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Bankruptcy Sales to Facilitate Open-Bank Recapitalizations

J. MARK FISHER

This article discusses the issues raised by current bank holding company structures in accomplishing an open-bank recapitalization and provides an overview of the bankruptcy solution.

Bankruptcy can provide a valuable tool to close a previously-negotiated recapitalization of a financially-distressed open bank. Buyers have recently become more interested in pursuing negotiated open-bank acquisitions, as opposed to an FDIC-sponsored auction of a failed bank's assets. An open-bank deal can avoid the damage to the franchise value of the target from the loss of employees and the loss of good will and deposits as a result of adverse publicity from competitors. Reduced FDIC loss-share support and greater competition have increased the risk and the price of bidding — often with as many as six or eight competitors — on a closed-bank deal, making open-bank transactions more attractive.

Unfortunately, recapitalizing an open bank may be difficult in those many instances where the bank's holding company carries a tremendous debt load in comparison to the capital of the bank. This problem is particularly difficult when realistic credit stress is applied to the bank's assets. Severing the bank from its holding company, therefore, is crucial to effecting a recapitalization of the bank. The sale of bank stock in a bankruptcy of the holding company provides the fairest and most effective means to

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accomplish such a transaction.

Banking lawyers may not be familiar with the bankruptcy process, since banks cannot file a voluntary bankruptcy petition under the United States Bankruptcy Code (the "Code"). Well-established procedures for the consideration of "stalking-horse" agreements for the purchase of assets under Section 363 of the Code apply to a bankrupt bank holding company's sale of its stock in one or more of its open banks. The process substitutes the bankruptcy court's order for the consent of shareholders and creditors that is required, but practically may be unobtainable, under nonbankruptcy law. The judicial process also provides certainty and protection against litigation for the buyer, its investors, the holding company's directors and even the trustee for trust-preferred securities ("TRuPS"). A judicially-supervised auction process protects creditors, but also moves the sale process to closure to achieve the regulatory timeline that will avoid FDIC receivership and loss to the FDIC insurance fund. By overcoming these logjams blocking recapitalization of over-leveraged bank holding companies, bankruptcy can serve the public interest in raising capital to meet regulatory mandates and avoiding more bank failures. This article briefly discusses the issues raised by current bank holding company structures in accomplishing an open-bank recapitalization and provides an overview of the bankruptcy solution. The recent bankruptcy of AmericanWest Bancorporation in Spokane, Washington and the 2009 pre-packaged bankruptcy of CIB Marine Bancshares in Milwaukee, Wisconsin are the first of many recapitalizations that will use bankruptcy to overcome the problems with consummating an open-bank deal.

CHALLENGES TO OVERCOME

The Problems of Double Leverage

Increased leverage during the past investment cycle and the collapse of the residential and commercial retail sectors have created a difficult dilemma for many banks seeking recapitalization. In order to double leverage equity, many banks are organized in a holding company structure, whereby their holding companies serve little economic purpose beyond

borrowing from other banks and investors who have purchased TRuPS. This allowed banks to borrow at their level in the capital structure and the holding company to borrow at its level, downstreaming the proceeds as equity or subordinated debt. Some correspondent banks lent money to holding companies to finance acquisitions and operations by loans secured by the stock of banking subsidiaries. As capital eroded from the growth in nonperforming assets ("NPAs") and the foreclosure of real estate collateral ("REO") at the bank level, holding companies borrowed from the sold preferred stock to the United States Treasury under the TARP and other successor programs.

These developments created a massive overhang of debt or preferred equity that stands between holding company shareholders and any return on their common equity investment. Holding company creditors and preferred shareholders must be paid before shareholders' equity interests are paid. The FDIC's "Problem List" of troubled institutions (those that are undercapitalized or worse) reached more than 800 during 2010.[1] If the banks are placed into FDIC receivership, the holding company creditors and shareholders receive nothing for their stakes. Even if there is franchise value and tangible equity in the bank, the value of the bank stock is drastically impaired by the need to inject new capital to meet regulatory requirements, the risk of further migration of performing assets to NPAs and the need to give a new stake to the new investor who brings it to the table. In short, a deep haircut is required for all holding company stakeholders.

This creates an impediment to a recapitalization at the holding company or bank levels. First, without a haircut of the existing debt, an investor would not buy new equity in the holding company level and take a risk that creditors would recover all of the value. Second, shareholder consent may be required to increase the authorized holding company shares to accomplish the substantial dilution of existing equity in the holding company. Third, an investor cannot buy new equity directly from the bank without the consent of the holding company's secured creditors, the holders of TRuPS and possibly the U.S. Treasury. The documents governing these loans or investments generally prohibit the dilution of the holding company's equity interest in the bank. Finally, consent of the holding company's shareholders may be required under state corporation law for

new equity investments in the bank because the substantial dilution of the holding company's equity interest in the bank may be tantamount to the sale of "substantially all" of the holding company's assets.[2]

The Problems of "Negative" Leverage

Despite the need for concessions, secured and subordinated holding company loan structures can impede consensual negotiation. Bankruptcy lawyers are used to the application of "negative leverage" — not excessive debt, but the ability of a creditor or equity holder to hold up a deal even if low asset valuation means that they are not entitled to receive any proceeds. The holding company structure is rife with negative leverage. TRuPS often are issued through conduits that make negotiation of consent difficult or impossible. First, the TRuPS indentures only permit modification of the securities with the affirmative consent of a high percentage of the securities outstanding. Second, the ultimate holders of the securities are unknown to the trustee, particularly if the conduit is unmanaged. Third, obtaining consent is more difficult because the securities often are blended into larger pools of holding company TRuPS in which investors participate in different tranches. Holders of the senior tranche are not impacted (and do not care) if one bank holding company's debt defaults. On the other hand, holders of the junior tranche will receive nothing unless they hold firm and demand "full payment" in exchange for any consent.

While a deal may be rich enough to pay off holding company creditors in some cases such as the recent purchase of Pacific Capital, it is impractical where the tangible equity of the bank is small and dropping. The latter category makes up the vast majority of banks in need of recapitalization.

The "Litigation Problem"

The thorniest problems deal with overcoming the inertia caused by the threat of litigation. Holding company directors are concerned about derivative litigation from stockholders and possibly creditors asserting breaches of fiduciary duty of care, loyalty or good faith in approving a recapitalization that wipes out existing shareholders and provides a modest

recovery to holding company creditors. Bank directors also are justifiably afraid of suit by the FDIC if the bank is placed into receivership.

The buyer and its investors are concerned that creditors or the shareholders of the holding company will sue after the deal closes to unwind investment to which they do not consent. Many state law and federal bankruptcy theories may be raised if plaintiffs prove that the purchase price of a successful, recapitalized bank was "too low."

Finally, the corporate trustee for TRuPS fears litigation from the bondholders if it agrees to concessions to facilitate a recapitalization without unanimous consent. The trustee's deep pockets are a tempting target, making it more attractive to sue than to wait around to see if a junior tranche of TRuPS will pay off. To a lesser extent, banks that specialize in holding company loans are concerned about making concessions because of the message that they are sending to their other borrowers about the availability of loan modifications or discounted payoffs.

THE BANKRUPTCY OPTION

The 363 Sale Process

The bankruptcy court-approved sale of the holding company's stock in the bank offers one solution to minimize or eliminate these potential problems. It follows four basic steps. First, the holding company, bank and buyer negotiate and sign prior to bankruptcy an asset purchase agreement for the purchase and sale of the existing bank stock and other specified assets and agreements owned by the holding company, and a simultaneous recapitalization of the bank by an additional investment in the bank. The agreement provides for a breakup fee or expense reimbursement payable to the buyer if an alternative transaction is consummated by the holding company either before or after the bankruptcy. The parties' obligations are expressly conditioned upon two bankruptcy court orders. Within a few days after the bankruptcy is filed, the court must enter a "bidding procedures order" that approves the buyer as "stalking horse" entitled to a breakup fee and/or expense reimbursement. The order sets standards for a market check and possible auction after the bankruptcy

by establishing financial and regulatory standards for qualified competing bidders and requiring them to use the agreement as the template for any qualified competing bid. The order also sets the deadlines for the debtor's solicitation of qualified competing bidders and competing bids, completing the bidders' due diligence and financing and the minimum initial bid and bidding increment at any auction.

The agreement also conditions the parties' obligations on bankruptcy court approval of the sale itself by an order containing specified provisions, including a sale "free and clear of liens, claims and interests" in the acquired assets, a finding that the buyer has acted in "good faith." Closing is subject to regulatory approval. The stalking horse bidder can get the jump on competing bidders by seeking preliminary approval once its due diligence is complete and it can satisfy the regulators (by an escrow or otherwise) that it can pay the purchase price and recapitalize the bank. Competing bidders who are not well-capitalized existing bank holding companies probably must wait until after winning the bankruptcy auction to seek regulatory approval.

Closing can occur promptly after the order approving the sale if the buyer is held to be a good faith purchaser, since any appeal will be rendered moot by the closing and the provisions of Section 363(m) of the Code, which provides that closed sales to such purchasers generally cannot be unwound. This can be important since the purchase price and other holding company assets are unlikely to pay more than a fraction of holding company debt. Indeed, the undercapitalization of the bank usually means that the purchase price for the bank stock sold under the agreement is a fraction of the funds that will recapitalize the bank. For example, in the AmericanWest transaction, the buyer proposes to pay $6.5 million for the bank stock and to pay up to $200 million to recapitalize the bank. TRuPS alone constitute $47 million of holding company debt. Consistent with the author's experience in other Section 363 sales, this transaction already has generated considerable interest among other potential bidders, so the ultimate recovery may be higher.

When the buyer's deal lacks due diligence and financing contingency, the holding company files its Chapter 11 bankruptcy petition and seeks approval of the sale and bidding procedures specified in the agreement, among

other "first day" motions. This allows the bankruptcy court, within a week or so, to authorize a well-organized market check and sale timetable that must meet the regulatory timetable set by any prompt corrective action or cease and desist order applicable to the bank or holding company.

The adverse publicity of the bank holding company bankruptcy can be minimized by an appropriately planned public relations campaign that takes advantage of the pending offer to purchase the bank's stock and place the bank in the "stronger hands" of the investor group. Depositors whose deposits exceed FDIC insurance limits and key customers can receive assurance that the financial reengineering of the holding company will not affect bank operations.

BENEFITS TO THE PLAYERS

Given the factual setting (an undercapitalized bank), all of the key constituencies receive fair, market-driven treatment that improves on the results of an FDIC-assisted closed-bank acquisition.

All Bidders

The winning bidder benefits from a transparent process ending with the certainty of a court order and a prompt closing of the purchase and recapitalization. It nullifies the threat of protracted litigation that can be used as negative leverage to extract an above-market payment to holding company creditors or stockholders who are "out of the money." Indeed, the bankruptcy court order supplants the consent from TRuPS holders and shareholders that otherwise is practically unattainable. Once it pays the judicially-approved purchase price in good faith, the buyer is not responsible for holding company debts unless they are specifically assumed. It can close promptly after receiving regulatory approval without material risk from an appeal.

Stalking Horse

The stalking horse bidder receives the benefit that the market check will be subject to reasonable timetables and competition only from well-

vetted and capable bidders who cannot take the deal for a minimal overbid. Even if it loses at auction, the stalking horse bidder is rewarded for getting the deal process underway by having its expenses or a breakup fee paid from the alternative transaction proceeds. Of course, the stalking horse also benefits from its head start on due diligence, fundraising and seeking regulatory approval.

Bank and Holding Company Directors

Directors still must comply with their fiduciary duties in the transaction, but they receive the valuable protection from bankruptcy court approval of the fairness of the winning bid, the market check process and distribution of the proceeds. This minimizes the risk of derivative litigation from creditors or shareholders of the Holding Company relating to the transaction itself. This can be an important benefit. While directors can rely on the business judgment rule and the advice of able financial and legal advisors to defeat litigation, it may nevertheless be filed. Exculpation and indemnification provisions of the charter, by-laws and state law and even directors' and officers' liability insurance may be inadequate, given the limited corporate resources of the bank and holding company. Finally, bank directors receive the benefit of saving the bank from FDIC receivership and the risk of suit by the FDIC for breach of fiduciary duty.

Creditors and Trustees

The Section 363 sale process benefits creditors by allowing a deal to get done, when FDIC receivership would result from gridlock that discourages the first bidders away. Holding company creditors receive far less if the bank is seized; the bank stock becomes valueless, the FDIC (as receiver) receives a ninth-priority claim (and possible immediate right to payment) of any financial commitment by the holding company to the bank under Section 365(o) of the Code. The Section 363 sale process is less expensive and sufficiently fast to meet the tight regulatory deadlines for recapitalization of the bank. Indeed, a structured dismissal of the bankruptcy may be the most expedient way to distribute the proceeds of

sale and other liquid assets of the holding company based on a bankruptcy court order allowing creditor claims. This may be important if the priority of creditors' claims is in controversy because the court, rather than holding company directors, will decide the question.

The TRuPS trustee similarly receives protections for itself and constituencies. The trustee has a forum in which to express and advance the interests of the holders regarding the terms of the sale and the fairness of the transaction. Once the bankruptcy court has approved the transaction, however, it is highly unlikely that holders of the TRuPS would be able to claim that the trustee breached its fiduciary duty to holders by approving the transaction. These protections are very important to the indenture trustee, who has extended no credit, but seeks to avoid unnecessary cost and avoid litigation against it from its holders.

Shareholders

Unfortunately, shareholders are unlikely to receive anything from the 363 sale process unless the value of the holding company's assets exceed its liabilities, or holders of claims are willing to give up value to pay something to shareholders. This is not the result of the process, per se, but the liquidation preference of common stock that ranks behind debt and preferred stock. Value can be created if a bidding war occurs to bid up the value of the bank stock during the auction. Other holding company assets may also exist that can be reduced to cash. If it appears that equity exists, the bankruptcy court will pay considerable attention to the position of the shareholders on proceedings in the case. Indeed, shareholders may even seek the appointment of an equity committee to protect equity holders' rights. However, the bankruptcy judge will ultimately decide whether to approve a sale, regardless of whether shareholders consent or even oppose the sale.

Public Interest

Saving the bank from receivership has tangible and intangible benefits to the public that justify the additional issues and cost created by the bankruptcy process. Regulatory resources are not wasted on the seizure of a

bank that can be saved. The FDIC insurance fund will not lose money on deposits or through the liquidation of NPAs and REO. Communities and depositors benefit from a less disruptive transaction.

CONCLUSION

While it is not perfect, the bankruptcy process can lead to a speedy and more certain recapitalization of a financially-distressed open bank. Given the challenges presented by numerous undercapitalized banks, this process will frequently be used in the upcoming years.

NOTES

[1] "Earnings of FDIC-Insured Institutions Increased to $21.6 Billion in Second Quarter of 2010," FDIC Press Release, August 31, 2010.

[2] *See, e.g.,* Illinois Business Corporation Act, 801 ILCS 5/11.60.