Raising Capital or Issuing Debt for Community Institutions

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By Jeffery E. Smith and Gregory J. Zelasko
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One of the very first considerations in deciding to issue new capital or debt involves whether the issuing institution desires to conduct a "public" offering, or a "private placement" which qualifies for an exemption from registration with the United States Securities and Exchange Commission (SEC).[1] Both are considered "securities" for SEC purposes. Institutions desiring to issue capital or debt obligations face a somewhat confusing array of choices if they desire to avoid registration of the offering with the SEC. Having the offering qualify for an exemption from registration is important to many institutions, especially because registering the offering will result in the institution becoming a "public company" and subject to the ongoing reporting obligations and expenses that accompany "public company" status.

Most non-public companies desire to remain non-public and, when faced with the need of raising capital or issuing debt, must consider a variety of potential alternatives in order to avoid that fate. Issuers should start from the presumption that a "public" offering of equity or debt will require SEC registration. However, if the offering meets certain criteria, it will qualify for an exemption from such registration. As always, the devil is in the details and the following are matters which an institution must consider when contemplating a debt or equity offering and the possible applicable exemptions from SEC registration. Each requires analysis prior to taking any action, including review of relevant corporate governance documents and the impact of those governance document provisions on a potential new equity or debt issue.

1. Bank Equity and Debt

Bank equity and debt (unlike **bank holding company** equity and debt, discussed below) are generally securities exempt from SEC registration. However, there are bank regulatory considerations and oversight that come into play when offering these securities, including the prior review and approval of the offering and the terms of those securities by bank regulators as well as ongoing reporting requirements.

2. Bank and Thrift Holding Company Equity and Debt

Bank and thrift holding companies are typically state corporations that are qualified to act as bank holding companies by the Federal Reserve. In that regard, they are much like any other corporation with regard to issuing stock or debt obligations, meaning that, unless the offering qualifies for an exemption from registration, the offering will need to be registered with the SEC. Even if the offering will qualify for an exemption from SEC registration, the Federal Reserve should be advised in advance in order to keep the agency apprised of the proposal.

There are potential exemptions from SEC registration for holding companies which desire to avoid SEC registration and oversight. Those exempt offerings include (1) situations where ALL offerees are residents of the state in which the bank holding company is located and has its principal place of business[2] and (2) an issue where all offerees will qualify as "accredited investors" with appropriate income, net worth and other risk tolerance criteria, and the offering meets all of the requirements of the exemption provided by SEC Rule 506, including the requirement that the management of the issuer has a substantive pre-existing business or personal relationship with every offeree.

Proposed reliance on any exemption from registration requires careful legal and regulatory analysis prior to relying on the exemption for any issue.

3. Bank Regulatory "Control" Issues

Care must be taken in any equity issue that an investor or group of investors does not inadvertently hold or "control" enough voting equity securities of a bank or a bank holding company following an acquisition, directly or indirectly, to trigger the need for pre-investment "control" approvals from state and federal banking agencies. That is a complicated and intrusive process for most investors, and carries significant business complications, including ongoing Federal Reserve regulation for business entities (including some trusts) that may be at risk of becoming a "bank holding company" without ever intending to do so. Likewise, individuals and groups of individuals may require prior approval for direct or indirect "control" of a bank based on their relationships with each other and the institution. Aggregation rules are complex and far-reaching. If that is a possibility, a very careful analysis by the potential "control" group is required in order to consider and address the potential issue.

In all instances, it is again highly recommended that any proposed offering be discussed in the early stages with the institution’s counsel and the relevant bank and holding company regulatory authorities.

4. Existing Outstanding Debt and Equity

Another important part of the analysis involves reviewing the terms of any outstanding equity and debt of the institution, as well as any equity plans, to determine whether the new proposed issue may require prior approvals of existing shareholders or lenders.

5. Investment Banker Involvement

In addition to providing critical advice to the institution's board regarding pricing and the offering structure, investment bankers may be retained to assist in the sale and distribution of new equity or debt in a number of ways that are guided by the nature of the offering. Offerings may be conducted as underwritten offerings, assisted placements, or in a number of other ways through the services of the investment banker. The offering may involve "passing the hat" around the institution's board table, forming an ESOP, structuring a "community" offering to local investors, negotiating a private placement with a private equity (PE) investor, or conducting a rights offering to existing shareholders followed by a private placement to accredited investors. Investment bankers are well aware of the various structures and alternatives, and can provide professional guidance and some level of protection for the institution's board, when an investment banker is properly engaged.

6. Private Equity Fund Considerations

While selling securities to a PE fund may be a quick method of securing capital, it requires careful analysis of the impact on other shareholders, on the institution, and on the community. PE investors may demand a number of things from the institution, including ongoing reporting obligations, special access to information, board seats, future registration rights, and other conditions that may affect the institution's board, existing shareholders and the institution's business plans after the investment. A PE investment is sometimes a necessity when there are insufficient available qualified investors to acquire the desired equity. PE investors must be cognizant of the "control" limitations discussed above. No two situations are the same, and circumstances, preferences and needs may dictate whether a PE investor is a viable or desirable option for a community institution.

7. Dealing with Preemptive Rights

The institution's governing documents may grant the existing shareholders of the institution the right to acquire that amount of an equity issue so as to maintain their ownership percentage of the institution after the offering. These "preemptive rights" may be problematic when a PE or "angel" investor wants to invest in the institution but only if that investment results in a certain percentage ownership or control level acquired by the PE or angel investor. Further, if there are numerous existing shareholders and those shareholders do not qualify as accredited investors, there may be no exemption from SEC registration available for the offering of the securities to those existing shareholders.

8. Material Non-public Information

Solicitation materials for any type of issue require disclosure of material information to potential investors. While public companies have clear SEC and listing agency public disclosure obligations, periodic disclosure requirements for non-SEC companies are less clear and there is no method for public distribution of information for those institutions. As a result, institutions that are facing potential material non-public events such as informal regulatory actions, reduced dividends, anticipated credit issues, and any number of other material events will need to take care in the timing and disclosures related to any capital-raising solicitations, including the potential for such issues to arise during the solicitation period. Timing with regard to regulatory examinations can be critical for institutions considering an offering.

These are just a few of the more important considerations that an institution needs to consider when thinking about raising capital through an equity or debt issue. These and other matters will need to be carefully considered by the institution's board. The institution should also involve its attorneys and relevant regulatory agencies very early in this process to assist in obtaining any necessary regulatory approvals and in determining how the offering can be conducted in compliance with securities laws.

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[1] Note: This article focuses only on possible exemptions from SEC registration. Compliance with the securities laws of each state where an offeree resides is also necessary for every offering of securities.

[2] Note: This "intra-state" exemption is not available when even one offeree is not a resident of the appropriate state, such as a "snowbird" having a Florida residence in an Ohio-only offering.