

## FDIC Adopts Qualifications on Private Equity Investors Bidding for Failed Banks

On August 26, 2009, the Federal Deposit Insurance Corporation (FDIC) announced the final terms of its Statement of Policy on Qualifications for Failed Bank Acquisitions (Statement). The Statement imposes stringent eligibility requirements unique only to private capital investors who are not in partnership or similar ventures with an existing depository institution holding company (excluding shell companies) where the institution has a strong majority interest in the target bank or thrift and an established record for successful operation of insured banks or thrifts (Investors). The Statement does not apply to investors who acquire five percent or less of the voting power in a bank or thrift provided there is no evidence of concerted action with other investors.

The FDIC's primary concern is to mitigate the risk to the Deposit Insurance Fund posed by the possibility of banks acquired by private capital investors failing a second time. The FDIC softened the Statement in several respects since its original proposal dated July 6, 2009, most notably removing the requirement that Investors act as a "source of strength" to an acquired institution. Nonetheless, the qualifications may put private equity funds, hedge funds and other private pools of capital at a significant competitive disadvantage to other bidders for troubled institutions and therefore may discourage private equity investing in these institutions at a time when substantial additional capital is needed in the U.S. banking system. The qualifications include:

*Required Capital Commitment.* An Investor seeking to acquire more than a 5% interest in a depository institution is required to cause the target depository institution to be initially capitalized at a minimum ratio of Tier 1 common equity to total assets of 10% throughout the first three years from acquisition, and then to maintain the depository institution at no lower level of capital adequacy than "well capitalized" during the remaining period of ownership. If at any time the depository institution fails to meet this capital standard, the institution would have to immediately take action to restore capital to the 10% Tier 1 common equity to assets ratio or "well capitalized" standards, as applicable.

*Cross Support.* If one or more Investors own 80% or more of two or more depository institutions commonly owned by these Investors, they must pledge the stock of their depository institutions to the FDIC as support to pay for any losses to the Deposit Insurance Fund resulting from the failure of, or assistance provided to, any of such institutions. The FDIC may waive this obligation if enforcing it would not reduce the cost of the bank or thrift failure to the Deposit Insurance Fund.

Cross support raises several issues for Investors and depository institutions, including the risk that Investors in one investment fund or group of investors may be indirectly exposed to cross support liabilities as a result of an investment made by another commonly managed investment fund or another group of investors. The FDIC added the minimum common ownership threshold of 80% in response to concerns raised by commenters. The Statement does not address whether and under what terms the FDIC may dispose of the pledged stock of a healthy financial institution as a result of the FDIC exercising the cross-guarantee.

*Prohibition on Transactions with Affiliates.* A bank or thrift acquired by or in which an Investor holds an investment may not extend credit to the Investor, its investment funds and any affiliates of either. The proposed Policy Statement would have prohibited all extensions of credit to any company in which the Investor or its affiliates hold even a nominal investment. In response to this concern, the Statement defines affiliate as any company in which an Investor (or potentially any affiliated investment fund) owns, directly or indirectly, 10 percent or more of the equity of that company for at least 30 days. Nonetheless, this restriction may pose significant compliance issues for Investors with affiliated private equity and hedge funds. Existing extensions of credit are exempt from this qualification. Investors will be required to regularly report to the depository institution identifying all affiliates.

*Limitations on Dispositions and Transfers.* Investors may not sell or transfer securities of the Investors' holding company or depository institution for a period of three years from acquisition, absent FDIC approval. The holding period does not apply to transfers to affiliates provided the affiliate agrees to comply with the ongoing qualifications in the Statement. The Statement has been revised to clarify that this restriction does not apply to mutual funds registered under the Investment Company Act of 1940. The holding period would apply to shares held by an Investor that desires to sell in a public offering. It remains unclear whether the three-year holding period is required to be reset as a result of a follow-on investment.

*Special Owner Bid Limitations.* Investors that directly or indirectly hold ten percent or more of the equity of a bank or thrift in receivership will not be considered eligible to be a bidder for another failed depository institution.

*Prohibited Ownership Structures.* The Statement states that so-called "silo" organizational structures in which "beneficial ownership cannot be ascertained," the responsible parties for making decisions are "not clearly identified," and/or "ownership and control are separated" are not eligible bidders for failed institutions. The FDIC intends to apply this qualification to all bidders of a failed bank or thrift. However, the FDIC specifically commented that it would not approve ownership structures that involve a private equity firm (or its sponsor) that creates parallel entities or alternative investment vehicles to acquire ownership of an insured depository institution due to concerns that the purpose of these structures is to artificially separate the non-financial activities of the firm from its banking activities so that the private equity firm is not required to become a bank or savings and loan holding company.

*Prohibition on Bank Secrecy Jurisdictions.* Investors may not use offshore entities domiciled in a "bank secrecy jurisdiction" unless they are subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board, agree to provide additional requested information and agree to comply with all regulations administered by the appropriate U.S. Federal banking agency applicable to the failed bank or thrift. A bank secrecy jurisdiction generally refers to any country that applies a bank secrecy law that limits U.S. bank regulators from determining compliance with U.S. laws or does not provide for transparency of financial activities by preventing the disclosure of information to U.S. regulatory authorities.

*Disclosure of Confidential Information.* Investors are also required to provide any information about their underlying investors and all entities in their ownership chain as the FDIC determines is necessary to assure compliance with the Statement. The Statement states that the FDIC will keep business information confidential, except where disclosure is required by law. Nonetheless, disclosure of such information may raise issues for Investors and their underlying investors, who may be contractually obligated to keep such information confidential, or who may view such information as proprietary or trade secrets.

*Duration.* The Statement provides that the application of the qualifications to a financial institution in which an Investor holds an investment may expire after seven years from acquisition, subject to FDIC approval and provided the institution has maintained a Camels 1 or 2 rating continuously for seven years. Such ongoing limitations may adversely affect an Investor's ability to dispose of an investment, and may have an adverse impact on price.

*Waivers.* The FDIC Board of Directors recognized that these qualifications may adversely affect bids for failed institutions, and accordingly the Board may waive one or more of the qualifications if in the best interests of the Depository Insurance Fund and the goals and objectives of the Statement can be accomplished by other means. The Board intends to review the impact of the Statement on bids for failed institutions within six months.

The Statement does not apply to acquisitions of failed depository institutions completed prior to the effective date of the Statement. Private equity sponsors interested in bidding for failed depository institutions should carefully review the Statement and determine whether such investments are feasible from both an economic and compliance perspective in light of the qualifications in the Statement.

You can find the full text of the Statement at [www.fdic.gov](http://www.fdic.gov).

If you would like further information, please contact the Ropes & Gray attorney who usually advises you.

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