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Anatomy of a Bank Recapitalization

CHRISTOPHER J. ZINSKI

The author discusses the key elements of a successful recapitalization of a troubled bank.

The start of the bank recapitalization era began in 2010. As an increasing number of banks failed and were put out to bid through the FDIC's receivership process, a handful of banks were saved from failure through pre-receivership recapitalization transactions. In a bank recapitalization, a distressed bank on the brink of receivership is saved through a significant capital injection that brings it back to at least an "adequately" capitalized threshold under the Prompt Corrective Action ("PCA") standards. This move often leaves the stockholders of the bank holding company significantly diluted or completely wiped out.

There is no single impetus for the bank recapitalization activity, but rather several factors have created this phenomenon. Recapitalizations were not viable before 2010 because credit quality only became transparent in the latter part of the recession and real estate devaluation cycle. While many banks remain under reserved, investors became more confident in 2010 that they could predict the amount of loss embedded in a distressed bank's loan portfolio and real estate owned, making for an informed investment decision. This degree of credit transparency was unavailable in 2009.

Investable capital and competition for banking enterprises gathered

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momentum in 2010, which created an opportunity for distressed bank acquisitions. Private equity firms began amassing large amounts of capital to invest in failed bank acquisitions in late 2009 and into 2010, recognizing the value of the FDIC's loss-share guarantee and the large number of solid core banking franchises that would fail over the next year or two.

Despite the capital available through private equity, regulators seemed reluctant to let these firms into failed bank acquisitions, and the competition in the FDIC-assisted acquisition transactions for banks in receivership became more intense by the second quarter of 2010. Therefore, private equity money with capital to spend became interested in investing in distressed banks short of receivership and the credit transparency that materialized at the same time gave a boost to this investment plan. Private equity firms came to realize that by investing in a distressed bank, the newly recapitalized bank could be used as a platform to acquire failed banks in the FDIC loss-share program, creating an opening for private equity to participate in the perceived upside investment potential offered in FDIC loss-share transactions.

BREAKING THROUGH THE WALL OF DENIAL

Well before a recapitalization plan evolves and is executed, the board of directors of the distressed bank must recognize the need for a recapitalization transaction and be willing to make the serious decisions leading up to it. Many boards of distressed banks deny the severity of the circumstances, and breaking through the wall of denial is a critical step to a successful recapitalization.

Directors, like many people in difficult situations, use denial as a defense mechanism. In the current banking environment, with the degree of credit loss severity in real estate-based asset classes and the attitude and mandates of the federal banking regulators, boards that perpetuate a state of denial can, through their inaction, cause the bank to cascade into receivership.

It is easy for directors to delude themselves that the bank is properly reserved even though market-based real estate valuations suggest otherwise. Likewise, directors can ignore signs of non-performing asset migra-

tion, believing that their bank's problems have leveled out, underscoring the importance of paying attention to pro forma capital levels. Management's natural bias toward optimism can feed a board's belief that the bank's situation is better than it really is. There is no magic way to break through the wall of denial but there are a few techniques that have proven useful in recapitalization transactions.

There is nothing that will shake a board out of its apathy and misguided optimism than a third party review of the bank's credit portfolio. Hiring an expert in credit portfolio valuations and charging the firm with providing the bank an assessment of the net realizable value of the its non-performing assets will show the board what the bank could expect to realize if it were to sell its non-performing loans and foreclosed real estate over a six- to 12-month time horizon. That net realizable value analysis is likely to demonstrate that the bank's reserves are inadequate if it decides to sell its non-performing assets ("NPA") over a short time horizon with the goal of cleaning up the balance sheet. Likewise, the board will become better informed about its credit problems if that third party also calculates the bank's cost to carry its NPA portfolio. Armed with the cost-to-carry data, the board can start making informed decisions about NPA dispositions and begin the process of assessing its future capital needs.

This type of in-depth credit and valuation analysis is critical to attracting new capital into the bank. Any sophisticated investor will ask early in discussions regarding a recapitalization transaction about the bank's credit risk and "how deep the crater is," referring to the net capital left on the bank's balance sheet after making a realistic assessment of losses embedded in its credit portfolio, assuming a disposition of NPAs over a short time horizon. To this point, "new money" that is injected into the bank will not want fresh capital used to absorb old credit losses on the balance sheet and will want assurance that the bank has, after a realistic assessment of credit losses, positive equity capital before the recapitalization transaction.

Anticipating this need for credit transparency, any bank interested in a recapitalization transaction is well advised to have this type of credit review performed well in advance of planning to induce new capital into the institution. As part of this credit assessment, the third party firm should be asked to develop a tactical NPA disposition plan, creating an order of

priority for the disposition of NPAs, once sufficient capital is injected into the bank to back-stop the charges to capital such dispositions will bring.

STAGING THE TURNAROUND

A recapitalization of a bank is not a transaction but a culmination of a process that begins with steps of a “classic” turnaround. This means that the board of directors must establish a leadership protocol that will drive a process that positions the bank toward a recapitalization transaction. Bank management and boards often believe they can call an investment banker who, following a transaction-based mentality, can raise the amount of capital that is needed to offset the credit risk in the bank’s balance sheet, bring the bank’s capital up to the adequately capitalized level (after recognizing the credit risk), and stockpile enough excess capital to create a growth story that induces investors to inject capital in the first place.

A classic turnaround approach requires that the board determine whether the bank’s current CEO is up to the task of organizing and executing this approach, or whether a new CEO or the Chief Restructuring Officer (“CRO”) needs to lead the process. Moreover, investors in a distressed bank will want to see new leadership. This exemplifies the need for boards to knock down the wall of denial, because these are board-level decisions that require risk-taking and strategic vision. Successful recapitalizations have these leadership decisions in place early in the process.

The leader of the turnaround, whether the old or new CEO or CRO, must complete a critical analysis that realistically evaluates the bank’s financial and regulatory condition and determines whether a recapitalization is viable and how it should be structured to enhance its chances for success. Creating the blueprint is complicated, and it must reflect a process that asks the right questions, creates a team of senior management and outside professionals who work well together toward the common goal, involves the board of directors, and remains agile enough to adjust to the inevitable twists and turns that the turnaround of any distressed company requires.

The critical pathway for a bank turnaround has several stages — triage, strategic assessment and planning, communication of the plan and

execution. The triage stage lasts between 30 and 60 days and involves a realistic assessment of the bank's financial condition, including credit, capital and liquidity. It is during this stage that a third party credit review firm needs to determine the losses embedded in the bank's credit portfolio assuming NPA disposition and the balance sheet cleanup over a six- or 12-month time horizon. Likewise, the financial condition review should judge whether there is a viable strategy to shrink the balance sheet that may produce constructive results in terms of capital ratio maintenance, as well as determine if there are capital accretive opportunities on the balance sheet. Liquidity is a priority issue through the turnaround and recapitalization. Developing plans for enhancing liquidity for a six- or nine-month period and anticipating liquidity stress are important.

With the triage completed, the CEO (whether old or new) or the CRO needs to lead a series of meetings with the board to explain the results of the triage, particularly the credit review, and develop in conjunction with the board a variety of strategic options. Those options may include attempting to sell the bank, pursuing a recapitalization of the bank, or shrinking the bank's balance sheet while buying time to execute a recapitalization plan. The important part of these meetings is that the board have access to a realistic assessment of the bank's future prospects including a professional prediction about how the bank examiners will treat the bank in the next two exams, the bank's walk down the PCA capital "ladder," and the timing of the capital deterioration. This analysis is important in determining how much time the board has to execute strategic options, the strategy for buying time with the regulators, and balance sheet management techniques that serve the primary goal of staving off receivership as long as possible.

Communication is the next step in the turnaround. A thoughtful communication plan needs to be developed so that the bank can effectively and honestly communicate with its regulators, employees, stockholders, customers, the media and other constituents. A well organized turnaround plan has the advantage of feeding into the regulatory supervision and exam process; the board's strategic assessment and choice of options can serve as the basis for any capital restoration plan that the regulators require. If properly communicated, a focused turnaround plan can buy management

and the board credibility with the bank's regulators and ultimately can buy time for the bank to execute on a strategic option. Without such a plan, the bank will be one of hundreds of banks viewed by the regulators as being in a state of denial and rudderless when it comes to addressing its balance sheet and capital challenges. In short, a turnaround plan, particularly the communication segment, needs to include a tactical approach to dealing with regulatory risk and restoring management and the board's credibility with the regulators.

In bank turnaround plans, like most well designed outcomes, 80 percent of time is spent in the planning stage and 20 percent is spent executing the plan. The triage, strategic assessment, and communication stages can take between four and six months, and the execution stage can take two to three months. When the board nears a decision on its strategic options, it should consider retaining an investment banking firm for advice and to assist the bank in the execution of its strategic options.

In a recapitalization transaction, the investment banker will be essential in handicapping the banks chances of finding investors interested in recapitalizing the bank, based on the third party credit analysis conducted and the other triage results. The investment banker can also give the board advice as to whether pursuing a recapitalization of the bank is the company's best strategic option under all the facts and circumstances or whether a sale of the company or some other option is more realistic.

The rigor and focus of a well executed turnaround plan requires leadership, most of all. Serious questions need to be addressed and serious decisions need to be made because the future of the bank is at stake. This leadership role requires an in-depth understanding of financial statements, strategy and regulatory issues.

ESSENTIALS FOR A SUCCESSFUL RECAPITALIZATION

Investors will invest in a distressed bank if they believe the institution has a solid core franchise. That is, despite the problems in the credit or investment securities portfolio, the bank has to have a track record of generating sustainable operating income, have a solid core customer base and serve an attractive marketplace. Size of the institution also matters in

determining whether it is a valuable core franchise or not.

Many investors will be attracted to distressed banks in or near large metropolitan areas, believing they provide the best opportunities for growth and expansion and investor returns. But a solid bank franchise in a smaller metropolitan area may have unique favorable characteristics if investors can be persuaded that the bank can be used as a “base” for acquisitive growth into larger metropolitan markets or if the bank has a niche business, such as agricultural lending, mortgage banking or specialty finance.

The next question is whether, after making realistic assumptions based on the third party credit review, the bank has any positive equity capital remaining. This so-called “burn down” analysis is more complicated than simply starting with the holding company’s tangible equity capital and subtracting the losses predicted from a fairly rapid disposition of NPAs because tax effects need to be considered, including the deferred tax asset, as well as disposition and carrying costs of the NPAs. The burn down analysis needs to be realistic, indeed conservative. The equity capital that is left after the burn down analysis is the capital left for the current stockholders and in many cases this analysis proves that the current stockholders will need to suffer severe dilution in order for a new investor to agree to invest fresh capital in the institution. New investors will not finance old credit quality problems of the bank. In order for the burn down analysis to have credibility, the third party credit assessment needs to be completed well before the burn down analysis is run.

Bank leadership and management post-recapitalization will be another key element to consider. Institutional investors will want to know who will be running the institution going forward, their track record, and their vision for deploying the new capital and translating it into reasonable investor returns. Normally, new investors will not have confidence in the CEO that managed the bank into its current position of distress. Therefore, the board will have to make a serious decision as to whether to replace the CEO prior to launching a recapitalization or acknowledging that once a lead investor is identified that a process needs to be put into place to identify and hire a new CEO.

While the CEO may need to go in order to get the recapitalization done, the fate of other members of senior management is not nearly as certain.

Other members of senior management may be asked to stay on temporarily or permanently to promote a smooth transition during the recapitalization, though the new CEO may have his own management team to bring forward. You can imagine the serious discussions in the boardroom about replacing the CEO as part of a successful recapitalization. But a recapitalization would not be on the table unless the bank was under severe distress and needed a significant amount of capital to survive. Because corporate survival is on the line and after the wall of denial is conquered, boards will typically make the changes that need to be made to avoid receivership.

HOLDING COMPANY DEBT OBSTACLES AND OPPORTUNITIES

It is becoming increasingly apparent in the current environment and as more recapitalization transactions are announced that holding company indebtedness is a major obstacle to accomplishing a recapitalization. Bank holding companies may have a senior secured credit facility at the holding company level or trust preferred securities outstanding, TARP money owed to the U.S. Treasury, or a combination of some or all of these debt or preferred equity instruments. The total dollar amount of these debt or preferred equity instruments can be so large, and their service requirements so substantial, that a recapitalization of the holding company is not financially viable unless some or all of these stakeholders agree to take a severe haircut on the amounts they are owed.

As with the credit burn down analysis mentioned, new investors will not invest fresh capital only to have that capital used to pay off a senior secured lender or the U.S. Treasury or trust preferred securities holders. The amounts owed to these stakeholders are an integral part of the burn down analysis. That is, the amount owed to the stakeholders who have positions in the capital structure above the holding company's common stockholders is something that has to be resolved by the company's current equity after all credit losses embedded in the NPA portfolio are accounted for. In most cases, there is barely enough equity capital at the bank level to address NPA losses let alone also repay TARP, trust preferred or the senior lender at the holding company level. Even if accommodations by these stakeholders on amounts owed to them would work financially, the trust

preferred stakeholders present a special problem in terms of acquiring the necessary consent to any recapitalization transaction.

CREATING STABILITY DURING TRANSITION

From the start of the turnaround program through a recapitalization, stabilizing the franchise needs to be a priority. While stability in many areas is important, no issue is more important than liquidity. A bank can continue to function as a going concern even if its capital is all but totally depleted. But if the bank loses access to liquidity sources, it cannot fund its day-to-day operations. Moreover, we have seen countless examples where the regulators have intervened quickly to put a bank into receivership following a one- or two-day liquidity run or simply an unusually high degree of liquidity stress that threatens the bank's ability to fund deposit withdrawals. Thus, management and the turnaround leader need to establish liquidity reports and a process for addressing liquidity needs over the six- to nine-month time period that a turnaround and recapitalization plan can take to execute.

Capital is another area that requires focus and stabilization techniques, though this is much harder to control than liquidity because the swings in capital can be large and dramatic based on credit quality, and capital impairment can occur based on judgment calls rather than counter-party actions. In any event, as a turnaround program is initiated, the turnaround leader will put in place a monitoring and reporting process that measures the bank's capital against the PCA thresholds on a monthly basis.

Stress to capital will be a topic of frequent conversation and once the bank drops to the significantly undercapitalized level, the bank regulators will increase their rhetoric and monitoring of capital as well. This is why it is important early in the turnaround to find as many constructive approaches as possible to enhancing the bank's capital ratios through balance sheet shrinkage or finding capital accretive opportunities, such as selling securities with a gain or reversing compensation accruals if possible. Every percentage of extra capital in relation to the PCA capital thresholds matters as the bank incurs more capital depreciation resulting from credit losses and when buying time is essential to executing on a recapitalization plan.

Keeping employee morale up when the bank faces an uncertain future and rumors are percolating about its survival prospects is a daunting task. It is important that senior management maintain credibility with employees but equally important that they use employees as the first line of defense against deposit runs and customer concerns about the safety of their deposits. There is no magic formula to keeping employees right minded but the turnaround leader must have as a goal keeping employees engaged and hopeful that the bank will survive and a recapitalization transaction is well planned for and quite possible. Of course soured employee morale can lead to key employee departures, including of members of senior management who are best versed in the troubles that beset the company and its future prospects. Creating as much stability in the employee base as is reasonably possible is a key strategy and a tactical plan to accomplish this goal is essential early on in the turnaround planning.

Stockholders will get wind of the bank's stressed financial situation either through communication from the bank or the holding company management or as a result of the publication of a regulatory enforcement action against the bank. Early thought needs to be given to a communication plan toward stockholders and a strategy that keeps stockholders fully and honestly informed, at the appropriate time, about key developments affecting their investment. Disgruntled, complaining or litigious stockholders can distract management and the board from the primary task — saving the company. Indeed litigious stockholders can take steps that interrupt or delay key corporate actions necessary to recapitalize the company, all when time is precious. Accordingly, managing stockholder relations is an essential stabilization challenge.

MANAGING THE BURNING “REGULATORY” FUSE

When a bank becomes distressed, pressure from its regulators builds and management can find itself spending more time managing to the regulators' demands than managing the business. This is particularly true when a distressed bank is downgraded in its risk rating and one or more of its regulators imposes a regulatory enforcement action. Particularly onerous regulatory enforcement orders can charge the bank with increasing its

capital levels over a short period of time or significantly reducing its NPAs or both. Finding additional sources of capital quickly is the remedy for both ills, but often, if the bank has not moved quickly enough in the early stages of its distress, it simply runs out of time and the bank tumbles fairly quickly in the final months into receivership. Fundamental to successful recapitalization transactions is managing the regulatory risk the bank faces, which involves anticipating the bank examiner's next major moves and restoring credibility with the bank's regulators through improved communication, straight talk and delivering on promises.

In the triage of a distressed bank, understanding where the bank stands in relation to the PCA capital standards is critical. But even more critical is having a third party expert forecast balance sheet and regulatory events that can depreciate the bank's capital levels to below adequately capitalized and the timing of those prospective downgrades. This pro forma analysis will give management and the board an opportunity to time the launch of the recapitalization and assess how much time the bank can afford to spend in the preparation stages of the recapitalization. Ideally, the regulators will be presented with a well thought through recapitalization plan that reflects preparation, tangible progress and reasonable prospects for success. Conversely, "concept designs" for a recapitalization plan that reflect a hastily conceived plan will not impress the regulators and will not buy the institution more time.

Early on in the bank turnaround program, the CEO or CRO needs to assess the regulatory risks the bank faces, prioritize those risks and, as mentioned, find a reliable estimate of the time remaining before the bank becomes critically undercapitalized. Armed with this information and forecast, the CEO or CRO can develop a strategy for engaging the regulators going forward and mitigating regulatory risk. In all cases, regulatory risk management is integral to preparing for and successfully accomplishing a recapitalization transaction because, in the end, a recapitalization is a race against time. Many banks have failed because they simply ran out of time. Capital and liquidity are precious commodities when a bank is distressed, but time is the most precious commodity. Taking proactive steps in a turnaround program to extend the useful life of a failing bank by three months or six months can mean the difference

between having sufficient time to prepare for and execute a recapitalization transaction or not.

FINDING INVESTORS

Recapitalizations are only successful when institutional investors put up millions of dollars to save the bank, and finding those investors is challenging. Private equity firms and other institutional investors receive numerous “pitchbooks” every week, and there is an underlying skepticism that the burn down analysis is unrealistically optimistic. Therefore, to attract bona fide investor interest, a recapitalization candidate needs to support its burn down analysis with credible third party credit intelligence and craft a “use of proceeds” story that differentiates the bank from the hundreds of other banks canvassing the same universe of investors for capital. The competition for capital is intense and will only grow more so as more banks experience deterioration in capital levels and regulatory pressure and bank failure rates continue to climb.

Not all investment banking firms are created equal and care needs to be taken in interviewing and selecting the best firm for the particular circumstances facing the bank. Consideration needs to be given to the firm’s prior recapitalization experience, the amount of capital that needs to be raised, whether national or regional institutional investors will be tapped and the capacity and resources of the investment banking firm to manage the capital-raising process at the time the process needs to launch.

The investment banking firm will play a pivotal role in helping the CEO or the CRO (in advance of the new CEO taking over) develop the “story” for the pitchbook and positioning the bank as an attractive investment opportunity. This is so because the investment bankers will understand, unlike most members of senior management or the board, how the private equity community and other institutional investors view these types of transactions in terms of risks and rewards. The investment banker will give advice on the type of security or securities that should be used and the type of offering that will be most effective, including, for instance, supplementing a capital raise from private equity firms with a rights offering to current stockholders.

These decisions are fundamental to the success of the recapitalization and undoubtedly they will affect the rights and interests of the current stockholders as well as any senior secured lender, trust preferred securities holders and the U.S. Treasury, if the bank accepted TARP money. Careful consideration needs to be given to all of these constituencies as the board identifies, with the advice of its financial advisor, the critical pathway for a successful recapitalization transaction. That advice, coupled with legal advice, will support the board's exercise of its business judgment and is essential to proper management of the board's fiduciary obligations.

CONCLUSION

Recapitalizations are extremely complex transactions requiring excellent project management skills, leadership, and creative thinking. They also require nerves of steel because most of the key business decisions made in preparation and during execution of a recapitalization program put the viability of the bank at risk. Recapitalizations, reflecting the culmination of a successful bank turnaround, require risk-taking to be successful, and the board needs to be prepared to accept those risks. For most severely distressed banks, there is risk in inaction as well.

In conclusion, there are three things to remember during every step of a bank turnaround and a recapitalization transaction: first, do not harm (the Hippocratic oath of the medical professional applies to the CRO, senior management and the board in a corporate turnaround); second, persevere while recognizing that turnarounds and recapitalizations inherently involve multiple setbacks that often appear to doom the bank; and third, be pragmatic — make decisions that make sense and make them quickly.