February 1, 1983

To Our Clients:

Bank Takeovers: An Update

The latter half of 1982 witnessed relatively few transactions involving substantial equity investments by bank holding companies in out-of-state banks or bank holding companies. The Federal Reserve Board's Statement of Policy on Non-voting Equity Investments by Bank Holding Companies, issued in July 1982 (see our memorandum dated July 9, 1982), made clear that any such investment, if it were to comply with the provisions of the Bank Holding Company Act and Regulation Y, could only be made on terms that significantly restricted the extent to which the acquiror could directly or indirectly control the acquiree and thus protect its investment pending the legalization of interstate bank acquisitions. The Policy Statement, combined with the disinterest on the part of Congress in considering legislation to amend or repeal the Douglas Amendment (Section 3(d) of the Holding Company Act), thus made this kind of non-voting equity investment considerably less attractive, especially if the acquiree was financially troubled.

Congress, the various federal regulatory and supervisory agencies and the banking and financial services industry continue to direct their collective attention to functional and structural changes that do not involve direct relaxation of the current geographical restrictions on commercial banking in the United States, i.e., those restrictions embodied in the McFadden Act and the Douglas Amendment. However, while there is every reason to believe that this situation will continue for the immediate future, there have been several recent developments in the area of interstate bank acquisitions that are worthy of mention.

A. Non-voting equity investments.

United Midwest Bancshares, Inc./Southern Ohio Bank. On November 29, 1982, the Federal Reserve Board issued a decision approving a restructured proposal by United Midwest Bancshares, Inc. to form a bank holding company by acquiring Southern Ohio Bank. The Board had denied an earlier application on October 14, 1982. The transaction did not have an interstate element; however, the decision is of some interest insofar as it elaborates, in somewhat unusual circumstances,

on the Policy Statement and the concept of "controlling influence" that is central to the operation of the Holding Company Act. The first application had been rejected on financial grounds and because of the large proportion (67%) of United Midwest's total equity that would be owned by Baldwin-United Corporation. The total purchase price for Southern Ohio of $30 million was to be provided by $15 million in bank borrowings, $5 million from the sale of United Midwest's common stock, and $10 million from the sale of United Midwest's non-voting preferred stock to Baldwin-United. Baldwin-United, if it were deemed a bank holding company by virtue of its ability to exercise a controlling influence over United Midwest through its ownership of United Midwest's preferred, would have been in violation of Section 4(a)(2) of the Holding Company Act inasmuch as it was engaged in impermissible non-banking activities. The Board found that, in light of the Policy Statement (which was regarded as relevant to situations where non-banking companies seek to invest in banks or bank holding companies), Baldwin-United had both the incentive and ability to exercise a "controlling influence" over United Midwest within the meaning of the Act. This finding was based on the following factors:

(i) the preferred stock investment represented 67% of United Midwest's total equity, a percentage well above the 25% set forth in the Policy Statement;

(ii) Baldwin-United's investment, through the structure of United Midwest's capitalization and by contract, carried a number of rights that were otherwise available only through the ownership of voting shares; and

(iii) the general "economic leverage" which Baldwin-United would have held as a result of projected arrearages of preferred stock dividends.

Under the restructured proposal, Baldwin-United's investment was reduced to 19% ($4 million) from 67%, the proportion of United Midwest's capital represented by common stock was increased from $5 million to $17 million and bank borrowings were decreased by one-half. Interestingly, most of the additional common was to be purchased by four companies which would obtain funds by selling non-voting preferred stock to Baldwin-United. The Board dismissed the contention that Baldwin-United was doing indirectly what it could not do directly and that its investment in the four companies should

be aggregated with its investment in United Midwest: its equity investment in each of the four companies was relatively low; there was no evidence that any of them were acting at Baldwin-United's behest or were otherwise controlled by it, nor were there any agreements or understandings between any of the companies and Baldwin-United as to the voting or disposition of the companies' shares in United Midwest; and dividends on the preferred stock issued by the companies were not linked to United Midwest's earnings.* In addition to reducing Baldwin-United's investment in United Midwest, the parties also modified or eliminated various aspects of the first transaction that the Board had found objectionable, such as Baldwin-United's influence over the disposition of control of United Midwest and its right to limit management's ability to issue additional equity capital and pay common stock dividends.

First National Boston Corporation/Colonial Bancorp. FNBC's $25 million investment in Colonial Bancorp (Connecticut) was approved in principle by the Board on December 16, 1982 and to our knowledge is the first major interstate investment approved by the Board since the issuance of the Policy Statement. The decision is significant inasmuch as FNBC's investment represents approximately 35% of the total equity of Colonial Bancorp, a percentage well above the 25% set forth in the Policy Statement. The investment comprises common stock (4.99%) and non-voting Series A Cumulative Perpetual Preferred Stock with detachable warrants to purchase a further 20% of the common stock. As usual, the warrants become exercisable only in the event that interstate banking becomes permissible. In the Board's view, a number of aspects of the transaction obviated the control problem. These included:

(i) the warrants are transferable only in a widely dispersed public offering and are subject to Colonial's right of first refusal;

(ii) although Colonial is restricted in its ability to pay dividends, it has the right to call

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* The Board did not view Baldwin-United's investment in each of the four companies as providing the "formalized structure" or common control that would make the four an association or company under the Holding Company Act. For a discussion of a recent decision of the Board holding that certain formal arrangements between a group of investors in Southeast Banking Corporation caused the group to be a company for the purposes of the Act, see our memorandum dated September 15, 1982.

the preferred and thus be released from the restriction;

(iii) there are no restrictions on the banking or permissible non-banking activities of Colonial; and

(iv) there is no restriction on Colonial's ability to make acquisitions.

B. State legislation. Section 3(d) of the Holding Company Act provides an exception to the prohibition on interstate acquisitions if the acquisition "is specifically authorized by the statute laws of the state in which [the acquired] bank is located." Until recently, only a small number of states (Alaska, Delaware, Iowa, Maine, New York and South Dakota) have legislated, to varying extents, to permit interstate acquisitions of domestic banks. Of these states, only Maine and New York have "reciprocity" legislation, i.e., legislation which permits acquisitions by out-of-state banks or bank holding companies provided the state in which the acquiror is incorporated or conducts its principal business has similar legislation. Alaska has no reciprocity requirement. Delaware, Iowa and South Dakota have no such requirement but place significant restrictions on interstate acquisitions.

Massachusetts has now added itself to the list by enacting legislation which permits, among other things,* an out-of-state bank or bank holding company, having its principal place of business in any of the five other New England states, to merge with or acquire Massachusetts banks, provided the laws of the state in which the acquiror has its principal place of business permit acquisitions by Massachusetts banks "under conditions no more restrictive than those imposed by [the Massachusetts law]." As indicated above, Maine is the only other New England state which has to date enacted interstate banking legislation, although Connecticut's legislature is currently considering such legislation. The First National Boston/Colonial Bancorp transaction was no doubt entered into with the enactment of such legislation in mind.

The regional nature of the Massachusetts legislation is made clear by a prohibition against a bank or bank holding company in a state outside New England acquiring a bank in Massachusetts by first acquiring a bank in another

* The Act also permits branching in Massachusetts by out-of-state banks on the same basis as acquisitions are permitted.

New England state: the definition of "out-of-state bank" excludes an entity which is controlled by a bank holding company with its principal place of business in any state other than Massachusetts or the other New England states. Views may differ as to whether the Act would survive constitutional challenge -- a not improbable event. However, regardless of whether such a challenge is made (or if made, whether it is successful), it seems unlikely that Congress will stand by and permit the states to fashion a regional solution to the problem of interstate banking. At the very least, therefore, the Massachusetts legislation may provoke Congress to give more urgent consideration to the question than might otherwise have been the case.

C. Related developments. As indicated above, the primary focus of attention in the banking and financial services industry has been directed to changes occurring outside the area of interstate banking. Two such areas in which developments have occurred are worth mentioning as having a direct impact on bank acquisitions generally.

Nonbank banks. The definition of a "bank" under Section 2(c) of the Bank Holding Company Act continues to occupy the attention of the Federal Reserve Board. For purposes of the Act, a "bank" is defined as an institution that "(1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans." On a number of occasions both non-banking companies and bank holding companies have avoided the provisions of the Holding Company Act by divesting commercial loan portfolios of acquired companies chartered as banks and/or by appropriately limiting the lending or deposit-taking activities of such companies. Recently, however, the Board has indicated a more expansive view of both parts of the definition of a "bank." First, in connection with the acquisition by Dreyfus Corporation of Lincoln State Bank, the Board has reiterated its view that a "commercial loan" is "any loan other than a loan the proceeds of which are used to acquire property or services used by the borrower for personal, family, household or charitable purposes." In a letter to the Federal Deposit Insurance Corporation dated December 10, 1982 regarding the Dreyfus acquisition, the Board stated that:

> [t]his definition of commercial loan is broad in scope and includes the purchase of such instruments as commercial paper, bankers' acceptances, and certificates of deposit, the extension of broker call loans, the sale of federal funds, the

deposit of interest bearing funds and similar lending vehicles.

The Board has also held, in recent rulings, that certain types of accounts offered by S&L's, including NOW accounts and sweep arrangements with transactional capabilities, are within the definition of "demand deposits." According to the Dreyfus letter quoted above, the Board views with considerable concern the efforts by non-banking organizations to evade the Holding Company Act by artificially limiting the activities of their banking subsidiaries and has indicated that it will request Congress to review the definition of a "bank" under the Act. The FDIC has strongly protested the Board's definition of a commercial loan, and has stated that it intends to request from Congress a "broad-based . . . review of the activities in which banks, thrifts and their holding companies or affiliates should be permitted to engage." It should be noted that Section 333 of the Garn-St. Germain Act specifically excludes from the definition of "bank" under the Holding Company Act an institution the accounts of which are insured by the Federal Savings and Loan Insurance Corporation or an institution chartered by the Federal Home Loan Bank Board.

Antitrust. The expansion of the powers of thrift institutions resulting from the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Act have made it increasingly difficult to characterize commercial banking as a distinct line of commerce for antitrust purposes. This possibility was recognized by the Supreme Court in U.S. v. Connecticut National Bank, 418 U.S. 656 (1974) when it stated that "[a]t some stage of the development of savings banks it will be unrealistic to distinguish them from commercial banks for purposes of the Clayton Act" (at p. 666). The decisions of the Comptroller of the Currency in November 1982 approving the application to merge United Kentucky Bank with Liberty National Bank & Trust Company and in December 1982 approving (with certain reservations on the part of the Justice Department and the Federal Reserve Board*) the merger of the Connecticut Bank and Trust Company with The State National Bank of Connecticut indicate general recognition by one of the bank regulatory agencies of the competitive effects of expanded thrift powers. The

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* To allay the concerns of the Justice Department with respect to competition in the relevant commercial loan market, CBT amended its application by committing to make certain divestitures.

Justice Department and the Federal Reserve Board have also recognized the effect on competition of expanded thrift powers, but have to date tended to follow a more conservative approach. For instance, with regard to the application to merge First Bancorp of N.H., Inc. with The Bedford Bank (New Hampshire) in November 1982, the Board recognized the competitive influence exerted by thrifts as depository institutions and, by including in the relevant line of commerce a percentage of deposits held by thrifts, was able to approve an acquisition it would apparently have otherwise denied. However, the Board did not go so far as to conclude that New Hampshire thrift institutions had developed their commercial banking services to the point where they could be considered as fully competitive with commercial banks. A similar approach was taken by the Justice Department in the CBT merger mentioned above.

Martin Lipton
David G. McDonald