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BANKS NEED TO USE THE CLASSIC TURNAROUND METHODOLOGY

CHRISTOPHER J. ZINSKI

The author advises banks facing mounting non-performing assets and the related workout expenses, depreciating capital ratios, and threats of regulatory enforcement actions to take a step back and adopt an approach used by titans in the turnaround business: develop a turnaround strategy and plot a course to improve asset quality, manage capital ratios, and find opportunities to improve short- and long-term financial performance.

Robert Wilson turned around Memorex, Tom Wilcox turned around Crocker National Bank, Lee Iacocca turned around Chrysler and Vince Lombardi turned around the Green Bay Packers. Each of these turnaround leaders — in effect, Chief Restructuring Officers (“CROs”) — had different styles but the methodology they used to turn around their organization was fundamentally the same.

Each leader relied on a disciplined, deliberate approach to managing the organization with clearly communicated performance goals. In addition, each made the serious decisions necessary to achieve his stated objectives. With over 700 banks on the FDIC watch list and many hundreds more suffering severe credit quality, earnings and capital problems, Boards of Directors and senior management need to employ the basics of the classic turnaround model to save their banks from failure.

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SYMPTOMS OF THE PROBLEM

The need for a methodical planning and execution approach to improving the financial performance of distressed banks is obvious. But many Boards and management teams are in denial, a classic symptom of a company in severe need of a turnaround strategy.

Facing mounting non-performing assets (“NPAs”) and the related work-out expenses, depreciating capital ratios and threats of regulatory enforcement actions, senior management will find itself working around the clock, putting out erupting fires. But is serious progress being made or are wheels simply spinning? The stress in most banks these days, the constant fire drills, the uncertainty of future economic conditions and mounting and unpredictable examiner pressure make it difficult for management to step back, plan a turnaround strategy, engage the Board in the strategy discussion and establish metrics to measure performance in executing the plan. CEOs in distressed banks can be heard saying “we’ll keep our head down and hope credit quality improves” or “some of our peers are in worse shape.”

The reality is many senior management teams have not been in this type of environment before so they do not know what to do. The interrelationship among issues when a bank is distressed is complex. For instance, many banks are trying to manage the risk around their deferred tax asset (“DTA”) because taking an impairment charge drains capital. The DTA is a complex tax and accounting issue but it is a contingency that threatens capital and a bank’s standing with its regulators. Banks under regulatory orders are typically directed to reduce NPAs. Executing on that regulatory directive will inevitably put severe pressure on a bank’s capital ratios.

A well executed turnaround plan brings a strategic approach to moving NPAs off the books with a critical eye on the effect the disposition activities will have on capital ratios under the prompt corrective action thresholds. An ad hoc approach to asset disposition — which can result from an overburdened management team feeling the pressure of a regulatory directive — can have unintended consequences on capital, the DTA and the bank’s long-term viability.

THE HIPPOCRATIC OATH

The overriding rule a CRO must always observe is, like for physicians: first, do no harm. Banks in distress present very complicated financial engineering questions and often there is not much room to maneuver on the balance sheet. When executing a turnaround strategy, the risks associated with turnaround activities need to be well understood in advance and cleared with the Board. Unintended consequences can be catastrophic, such as an unexpected impairment to the DTA and its resultant adverse effects on capital, distressed asset sales that impair capital materially more than expected, or provoking earlier than normal regulatory intervention.

CLASSIC TURNAROUND MODEL DEFINED

A turnaround program for a bank identifies the action steps that provide the highest leverage for positive turnaround effects. Those steps relate to well defined strategic and performance objectives and involve urgent action and risk taking to dramatically improve the bank's chance of survival. While steps and objectives for any two distressed banks may share similarities, each bank's situation is unique and the turnaround program must be customized to the bank's particular circumstances. It is possible to triage a situation and develop a turnaround program that significantly enhances the bank's prospects for avoiding receivership. The program for a bank has four defined stages:

- Triage — where the bank's financial performance issues are studied, defined and realistically assessed;
- Work stream management — where the handful of high leverage turnaround opportunities are aggressively managed in a project management formula;
- Tactical NPA disposition plan development and execution — where NPAs are strategically organized for disposition based on recovery value, liquidity, carrying cost and capital effect and then moved off the balance sheet; and
- Review and execution of strategic alternatives, including raising capital or selling the bank.

When saving the bank is the goal, the turnaround strategy must move quickly but with sequential logic. Clearly, understanding the balance sheet problems fully and taking reasonable steps to improve the balance sheet improves the chances for a strategic solution, whether it is a capital raising event or sale of the bank. The triage and work stream management activities occur simultaneously and inevitably management focuses on the handful of activities that provide the greatest opportunity to leverage the turnaround and find opportunities to improve the balance sheet. Triage and work stream management uncover capital accretive opportunities, expense reduction and restructuring opportunities that would not be uncovered, or at least uncovered as quickly, in a business as usual operating environment.

The four steps mentioned suggest an organized and focused “command and control” protocol under the leadership of a CRO. It is the CRO’s responsibility to engage management, the Board and the other professionals involved in an intense and realistic evaluation of the condition of the bank and lead the group through the logical development of a turnaround program.

KEEP AN EYE ON THE DASHBOARDS TO AVOID A CRASH

The first dashboard that must be prepared and becomes the centerpiece of the CRO’s activities is the capital-prompt corrective action (“PCA”) dashboard. The bank’s current capital position relative to the PCA capital standards — well, adequate, undercapitalized, significantly undercapitalized and critically undercapitalized — needs to be memorialized on paper along with the same ratios on a quarter-forward pro forma basis. All material decisions in the turnaround need to be evaluated in the context of their effect on capital within the context of the PCA thresholds. Understanding the bank’s “capital cushion” at each point along the PCA continuum allows management and the CRO to assess the capital risk of each major business decision in the turnaround.

The second dashboard covers a multitude of credit quality indicators, with special attention given to criticized and classified assets, respectively, to tier 1 capital plus the allowance for loan and lease losses. The bank’s coverage ratio is another material ratio to monitor. Goals need to be set early in the turnaround process for the improvement in key credit quality metrics.

AGGRESSIVE MANAGEMENT OF THE CREDIT PROBLEM

Credit quality is the dominate issue on most bank balance sheets and a third party review of the portfolio is essential to get a realistic assessment of the problems and an objective view on the best strategy for reducing NPAs. Ideally, a turnaround strategy would have at its core disposing of the largest NPAs with the smallest effect on the bank's capital ratios and moving those assets off the balance sheet quickly. But this ideal is generally not possible in the current environment where the market is saturated with problem assets and many loans secured by real estate assets ("REO") have peculiar features making quick, clean, par value sales virtually impossible. A great deal of deep thinking must occur to develop a disposition strategy that achieves a meaningful reduction in NPAs while not decimating the bank's capital position and pushing it toward critically undercapitalized status.

Until the bank has a realistic view of its credit situation and has developed a tactical NPA disposition plan, not much progress will be made in improving credit quality. The first step in improving credit quality is to retain an expert third party asset quality firm which can assess the portfolio, particularly the distressed asset class or classes. That third party review will inevitably provide color on the quality of the bank's loan files, how effectively management is managing the NPA portfolio and ideas for more effective management of the credit portfolio overall. Senior management may not like what it hears from the third party firm, but an objective perspective is the first step to overcoming denial and attacking the problems head on. It also gives the CEO, the Board and the CRO a realistic assessment of the depth of the credit problems.

A third party firm should be charged not only with reviewing the distressed portfolio or portfolios, but estimating the bank's cost to carry its NPA portfolio and implied market discounts on NPAs. It is likely that the discount analysis will reveal that the bank is significantly under reserved and that realization, as stark as it is, will give the Board the insight it needs to make important strategic decisions about the future of the bank. The Board, armed with the credit impairment data from the third party firm, can make decisions about NPA disposition, capital raising or a sale of the bank. Critical to this process is the third party firm creating a tactical NPA disposition plan

that literally ranks NPAs for disposition based on a strategic approach.

This may include, for instance, wrapping certain distressed assets with performing loans to make the loans more attractive to counterparty bidders and increasing the recovery yield on the distressed assets by blending them with performing notes. The tactical NPA disposition plan has to take into consideration a number of factors, including the effect on capital of the sequencing of NPA dispositions, balance sheet shrinkage advantages, the examiner's perspective on the plan, directives under any enforcement action the bank may be subject to and how prospective investors in the bank or an acquirer of the bank may view the disposition methodology and its effects on the balance sheet.

SOLUTIONS IN THE FORM OF STRATEGIC TRANSACTIONS

Many banks want to attack their credit quality and weakened capital positions by raising capital. The days of transaction-based capital raising are over for all but the largest banks with liquid securities. Banks in the billion dollar asset size range and up need to clean up their balance sheets and get their arms around their credit quality problems before they can effectively raise capital in this environment. Investors are skeptical about credit quality and do not want to fill a hole in the balance sheet that will be revealed after the capital raise. Moreover, many banks are chasing capital so investors are being very selective in their investment choices. Distressed banks must, to have a chance to execute a capital raise, focus on balance sheet improvement, develop a story about the future prospects of the bank and take a less traditional approach to finding investors.

Highly distressed banks may need to take a two prong approach to finding strategic solutions to their balance sheet weaknesses. It may be advisable to pursue a capital raising transaction concurrent with a sale of the bank. This approach has several advantages. Highly distressed banks typically do not have sufficient time to raise capital. Spending two or three months chasing capital without closing a capital raise wastes precious time. It may be more logical to have an investment banker tap natural sources of capital from institutional investors while at the same time seeking out an acquisition solution either from those same institutional buyers or from other financial institutions. In short, like everything else in a classic turnaround, the Board and

the CRO must evaluate the distressed bank's options with a strategic focus, analyzing the most likely approach to a strategic transaction that will save the bank from receivership.

LEADERSHIP AND LASER FOCUS

Balance sheet management in a bank turnaround has several dimensions. It requires a laser focus on credit quality and the development of a well reasoned NPA disposition plan. But the balance sheet also needs to be scrubbed for capital accretive opportunities. If investment securities can be sold at a gain, this should be considered. If prior accruals for long-term compensation can be reversed, management should give it serious consideration. Likewise, shrinking the balance sheet to improve the capital ratios must be given attention.

A turnaround requires leadership, discipline and straight talking. If management feels overwhelmed with the bank's current problems and day to day management issues, retaining a turnaround project manager may be valuable to keep management focused on turnaround priorities in a regimented process. The turnaround manager also can help management assess the priorities for leveraging the turnaround to the maximum and keep the program moving forward with a sense of urgency.

Besides delaying classic turnaround steps based on a state of denial, management can make other mistakes when a bank is in distress. It is common for management to fall into old behavior response patterns that may work effectively in a more benign operating environment but have a detrimental effect when a bank is severely distressed. For instance, management may be inclined, given its natural marketing tendency, to grant loan extensions to customers who represent marginal long-term profit opportunities rather than encouraging marginal customers to move their credit elsewhere and taking the balance sheet shrinkage opportunity that renewals present.

STRATEGIC GOAL SETTING

Whether a distressed bank can be turned around or saved from receivership depends on many factors and a little luck. A priority goal in any bank turnaround is to take steps that buy the bank time with its regulators. Time

can produce a lucky bounce or improved market conditions giving the bank a chance to work through its balance sheet problems. Keeping the regulators satisfied requires giving them periodic, substantive updates on the progress under the turnaround plan and by doing so earning management some credibility. The bank's correspondent bank, if a holding company credit facility is in place, may value a formal turnaround and monitoring plan, giving the holding company more time to right itself.

A formal turnaround program raises everyone's stress levels because it breaches the normal wall of denial that senior management and the Board builds around itself when a bank's balance sheet deteriorates and the very real prospects of a bank receivership loom on the horizon. With a CRO and a third party firm involved, straight talk happens and a realistic assessment of the bank's condition begins to take hold in the Board room. It is only when reality is addressed head on that senior management and the Board have a chance to save the institution. And the sooner the wall of denial is breached, the sooner remediation steps can be taken to save the institution. While capital and liquidity are precious commodities in the current banking environment, the most precious commodity is time. Failure to take deliberate, well reasoned steps to save the bank further narrows the bank's strategic options tomorrow.

As a bank begins to fail, management and the Board inevitably lose credibility in the eyes of the regulators. Moreover, the regulators understand how the wall of denial can encumber the ability of senior management and the Board to take the necessary action to address the bank's problems. Therefore, two things need to happen in a formal turnaround program to win back credibility. First, senior management and the Board need to persuade the bank's regulators that they are no longer in a state of denial and that they understand the serious financial and regulatory issues facing their bank. That kind of simple communication is enormously helpful in winning back some credibility. Second, management and the Board need to proffer a written turnaround plan to the regulators and keep the regulators frequently undated on the progress against the plan.

This approach reflects what the regulators would be doing with the institution if they were in charge of it and trying to save it from failure. Therefore, management and the Board are persuading the regulators that their institution has a reasonable plan for improving financial performance and the Board

is prepared to be held accountable to that plan. The point is to persuade the regulators to give your bank time — compared to other distressed banks without a plan — to take the remedial steps necessary to restore your bank to financial health.

SEQUENCING IS CRITICAL

While a great deal of work needs to be done in a classic turnaround, it cannot all be done at once. It needs to be appropriately sequenced for best effect. A bank turnaround has at least a six month cycle. The first two months focus on setting strategic goals for the turnaround, hiring the third party firm, triaging the distressed portions of the credit portfolio, developing the tactical NPA disposition plan and designing an approach to rebuild credibility with the regulators. This initial two months also will focus on balance sheet improvement opportunities and cost cutting measures.

Once the third party firm has analyzed the distressed portfolio and the depth of the problems are well understood, phase two of the turnaround focuses on realistic strategic options for the bank, which may include a capital raise, a sale of the bank, a sale / leaseback of branch offices or a combination of these and other strategic choices. In any event, hard work must be done on the credit portfolio first before the Board can realistically assess the bank's strategic choices. The triage process that occurs during the first two months may indicate that the bank can afford to take a more prolonged approach to resolving its credit and other balance sheet issues and that will affect the Board's go-forward approach to managing the turn around. It may, on the other hand, reveal that the bank is farther down the receivership "slide" than originally understood, compelling the Board to take swifter, and more dramatic action to stave off receivership. Whatever the steps taken in stage two of the turnaround, they require risk taking.

RISK TAKING

A severely distressed bank is at risk of failing. If it fails, stockholder value is wiped out, reputations of officers and directors are tarnished and the community loses a valuable source of credit and banking services, which may not be

fully restored by the bank that buys the failed bank's deposits and loans through a receivership transaction. The stakes are enormously high and so are the risks.

A turning point is reached in the Board room when the Board realizes that inaction or acting without a sense of urgency puts the bank at greater risk than taking deliberate, often dramatic action to improve the bank's balance sheet and manage the regulatory relationship. Turnaround programs are high risk. The third party asset quality firm is likely to conclude in writing that moving NPAs off the balance sheet will put extreme pressure on the bank's capital ratios, a reality that will need to be discussed with the examiners. The examiners will already understand this situation but this does present the opportunity to enhance the credibility of management and the Board. As NPAs are sold, capital will depreciate and the bank will move down the receivership slide toward critically undercapitalized status. That reality needs to be managed.

Moving forward with a capital raise or selling the bank means that the final strategic options for the bank either will or will not materialize. This "market check" will tell the regulators whether the market thinks the bank is worth saving or not. A failed capital raise or sale may move the bank one step closer to failure. But failing to act has risks too. Banks with high levels of NPAs that refuse to move them off the books or organize NPA dispositions in concert with a plan to raise capital or sell the bank may face inevitable receivership. The message is that early, thoughtful and decisive action is often the best chance to save the bank from failure. Waiting and hoping that the bank's fortunes will turn around is not a plan.

CONCLUSION

Imagine your senior management team working with a turnaround project manager and an asset quality review firm week after week as your bank plots a course to improve asset quality, manage your capital ratios and find opportunities to improve short and long term financial performance. Imagine the benefits of a disciplined, rigorous approach to turning your bank around and the value of having more brainpower around the table to identify and deliberate over your most significant and trying problems. This is the approach used by titans in the turnaround business and the approach can be effective with distressed banks too.