The Deal

REPRINT FROM APRIL 16, 2007 P. 37

CONTROL ISSUES

WHEN DID OUR FUND SUDDENLY BECOME A BANK HOLDING COMPANY

BY THOMAS VARTANIAN AND DAVID ANSELL

THE QUIET CONFLUENCE OF SEVeral unconnected events are altering acquisition markets. Unlike prior M&A binges, this one is marked not by companies buying companies but by private equity and hedge fund acquisitions.

The Congressional Budget Office confirms that the tax cuts of 2003 have unexpectedly created $133 billion in revenue for the government. Global M&A transactions set records last year, with the worldwide value of LBOs rising 156%, to $693.5 billion.

Regulated financial institutions are participating in this new acquisition market as lenders, equity investors and targets. Some transactions may actually put financial institutions in the unique position of being the lender, investor and target in the same deal.

Assume that Equity Fund A never intended to go into the business of controlling banks. But it purchases 9.9% of a manufacturing company (XYZ), which owns 100% of an industrial loan company (ILC) in State Q, and a grandfathered federal savings bank (FSB) regulated by the Office of Thrift Supervision (OTS).

Since Fund A's ownership of the parent company is equated under federal banking laws with ownership of its subsidiaries, Fund A needs prior approval under federal-change-in-bank-control or holding company laws to pass the 9.9% threshold of voting common, even if it has no interest in controlling anything other than the parent's manufacturing business.

This is a type of poison pill for those companies that acquired thrift institutions prior to 1999, when the Gramm-Leach-Bliley Act, or GLB Act, prohibited such acquisitions. The only real option available to Fund A is to file a rebuttal of control with the regulators and become a passive investor. But Fund A would already have a problem if State Q's change-in-control requirements were triggered at any point lower than the 10% federal level. In that case, Fund A would either have to sell down below State Q's trigger or satisfy state banking control requirements.

If a regulated bank or savings and loan holding company invested in Fund A's investment entity and is also financing the XYZ acquisition through its bank or thrift subsidiary, it must be aware of the extent to which it may be deemed to "control" Fund A, or an entity controlled by Fund A. If the holding company invests 25% or more of Fund A's limited partnership interests, it will, for banking purposes, control Fund A. Under these circumstances, Fund A's 9.9% investment in XYZ company (which controls an ILC and an FSB in our example) would be attributed to the holding company, which could result in the holding company being in violation of other federal restrictions that are tripped at the 5% level, such as the ownership of companies engaged in nonbanking activities. A target investment of a downstream fund that the holding company is deemed to control could actually be the holding company itself.

The holding company must also be cognizant of any investments in XYZ made by any of its affiliates: parties it may be acting in concert with, or partnerships or LLCs in which it may act as a general partner. In those cases, the shares controlled by those other parties are aggregated with those owned by the holding company for purposes of determining whether any of the applicable control thresholds have been triggered.

If the holding company is a GLB Act "financial holding company," its investment in XYZ may qualify as a merchant banking investment, enabling the holding company to own up to 100% of XYZ, notwithstanding the nonfinancial nature of its activities. Even so, state and federal change-in-control rules would continue to be applicable to the underlying ILC and FSB subsidiaries.

To the extent that the holding company's subsidiary bank is financing some aspect of the transaction, it will be subject to a variety of affiliate lending restrictions, which may conflict with its ability to be an investor in the deal.

Finally, since it is not readily apparent from a company's name whether it controls a regulated financial institution or holding company, it is important that investors undertake a careful analysis under federal and state banking laws of all investments before they are made. ■

Thomas Vartanian and David Ansell are partners in the Washington office of Fried, Frank, Harris, Shriver & Jacobson LLP and specialize in bank control investments and acquisitions.



AS FEATURED IN The Deal

WWW.THEDEAL.COM

THE DEAL (ISSN 1541-9878) IS PUBLISHED WEEKLY EXCEPT BIWEEKLY IN JANUARY, JULY, AUGUST AND DECEMBER BY THE DEAL LLC.
©2006 THE DEAL LLC. THE COPYRIGHT ACT OF 1976 PROHIBITS THE REPRODUCTION BY ANY MEANS OF ANY PORTION OF THIS PUBLICATION EXCEPT WITH THE PERMISSION OF THE PUBLISHER.