

Client Alert

Corporate Department

September 29, 2008

Federal Reserve Issues Policy Statement Relaxing Longstanding Rules Regarding Minority Shareholder Investments in Banks

Permits a Minority Investor to Have a Single Representative on the Board of Directors of a Banking Organization

On September 22, 2008, the Federal Reserve Board (the “Board”) announced the approval of a policy statement on equity investments in banks and bank holding companies. The policy statement provides additional guidance on the Board’s position on minority equity investments in banks and bank holding companies that generally do not constitute “control” for purposes of the Bank Holding Company Act (the “BHCA”). This move by the Board in response to the current financial crisis is ostensibly aimed at attracting capital to the banking sector in the wake of the current financial crisis.

Historically, financial investors, including private equity firms and hedge funds, have largely steered clear of acquiring sizable minority stakes in banking organizations since any investor that is deemed by the Board to “exercise a controlling influence” over a banking organization would fall under the BHCA’s definition of a “bank holding company.” Bank holding companies are subject to a wide swath of cumbersome investment restrictions and regulations under the BHCA. For example, the BHCA restricts bank holding companies from engaging in non-financial activities, including, subject to certain exceptions, (i) owning or holding investment real estate, (ii) dealing in or underwriting securities and (iii) acquiring more than 5% of the voting securities or 25% or more of the total equity of non-financial companies without the Board’s approval. Such restrictions are generally unpalatable and problematic for private equity firms and hedge funds, which both require flexibility in terms of their investments in portfolio companies across various business sectors.

Under the BHCA, a company is deemed to have control over a banking organization if (i) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25% or more of any class of voting securities of the banking organization; (ii) the company controls in any manner the election of a majority of the directors or trustees of the banking organization; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the banking organization. Generally, minority equity investments in banking organizations are designed not to trigger either of the first two prongs of this definition of control.

In determining whether a minority investor has a controlling influence over the management or policies of a banking organization, the Board will look at the facts and circumstances surrounding the investment, as well as the investor’s relationship with the banking organization. The Board’s policy statement updates its guidance to provide greater clarity and certainty to investors who wish to acquire minority stakes in banking organizations, but who wish to avoid the harsh restrictions of the BHCA.

The Board’s changes and clarifications relate to four principal areas:

- Director representation;
- Total equity ceilings;

- Communications with management; and
- Business relationships and veto rights.

1. Director Representation

Until now, the Board has generally not allowed an investor that acquires between 10% and 24.9% of the voting stock of a banking organization to have representation on the board of directors without being deemed to exercise a controlling influence over the banking organization.¹

The Board has revised its position and currently believes that:

- A minority investor generally should be able to have a single representative on the board of directors of a banking organization without acquiring a controlling influence; and
- A minority investor that has up to two representatives on the board of directors is unlikely, absent other indicia of control, to exercise a controlling influence when the investor's aggregate director representation is proportionate to its total interest in the bank, but does not exceed 25% of the voting members of the board, and another shareholder is a bank holding company that controls the banking organization under the BHCA.²

While the Board continues to believe that a representative of a minority investor should not serve as the chairman of the board or as the chairman of any committees of the board, the Board believes that representatives of minority investors may serve as members of committees of the board when those representatives do not occupy more than 25% of the seats on the committee and do not have the practical ability or authority to unilaterally make decisions that bind the board or management.

2. Total Equity Ceilings

Under previous guidance, nonvoting equity investments exceeding 25% of the total equity of a banking organization would generally raise control issues under the BHCA. The new guidance provides that a minority investor would not be expected to have a controlling influence if the investor owns a combination of voting 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% or more of any class of voting securities of the organization.³

¹ One exception to this general rule has been if the investor owns less than 15% of the voting stock and another person, or group of persons, owns a larger block of voting stock.

² For example, an investor with a 10% voting interest and a 20% total equity interest generally could have two representatives on the board of directors of the banking organization if the investor's director representation does not exceed 20% of the board seats. On the other hand, an investor with a 15% voting interest and a one-third total equity interest generally could have two representatives on the board of directors of the banking organization if the investor's director representation does not exceed 25% (rather than one-third) of the board seats.

³ Nonvoting shares that may be converted into voting shares at the election of the holder of the shares, or that mandatorily convert after the passage of time, should be considered voting shares at all times for purposes of the BHCA. However, the Board has recognized in previous cases that nonvoting shares that are convertible into voting shares carry less influence when the nonvoting shares may not be converted into voting shares in the hands of the investor and may only be transferred by the investor subject to certain limitations.

3. Communications with management

The new Board guidance also clarifies that a minority investor may, directly or through a board representative, communicate with management about, and advocate for changes in, the banking organization's policies and operations, including:

- Changes in the dividend policy;
- Strategies for raising additional debt or equity financing;
- Ideas about avoiding a new business line or the divestiture of a material subsidiary;
- Reasons management should consider merging with another firm or selling to a potential acquirer; or
- Changes in management and recommendations for new or alternative management.

However, communications by minority investors should not be accompanied by explicit or implicit threats to dispose of shares in the banking organization or to sponsor a proxy solicitation. The guidance also suggests that a minority investor should limit its role in any such decision to adopt a particular position or take a certain action to voting its shares in its discretion at a shareholder meeting.

4. Business relationships and veto rights

While the Board has traditionally prohibited a non-controlling minority investor from having any material business transactions or relationships with the banking organization, the Board has allowed minority investors to have "quantitatively limited and qualitatively nonmaterial" business relationships with the banking organization in which they have invested. The new guidance reiterates that such business relationships should remain limited and will continue to be reviewed on a case-by-case basis, with particular attention being paid to: (i) the size of the proposed business relationships and (ii) whether they would be on market terms, non-exclusive and terminable without penalty by the banking organization.

The Board also reiterated its position that minority investors will not be permitted to have any meaningful veto rights to protect the value of their investments, without being deemed to control the banking organization. The Board reaffirmed its view that minority investors may have veto rights, subject to safety and soundness concerns, over very limited matters such as issuing senior securities or borrowing on a senior basis, modifying the terms of the minority investor's security, or liquidating the banking organization. Minority investors may also be granted limited financial information rights and limited consultation rights.

Do the Board's Liberalized Rules Open the Door for a Softer, Non-Hostile Form of Activist Investing in the Banking Sector?

The Board's relaxed rules were designed to spur private equity and hedge fund investment in undercapitalized and distressed bank organizations. The new rules appear to have swung the door open just far enough for activist investors to acquire positions in undervalued banking organizations and "softly" agitate for certain types of change. It appears that investors may now pursue certain, limited traditional activist tactics if done in a non-threatening manner and in accordance with the Board's guidance. For example, the Board's guidance suggests that an investor may, among other things, seek minority board representation on a banking organization's board of directors and communicate with management regarding certain ideas and plans for maximizing shareholder value. However, the Board indicated that it intends to carefully monitor the situation, and it is unknown how the Board will respond to

forms of traditional activist investing in banking organizations. Prior to making any significant investment in a bank holding company or other entity subject to the BHCA, we advise you to discuss the potential ramifications with your Olshan Grundman Frome Rosenzweig & Wolosky LLP contact.

If you have questions or would like to discuss the contents of this alert, please contact us or your regular Olshan Grundman Frome Rosenzweig & Wolosky LLP contact.

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