. Additionally, private equity firms seek to take advantage of "tax loopholes" to extract large profits, which are primarily gained by taking risky positions and operating around "lax regulation."

As an aggregate, private equity funds are estimated to have over $450 billion in capital ready to invest. Private equity firms have, to a large extent, remained on the sidelines regarding investments in banks due to the Bank Holding Company Act (BHCA), which is the federal statute that regulates a non-banking entity seeking to gain "control" over a bank or bank holding company. Acquiring control of a bank requires a private equity firm to register as a bank holding company. Designation as a bank holding company necessitates significant amount of federal oversight and regulation. For instance, bank holding companies are limited to engaging only in activities closely related to banking. If a bank holding company also qualifies as a financial holding company it is limited to activities that are financial in nature. The purpose of requiring an investor to register as a bank holding company is to prevent the investor from being substantially involved in non-banking activities that might undermine the capitalization and soundness of a bank. Therefore, private equity firms, which have traditionally engaged in a host of non-banking and non-financial activities, find it difficult to become a bank holding company and still maintain their other investments.

Private equity firms prefer to operate away from the public and have historically found entering the banking industry to be

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16. Id. ("Not only is a far larger share of executive pay tied to the performance of an executive's business, but top managers may also be required to put a major chunk of their own money into the deal.").
17. Stern, supra note 2.
21. See infra notes 43-57 and accompanying text.
23. Id.
overly burdensome. Private equity firms are turned off by the disclosure requirements and limitations on banking and non-banking activities imposed by the Board, which is the chief regulator of bank holding companies. Furthermore, the Board who requires banks to maintain an adequate capital balance. Bank holding companies are also required to act as a source of financial and managerial strength for the banks they own, and so they must be ready to infuse capital when a bank’s capitalization becomes inadequate. For which, private equity firms are neither structured nor willing to necessarily provide an endless supply of financial support like bank holding companies.0

Recently, there has been a shift in private equity behavior as private equity firms view the current economic downturn in the banking industry as an opportunity to gain large stakes in financial institutions at bargain prices. The recent downfall of large financial institutions represents a perfect opportunity for private equity firms to turnaround undervalued banks and sell them for a profit. The September 2008 Policy Statement issued by the Board, therefore, is a welcome step forward for private equity investors.

Part II of this Note will discuss the federal statutes and Policy Statements issued by the Board that limits private equity investment in banks. Part III will put forth the options available to private equity firms for investing in banks along with specific examples of ways private equity firms have been able to work around the Board’s current rules. Part IV will weigh the

26. See Colvin & Charan, supra note 14 (private equity firms like to be able to act quickly and free from regulations such as Sarbanes-Oxley and others); see also Stern, supra note 2 (stating “private-equity firms operate in secret, virtually free from regulation”).
27. Sisk, supra note 2; Stern, supra note 2.
29. 12 C.F.R. § 225.4.
31. See Loan Rangers, supra note 18.
32. See id.; Colvin & Charan, supra note 14 (private equity firms specialize in turning around undervalued companies).
33. See infra Part II and accompanying text.
34. See infra Part III and accompanying text.
advantages and disadvantages of allowing greater private equity investment in banks. Part V will summarize the state of private equity investment in banks and what issues remain unresolved.

II. FEDERAL STATUTES AND POLICIES

There are two federal statutes that are intended to regulate the control of banks. One is the BHCA of 1956 and the other is the Change in Bank Control Act (CIBCA). The BHCA defines a bank holding company as "any company which has control over any bank." According to the BHCA, "control" is established whenever a company acquires an ownership interest of greater than 25% of any class of voting stock of a bank or bank holding company. The CIBCA, similar to the BHCA, defines "control" by an investor as acquiring 25% or more of any class of voting stock. The two definitions of "control" slightly differ in that the BHCA also states that "control" exists when the "company directly or indirectly exercises a controlling influence over the management or policies of the bank," whereas the CIBCA requires the investor to "direct the management or policies." The primary differences between the two statutes are that the CIBCA applies to individual investors who do not fall within the definition of a "company" under the BHCA, and for acquired depository institutions that do not fall within the definition of a "bank" under the BHCA.

A. Bank Holding Company Act (BHCA)

The BHCA of 1956 set specific criteria for determining when a company has gained "control" over a bank. "Control" exists when a company, directly or indirectly, or through others,
owns or controls 25% or more of any class of voting stock of a bank. “Control” also exists when the “company controls in any manner the election of a majority of the directors or trustees of the bank.” Additionally, the Board can determine independently, after notice and opportunity for hearing, whether the company directly or indirectly has a “controlling influence” over the bank’s management or policies. Alternatively, “a company may not be held to have had control over any given bank” when the investment is limited to less than 5% of the voting stock. Only investors that trigger one of the above control elements are required to register as a bank holding company, file for approval of the Board, and be regulated thereafter as a bank holding company.

Being classified as a bank holding company subjects a company to a great deal of oversight and ongoing requirements. The BHCA requires investors to meet certain managerial and capital requirements in order to maintain status as a bank holding company. Furthermore, a bank holding company is subject to continued Board supervision, examination, and regulation, restrictions on direct and indirect activities and investments, standing as a “source of strength” for the bank and its subsidiaries, and limitations on its ability to use leverage in support of company activities. Of particular concern to private

44. Id.
45. Id.
49. Goodwin Procter, supra note 47.
50. 12 C.F.R. § 225.5.
52. 12 C.F.R. § 225.4.
53. See id. (the BHCA requires that when a bank holding company, with consolidated assets of $500 million or more, seeks to purchase or redeem its own
equity firms is the limitation on non-banking activities and investments. These restrictions substantially limit the industries and sectors private equity firms are allowed to invest in. The other major concern for private equity firms is that a bank holding company must act as a “source of strength” for the bank, and is vulnerable to all of the liabilities that the bank may encounter. These liabilities are not solely restricted to the immediate investor, as parent entities that are directly or indirectly in control of the investor may also be liable.

B. Change in Bank Control Act (CIBCA)

The second piece of legislation that seeks to regulate the control of financial institutions by non-regulated entities is the CIBCA. Investors that do not meet the standards of a “company” or “bank” under the BHCA may nevertheless be subject to the CIBCA. The CIBCA applies to any individual or individuals, acting in concert, that acquire control of a bank or where there is a change of control of a bank. The “control” thresholds under the CIBCA are when the investor: (i) directly or indirectly, oversees the management or policies of an insured depository institution, or (ii) owns 25% or more of any class of voting stock of the insured depository institution. Since an investor that directs the management or policies of a bank is considered to be in “control,” the CIBCA will generally apply anytime there is an acquisition of 10% or more of any class of voting stock of a bank in the United States.

The CIBCA establishes a set of factors that must be reviewed before an investor can gain approval from a federal

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54. 12 C.F.R. § 225.
55. Id.
56. See Hill, supra note 12.
57. See Goodwin Procter, supra note 47.
59. See id.; Goodwin Procter, supra note 47.
agency to acquire a controlling position in a bank. These factors “focus on the competitive effects of the proposal, the managerial competence[,] experience, integrity and financial strength of the acquirer, certain informational requirements, and whether the transaction would result in an adverse effect on the deposit insurance funds.” The CIBCA does not impose any activity limitations or ongoing supervisory requirements like the BHCA.

C. Application of the BHCA

Under the BHCA, investments of up to 24.9% are allowed in any class of voting stock of a bank without finding the investor to be in “control” of the bank. In reality though, the Board looks to restrict ownership positions in banks to less than 15%, voting and nonvoting stock combined, and limits ownership stakes further to less than 10% when an investor seeks to appoint a director. The Board has a general distaste for allowing investors, such as private equity firms, to have board representation because of the fear that they will exert too much control or influence over the bank. The concern is that if unregulated investors are allowed to meddle with management policies, then this will lead to unsound banking practices. Furthermore, when the Board is determining whether an investor has surpassed a certain ownership percentage threshold, it will consider nonvoting stock that is convertible to voting stock to have already been converted. This prevents investors from bypassing the regulations of the BHCA and later gaining control.

The Board’s first Policy Statement, issued in 1982, on nonvoting equity investments by bank holding companies provides

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64. 12 U.S.C. § 1817(j)(7); Hearing of the Senate Banking Comm., supra note 46, at 8.
65. Hearing of the Senate Banking Comm., supra note 46, at 8.
68. See Sisk, supra note 2.
69. See Stern, supra note 2.
70. O’Melveny & Myers, supra note 30.
guidance on the policies the Board considers when determining whether an investor is attempting to exert a “controlling influence” over a bank’s management or policies. In the 1982 Policy Statement, the Board noted specific arrangements investors were creating, in order to protect their investments, as being inconsistent with the control provisions of the BHCA. These arrangements include covenants or options that, among other things, allow investors to prevent takeovers by others, limit the discretion of the bank’s management over major policies and decisions, and reserve the right for investors to sell their options, warrants, and rights to a person of their choice. The Board, however, also included guidance on provisions that could be incorporated to avoid control. These provisions include allowing “management [to be] free to conduct all banking and permissible nonbanking activities,” granting banks a right of first refusal when an investor seeks to dispose of his investment, and limiting the amount of voting and nonvoting stock acquired by an investor so as to avoid owning a controlling percentage of the bank’s total equity.

Also in the 1982 Policy Statement, “the Board recognizes that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control . . . must take into account . . . [the] provisions . . . and circumstances of each case.” Since each case is unique, investors with less than a 25% voting interest in a bank and who are considered to have a “controlling influence” are given an opportunity to rebut the claim and thus avoid becoming a bank holding company. A rebuttal of control will typically require the investor to enter into some form of agreement with the banking regulator, whereby the investor agrees to remain “passive.” Such an agreement usually calls for

71. 12 C.F.R. § 225.143.
72. Id.
73. Id.
74. Id.
75. Id.
76. Id.
77. 12 C.F.R. § 225.143. See Goodwin Procter, supra note 47.
78. See Goodwin Procter, supra note 47 (The passivity agreements are consistent
commitments such as “not to seek to exercise a controlling influence over the management or policies” of the bank, and “not to seek or accept representation on the board of directors” of the bank. These passivity commitments seek to ease the worries that the Board has about banking operations being dominated by unregulated investors.

There are two standard passive investment agreement forms, the Lincoln and Crown X, which the Board issues to prevent an investor from exerting a “controlling influence” over the target bank. The target bank is the bank in which the investor seeks to make an investment. The rules attached to these passive agreement forms run counter to the way private equity firms normally operate. The more stock a private equity firm owns, the more control they want over the company’s operational policies, which often includes board representation; however, under the Lincoln and Crown X commitments the Board is unwilling to give such “controlling influence.”

The Lincoln commitment applies to those investors seeking to acquire between 10% and 14.9% of any class of bank voting stock and who will not, thereafter, be the largest shareholder of the target bank. The Lincoln commitment will not allow the investor to have more than one representative on the target’s board of directors. Furthermore, the commitment requires that this board position be terminated if the investor ever becomes the largest shareholder of the target or acquires more than 15% of the voting stock. Moreover, the Lincoln commitment will not let an investor: appoint employees to serve in the management of the bank or its subsidiaries; take action that would cause the bank to

with the guidance provided in 12 C.F.R. § 225.143(d) - Provisions that Avoid Control).

79. 12 C.F.R. § 225.144; Goodwin Procter, supra note 47.
80. Federal Reserve Considering Flexibility for Private Equity Bank Investments, Legal Alert (Sutherland), July 2, 2008, available at http://www.sutherland.com/files/News/9c168402-6b0f-459b-64e3fa93d5f2d43/Presentation/NewsAttachment/aef9c4787-c3de-4966-afcf-012626a73e2/LegalAlertCorpPrivateEquityBankInvestments72208.pdf [hereinafter Sutherland].
81. See id.
82. Id.
83. Id.
84. Id.
become a subsidiary of the investor's company; acquire a combined interest between investors, directors and officers of 25% or more; propose a director in opposition to one proposed by management or the board of directors; solicit proxies; attempt to influence the operational policies of the bank; dispose or threaten to dispose of stock in retaliation to some action or nonaction taken by the bank; or, engage in transactions with the bank besides maintaining a deposit of up to $500,000 in the bank.85

The Crown X commitment applies to those investors seeking to acquire between 10% and 24.9% of any class of bank voting stock.86 For those investments between 10% and 14.9%, the determining factor between the use of the Lincoln and the Crown X commitment will be whether the investor would be the largest single shareholder.87 If the investor will be the largest shareholder than the Crown X commitment must be used.88 The provisions of the Crown X commitment are identical to those of the Lincoln commitment except that the Crown X commitment does not allow for an investor to have any representation on the board of directors of the bank.89

D. Board Issues New Policy Statement

The Board released a new Policy Statement in September 2008, which eases the ability of investors to make non-controlling equity investments in banks under the BHCA.90 The changes are particularly advantageous for private equity investors.91 Representation on the board of directors is an issue the Board has
changed its stance on, as it now believes that passive investors should be able to have a single representative on the board.\textsuperscript{92} The Board believes that because banking organizations typically have a nine to ten member board of directors, it would be difficult for a minority investor with only one representative to exert a "controlling influence" over the management or policies of the bank.\textsuperscript{93} The new Policy Statement actually allows investors to have up to two representatives on the board, as long as the number of directors is proportionate to the investor's interest in the bank.\textsuperscript{94} An investor's board appointees, however, cannot exceed 25% of the voting members of the board; in order to have two board seats, the bank must be controlled by another shareholder who is registered as a bank holding company.\textsuperscript{95} The Board believes that the presence of a controlling shareholder (the bank holding company) that is subject to Board supervision and regulation is a powerful enough force to counter the influence of any minority investor.\textsuperscript{96} Board representatives that serve on behalf of the unregulated investor may not serve as chairman of the board or as a chairman of a committee of the board.\textsuperscript{97} Furthermore, a private equity firm's representatives are free to serve on a committee so long as they do not represent more than 25% of the committee and "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 banking organization."\textsuperscript{98}

Formerly, the Board provided little guidance regarding communications with management.\textsuperscript{99} The general attitude was that only limited communication between investors and banks was allowed because the Board did not want unregulated investors to influence bank policies.\textsuperscript{100} The 2008 Policy Statement now openly allows investors to communicate with management regarding bank

\begin{thebibliography}{99}
\bibitem{92} 12 C.F.R. § 225.144.
\bibitem{93} Id.
\bibitem{94} Id.
\bibitem{95} Id.
\bibitem{96} Id.
\bibitem{97} Id.
\bibitem{98} 12 C.F.R. § 225.144.
\bibitem{99} Mayer Brown, \textit{supra} note 91.
\bibitem{100} See 12 C.F.R. § 225.144; Mayer Brown, \textit{supra} note 91.
\end{thebibliography}
Investors may voice their opinion about the bank’s dividend policy, discussions about raising additional debt or equity, entering or terminating new lines of business, mergers and acquisitions, or the general role of management. The ultimate decision making power still rests with the bank’s shareholders, board of directors, or management. The Board does not believe that discussions with management are the type of “controlling influence” the BHCA sought to prevent. Even by allowing discussions, the minority investor’s role in the ultimate decisions of the bank is limited to the investor’s voting stock and board representation.

The Board has long believed that the overall size of the equity investment in a bank is an important indicator of the level of influence an investor has. Previously, the Board’s general position was that nonvoting securities representing 25% or more of a bank’s equity would raise “control” issues. Acquisitions of 25% or more of any voting security are automatically “control” investments. The new Policy Statement gives an investor the ability to acquire up to a 33% equity interest in a bank without triggering any assumption of control as long as the one-third equity interest is divided between voting and nonvoting stock and the investor holds no more than 15% of any class of voting securities. The Board continues to believe that an investor that makes a large equity investment is likely to exert a “controlling influence” over the bank’s management or policies, but recognizes that a substantial ownership of nonvoting stock hinders an investor’s ability to directly participate in the bank’s management or policies. Therefore, it remains that an investor with an ownership interest of 25% or more, in voting and nonvoting stock

101. 12 C.F.R. § 225.144.
102. Id.
103. Id.
104. Id.
105. Id.
106. Id.
107. 12 C.F.R. § 225.144.
109. 12 C.F.R. § 225.144 (assuming conversion of all convertible nonvoting shares held by the investor).
110. Id.
combined, has the ability to have a "controlling influence" over the management and policies of the bank.111

III. OPTIONS FOR INVESTING IN FINANCIAL INSTITUTIONS

As private equity firms become increasingly interested in investing in banks, they continue looking for ways to navigate around the BHCA to avoid registration as a bank holding company.112 There are a number of options available for private equity firms to structure their investments so that they can avoid exercising a "controlling influence" over banks and are not subjected to regulation as a bank holding company.113 If private equity firms find none of these investment structures viable, then their only option to invest in banks remains to register as a bank holding company.

A. Limited Voting Stock and Passivity Commitments

Since investments of 25% or more of voting securities are automatically treated as "controlling," private equity firms seeking to invest in the banking industry should look to make smaller, more diverse investments.114 Typically, regulators have not worried about acquisitions of less than 10% of the voting stock of a bank, a sort of de facto safe harbor.115 The belief is that investors of this size would have a difficult time exerting a "controlling influence" over the bank’s management or policies.

Consequently, private equity firms must limit their voting interest to 9.9%.116 Or, in an effort to maximize their investment, by taking an ownership interest of between ten and 25% of voting stock, they can enter into passivity agreements to

111. Id.
112. See Goodwin Procter, supra note 47.
115. Goodwin Procter, supra note 47.
116. Id.
avoid triggering the requirements of the BHCA.\textsuperscript{117} Agreements such as the Lincoln or Crown X commitments are specifically designed to negate control and ensure that the investor remains passive.\textsuperscript{118} The problem previously had been that these passivity agreements were too restrictive and ran counter to the business practices of most private equity firms. The Board’s recent Policy Statement though no longer requires such strict passivity agreements, as the Board recognizes that limited board representation, voting interests, and discussions with management are not as threatening as previously thought.\textsuperscript{119} Limiting the percentage of voting stock and entering into passivity agreements is the most immediate solution available to private equity firms that wish to invest in banks.

The private equity firm TPG led a $7 billion investment in Washington Mutual Inc. in April 2008, in which TPG committed $1.35 billion of its own capital.\textsuperscript{120} TPG limited its investment to a 9% ownership interest in Washington Mutual.\textsuperscript{121} Due to this arrangement, TPG was able to take a seat on Washington Mutual’s Board of Directors.\textsuperscript{122} Later in that same month, a similar structure was used when private equity firm Corsair Capital committed $985 million of a $7 billion capital infusion into National City.\textsuperscript{123} After the transaction Corsair Capital maintained exactly a 9.9% investment interest in National City.\textsuperscript{124}

B. Investments in Nonvoting Stock

Another option, for private equity firms wishing to avoid “control” is to acquire nonvoting securities as a portion of their

\begin{footnotes}
\item[117] See id.
\item[118] See Sutherland, supra note 80.
\item[119] See 12 C.F.R. § 225.144.
\item[121] Lattman, supra note 120.
\item[122] Id.
\item[124] Robin Sidel, David Enrich & Peter Lattman, NatCity Close To $6 Billion Cash Infusion, WALL ST. J., Apr. 21, 2008, at C1.
\end{footnotes}
investment.\textsuperscript{125} Nonvoting securities may include preferred stock, convertible debt, warrants and options, or other subordinated securities.\textsuperscript{126} By acquiring a portion of their investment as preferred stock, private equity firms would be able to avoid bank holding company status so long as the stock: (i) does not allow the investment company to vote for or influence the selection of the bank’s board of directors; (ii) constitutes a passive investment or financing device that does not allow for the investor to control the bank’s management or policies; and (iii) limits voting rights to those afforded by state law to shareholders whose rights have been adversely affected.\textsuperscript{127}

Private equity firms must be careful when dealing with nonvoting securities that are convertible into voting stock. The Board will look to see how quickly those securities are convertible and whether or not the firm is taking on an overweighing balance of the risk associated with the voting stock.\textsuperscript{128} Nonvoting securities that are convertible into voting stocks are considered to have already been converted for banking law purposes, since the conversion is usually a significant reason for the investment.\textsuperscript{129}

Under the guidance of the 2008 Policy Statement issued by the Board, private equity firms are capable of acquiring up to a 33\% equity interest in banks through a combination of voting securities, nonvoting securities, and convertible securities.\textsuperscript{130} Private equity firms that seek ownership up to this limit are restricted from owning 15\% or more of any class of voting stock, including any convertible stock.\textsuperscript{131} The balance of the ownership equity must come in the form of nonvoting stock.\textsuperscript{132} The Board favors this structure because “the limitation on voting rights reduces the potential that the investor may exercise influence that is controlling.”\textsuperscript{133}

\begin{itemize}
  \item 125. Goodwin Procter, \textit{supra} note 47.
  \item 126. Vartanian, \textit{supra} note 113; Goodwin Procter, \textit{supra} note 47.
  \item 127. Vartanian, \textit{supra} note 113; Goodwin Procter, \textit{supra} note 47.
  \item 128. Vartanian, \textit{supra} note 113; Goodwin Procter, \textit{supra} note 47.
  \item 129. 12 C.F.R. § 225.144. \textit{See also} Vartanian, \textit{supra} note 113; O’Melveny & Myers, \textit{supra} note 30.
  \item 130. 12 C.F.R. § 225.144. \textit{See also} Vartanian, \textit{supra} note 113.
  \item 131. 12 C.F.R. § 225.144.
  \item 132. \textit{See id}.
  \item 133. \textit{Id}.
\end{itemize}
C. Consortium of Private Equity Investors

Private equity firms seeking to avoid “control” or unwilling to make large individual investments may, alternatively, pool a group of individual investors together. Forming a consortium of investors to invest in a bank is tricky because the individual interest of investors is often aggregated under the presumption that they are acting “in concert.” Even if no single investment triggers an assumption of “control,” the overall investment may put the consortium over the threshold limit if the investors are found to be acting “in concert.” Typically, investors are found to be acting “in concert” when they consciously exhibit the same pattern of behavior with regard to the control of the voting securities of the bank. When such behavior is present, for control purposes, the different investors are presumed to be acting as one unit and are, therefore, subject to the bank holding company requirements of the BHCA. If the investors do not complete the appropriate “control” filings required for Board approval, then the Board or other bank regulators can call for a divestiture of the investment or take other remedial actions in addition to the imposition of fines.

There are a number of ways to structure investments so as to avoid the aggregation of multiple investors, but the most crucial factor is to establish a significant amount of separation and independence between the various investors. Individuals that would have normally invested as one group or private equity fund may form multiple, separate entities or trusts to control the investment. They may also enter into passivity agreements to avoid triggering bank holding company requirements.

134. Vartanian, supra note 113; Goodwin Procter, supra note 47.
135. See Vartanian, supra note 113.
136. Id.
137. See id.
138. Id.
139. Id.
140. Id.
141. Vartanian, supra note 113.
Additionally, these separate entities must reassure regulators that they do not plan to act "in concert.\textsuperscript{142} The 2008 Policy Statement issued by the Board does not address how it would treat an investment by a consortium of investors. However, there have, in the past, been successful investments in large banks by a consortium of private equity investors without any of them being deemed to have acquired control over the bank as an aggregate or individually.\textsuperscript{143} One of the largest such deals was the recapitalization of Doral Financial Corporation (Doral).\textsuperscript{144} In the Doral deal, Bear Stearns, Goldman Sachs, and other equity investors pooled together to each acquire less than 10% of the voting stock of the investment entity, Doral Holdings, which acquired Doral.\textsuperscript{145} The equity investors also entered into passivity agreements and made representations of their independence from the other investors.\textsuperscript{146} Since Doral Holdings was a bank holding company subject to oversight by the Board, it was able to purchase 90% of Doral.\textsuperscript{147} Additionally, several of the equity investors were able to designate one representative on behalf Doral Holdings to be on the board of Doral.\textsuperscript{148}

\textbf{D. Bank Focused Private Equity Funds}

Private equity firms can create entirely new investment vehicles focused solely on banks.\textsuperscript{149} This investment structure is commonly referred to as the "silo" approach, which seeks to keep the general partnership of the private equity firm at arms length from the bank investment.\textsuperscript{150} These "silo" funds can actually be

\begin{footnotes}
\footnote{142. See id.}
\footnote{143. See Vartanian, supra note 113; Goodwin Procter, supra note 47.}
\footnote{144. Vartanian, supra note 113; Goodwin Procter, supra note 47.}
\footnote{145. R. Christian Bruce, \textit{Bear Stearns Bid for Doral Financial Shows Private Equity Firms Eyeing Banks}, \textit{Banking Daily}, May 21, 2007; Goodwin Procter, supra note 47.}
\footnote{146. Goodwin Procter, supra note 47.}
\footnote{147. Bruce, supra note 145.}
\footnote{148. Vartanian, supra note 113.}
\footnote{149. Kelly Holman & Aleksandrs Rozens, \textit{The New Old Bank}, \textit{Inv. Dealers’ Digest}, Oct. 6, 2008, at 18; Goodwin Procter, supra note 47.}
\footnote{150. Holman & Rozens, supra note 149.}
\end{footnotes}
structured as bank holding companies, therefore, allowing for investments of greater than 25% of voting securities or 33% of total equity.\(^{151}\) By creating an entirely separate fund, private equity firms limit their overall exposure from the oversight and regulations associated with being a bank holding company.\(^{152}\) Portfolio holdings outside of the “silo” fund, created solely for banking purposes, are not affected by the “silo” fund’s bank holding company status.\(^{153}\) This structure is particularly advantageous because it eases the concern that many private equity firms have about being restricted from investing in a diverse set of industries, and that their other holdings may be required to be a “source of strength” for the bank.\(^{154}\) Without these concerns, private equity firms are more inclined to acquire equity interests of up to 33%.

Also, since the BHCA does not reach individuals, those individuals that control the “silo” fund or its general partner are not subject to the regulations of the BHCA, but would instead be subject to notice requirements of the CIBCA.\(^ {155}\) Therefore, the individual investors can continue with their other private equity investments and fund management so long as it takes place separate from the “silo” bank fund.\(^ {156}\) Essentially, what occurs is private equity firm X will create multiple investment funds, one of which will be solely dedicated to bank investments, and may or may not be structured as a bank holding company. Fund I, the designated bank fund, will therefore be the only investment portfolio subject to the regulations of the BHCA. Funds II, III, IV, and so on will not be affected by Fund I’s status as a bank holding company.

Although the Board’s Policy Statement does not address bank-focused private equity funds, the approach has been successfully accomplished by the private equity firm JLL Partners.\(^ {157}\) JLL Partners has put over $4 billion in capital to use in

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151. See id.
152. See Goodwin Procter, supra note 47.
153. See id.
154. 12 C.F.R. § 225 (Subpart C); 12 C.F.R. § 225.4.
155. See 12 C.F.R. § 225 (Subpart C); 12 C.F.R. § 225.4.
156. See 12 C.F.R. § 225 (Subpart C); 12 C.F.R. § 225.4.
157. See Goodwin Procter, supra note 47.
a variety of industries through a series of funds. 158  Due to its diverse set of holdings, JLL Partners had no intention of becoming a bank holding company when it sought to acquire First Community Bank (First Community) in Dallas, Texas. 159 Instead, JLL Partners created a separate fund, JLL Partners Fund FCH, which was used to invest in a newly created bank holding company that actually acquired over 60% of First Community. 160 Because JLL Partners has created this specific bank holding company fund, none of the individual principals or any of JLL’s other private equity investments conducted outside of the fund are exposed to the BHCA regulations. 161 However, had JLL’s “silo” fund been controlled by a management organization rather than individual principals all of the other funds or investments controlled by the same management organization would also be subject to regulation and supervision under the BHCA. 162

In order to make sure that these funds are sufficiently separate from one another, the Board focuses on inter-fund relationships to make sure that the private equity firm’s funds maintain separate economies. 163 The Board looks to make sure that there are “no common portfolio investments, no cross-investment or lending among the funds, no asset transfers among the funds, and no material economic linkages among the funds.” 164 It is important for private equity firms to make sure that none of the actions above take place in order to avoid the unnecessary regulation of their other portfolio holdings. 165

IV. PRIVATE EQUITY INVESTMENT: GOOD OR BAD?

The Board and other bank and thrift regulators have many fears about allowing private equity firms to invest in banks. One of the goals of the BHCA was to create a “separation [between]

159. Holman & Rozens, supra note 149.
160. Id.; Goodwin Procter, supra note 47.
161. See Goodwin Procter, supra note 47.
162. See O’Melveny & Myers, supra note 30.
163. See Goodwin Procter, supra note 47.
164. Id.
165. See id.
Banks must maintain a degree of separation from other businesses because almost every business and individual is tied to a bank in some form or fashion, whether it is where they keep deposits or borrow money. As an integral part to the free flow of commerce, banks should be monitored closely so as to prevent the use of unsound banking practices that could result in market failures.

Private equity investment poses a threat to the separation of commerce and banking because private equity firms traditionally invest in portfolio companies across a range of industries. Not only do private equity firms invest in a lot of different industries, but they also seek “control” over their investments in order to influence operations. Therefore, the fear is that private equity firms have too many varying interests. This could lead to a dangerous mix of banking and commercial interests if private equity firms try to raise money at below market rates through FDIC insured deposits to use for their other holdings. The Board has specifically intended to limit such behavior.

Additionally, the Board requires that a bank holding company be a reliable source of financial and managerial strength, and it is unclear whether a private equity firm could always provide the financial support needed. Typically, private equity firms look to raise a set amount of capital for each fund, and once that amount is raised, they put it to work by investing in a portfolio of companies. Since each fund is a separate legal entity the capital available for investment is limited, and any new capital is only raised once the investment phase of an existing fund is completed. The problem that arises is that if a private equity firm

166. O’Melveny & Myers, supra note 30.
167. See 12 C.F.R. § 225.144; O’Melveny & Myers, supra note 30.
168. See 12 C.F.R. § 225.144; O’Melveny & Myers, supra note 30.
169. See Sarkozy & Quarles, supra note 67; O’Melveny & Myers, supra note 30.
170. See O’Melveny & Myers, supra note 30.
171. See 12 C.F.R. § 225.144.
172. Id.
173. Id.
175. See id.
fund invests in a bank, which experiences a need for additional capital, there may be no excess capital for infusion because all of the capital raised by the fund that made the investment in the bank has already been put to work. Will private equity firms be able to borrow from their other portfolio holdings and funds or will they be forced to raise new rounds of capital? Will current investors be put on the hook for additional amounts of capital or will new investors have to be pursued? Private equity investors will find it difficult to provide support for potentially unlimited amounts of losses. No firm or investor wants to be responsible for potentially endless amounts of financial support. Investors buy into such funds in large part due to the diversified risk potential and the ability to lose on one investment while gaining on another.

Furthermore, there is an assumption that if private equity firms were able to gain control of banks they would be more likely to engage in the unsound banking practices regulators fear. Private equity firms are not typically long-term investors. The average life span for a given fund may be anywhere from less than one year to more than ten years, depending on the firm and investment objectives of that fund. Therefore, private equity firms look to grow companies quickly and earn a large return in the process. This is an investment strategy that is ripe for being involved in the same kind of practices that landed banks in their current predicament – making speculative and risky loans, engaging in unfair lending practices, and charging higher fees and higher interest rates on consumer products. The traditional notions of private equity investments seem to run counter to the long-term financial support the Board and other government entities seek when looking for significant bank investors.

176. See id.
177. See Sarkozy & Quarles, supra note 67; O'Melveny & Myers, supra note 30.
178. See Loan Rangers, supra note 18.
179. See Stern, supra note 2.
180. Stern, supra note 2; Colvin & Charan, supra note 14.
183. Id.
There are positive aspects, however, to private equity investment in banks. Private equity firms offer a major source of capital and are a group of investors that are ready to put their money to work. It is estimated that private equity firms have almost $450 billion ready to invest. Fittingly, this is also a time when banks are in need of additional capital due to their deteriorating balance sheets as a result of failing loans and investments. Banks have already been forced to raise capital through a variety of measures totaling $400 billion, but it is estimated that they will have to raise billions more to compensate for additional losses and to maintain adequate capital reserves. The problem is that the ability of banks to raise money on the public markets is coming at an increasing cost, as banks have to issue new stock at steep discounts to their current value. Wells Fargo was able to raise $11 billion, but at a 15% discount to the closing price of the day before the offering was announced. Bank of America raised $10 billion at an 8% discount to the closing price of the day before the offering was announced. The federal government has responded with a bailout bill, the EESA, which is intended to provide banks with some of the capital that they so desperately need. The plan calls for the Treasury Secretary to purchase up to $250 billion of preferred stock in banks in an effort to keep money flowing through the financial system.

The main purpose of the bailout is to restore the confidence of private investors. The current problem for banks

184. Sisk, supra note 2.
185. Loan Rangers, supra note 18.
186. Sisk, supra note 2; Holman & Rozens, supra note 149.
187. Sisk, supra note 2.
189. Id.
192. Id.
193. See id.
is that those investors that contributed during the early rounds of capital-raising are no longer willing to sink greater amounts of capital after seeing their investments plunge. Of the forty-two public equity infusions into banks since mid-2007, thirty-nine banks are trading below their issue price. The inability to go to the capital markets and the unwillingness of sovereign funds, pension funds, and other large institutional investors to invest has left banks with very few options. Private equity firms, on the other hand, are a group of investors that have the time, resources, and capability to evaluate banks more critically and make informed investment decisions.

Due to the current market dynamics, private equity firms are a natural fit as bank investors. Private equity firms are capable of bringing a lot of industry experience and knowledge to banks, which is especially needed during a time when banks are struggling. Private equity firms are savvy investors that look to bring the best and brightest minds onto their management teams. Experienced industry managers are often sought before a private equity firm even chooses to invest in a company. Management, in many cases, is required to invest its own money into the transaction, creating an ownership mentality for management and further tying compensation and pay to performance. One of the reasons why the TPG – Washington Mutual relationship did not result in a fire-sale of Washington Mutual stock was because the founder of TPG, David Bonderman, has a vast amount of industry experience dating back to the savings and loan crisis of the late 1980s. Furthermore, if private equity firms cannot find the expertise from within their organization, they have the money to buy and assemble a team as they progress.

194. Sisk, supra note 2.
195. Sarkozy & Quarles, supra note 67 (Figures are as of the time the article was printed on June 26, 2008.).
196. Sisk, supra note 2.
197. See Sarkozy & Quarles, supra note 67.
198. See Barr, supra note 120.
199. See Colvin & Charan, supra note 14; Barr, supra note 120.
201. Id.
202. Barr, supra note 120.
203. See Loan Rangers, supra note 18.
V. Conclusion

As previously enforced, the BHCA was too restrictive to allow for any meaningful investment by private equity firms in banks. The Board's recent Policy Statement regarding equity investments in banks and bank holding companies is a positive step forward and serves as a proper median for allowing larger equity investments.\(^{204}\) Under the BHCA, "control" exists when there is an acquisition of 25% or more of any class of voting stock, but in reality the Board finds a "controlling influence" any time there is an acquisition of 15% or more of the voting stock of any company.\(^{205}\) Under the 2008 Policy Statement, investors are still permitted to own up to 24.9% of the voting stock without any finding of a "controlling influence" over the bank.\(^{206}\) The new Policy Statement also provides guidance for equity investments of up to 33% in a bank, but with the limitation that an investor's voting stock interest be less than 15% in order to avoid exerting a "controlling influence."\(^{207}\) The new guidelines issued by the board also allow investors up to two seats on the board of directors, whereas previously board representation was limited to one seat and only in cases where investments totaled less than 15%.\(^{208}\) The Board further allows limited communication between minority investors and bank management, which had previously been strictly prohibited by passivity agreements.\(^{209}\) Due to these new guidelines, passivity agreements will no longer need to be as strict and unattractive as the Lincoln and Crown X commitments.

The new Policy Statement eases the fear and worries of many private equity investors, but the rules are still stringent and there is no great power conferred upon private equity investors. The Policy Statement merely provides investors with a small voice in the operations of a bank. Equity investments are still capped,

\(^{204}\) See 12 C.F.R. § 225.144; Mayer Brown, supra note 91.
\(^{205}\) 12 U.S.C. § 1841(a)(2); Sarkozy & Quarles, supra note 67.
\(^{206}\) 12 C.F.R. § 225.144.
\(^{207}\) 12 C.F.R. § 225.144; Mayer Brown, supra note 91.
\(^{208}\) 12 C.F.R. § 225.144.
\(^{209}\) Id.; Sutherland, supra note 80.
board representation is still limited, and policy and operational influence is restricted to discussion only.\textsuperscript{210} Investing in banks is inherently risky. Consequently, private equity firms are going to be hesitant to make a substantial investment in a company in which they must remain passive. Washington Mutual’s failure, which is the largest bank failure in U.S. history, completely wiped out TPG’s $1.35 billion equity investment made just five months earlier.\textsuperscript{211} Private equity firms specialize in actively managing troubled companies, and with an interest in protecting their investment, they will not take well to being bystanders while others mismanage their holdings.\textsuperscript{212} They look to take advantage of distressed companies by bringing in new management and scaling the business for growth.\textsuperscript{213}

The Policy Statement fails to clarify the Board’s position in a few areas. The voting stock investment range in between 5% and 25% remains grey since there is no strict criteria for determining when “control” exists and each case must be judged on its own facts and circumstances.\textsuperscript{214} The Board continues to maintain that the determination of whether there is a “controlling influence” will be based on a case-by-case analysis of the facts and circumstances around the transaction.\textsuperscript{215} This allows the Board greater flexibility, but it also discourages private equity investors because there is no certainty as to what exactly will constitute a “controlling influence” in investments of less than 25%.\textsuperscript{216} Furthermore, the Board must be consistent in its enforcement. For example, the TPG – Washington Mutual deal was allowed while the Corsair Capital – National City deal, as initially proposed, was rejected by the Board even though a large part of the language of that deal came from the TPG – Washington

\begin{thebibliography}{10}
\bibitem{210} 12 C.F.R. § 225.144; Holman & Rozens, \textit{supra} note 149.
\bibitem{212} \textit{See} Colvin & Charan, \textit{supra} note 14.
\bibitem{213} \textit{Id}.
\bibitem{214} \textit{Loan Rangers}, \textit{supra} note 18.
\bibitem{215} 12 C.F.R. § 225.144; Mayer Brown, \textit{supra} note 91; Sisk, \textit{supra} note 2.
\bibitem{216} \textit{See} Sisk, \textit{supra} note 2; Mayer Brown, \textit{supra} note 91.
\end{thebibliography}
Mutual transaction. Specifically, the "reset" provision that the Board was so afraid of in the Corsair deal was also a part of the approved investment agreement between TPG and Washington Mutual.

Another area where the Board is unclear is in regard to equity investments between 25% and 33%. With investments of less than 25%, investors are allowed to own up to an equal amount of voting stock; however, when equity investments rise to 33%, the voting stock must be limited to less than 15%. Does this mean that equity investments of 25.1% are also limited to less than 15% voting stock or only investments of 33%? Additionally, the Policy Statement does not address its view on consortium investments or bank-focused private equity funds.

There are a few things private equity firms are looking for before they commit capital in their bid to save banks. Private equity investors like to feel in charge by bringing in their own management or by providing operational guidance themselves. The Policy Statement does allow for greater board representation, but it still relegates minority investor board representatives to a cursory role where they are able to effectuate little change.

Private equity investors are also looking for a more liberal stance on when private equity firms are found to be acting "in concert." Additionally, they would like to be able to "ring-fence" funds that invest in banks so they can protect their other portfolio holdings.
made via separate funds. The “source of strength” requirement is also overly burdensome and can be a liability on all of the other portfolio holdings of a private equity firm. Being able to separate, or “ring fence,” a bank only fund from the other private equity funds would ensure the safety of an investor’s other holdings.

The requirements of the BHCA and CIBCA can only be changed by Congress, but the Board has a great deal of leeway in how it interprets the rules set forth. The Board exercised this power with its 2008 Policy Statement. The Policy Statement is the Board’s attempt to tap the large pools of capital that private equity firms have ready to invest. Nonetheless, given the turmoil in the market, the Board will be hesitant to allow private equity firms any greater amount of freedom. Therefore, as the Board continually monitors the regulations surrounding private equity investment in banks, private equity firms interested in entering the industry should be prepared to abide by the current regulations.

Private equity firms should therefore look to structures such as: acquiring a limited amount of voting stock and entering into passivity agreements, acquiring non-voting stock, forming a consortium of private equity investors, or creating special bank-focused private equity funds.

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223. Loan Rangers, supra note 18.
224. Enrich, Sidel & Paletta, supra note 222.
225. See supra Part II.D.
226. See supra Part II.
227. See supra Part III.