THE CURRENT MARKET OF BANK RESTRUCTURING ALTERNATIVES

THE PROBLEMS AND CHANGES IN THE BANK MARKET

While the number of banks that have failed in 2013 (23 so far), 2012 (51) and 2011 (92) has fallen from the highs of 2009 (140) and 2010 (157), reports suggest that the reduced number of failures is not only the result of the improved conditions of the banks or of a broader economic recovery. Rather, the stress on the regulatory system of the scope of the crisis has resulted in troubled banks operating longer in distress than anticipated. Over 480 banks have failed nationwide since the start of the financial crisis in 2008, and nearly 9% of FDIC insured banks remain on the FDIC's Problem Bank List.

The complex and evolving regulatory environment has increased the difficulty for many troubled banks to find the capital necessary to emerge successfully from the continuing crisis. Both Section 171 of the Dodd-Frank Act (the Collins Amendment) and the risk-based capital rules adopted earlier this year by the Federal banking regulators require bank and savings and loan holding companies to phase-out reliance upon trust preferred securities (TruPS) depending upon the type and asset size of the issuing institution and the date on which the TruPS were issued. Consequently, many larger institutions, such as Regions Financial Corporation, Bank of America, JP Morgan Chase and BONY Mellon took the steps necessary to redeem outstanding TruPS securities in the second half of 2012. Other smaller institutions including community banks lack the independent resources to redeem these securities in full. The table below describes the implementation schedule set out in the revised risk-based capital rules for certain financial institutions, including community banks:

Type of Entity	Final Risk Based Capital Rule Transition Provisions
Bank holding companies (BHCs) and savings and loan holding companies with total assets of less than $15 billion as of December 31, 2009, and organizations that were mutual holding companies on May 19, 2010	In general, non-qualifying instruments issued on or after May 19, 2010 will not be included in Tier 1 capital as of January 1, 2015. Non-qualifying instruments issued before May 19, 2010 will be grandfathered if they were included in capital as of January 1, 2014. Grandfathered capital instruments will be subject to a limit of 25 percent of Tier 1 capital elements, excluding any non-qualifying capital instruments. This limitation is somewhat more restrictive than the current limitation of 25% or core capital elements, including restricted core capital elements.

Type of Entity	Final Risk Based Capital Rule Transition Provisions
All other BHCs	Beginning January 1, 2014 (for advanced approaches organizations) and January 1, 2015 for all other institutions, non-qualifying capital instruments will not be included in capital, subject to a phase-out schedule between 2014 and 2022 for instruments issued prior to September 12, 2010.
Savings and Loan Holding Companies	Generally, subject to the same grandfathering rules as BHCs described above, except that (i) savings and loan holding companies will not become subject to most requirements until January 1, 2015, and (ii) the rule includes temporary exemptions for savings and loan holding companies substantially engaged in insurance underwriting or commercial activities.
Small bank holding companies subject to the Small Bank Holding Company Policy Statement (as in effect on May 19, 2010) (e.g., less than $500 million of consolidated assets) (This exemption does not apply to similarly situated small savings and loan holding companies)	No prohibition on issuing new trust preferred securities. Existing instruments grandfathered.

Indeed, community and regional banks have been especially frustrated in their attempts to recapitalize. Published reports indicate that banks with under $1.5 billion in assets have the greatest difficulty in landing available capital. There is a need for private equity to play a role, but bank holding company regulations have precluded these potential investors from playing a significant role. In fact, the Conference of State Bank Supervisors (CSBS) published a report at the end of 2011 highlighting the capital problem facing community banks.

THE TRUPS DILEMMA

According to Fitch ratings, since 2000, 1,813 banks, thrifts and BHCs issued approximately $37.7 billion of TruPS. As a general matter, TruPS are usually widely held across multiple CDOs and therefore, approval of significant transactions for an issuer can be daunting. At the end of the third quarter of this year, Fitch Ratings reported that 222 bank issuers of TruPS held in Fitch rated CDOs were in default and 282 bank issuers had exercised deferral rights that were then in effect. That meant that almost 36% of the Fitch rated TruPS CDO universe was either in default or deferral. The end of the five year deferral period for many of those banks will start to hit in 2014, requiring those institutions to catch up on deferred interest payments. Even institutions that are not required by the new capital rules to raise additional capital to replace non-qualifying TruPS may find that the mere presence of TruPS may in some cases make it more difficult to attract new investment. These securities, once a darling of the bank finance market, have created a significant barrier to successful new investments in community banks because, fundamentally, new investments in community banks must solve two problems:

- first, any new investment must shore up the Tier 1 capital requirements for the operating bank itself; and
- second, new investments must satisfy the claims or interests of old and cold capital providers who are, in many instances, the holders of the TruPS.

Given that market valuations have not returned to pre-crisis levels, smaller banks cannot raise funds to satisfy both sets of obligations in full. Practically, the difficulty dealing with the TruPS is evident from a cursory review of the typical structure:

RESTRUCTURING ALTERNATIVES

Whereas historically any bank merger transaction usually meant payment in full of the outstanding amount of the TruPS, the depth of weakness in the market compelled banks to search for other solutions to address outstanding TruPS obligations and to preserve both the institution themselves. The key to success of any of these transactions is the coordination of the new capital raise with the restructuring of the troubled bank's outstanding obligations.

The Bankruptcy Code Section 363 Sale: AmWest & Jefferson Bank

Cases under the federal Bankruptcy Code have long provided for the expeditious sale of assets of overly leveraged troubled companies free and clear of all liens, claims and interests. This sale strategy was adopted for some of the largest, most successful restructurings including Chrysler and General Motors. Named for the applicable provision of the Bankruptcy Code, these Section 363 sales are bankruptcy court supervised auctions that typically occur on an accelerated time frame. "Stalking horse bidders" in these transactions who present a fully documented bid are typically awarded break-up fees and expense reimbursement as part of the bid procedures approved by the bankruptcy courts leading up to a possible auction. The stalking horse bid is then made subject to higher and better offers. At closing, the liens, claims and other interests that encumbered the troubled company's or debtor's assets attach to the proceeds of the Section 363 sale by order of the bankruptcy court. These sales can be consummated over the objections of individual creditors, but still require applicable regulatory approval.

In the case of AmericanWest Bancorporation (AmWest), a Section 363 sale was employed to recapitalize the bank that had 58 branches across eastern Washington, northern Idaho and Utah. Working closely with its regulators, the publicly-traded AmWest, after failing to raise capital for more than one year, proposed a Section 363 sale to a joint venture owned by Goldman Sachs and Oaktree Asset Management. Under that agreement, AmWest would sell the shares of its operating banks, free and clear, for a purchase price of $6.5 million and an equity contribution of $200 million by the joint venture purchaser to recapitalize the operating bank. Within approximately two months of the execution of the asset purchase agreement, the bankruptcy court approved the sale over the objection of at least one holder of the TruPS. The key element of the transaction was that the Section 363 sale dispensed with the need for approval by TruPS holders who would only be paid a fraction of the approximately $43 million they were owed.

The Section 363 Sale provided four key benefits to the buyer and the seller:

- *Speed:* From the bankruptcy filing date to the closing, the parties need only eight weeks. A critical component was bringing the regulators into the process early.
- *Transparency:* The open nature of the bankruptcy process meant that regulators and all parties could follow and participate to the extent necessary.
- *Notice:* All creditors and other stakeholders, including TruPS holders, were on notice (one TruPS holder objected – unsuccessfully) and became bound by the bankruptcy court's order.
- *Procedural Certainty:* For the successful purchaser, a quick bankruptcy process preserves value. Moreover, regulatory change of control requirements may limit the number of potential competitors.

Not surprisingly, holders of TruPS became more sophisticated in their efforts to challenge a sale after AmWest and used other bankruptcy remedies to gain leverage in subsequent transactions. Eighteen months after AmWest, in the bankruptcy case of Outsource Holdings, Inc., the TruPS holders attempted to move for the appointment a trustee to take control of Jefferson Bank from its holding company, Outsource Holdings, to gain leverage in the bankruptcy case. This extreme remedy was settled for the appointment of an examiner who analyzed the marketing process leading up to the proposed Section 363 transaction and found it to be fair. As a result, the bankruptcy court approved the merger of Jefferson Bank with the stalking horse bidder, First Bank & Trust.

The Chapter 11 Plan Alternative

The more traditional way for a debtor to emerge from bankruptcy is through confirmation of a chapter 11 plan of reorganization. The Bankruptcy Code sets forth in Section 1129 and elsewhere fairly stringent requirements for confirmation of a plan. Among other requirements, a plan must be approved by ½ in number and 2/3 in dollar amount of claims (that have been voted) in each class of similar claims that are impaired, that is, adversely affect by a proposed plan. A debtor may also

propose under certain circumstances a plan that "crams down" one or more classes of claims so long as it treats such class(es) fairly and equitably. This voting requirement provides debtors with a powerful weapon over recalcitrant creditors or other stakeholders who oppose a plan, but do not hold a sufficient number or amount of claims to block an affirmative vote by their class. In addition, it protects debtors from creditor "indifference" or the failure of holders to vote. As long as the debtor meets the threshold from the actual voting pool, then the voting requirements are satisfied.

Time and space limit the discussion here of all of the considerations encompassed in the confirmation of a plan, but a few salient points are worth noting. First, a plan process generally takes longer than a Section 363 sale. Depending on how severe a troubled bank's condition may be, time may be a factor. If, on the other hand, the troubled BHC needs time to raise capital and has a window of time with its regulators, the plan process can demonstrate progress necessary to interest potential capital providers. Second, a chapter 11 plan typically resolves all of the claims and interests against a troubled bank. In the context of Section 363 sale, disputes over the proceeds of a Section 363 sale could continue indefinitely. Third, the plan may also allow for the liquidation or recovery, and ultimately the distribution, of other assets such as tax refunds. Many of the troubled BHCs that filed for bankruptcy after the operating bank was seized or closed by regulators had only tax refunds (albeit in large sums in certain cases) to distribute to their creditors. Indeed, material litigation has occurred between creditor constituencies and the FDIC over the appropriate distribution of the tax refunds.

One troubled BHC presently navigating its way through the bankruptcy process is Capitol Bancorp Ltd. (CBC). CBC filed for bankruptcy in August 2012 in Michigan with the hope of confirming a pre-packaged plan of reorganization in the fall. The plan was contingent on attracting new capital but apparently later fell apart when a new investor failed to materialize. The company later submitted a new plan under which it would sell its remaining banks in 363 sales and liquidate.

The fact that CBC initially successfully solicited votes for a plan, demonstrates the increasing sophistication of the TruPS market. Previously, Corus Bancshares successfully confirmed a plan – albeit after the FDIC seized its bank subsidiary – by garnering sufficient votes of the TruPS holders after several attempts. Like other securities and claims in the secondary market, control over TruPS has changed hands from the original holders to parties that have established investment positions in these securities in the secondary market. It has led to a more knowledgeable and liquid market in these securities which creates both its own set of opportunities and challenges. BHCs now may have a quorum of holders with whom they can negotiate or, alternatively, holders may join together to block a proposed transaction or plan that they consider less desirable.

BB&T/BankAtlantic: Out of Court Transaction Risk

The risk associated with out-of-court restructuring transactions became plainly evident in the original acquisition transaction for BankAtlantic by BB&T. After the Florida real estate market collapsed, BankAtlantic spent two years looking to restructure. It had raised $285 million in the TruPS market from 2002 to 2007 and suffered substantial losses from 2008 to 2010. Its efforts to raise cash through asset sales fell short repeatedly and in July 2011, BankAtlantic looked to develop a good bank/bad bank transaction in which it would sell deposits and performing loans, but retain certain criticized assets. In November of 2011, BankAtlantic entered into an agreement with BB&T under which it tried to circumvent proscriptions in the trust indentures for the TruPS that precluded sales of substantially all of the assets of BankAtlantic unless the buyer assumes the obligations for

the TruPS under the trust indentures. The Delaware Court of Chancery permanently enjoined the transaction as proposed as a violation of the express language of the various trust indentures. In addition, the court expressed its concern over the marketing process in which the BB&T transaction was selected because the marketing and selection process appeared to benefit insiders at the expense of overall transaction value.

CONCLUDING CONSIDERATIONS

As the regulatory environment increases capital pressure on banks and markets recover more slowly than many had anticipated, more banks, especially community banks, will need to think more broadly about potential solutions to the continuing capital crisis. As the recent developments indicate, successful restructurings require coordination of new capital, resolution of outstanding obligations and approval of the relevant regulators. Moreover, this must occur in the context of a more mature market in which all parties have greater awareness of market developments and the need to act expeditiously. Accordingly, parties must start earlier in their efforts to negotiate a successful resolution or banks run the risk that regulators will act to seize their assets before an agreement is reached and a transaction closed. TruPS holders run the risk that they will obtain a more modest recovery in the context of a chapter 11 case. Finally, regulators run the risk that inaction will cause more institutions to fail placing greater burdens on their limited resources when private capital may have been available to resolve a struggling bank's difficulties.

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