



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SCOTT G. ALVAREZ
GENERAL COUNSEL

August 24, 2005

[REDACTED]

Dear Mr. [REDACTED]

This is in response to the request by [REDACTED] for Board staff's views regarding whether investors in voting preferred shares ("Preferred Shares") to be issued by [REDACTED] Holding, Inc. ("[REDACTED] Holding"), currently an indirect wholly owned subsidiary of [REDACTED] would be deemed to control [REDACTED] Holding for purposes of the Bank Holding Company Act ("BHC Act"). [REDACTED] proposes that [REDACTED] Holding would control several subsidiaries, including [REDACTED] a domestic company that [REDACTED] intends to convert to an agreement corporation under section 25 of the Federal Reserve Act (12 U.S.C. § 601). [REDACTED] has also requested staff's views regarding whether an investment in the Preferred Shares would be deemed an investment in the stock of an agreement corporation under section 25A of the Federal Reserve Act (12 U.S.C. § 618).

Factual Background

We understand that [REDACTED] proposal has several components. In summary, [REDACTED] intends to deconsolidate certain domestic and foreign subsidiaries from its consolidated tax group for federal income tax purposes. [REDACTED] currently holds four of the subsidiaries it intends to deconsolidate [REDACTED] through an Edge corporation subsidiary of [REDACTED] Holding. [REDACTED] proposes to dissolve the Edge corporation, to convert [REDACTED] to an agreement corporation, and to transfer the three foreign subsidiaries to [REDACTED] after it has become an agreement corporation.

You have stated that [redacted] would be able to deconsolidate the subsidiaries for federal income tax purposes if one or more third-party investors were to acquire more than 20 percent of the voting stock of [redacted] Holding. To effect the deconsolidation, [redacted] intends to sell Preferred Shares of [redacted] Holding to three investors (the "Preferred Shareholders"):

[redacted] You have indicated that [redacted] would each purchase [redacted] of the Preferred Shares (representing 1.6 percent of [redacted] Holding's total equity and 9.55 percent of the total voting power of [redacted] Holding's shareholders) and [redacted] would purchase [redacted] of the Preferred Shares (representing 0.8 percent of [redacted] Holding's total equity and 4.9 percent of the total voting power of [redacted] Holding's shareholders).

Under the proposal, the holders of the common shares and Preferred Shares of [redacted] Holding would vote together as a single class in most instances. Accordingly, the holder of the common stock [redacted] would be entitled to cast 76 percent of the vote, and the Preferred Shareholders collectively would be entitled to cast 24 percent of the vote, at a meeting of the shareholders of [redacted] Holding. [redacted] Holding would not be able to take the following actions, however, without the consent of at least 85 percent of the Preferred Shares voting as a separate class: (i) amend any provision of its certificate of incorporation if such action could significantly and adversely affect the rights or preferences of the Preferred Shareholders; (ii) liquidate or wind up its affairs; (iii) create or issue any shares of capital stock (other than common stock); or (iv) redeem or make any payment on common stock or any security junior to the Preferred Shares if a Special Event (defined below) has occurred.

In addition, the proposal contemplates that the board of directors of [redacted] Holding would consist of eleven members. The Preferred Shares Purchase Agreements would provide that each of the Preferred Shareholders is entitled to have one director serve on the board.

Under the Preferred Shares Purchase Agreements [redacted] Holding also would make several covenants to the Preferred Shareholders, including (i) to provide the Preferred Shareholders with certain financial information; (ii) not to pay a dividend or redeem any equity security (other than the Preferred Shares) except for payments not exceeding \$100 million in the aggregate in any year; (iii) not to engage in "banking" or take any action that

would cause [] Holding to be required to meet regulatory capital requirements; and (iv) to notify the Preferred Shareholders if [] Holding intends to engage in any activities other than certain specified activities and operations ("Expected Activities"). The Expected Activities would include engaging in certain leasing and lending businesses; not having more than 30 employees; not incurring material amounts of additional indebtedness other than certain anticipated liabilities; and not merging or consolidating with another party.

Furthermore, the Preferred Shares may be redeemed in the following three circumstances: (i) the Preferred Shares are mandatorily redeemable by [] Holding on May 31, 2020; (ii) the Preferred Shares are redeemable in whole at the option of [] Holding at any time; and (iii) the Preferred Shares are redeemable in whole at the option of each Preferred Shareholder following the occurrence of a Special Event. A Special Event generally includes failure by [] Holding to pay a dividend on the Preferred Shares, failure by [] Holding to meet certain minimum financial ratios, breach by [] Holding of a material covenant in the transaction documents, decline in [] Holding's external credit rating, and notification that [] Holding intends to deviate from the Expected Activities. Except in two limited circumstances, [] Holding would not be required to pay a redemption penalty.¹

BHC Act Control Analysis

For purposes of the BHC Act, a company has control over another company if the company (i) directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company; (ii) controls in any manner the election of a majority of the directors of the other company; or

[] would have to pay a redemption penalty only in the event of an optional redemption after a change in control of [] and an optional redemption associated with a refinancing of the Preferred Shares by [] at a lower dividend rate. Staff has considered the amount and other terms of the redemption penalty and notes in particular that the requirement to pay the penalty expires after three years

(iii) directly or indirectly exercises a controlling influence over the management or policies of the other company.² The Board's Regulation Y also sets forth a set of rebuttable presumptions of control.³

Under the proposal, the Preferred Shareholders would only be deemed to control [] Holding for purposes of the BHC Act if the Board were to find the Preferred Shareholders exercised a controlling influence over the management or policies of [] Holding. The Preferred Shareholders would not own, control, or hold with power to vote more than 25 percent of a class of voting securities of, or control the election of a majority of the directors of, [] Holding.⁴ In addition, the Preferred Shareholders would not trigger any of the rebuttable presumptions of control in Regulation Y.

The Board has previously expressed its view that covenants by an issuer to an equity investor that substantially limit the discretion of the issuer's management over major policies and decisions, such as restrictions on entering into new activities without the investor's approval, suggest control by the investor over the management and policies of the issuer.⁵ The Board has also indicated, however, that restrictive covenants may be consistent with a non-control finding if they are combined with other provisions that mitigate the investor's control over the issuer, such as provisions that (i) preserve the ability of the issuer's management to conduct business or (ii) enable the issuer to redeem the investor's equity interest without penalty to ensure that restrictive covenants that may become inhibiting can be avoided by the issuer.⁶

² 12 U.S.C. § 1841(a)(2); 12 C.F.R. 225.2(e).

³ See 12 C.F.R. 225.31(d).

⁴ As noted above, the common shares and Preferred Shares of [] Holding would vote together with few exceptions. The class voting rights associated with the Preferred Shares appear to be limited solely to the types of class voting rights customarily provided by statute with regard to matters that would significantly and adversely affect the rights or preferences of the Preferred Shares. See 12 C.F.R. 225.2(q).

⁵ See 12 C.F.R. 225.143(c)(4).

⁶ See 12 C.F.R. 225.143(d)(1) and (2).

To address concerns that the Preferred Shareholders, individually or collectively, might have the ability to exercise a controlling influence over [redacted] Holding, [redacted] has made the following arguments. First, [redacted] has emphasized that the most restrictive of the proposed limitations on [redacted] Holding (namely, the limitation on Expected Activities) is not in the form of a covenant. Rather, the limitation is in the form of a trigger event for a right of redemption by the Preferred Shareholders. [redacted] has argued that a redemption right in favor of the Preferred Shareholders would give the Preferred Shareholders a controlling influence over [redacted] Holding only if the potential loss of capital to [redacted] Holding from the redemption would be sufficiently detrimental that [redacted] Holding would in fact cede control over its policies or management to the Preferred Shareholders in order to preserve capital. In this regard, [redacted] asserts that the threat of withdrawal of capital by one or more of the Preferred Shareholders in connection with a change in [redacted] Holding's activities is inconsequential because (i) [redacted] does not intend and would have no need to engage in any activities through [redacted] Holding other than the Expected Activities; (ii) the level of investment by the Preferred Shareholders in [redacted] Holding is small (approximately 4 percent of [redacted] Holding's total equity); and (iii) the optional redemption right of the Preferred Shareholders is without a redemption penalty.

[redacted] also contends that the influence of the Preferred Shareholders in this case would be limited because of [redacted]'s maintenance of 76 percent of the voting power at [redacted] Holding and over 70 percent representation on the board of directors of [redacted] Holding. In addition, [redacted] would have both the legal ability to effect a redemption of the Preferred Shareholders at any time without penalty and an actual ability to effect a redemption of the Preferred Shareholders at any time (because, as part of the proposal, [redacted] must maintain a minimum ratio of net liquid assets to the aggregate redemption price of the Preferred Shares).

In view of all the facts of record in this case – including the small relative size of each Preferred Shareholder's investment, the presence of a significantly larger [redacted] Holding shareholder, and the ability of [redacted] Holding to redeem the Preferred Shares at any time without a redemption penalty – staff would not at this time recommend that the Board find that the proposed investment would allow the Preferred Shareholders, individually or collectively, to exercise a controlling influence over the management or

policies of [redacted] Holding (or, indirectly, [redacted]) for purposes of the BHC Act.

Edge Act Investment Limit Analysis

Section 25A of the Federal Reserve Act limits a member bank's investments in the stock of Edge and agreement corporations to no more than 10 percent of such bank's capital and surplus (or 20 percent of capital and surplus if the Board determines such additional investment would not be unsafe or unsound). As noted above, [redacted] also has requested staff's views on whether, assuming no Preferred Shareholder is viewed as controlling [redacted] Holding, such Preferred Shareholder's investment in [redacted] Holding would be applied against the investor's investment limit under that section.

Staff has generally advised member banks that investments in a holding company parent of an Edge or agreement corporation are deemed to be investments in the stock of the subsidiary Edge or agreement corporation on a proportionate basis. In those previous cases, the sole or primary function of the holding company was to hold the shares of an Edge or agreement corporation. In this case, however, [redacted] would represent only 18 percent of [redacted] Holding's consolidated assets and none of the Preferred Shareholders would acquire more than 10 percent of any class of voting shares of [redacted] Holding. In addition, none of the proceeds of issuance of the Preferred Shares would be invested by [redacted] Holding in [redacted] and [redacted] intends to run off [redacted]'s assets.⁸ In view of all the facts of record in this case, staff would not recommend that the Board count the investment in [redacted] Holding by a Preferred Shareholder toward the investment limit of the investor for member bank investments in Edge and agreement corporations.

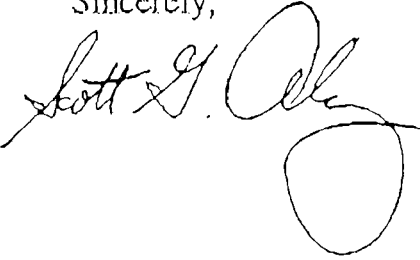
⁷ The proceeds of the Preferred Shares would be used to capitalize [redacted] Holding's other subsidiaries.

⁸ You have stated that no new leases would be acquired by [redacted]. You have also asserted that the Preferred Shareholders have indicated that their decision to invest in [redacted] Holding was based on their interest in the business of [redacted] Holding's other subsidiaries and not on the operations of [redacted].

In reaching the opinions set forth in this letter, staff has relied on all the facts of record, including all the representations and commitments made by or on behalf of [redacted] (whether noted in this letter or otherwise contained in [redacted]'s correspondence with the Board). Any change in the terms or circumstances of the proposed transactions may result in a different decision. In this regard, you should advise Board staff before making any material modification to the proposal.

To address the possibility of a controlling influence developing in the future, the Board retains the authority to review the investment and relationships regularly to determine whether, under all the facts and circumstances, any of the Preferred Shareholders has acquired a controlling influence over [redacted] Holding for purposes of the BHC Act.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott G. Allen". The signature is written in a cursive style with a large, prominent loop at the end.

cc: