WEIL GOTSHAL

Private Equity Alert

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Weil News

- Weil Gotshal advised Advent International in connection with its tender offer for women's retailer Charlotte Russe Holdings in a cash deal valued at $380 million
- Weil Gotshal advised eTelecare and its controlling stockholders, Providence Equity Partners and Ayala Corporation, in connection with the business combination of eTelecare with Stream Global Services
- Weil Gotshal advised Macquarie Group in connection with its $428 million acquisition of Delaware Investments, a diversified asset management firm
- Weil Gotshal advised CCMP Capital and Bancroft Private Equity in connection with the €250 million sale of Nowaco to Bidvest
- Weil Gotshal advised Change Capital Partners in connection with its acquisition of German fashion retail chain Hallhuber GmbH
- Weil Gotshal partner Mark Soundy was a consultant editor to, and Weil Gotshal partners Christopher Aidun, David Kreisler, Dominic McCahill and Mark Soundy were contributors to, the new book "A Practitioner's Guide to Private Equity" published by City & Financial Publishing

The FDIC Budges – A Little

By Walter E. Zalenski (walter.zalenski@weil.com)

The Federal Deposit Insurance Corporation ("FDIC") recently adopted a final policy statement establishing the conditions for private investors to acquire failed depository institutions from FDIC receiverships. When the FDIC issued a proposed version of the policy statement in July, we concluded that the proposal would stymie much needed capital flows to the banking sector from private equity investors. The FDIC's 30-day public comment period elicited similarly sharp critiques from various private equity sponsors and others. In adopting the final version of the policy statement, the FDIC dialed back some of the most burdensome requirements previously proposed, most notably by reducing the required capital requirements and abandoning source-of-strength obligations that would have required private equity investors to be an ongoing financial backstop for banks acquired from the FDIC. The FDIC also clarified a number of other issues in the proposal. Nevertheless, important impediments to private equity investment in failed depository institutions remain in the final policy statement.

Scope and Applicability

The policy statement applies prospectively to private investors in a company, including any company acquired to facilitate bidding on failed banks or thrifts, that is proposing to directly or indirectly assume deposit liabilities (or deposits along with related assets) from the resolution of a failed institution. The policy will not apply to private investors with 5% or less of the total voting power of an acquired institution or its holding company (assuming no evidence of concerted action among investors). In an attempt to foster partnerships between private equity and strategic investors, the policy does not apply to transactions where an established regulated depository institution holding company (excluding shell companies) will have a clear majority interest in the acquired depository institution.

While unlikely to be material, a private equity investor may apply to the FDIC to be excluded from the policy statement requirements after the acquired institution (or depository institution holding company) has maintained continuously for seven years a 1 or 2 CAMELS rating – a supervisory rating of an institution's overall condition, ranging from 1, the strongest rating, to 5, the weakest.

Qualification Standards

Capital. Rather than the initially proposed required maintenance of a 15% Tier 1 leverage ratio for the acquired institution, the FDIC reduced the capital requirement to a 10% common equity to total assets ratio. This ratio, which still exceeds otherwise applicable standards, must be maintained for three years. Thereafter, capital levels must be maintained at "well capitalized" levels. If capital dips below

these prescribed levels, the FDIC could avail itself of extraordinary remedial powers under the so-called "prompt corrective action" regime.

Source of Strength. As noted, the FDIC's original proposal suggested that covered investors would have a vague but potentially unlimited "source of strength" obligation to the acquired bank. Industry comments persuaded the FDIC to abandon this requirement in the final policy statement.

Cross Guarantees. As proposed, the policy statement required private investors that individually or collectively acquire a majority interest in two or more depository institutions to pledge their proportionate interests in each depository institution to repay the FDIC for any losses resulting from the failure of, or assistance provided to, any such controlled depository institution. This requirement, now referred to as a "cross support" obligation rather than a guarantee, was maintained in the final policy statement but limited to instances where two or more depository institutions are at least 80% controlled by the same investors. The FDIC can waive this requirement if enforcing the obligation would not reduce the cost of the resolution of the failed entity. This cross-support obligation is an analogue to current law where a cross-guarantee applies only to commonly controlled banks in a holding company structure. Under existing law, however, liability is assessed only against the non-failing banks themselves, not their owners.

Mandatory Holding Period. The FDIC retained in the final policy statement the proposal's mandatory three-year holding period. The policy statement provides, however, that the FDIC will not unreasonably withhold consent to the sale or transfer to an affiliate that agrees to be subject to the restrictions applicable to the original investor. The holding period will not apply to open-end registered mutual funds that issue securities redeemable by investors on demand.

Affiliate Transactions. Like the proposal, the policy statement prohibits extensions of credit or similar transactions by an acquired depository institution to investors, their investment funds, any affiliate of either ("affiliate" meaning any company in which an investor owns 10% or more of the company's equity for a period of at least 30 days). Preexisting extensions of credit are exempt from this prohibition. To ensure compliance, a covered investor is required to provide the depository institution regular reports identifying all of its affiliates.

The final FDIC policy statement retains important impediments to private equity investment in failed depository institutions.

Secrecy Law Jurisdictions. The FDIC also retained the proposal's rule that private investors with ownership structures domiciled in "secrecy law jurisdictions" are not eligible to acquire failed depository institutions. The agency added a broad definition of "secrecy law jurisdiction", but not in a way that affords certainty about how specific jurisdictions will be treated. A secrecy law jurisdiction is "a country that applies bank secrecy law that limits US bank regulators from determining compliance with US laws or prevents them from obtaining information on the competence, experience and financial condition of applicants and related parties, lacks authorization for exchange of information with US regulatory authorities, does not provide for a minimum standard of transparency for financial activities, or permits off shore companies to operate shell companies without substantial activities within the host country." The FDIC failed to provide a listing or any examples of such jurisdictions. Although almost certainly not relevant for a private equity investor, this prohibition could be avoided altogether if the investor is a subsidiary of a company that is otherwise subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board and consents to the jurisdiction of US, the applicability of US banking law, disclosure of information that might otherwise be covered by foreign confidentiality or privacy laws, and similar requirements.

Other Limitations. A private investor that directly or indirectly holds 10% or more of the equity of a bank or thrift in receivership would be disqualified as a bidder to become an investor in the deposit liabilities (or both deposit liabilities and related assets) of that failed institution. Also, so-called "silo" and similar organizational arrangements would be ineligible as bidders to the extent the FDIC view them as "complex and functionally opaque ownership structures in which the beneficial ownership is difficult to ascertain with certainty, the responsible parties for making decisions are not clearly identified, and ownership and control are separated." The proscribed structures also are "typified by organizational arrangements involving a single private equity fund that seeks to acquire ownership of a depository institution through creation of multiple investment vehicles, funded and apparently controlled by the parent fund."

Disclosure. The original proposal's requirements for private investor disclosure were retained in the final policy statement, with the addition of the agency's assurance that it will not publicly disclose confidential business information. Private investors would be expected to disclose to the FDIC information about themselves and all entities in the chain of ownership,

including such information as size of fund, its diversification, the return profile, marketing documents, the management team, business model and any other information the FDIC deems necessary.

* * *

In adopting the policy statement, the FDIC stated that it was mindful of the role private equity capital could beneficially play in adding capital to the banking system "provided this contribution is consistent with basic concepts applicable to the ownership of insured depository institutions that are contained in the established banking laws and regulations." Unfortunately, the agency proceeded to adopt guidelines that in many respects go well beyond existing banking laws and regulations. Even if the FDIC has managed to avoid scaring off private equity investors altogether, the policy statement no doubt will materially impact the amounts such investors are willing to bid for failed depository institutions.

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