POCKET GUIDE TO

EQUITY INVESTMENTS and CONTROLLING ACQUISITIONS involving US FINANCIAL INSTITUTIONS

By Thomas P. Vartanian, David L. Ansell, Robert H. Ledig, Mark Fajfar and Dominic A. Labitzky

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1. INTRODUCTION

Welcome to the new world of bank acquisitions for 2007! Recent transactions, including the acquisitions or proposed acquisitions of (i) 26.58% of HSH Nordbank, AG, by a number of private equity investors led by the J.C. Flowers Fund; (ii) 51% of GMAC by Cerberus; (iii) First Data Corp. by KKR; and (iv) 90% of Doral Financial Corp. by a consortium of private investors led by Bear Stearns Merchant Bank, have highlighted both the interest of investors and the spectrum of structures that are available with respect to the acquisition of regulated financial institutions by private equity investors and funds. *See* Vartanian and Ansell, "Control Issues: When Did Our Fund Suddenly Become a Bank Holding Company?," *The Deal* (April 16, 2007). In short, investments, acquisitions and transactions in the regulated financial services industry that never would have been thought to be doable by private equity investors are occurring now with some frequency. We leave for another day an analysis of why these transactions are occurring and will focus solely on the creative ways that they can be done.

Investing in, and/or potentially "controlling" a federally regulated commercial bank, thrift institution, either directly or through a company that *controls* a bank or thrift institution can be an attractive but daunting process. "Control" in the banking world can be triggered at 10% of a class of a company's voting stock, and many private or corporate investors cannot control a bank or thrift because of the restrictions that federal banking rules impose on the activities and capital, among other things, of such companies. Moreover, U.S. banking laws and regulations require persons seeking to acquire control to obtain regulatory approval *before* acquiring the stock. In the capital markets, where the passage of time can determine whether a transaction works, prior approval is a distinct disadvantage.

Private equity investors, hedge funds and commercial entities generally can invest in banks or thrifts in an amount that would otherwise trigger control by employing creative "dispersed control" structures that avoid the pitfalls that federal bank regulations create. This Pocket Guide will step through those intricacies to simplify current concepts of bank "control."

A list of the various articles that the authors have published on the topic are set forth at Appendix A.

1.1. What is Control?

In the banking world, concepts of control often have little to do with the ability to exercise *actual* control over an institution. Control (indirect as it may be) can arise, for example, by virtue of an investment in 10% or more of a class of voting securities of a company that owns 35% of another company, which, in turn, owns more than 25% of a bank or thrift institution.

The four A's of stock ownership, "**Aggregation**," "**Attribution**," "**Acting in Concert**" and "**Affiliation**," are critical components when evaluating the existence of "control" and the ways that the chain of control can be broken for federal bank regulatory purposes.

1.2. Why is Control a Bigger Issue Today?

As commercial entities and banking institutions have been permitted to affiliate, merge and acquire different types of banks, it is not always clear at first blush what companies are subject to federal bank control restrictions. For example, would the typical capital markets investor assume that the acquisition of stock in General Motors is subject to federal banking law? At the same time, events that have recharged the merger and acquisition ("M&A") markets have created a new generation of bank and thrift control issues for a wide variety of investors, funds and even banks and thrifts themselves.

Unlike prior M&A and investment binges that the country has experienced, the 2007 acquisition environment is not so dominated by companies buying companies, or banks buying banks. Today, private capital, hedge funds and other private sources of equity or merchant banks are increasingly investing in or acquiring public and private companies. The interesting and novel aspect of all this is how often this trend is now bumping up against federal and state banking laws because of the wide variety of industrial and financial organizations that have come to own banks or thrifts through one of the many loopholes that have existed for various periods of time over the last 40 years. The continued blending of commerce and banking, nominally recognized by the enactment of the Gramm-Leach-Bliley Act ("GLB Act") in 1999, has inadvertently thrown banking laws in front of the oncoming acquisition train.

Data released by the Congressional Budget Office in 2006 suggests that the tax cuts of 2003 unexpectedly created $133 billion in revenue for the government and that lower capital gains taxes gave stockholders a greater incentive to sell their shares and then reinvest the proceeds. Thus, as the National Venture Capital Association has reported, venture capitalists invested $25.6 billion in 2006. At the same time, the value of global M&A transactions set records in 2006, with the worldwide value of leveraged buy-outs ("LBOs") rising 156% to $693.5 billion. Reuters Loan Pricing Corp. reports that a record $612 billion of leveraged buyout loans were issued last year.

Financial institutions are participating in this new acquisition market in a number of different roles: (i) as lenders; (ii) as equity investors; and (iii) as targets. Indeed, some transactions have actually put some financial institutions in the unique position of being the lender, investor and target—all at the same time! These multiple roles raise issues regarding

compliance with bank and thrift investment, affiliate transactions and holding company rules, particularly for private investors and equity funds involved in these transactions. The recent trend of broker-dealers, substantial players in this new market, to form or acquire insured financial depository institutions, complicates this picture because they and those who invest in them are now also subject to these banking rules. In addition, the acquisitions of industrial loan companies ("ILCs") in states such as Utah by investment bankers, broker-dealers, car manufacturers and other non-bank financial companies has provided another level of regulatory complexity.

Most non-banks do not want to or cannot control a bank or thrift institution since such control may make them regulated holding companies. Many non-banking companies do own, however, ILCs, trust banks, credit card banks, savings institutions and other institutions that do not qualify as banks for the purposes of the Bank Holding Company Act ("BHCA").

1.3. What Accompanies Control?

Control of a bank or a post-1999 savings institution, if it results in the investor becoming a holding company, may mean: (i) a limitation on the activities in which the controlling party can engage; (ii) restrictions on the investments that they can make; (iii) a requirement to provide financial support to the bank or savings institution subsidiary; and (iv) becoming subject to bank regulatory examination, supervision and enforcement processes.

How control is defined by bank federal regulators—the Federal Reserve Board ("FRB"), Office of the Comptroller of the Currency ("OCC"), Federal Deposit Insurance Corporation ("FDIC") and Office of Thrift Supervision ("OTS")—and how the rules are applied in the context of various corporate transactions is also a moving target. Concepts of control—

and, therefore, when an entity may have to file to avoid it or qualify for holding company status—vary amongst the different federal banking agencies based on whether they regulate banks, savings institutions or their holding companies. Thus, an investor that acquires 12% of the voting stock of a savings and loan holding company ("SLHC") may not be viewed as a controlling investor by the OTS, whereas that same investment in a bank holding company ("BHC") may be viewed as a controlling investment by the FRB, necessitating prior regulatory approval. Control rules at the state level might also enter the equation if the holding company owns a state chartered bank or trust company. For example, a state like Massachusetts raises particularly noteworthy issues because it mandates that an entity that controls a Massachusetts bank becomes a bank holding company for purposes of that state's law if it also controls more than 25% of the voting stock of another bank located anywhere else in the world.

So, the first steps in any analysis is understanding (i) if there is a financial institution anywhere in the corporate family that is targeted for investment or acquisition, (ii) who regulates it, and (iii) what rules apply. Complicating matters even further, it is no longer always readily apparent from a company's name whether it controls a regulated financial institution and is subject to bank or thrift acquisition control rules. For example, many insurance companies, commercial companies and Wall Street firms that are household names are also savings and loan holding companies subject to OTS control rules. A partial listing of the diverse companies that are currently SLHCs—which includes companies that control limited purpose thrift institutions that engage solely in the trust business—is set forth at Appendix B. Some commercial and financial companies also own specialized banks, such as state-chartered ILCs and state or federal trust or credit card banks. A listing of some of the companies that currently own ILCs is set forth at

Appendix C. As a result, often unbeknownst to an investor, the acquisition of as little as 5% of the stock of the parent of such a specialized bank may trigger state or federal change in control requirements.

1.4. The Goal of the Pocket Guide

While federal bank and thrift acquisition control rules have been around for decades, the recent increase in private equity, hedge fund and other strategic investors has placed a renewed spotlight on these rules and how they might affect an entity's investment strategy in the financial services sector. The breadth and significance of control issues are not always readily apparent and will often depend on the particular facts and circumstances.

The purpose of this Pocket Guide is to provide a general perspective to equity investors, hedge funds, broker-dealers and financial institutions regarding the interplay between the investment, control, affiliate and acquisition rules of the various regulatory agencies, and how these control rules might be applied in the context of various investment and acquisition scenarios.