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Banking & Finance Law Alert

A Corporate Department Publication

October 2008

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Private Equity Investment in Banks

Federal Reserve Allows Larger Investments in Banks and Bank Holding Companies

A new Federal Reserve policy statement allows minority stakeholders in banks and bank holding companies to increase their investments without being subject to regulation under the Bank Holding Company Act of 1956 (the "BHC Act"). The new rules are intended to encourage private equity funds to invest in banking organizations at a time when many banks require additional capital. The new policy statement illustrates the Federal Reserve's desire to see private equity funds invest in banks sooner rather than later.

Federal Reserve Policy Statement

The BHC Act applies to any company that controls a bank or bank holding company. Minority investors in banking organizations commonly structure their investments to ensure that they do not obtain "control" of the banking organization, a status which triggers regulation under the BHC Act. "Control" is defined by the BHC Act to include the exercise of a controlling influence over the management or policies of the bank. The Federal Reserve's latest policy statement on this subject offers further guidance on what constitutes a "controlling influence." And the new relaxed standards it enunciates may pave the way for greater capital investments by entities such as hedge funds that had previously been reluctant to invest.

The new policy statement institutes the following important changes to allow a minority investor to avoid having a controlling influence:

- A minority investor is now permitted to have a representative on a banking organization's board of directors and may have two representatives if there are at least eight board members. There are limitations on the investor's representative serving as board chairman or on specific committees. Previously, an investor with 10 percent or more of the voting stock of a bank was not permitted to have representation on the board of directors unless it owned less than 15 percent of the voting stock and another investor owned a larger block.

- An investor does not have a controlling influence if it owns less than one-third of the total equity of the bank and less than 15 percent of any class of voting stock. Previously, equity investments could not exceed 25 percent of the total equity of the bank and the investor was required to own less than 10 percent of the voting stock.

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- A minority investor may now advocate a variety of positions, including changes in the bank's policies and operations, strategies for raising capital, new business lines, sales of subsidiaries and other assets, mergers, and changes in management, as long as the decision to act on such discussions remains with the shareholders as a group or the board of directors, as appropriate. Communications by minority shareholders should not contain threats to sell shares or to solicit proxies as a way of influencing management.
- Under the new policy statement, business relationships between minority investors and the bank may be allowed depending on the ownership percentage of the investor, and whether the business relationship is non-exclusive, on market terms, and terminable without penalty to the bank. Previously, a non-controlling minority investor in a banking organization could not have any material business transactions or relationships with the bank.
- The Federal Reserve continues to look unfavorably on contractual restrictions that inhibit a banking organization's ability to make decisions on hiring, firing, executive compensation, operations, raising capital, sales and acquisitions of major assets, and mergers and acquisitions. However, investment agreements that restrict issuing senior securities, borrowing on a senior basis, modifying the investor's security, or liquidating the bank are no longer discouraged.

At a time when banking organizations are seeking capital from all available sources, these changes could encourage much-needed investment by private equity funds.