Why Troubled Banks Are Increasingly Considering Ch. 11

Law360, New York (February 03, 2014, 1:44 PM ET) -- Historically, the Chapter 11 bankruptcy process was not used as a technique to recapitalize struggling banks. An aversion to using Chapter 11 was attributable in part to concerns that regulators and depositors might perceive a bankruptcy filing as synonymous with financial meltdown and trigger a "run on the bank."

One of the key developments — and lessons — from the recent financial crisis and recovery is that the federal bankruptcy laws, when employed as part of a carefully planned and executed recapitalization strategy, can be an effective tool to restructure and recapitalize troubled banking organizations in the United States.

In the wake of the financial crisis, the banking industry has used two basic transaction structures involving Chapter 11. The first structure is a "Section 363" sale, which was first employed in the recapitalization of AmericanWest Bank in 2010. Since then, more than a dozen community banking organizations have turned to the Section 363 sale to facilitate their recapitalization.

The second structure is a recent development involving a "prepackaged" plan of reorganization. Anchor BanCorp Wisconsin Inc. successfully utilized a prepackaged plan in September 2013 to comprehensively resolve more than $300 million of legacy debt and Troubled Asset Relief Program obligations and to raise $175 million of new common equity capital.

These Chapter 11 transactions overcame the historical concerns of regulators and other constituencies. The transactions also demonstrated that Chapter 11 restructuring techniques are flexible and can be tailored to the needs of the banking industry and specific institutions. In 2014, we expect an increase in Chapter 11 bank recapitalizations.

Background

Most commercial and retail banking organizations in the United States are structured with a parent holding company and a subsidiary bank. The parent company typically serves as the issuer of various equity securities (e.g., common stock, preferred stock, trust-preferred securities) and debt instruments (e.g., subordinated debt, senior borrowings).

For example, banking organization parent companies issue virtually all of the preferred securities to the U.S. Treasury Department under the TARP program. The parent company then downstreams the proceeds of these various issuances to the subsidiary bank as common equity.

If the organization runs into trouble, regulators generally will prohibit the subsidiary bank from paying dividends to its parent company to conserve capital at the subsidiary bank. Without dividends from its subsidiary bank, the parent company does not have a

ready source of funds to service the various securities it has issued to investors and lenders.

As a result, the parent company cannot make principal and interest payments on its borrowings or pay dividends to its trust-preferred security holders. This is the risk of "double leverage": the subsidiary bank alone might have a viable and valuable franchise, but its parent company is insolvent.

When these organizations seek to raise additional capital, prospective investors often are unwilling to invest unless the parent company's legacy obligations are resolved. This may be impossible without a Chapter 11 strategy.

First, many banking organizations have issued securities that are held by collateralized debt obligations and other pooled structures that make it very difficult to identify ultimate holders that are empowered to negotiate or make decisions. Second, even if the legacy holders can be identified, fashioning a deal that will command unanimous approval from those holders is difficult.

Threat of FDIC Receivership

Without a resolution of the parent company's legacy obligations, the organization is hindered significantly in its efforts to raise additional capital. This puts the subsidiary bank at risk of failure and Federal Deposit Insurance Corp. receivership.

FDIC receivership is a bad outcome for just about all constituencies. In a receivership, the FDIC seizes the subsidiary bank and simultaneously sells its assets and liabilities to a third-party bank preselected by the FDIC through an auction process. Only qualifying bank charters are allowed to participate in these FDIC auctions, which are conducted on a nonpublic basis, with limited opportunity for diligence and little flexibility in terms and structure.

In virtually every case, the parent company receives zero consideration. Its creditors and security holders receive little, if anything at all. In addition, the FDIC typically will suffer a meaningful loss in connection with the receivership. The FDIC will seek to recover that loss by bringing lawsuits and other enforcement actions against the former directors, officers and other institution-affiliated parties that it may regard as responsible for the bank's troubles.

Chapter 11 Strategies

For many struggling banking organizations, Chapter 11 bankruptcy techniques offer strategic options to avoid FDIC receivership and to preserve the bank's underlying value. Restructuring through Chapter 11 can:

- resolve legacy obligations of the parent holding company and maximize the value recovered by its legacy debt and security holders;
- enable the investment of new capital;
- preserve the underlying bank's franchise value, including to its employees, customers and community;
- achieve compliance with regulatory directives to raise capital;

- avoid FDIC receivership and loss to the Deposit Insurance Fund; and

- avoid reputational, legal and financial risk to directors and officers associated with FDIC receivership.

Section 363. A Section 363 sale involves the parent company filing for Chapter 11 bankruptcy. The bankruptcy involves only the parent company — not the subsidiary bank. The bankruptcy process enables the parent company to sell its subsidiary bank to the highest bidder in a court-supervised, open and public auction process.

In most cases, the parent company will have signed an asset purchase agreement with a "stalking-horse bidder" before filing for bankruptcy, as AmericanWest did with SKBHC Holdings. The stalking-horse bidder thereby sets a floor on the price and terms of the auction.

The Section 363 process allows the buyer to leave behind the parent company's legacy obligations. The buyer then can invest new capital in the bank and move forward without the overhang of the legacy parent company. The parent company continues in the regular bankruptcy process and satisfies its legacy obligations, to the extent possible, using the proceeds from the Section 363 sale of the subsidiary bank.

Prepackaged Chapter 11. Unlike a Section 363 sale, a prepackaged plan of reorganization does not involve a sale of the subsidiary bank, a stalking horse bidder or a public auction process. Rather, a prepackaged plan of reorganization is a formal written plan to resolve the parent company's legacy obligations, typically through partial payment or by otherwise compromising their terms.

The plan also can contemplate the receipt of new capital. The plan must be approved by the bankruptcy court and receive the consent of some — but not all — of the parent company's legacy creditors. The plan is "prepackaged" because the necessary creditor consents have been solicited before bankruptcy is even filed — which means the parent company is better able to manage the risks associated with the negative publicity of a bankruptcy.

A prepackaged Chapter 11 can be extremely effective — in the case of Anchor BanCorp, the total time from bankruptcy filing to court confirmation was just 18 days — but it does require certain conditions to be present, including having a segment of the creditor base that is identifiable, large enough to control the vote of its class and willing to negotiate the restructuring.

Implications

In light of the benefits of these restructuring strategies, well-advised boards of directors of troubled banking institutions are routinely considering their bankruptcy alternatives among other options. Banking regulators have been supportive of transparent and well-planned Chapter 11 restructurings and have acted reasonably promptly to review and approve live transactions. In both the AmericanWest Bank and Anchor BanCorp transactions, bank regulatory clearances were received and the transactions were completed less than 60 days after the bankruptcy filing.

More than 500 institutions remain on the FDIC's troubled-bank list, more than 100 institutions have failed to repay their TARP obligations, the coupon rate on TARP obligations is set to increase from 5 to 9 percent, and the coupon deferral period on many trust-preferred securities is set to expire. Considering these pressures, we anticipate that more banking institutions will pursue bankruptcy recapitalization strategies in 2014.

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