

September 25, 2008

Federal Reserve Eases Rules on Equity Investments in Banks

On September 22, 2008, the Federal Reserve Board (the "Board") issued a new policy statement (the "Policy Statement") on equity investments in banks and bank holding companies. This Policy Statement will make it easier for private equity and hedge funds to invest in banks and bank holding companies while taking a more active role in management without becoming subject to the supervision, regulation, and other requirements of the Bank Holding Company Act ("BHC Act").

By way of background, for many years, nonbank financial companies, private equity funds, and other firms have sought to make equity investments in banks and bank holding companies. These investments often have raised concerns about the extent to which the investment would cause the investor to become a bank holding company if it did not agree to be bound by certain passivity commitments.

In general, the BHC Act applies to any company that controls a bank or bank holding company ("banking organization"). The BHC Act, which places severe restrictions upon the activities of bank holding companies, provides that a company has control over a banking organization if:

- (1) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the banking organization;
- (2) the company controls in any manner the election of a majority of the directors or trustees of the banking organization; or
- (3) the Board determines that the company directly or indirectly exercises a controlling influence over the management or policies of the banking organization.

In addition to the BHC Act definition of control, in many circumstances, the Board's Regulation Y, which implements the BHC Act, creates a presumption that a company that owns 10 percent or more of the voting stock of a banking organization controls the banking organization.

Minority investments in banking organizations have been designed to avoid either of the first two prongs of the BHC Act definition of control. These investments often raise questions, however, regarding whether the investor will be able to exercise a controlling influence over the management or policies of a banking organization under the third prong of the BHC.

In 1982, the Board issued a Policy Statement on Nonvoting Equity Investments by Bank Holding Companies (the "1982 Policy Statement") to provide guidance on the Board's interpretation of the "controlling influence" prong of the BHC. That

For more information, please
contact any of the individuals
listed below:

R. Scott Beach ^{CT}
rsbeach@daypitney.com
(203) 862 7824

Jeffrey A. Clopeck ^{MA}
jaclopeck@daypitney.com
(617) 345 4612

Ronald H. Janis ^{NJ, NY}
rjanis@daypitney.com
(212) 297 5813

David A. Sussman ^{NJ}
dsussman@daypitney.com
(973) 966 8251

Robert M. Taylor III ^{CT}
rmtaylor@daypitney.com
(860) 275 0368

statement outlined the policies that the Board would consider in reviewing whether a minority investment in a banking organization would result in the exercise by the investor of a controlling influence over the management or policies of the banking organization.

The 1982 Policy Statement identified a number of measures that the Board believed would be appropriate to limit the ability of an investor to exercise a controlling influence over a banking organization. These included restricting the use of covenants that limit the discretion of banking organization management, restricting the amount of voting and nonvoting shares of the banking organization that could be acquired by the investor, and limiting the ability of the investor to transfer large blocks of voting shares.

To satisfy the 1982 Policy Statement, investors have avoided acquiring control over a banking organization by, among other things:

- (1) restricting the size of their voting and nonvoting (total equity) investment in the banking organization;
- (2) avoiding covenants that would enable the investor to restrict the ability of the banking organization's management to determine the major policies and operations of the banking organization;
- (3) not attempting to influence the banking organization's process for making decisions about major policies and operations;
- (4) limiting director and officer interlocks with the banking organization; and
- (5) limiting business relationships between the investor and the banking organization.

The new Policy Statement reflects the Board's current and relaxed views on the issues of director representation, limits on the amount of nonvoting shares that can be held in combination with voting shares, and the scope of discussions that minority investors may have with management of a banking organization.

Director Representation. The Board generally has not permitted a company that acquires between 10 and 24.9 percent of the voting stock of a banking organization (a "minority investor") to have representation on the board of directors of the banking organization. The principal exception to this guideline has been in situations in which the investor owns less than 15 percent of the voting stock of the banking organization and another person (or group of persons acting together) owns a larger block of voting stock of the banking organization.

Under the new Policy Statement, a minority investor should be able to have a single representative on the board of directors of a banking organization without acquiring a controlling influence over the management or policies of the banking organization. Although having a representative on the board of the banking organization enhances the influence of a minority investor, the Board noted that its experience has shown that, in the absence of other indicia of control, it would be difficult for a minority investor with a single board seat to have a controlling influence over the management or policies of the banking organization.

The Policy Statement further provides that a minority investor with up to two representatives on the board of directors of a banking organization is unlikely, absent

other indicia of control, to be able to exercise a controlling influence over the banking organization when the investor's aggregate director representation is proportionate to its total interest in the banking organization but does not exceed 25 percent of the voting members of the board and another shareholder of the banking organization is a bank holding company that controls the banking organization.

Total Equity Investment. The BHC Act control test makes no explicit reference to nonvoting equity investments. Nevertheless, the Board long has subscribed to the view that the overall size of an equity investment, including both voting and nonvoting equity, is an important indicator of the degree of influence an investor may have. In the 1982 Policy Statement, the Board set forth a guideline that nonvoting equity investments that exceed 25 percent of the total equity of a banking organization generally raise control issues under the BHC Act.

In the new Policy Statement, the Board has indicated that it would not expect that a minority investor would have a controlling influence over a banking organization if the investor owns a combination of voting shares and nonvoting shares that, when aggregated, represents less than one-third of the total equity of the organization (and less than one-third of any class of voting securities, assuming conversion of all convertible nonvoting shares held by the investor) and does not allow the investor to own, hold, or vote 15 percent or more of any class of voting securities of the organization.

Conversations with Management. In the past, minority investors have agreed to a variety of passivity commitments so as not to attempt to influence the operations, management, or strategies of the banking organization in which they have invested.

In the new Policy Statement, the Board has indicated that a noncontrolling minority investor, like any other shareholder, generally should be able to communicate with banking organization management about, and advocate with banking organization management for changes in, any of the banking organization's policies and operations. For example, a minority investor may advocate for changes in the banking organization's dividend policy; discuss strategies for raising additional debt or equity financing; discuss whether the banking organization should enter into or avoid a new business line or divest a material subsidiary; or attempt to convince banking organization management to merge the banking organization with another firm or sell the banking organization to a potential acquirer.

Conclusion. In sum, the positions espoused in the new Policy Statement will make it easier for private equity and hedge funds to make significant investments in banks and bank holding companies and to have significant input into the general direction of the banking organization without becoming subject to the burdensome restrictions of the BHC Act.

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For more information about the Distressed Assets Practice Group, please contact co-chairs Robert G. Siegel and James J. Tancredi at rsiegel@daypitney.com and

jjtancredi@daypitney.com.

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