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The use of pre-packs in bank restructuring and M&A

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In response to the financial crisis, in October 2008 the US Treasury initiated the Capital Purchase Program of the Troubled Asset Relief Program whereby the government invested over $200bn in troubled financial institutions. Although those financial institutions have returned approximately $220bn to the government, almost $9bn of the original investment remains unpaid by over 100 financial institutions. In addition, a number of institutions have missed almost half a billion dollars in scheduled coupon payments to the US Treasury. Under TARP, the coupon rate on those investments nearly doubles (from 5 to 9 percent) on the fifth anniversary of the initial funding, which for most recipients arises between Q4 2013 and Q1 2014. As a consequence, financial institutions with TARP will have an even greater sense of urgency to repay TARP and resolve their capital structure issues than previously.

Against this backdrop, there has emerged a creative use of pre-packaged Chapter 11 reorganisation to address the recapitalisation needs of stressed and distressed financial institutions. On 27 September, Anchor BanCorp Wisconsin Inc. completed a novel transaction that raised $175m of capital from institutional

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investors and comprehensively resolved in excess of $300m of legacy debt obligations and capital structure, including TARP. Anchor BanCorp completed its pre-packaged Chapter 11 in just 18 days, with every voting class accepting the plan. Existing shares were cancelled, and new shares issued to new investors in exchange for the $175m recapitalisation. Anchor BanCorp is the parent company of AnchorBank, fsb, which is a Wisconsin-based community bank with over $2bn in assets. Given the volume of financial institutions that continue to suffer from the same pressures that AnchorBanCorp faced, we anticipate that such financial institutions will also explore use of the pre-packaged Chapter 11 as a viable option in 2014.

Background

With the economic downturn, Anchor had suffered significant credit losses. It was deemed in troubled condition by its regulators and was unable to repay $200m of obligations owed to its senior secured creditors. Anchor was also the recipient of $110m of TARP preferred capital from the US Treasury, on which dividends were severely in arrears. This legacy capital structure made it difficult for Anchor to raise the capital needed to achieve regulatory minimums.

Anchor's recapitalisation was facilitated through the use of a voluntary 'pre-packaged' bankruptcy process. This process allowed Anchor to fully discharge its debt and TARP obligations at significant discounts based on the consent of some – but not all – of its creditors. Simultaneous with the bankruptcy process, Anchor raised $175m of capital from a number of institutional investors. The recapitalisation required review by the federal bankruptcy court and banking regulators. It was the first-of-its-kind in the banking industry and was completed less than 60 days after announcement.

Anchor BanCorp's pre-packaged Chapter 11

A pre-packaged Chapter 11 is distinct from a so-called 'Section 363' sale. A Section 363 sale is another bankruptcy tool that has become more common in the banking industry. Unlike a Section 363 sale, a pre-packaged Chapter 11 does not involve a stalking horse bidder or require an auction process. Rather, it contemplates the confirmation of a plan of reorganisation where the solicitation of votes regarding the plan occurs before the Chapter 11 is filed. Anchor BanCorp solicited two classes prepetition: their three-bank class holding secured debt and US Treasury holding TARP. Two members of the bank group and US Treasury voted to accept the plan.

Before Anchor BanCorp's successful Chapter 11, every other pre-packaged Chapter 11 of a bank holding company that required the investment of new capital had failed due to the failure of the debtor to raise the new money during Chapter 11. To address this, Anchor BanCorp pursued a $175m capital raise through a private placement before commencing Chapter 11 among dozens of investors. This approach had several advantages. First, the volume of smaller investors involved less regulatory scrutiny than a transaction involving a smaller group of larger investors. Second, for similar reasons, Anchor BanCorp was able to preserve certain favourable tax attributes, making the transaction more attractive for new investors.

One of the key challenges arising in the Chapter 11, as with any Chapter 11 of a bank holding company, is that the automatic stay in Chapter 11 does not protect the primary asset of the debtor, i.e., its deposit base. In addition, unlike many pre-packaged Chapter 11 cases, where non-voting classes remain unimpaired, it was necessary

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for Anchor BanCorp to cancel existing shares in order to exchange new shares for its new $175m investment. Accordingly, tension arose between completing the Chapter 11 quickly in order to mitigate the risk of depositor defection and providing shareholders an appropriate time to respond to the cancellation of their shares. Ultimately, Anchor BanCorp developed a communications package that both provided clear communication to depositors regarding the protection of their funds as well as prompt notice to shareholders to permit a short stay in Chapter 11 of only 18 days. At the confirmation hearing, the US Bankruptcy for the Western District of Madison overruled eight objections by shareholders and confirmed the plan of reorganisation.

Implications

This recapitalisation involved three key innovative components which all worked together toward a successful outcome. First, the debtor pursued an aggressive strategy of raising new capital before it ever commenced Chapter 11. Second, the debtor required a sufficient critical mass of existing creditors to support the transaction and vote in favour of the deal. Third, the debtor needed to pursue prompt approval of the deal in order to ensure a prompt and successful exit from Chapter 11.

Given the status of the TARP program generally, we anticipate that more distressed financial institutions will examine whether they will qualify for similar pre-packaged restructurings. Due to the inevitable increase in coupon on TARP, we also expect that such institutions will be more aggressive in their examination of these options during the first half of 2014. ■