

Client Alert

Jointly Prepared by Goodwin Procter's Financial Services and RE, REITs & RE Capital Markets Groups

Real Estate Activities Under the Framework of the Bank Holding Company Act: Limits and Opportunities

In the last two months, a number of firms – ranging from American Express to Goldman Sachs to Merrill Lynch – either have chosen to become bank holding companies (“BHCs”) or have become subsidiaries of BHCs.¹ These choices typically have been dictated by the benefits of BHC status, including opportunities to participate in the U.S. Treasury Department’s Troubled Asset Relief Program, greater access to the Federal Reserve’s various funding and liquidity sources, and market perceptions regarding stability in this challenging economic environment. These benefits, however, are coupled with costs and restrictions. Chief among them, banking laws, in particular the federal Bank Holding Company Act (“BHC Act”), restrict the ability of BHCs and their affiliates to engage in non-banking activities (“activities restrictions”) and acquire and hold non-banking assets and interests in companies engaged in non-banking activities (“investment restrictions”).

The activities and investment restrictions of the BHC Act will have important implications for the real estate investment, management and other activities of newly minted BHCs.² Many real estate related activities – including real estate brokerage, management and development – are impermissible for BHCs, and real estate investments are only allowed if structured to fit within certain investment restrictions of the BHC Act. Many real estate investments – beyond minority and passive investments – will need to fit within the so-called “merchant banking rules,” as discussed below. Those rules are detailed, imposing various limits on how real estate investments can be managed, and contain time limits on how long investments may be held. This Client Alert outlines these restrictions and identifies the principal options for making real estate investments.

Activities Restrictions of the BHC Act

BHCs may engage in a limited number of activities that are deemed “closely related to banking.” A special class of BHCs – those that meet certain capital and management requirements – can elect to be treated as “financial holding companies” (“FHCs”) and may conduct a broader range of activities that are “financial in nature” or “incidental” or “complimentary” thereto. Many BHCs – including Bank of America, Citigroup and others – have elected FHC-status to take advantage of these broader powers.³

Within these limits, FHCs – and, to a somewhat lesser extent, BHCs – may engage in several real estate related activities. Among them are providing real estate appraisal, escrow and settlement services; real estate lending and leasing; and providing real estate related investment advice both to investors and to private or public collective real estate entities, including real estate investment trusts (“REITs”). BHCs and FHCs generally also may provide a broad range of management consulting advice on financial, economic, accounting and audit matters to clients (including funds or companies that develop, manage and broker real estate or other assets), provided that, among other things, they do not perform the operations of their clients on a day-to-day basis.

Although FHCs and BHCs may conduct the above-noted real estate related activities, they may not engage in other real estate activities. For example, BHCs and FHCs generally may *not* provide real estate brokerage services, including acting as agent for buyers, sellers and lessors; engaging in real property management; or engaging in real estate and land development activities. These prohibitions mean that BHCs and FHCs need to retain third-party providers to engage in these services with respect to real property that BHCs and FHCs may own.

Investment Restrictions of the BHC Act

BHCs and FHCs are restricted in their ability to make investments in assets, companies and funds, including, for example, REITs. Subject to certain exceptions explained further below, BHCs and FHCs may only invest in ventures engaged in activities in which BHCs and FHCs may engage directly. This means, for example, that an FHC may own shares of a real estate appraisal firm, but the FHC may not own and control a real estate management company or a real estate broker.

The investment restrictions also generally provide that BHCs and FHCs may invest in real property only under limited circumstances. They may own real estate for their premises and use. They also may own real estate in other limited capacities, such as holding real property for a limited time when it is acquired in satisfaction of debt previously contracted or making real estate investments for certain community development purposes.

There are several important exceptions to the restrictions on FHCs making real estate related investments.

- **De Minimis Investments.** An FHC or BHC may acquire, as a passive investment, up to 5% of a class of voting securities of any company or fund, regardless of that company’s or fund’s activities. This means, for example, that an FHC may permissibly acquire up to 5% of a class of voting shares of a publicly traded REIT.

- Non-Voting Equity Investments. An FHC or BHC may acquire non-voting equity interests in a company or fund, regardless of its activities, so long as the FHC or BHC does not attempt to exercise a “controlling influence” over the management or affairs of the company or fund. Under this approach, it may be possible for an FHC or BHC to acquire up to 33% of the total (non-voting) equity of a real estate owning entity or a real estate investment fund, but the investing FHC or BHC would need to remain a largely passive investor.

The rules governing non-voting equity interests are complex, however. First, many types of interests are accompanied by rights that could render them voting securities for BHC Act purposes, and the acquisition of such interests would not accord with the non-voting investment rules. In addition, BHCs and FHCs often need to design complex structures to avoid having a “controlling influence.” A controlling influence can arise not only in obvious circumstances (such as becoming a managing member or general partner of a real estate owning entity), but also in other situations that fall well short of control from an economic or business perspective (such as having a 20% voting stake in an entity).

- Merchant Banking. FHCs (but not BHCs) may engage in so-called “merchant banking” activities under rules issued by the Federal Reserve and Treasury Department. Pursuant to the merchant banking rules, an FHC may acquire 100% of the ownership interest of any company or fund engaged in otherwise impermissible activities for an FHC, subject to various restrictions and limitations described below.⁴

Merchant Banking Investments

FHCs may make a wide range of investments under the merchant banking authority; these investments may include any type of ownership interest in any type of company (including special purpose vehicles (“SPVs”) that hold real estate or companies engaged in real estate development, management or brokerage activities) or fund, including a REIT. FHCs may acquire and hold investments either directly or indirectly through their non-bank affiliates.

The merchant banking rules do not permit FHCs to hold assets directly (only ownership interests in entities and funds). Accordingly, real estate must be acquired through, or promptly transferred to, an entity (which the rules refer to as a “portfolio company”) that maintains an existence, management and operations separate from the investing FHC. For these purposes, a real estate owning portfolio company can be an SPV, organized as a limited partnership or

limited liability company (“LLC”) or in another form, created specifically to hold the real estate asset.

Various restrictions apply to merchant banking investments, including limits on FHCs routinely managing real estate investments and limits on how long an investment may be held. There also are capital, risk-management, recordkeeping and reporting requirements. The requirements applicable to investments made through pooled investment vehicles are lower because the regulators believe that the third-party investors in such funds will monitor FHCs’ investment activities and impose some market discipline on such investments.

Investments Directly in Portfolio Companies

Control of Portfolio Companies

As noted above, FHCs may own any amount of shares or other ownership interests in a portfolio company (e.g., an SPV) and may control portfolio companies. Such control may include appointing persons to serve on a portfolio company’s board, becoming the general partner of a partnership vehicle or serving as a managing member to an LLC.

While FHCs may acquire control, they generally may *not* “routinely manage or operate” portfolio companies such as real estate owning SPVs, except in certain “special circumstances” and then for very limited periods when necessary to protect an FHC’s investment. An investing FHC routinely manages or operates a portfolio company if, among other things, the FHC has certain director, officer or employee interlocks with the portfolio company, or the FHC restricts the ability of a portfolio company to make routine, ordinary course business decisions.

Importantly, the restriction on “routine management and operations” does not limit an FHC from requiring a portfolio company to obtain the FHC’s approval for actions “outside the ordinary course of business.” Thus, FHCs may prohibit a wide range of “significant” and non-ordinary course activities through contracts or other means. For example, FHCs may restrict the ability of a portfolio company to (a) acquire significant assets; (b) change business plans or accounting methods; (c) take on additional debt outside the ordinary course; and/or (d) redeem equity or debt securities.

In the context of a portfolio company that holds a real estate asset, the prohibition on routine management means that the portfolio company and its management (and not the FHC and its management) should make decisions on various portfolio company and property matters, such as routine facilities and property management, making building repairs or providing services to tenants, collecting rents and making routine filings with city, county or tax authorities.

The above-noted special-circumstances exception does allow some leeway for an FHC to take over routine management and control of an SPV to protect the FHC's investment. This exception means, for example, that in the case of a joint venture ("JV") with another party in which that other party breaches applicable agreements, the FHC would be able to take over routine management and operations of the JV for a temporary period. The FHC would need to provide a special notice to the Federal Reserve if that period were to extend for more than nine months, and the notice must include an estimate of when the FHC anticipates ceasing routine management and operations of the investment. On receipt of the notice, the Federal Reserve may determine to monitor more closely the FHC's investments and its management and operational activities – scrutiny that some FHCs may prefer to avoid.

Holding Period

In general, FHCs may own and control portfolio companies for up to 10 years. To be clear, a portfolio company may have a term of existence longer than this period but, within this 10-year time period, the FHC generally must sell its stake in the real estate owning portfolio company. The existence of such holding period limits may mean that existing investments of newly minted FHCs have to be modified.

To own a portfolio company for beyond the maximum period, an FHC must request an extension from the Federal Reserve. Such a request must be made at least 90 days before the expiration of the 10-year holding period and must provide various reasons for the request. In granting a request, the Federal Reserve may impose restrictions that it deems appropriate and will impose a special capital charge on the FHC. Because the merchant banking rules became effective fewer than 10 years ago, FHCs have not had to seek extensions from the applicable holding period limits. Should the current economic environment continue to exist, it will be interesting to see whether the Federal Reserve will be lenient in granting extensions to the normal holding period limits.

Investments Through Fund Vehicles

In addition to direct investments in portfolio companies, FHCs may make investments in pooled investment vehicles, which in turn invest in real estate owning portfolio companies. The merchant banking rules discuss two types of fund vehicles: so-called "private equity funds," and "non-qualifying funds" that do not meet the definition of a private equity fund.

Private Equity Funds

A private equity fund is defined as a fund that (a) is formed for the business of investing in shares and other ownership assets of portfolio companies, (b) is no more than 25% of the total equity of which is held by the FHC, its affiliates,

officers and principal shareholders, and (c) has a maximum term of existence of not more than 15 years.

- Control of Private Equity Funds and Their Portfolio Companies. Depending on the nature and extent of the relationship between an FHC and a private equity fund, the FHC may be deemed to control the fund; there are no restrictions, however, on an FHC controlling or managing a private equity fund.⁵ This means that the investing FHC may be the sole general partner or managing member of a private equity fund, elect all of the fund's directors or serve as its general partner or managing member, and/or become the fund's investment adviser or sponsor.

In addition, and in contrast to the limits that apply to investments through portfolio companies, there are no limits on the FHC running the day-to-day affairs of a private equity fund. But, if an FHC controls a fund, then that fund generally may not routinely manage or operate a portfolio company in which the fund invests. This means that a private equity fund controlled by an FHC would need to ensure third-party management of the SPV that holds the real estate in which the fund invests. If, on the other hand, the FHC does not control a private equity fund, then that fund faces no routine management and operation restrictions.

- Holding Period. Private equity funds, by the Federal Reserve's definition, may not have a term of life longer than 15 years, inclusive of all renewals and extensions. One of the chief advantages of investing through a private equity fund is that FHCs may retain their interests in such funds for their entire term – that is, 15 years (5 years longer than FHCs may own portfolio company interests directly). Private equity funds, in turn, are not required to dispose of their merchant-banking investments within 10 years. Thus, such funds may hold real estate investments for their full 15-year term of existence.

Non-Qualifying Funds

As noted above, in addition to investing in private equity funds, FHCs may invest in non-qualifying funds – pooled or collective investment vehicles that do not meet the Federal Reserve's definition of a private equity fund. (By way of example, a non-qualifying fund may be a fund that will be in existence for longer than 15 years or may be a fund in which the FHC holds a greater than 25% equity stake.)

- Control of Non-Qualifying Funds and Their Portfolio Companies. The merchant banking rules do not place restrictions on an FHC

routinely managing, operating or controlling a non-qualifying fund. But, if an FHC controls a non-qualifying fund, then the routine management and operation restrictions apply to investments made by the fund in the same manner as those restrictions would apply if the investments in the portfolio companies were held directly by the FHC. This means that, for example, a non-qualifying fund that is controlled by an FHC would not be allowed to routinely operate and manage a real estate owning portfolio company in which that fund invests.

- Holding Period . Investments in non-qualifying funds generally are subject to the 10-year holding period restriction (not the 15-year period available to private equity funds). There may be two ways for an FHC to manage this holding period limit – the FHC either could sell its stake in the fund in 10 years, or the fund could manage its real estate investments so that it holds no investment for longer than 10 years.

Conclusion

The BHC Act imposes a variety of limits on the real estate activities of those entities to which the Act applies. Those restrictions likely will need to be considered by those financial services firms that have chosen recently to become BHCs. For example, the newly minted BHCs may need to review their direct property investments and their relationships with joint-venture parties, REITs and real estate operating companies. The new BHCs also may need to consider the interplay of the BHC Act's rules with other regulatory requirements that may apply to certain funds and investments, such as those of the Employee Retirement Income Security Act, which do not always dovetail with the restrictions of the BHC Act. Ultimately, the real estate activities and investments of the new BHCs may need to be modified to accord with the BHC Act's intricacies and requirements.

¹ Other financial services firms, such as The Hartford, have chosen to become thrift holding companies (“THCs”), which are governed by another federal statute, the Home Owners’ Loan Act. Although this Client Alert speaks specifically to the BHC Act, the limitations in the two Acts are closely parallel and, although there are variations in the powers of THCs versus financial holding companies, the discussion herein generally is applicable to THCs.

² The Federal Reserve and BHC Act provide newly formed BHCs time to conform their activities to the statute’s requirements. Specifically, the BHC Act gives new BHCs two years to bring their activities and investments into compliance with the Act, and the Federal Reserve may grant three one-year extensions beyond this period.

³ The Federal Reserve maintains [a list of FHCs](#) on its website.

⁴ FHC affiliates that are insurance companies are granted highly similar authority to make investments under the BHC Act but may do so without some of the restrictions applicable to merchant banking investments.

⁵ An FHC may control a private equity fund in a variety of circumstances, including if the FHC (or any of its directors, officers, employees or principal shareholders) (a) serves as the fund’s general partner, managing member or trustee; (b) selects, controls or constitutes a majority of the directors, trustees or management of the fund; or (c) owns more than 5% of any class of voting shares or similar interest in the fund and acts as the fund’s investment adviser.

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