Davis Polk

CLIENT MEMORANDUM

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Investing In or Acquiring Troubled Banks: The Problem of Holding Company Debt

In the wake of the recent purchase of AmericanWest Bank by a joint venture between a Goldman Sachs fund and Oaktree Capital, we have received numerous client inquiries regarding the different techniques that might be used to acquire or recapitalize troubled banking organizations.

The Goldman/Oaktree venture acquired AmericanWest through a Bankruptcy Code Section 363 sale as part of a bankruptcy of AmericanWest's parent corporation. Davis Polk has a great deal of experience representing purchasers, sellers and other parties in Section 363 sales. We also have deep experience with several other techniques that might be used to make similar investments, including prepackaged bankruptcies, investments at the bank holding company level with voluntary debt restructuring and investments at the bank level without holding company concessions. *We caution that the use of any technique or strategy is highly dependent on the facts and circumstances, and that there are a multitude of tax, regulatory, corporate, contractual and litigation risks to be evaluated prior to embarking on any particular course.*

Perhaps the single biggest obstacle is finding the unicorn – the bank that is fundamentally viable, with problem assets that have not completely destroyed all value, that recognizes the need for capital, and that has a board willing to accept a transaction involving substantial dilution of existing equity in exchange for a capital infusion that will save the institution from FDIC receivership. All too often, the board refuses to accept the reality of its situation until the financial condition of the bank is hopeless.

Once the unicorn is found, however, holding company debt often complicates a transaction. Not only will the economics of the debt often preclude a viable recapitalization, but often debt covenants and restrictions will appear to prohibit recapitalization transactions. Bank stock loans are typically secured by the shares of the subsidiary bank. The terms of the subordinated debt underlying trust preferred securities generally preclude sales of all or substantially all of the assets of the holding company unless the debt is assumed by the successor entity, and some indentures require the holding company to maintain its subsidiary bank. Even preferred securities issued to the US Treasury will contain covenants that may preclude redemption of other securities as part of a debt restructuring without its consent.

Troubled Bank Investment Techniques Outside an FDIC Receivership

While fortunately the US Treasury has been willing to restructure its preferred stock holdings to accommodate a restructuring where necessary to avoid failure, private holders of debt have proven to be less flexible, particularly the holders of trust preferred securities. Numerous potential bank investments have failed because the holders of trust preferred securities either could not or would not agree to a consensual restructuring of their debt. In part this is due to trustees' difficulty in identifying the holders of trust preferred securities when these securities are included in pools underlying collateralized debt obligations, the holders of whom are often unknown to the trustees.

With that backdrop, we wanted to provide a short summary of four basic techniques that might be used to make a troubled bank investment outside of an FDIC receivership:

- direct holding company investment;
- prepackaged bankruptcy;
- Section 363 sale out of bankruptcy; and
- direct dilutive share issuance by the subsidiary bank.

Direct Holding Company Transaction

In several transactions, the investors have proceeded to recapitalize or acquire the holding company, needing only the concessions from the US Treasury on its preferred securities. Other creditors were protected and benefited from the injection of new capital. Prominent examples are Sterling Financial Corporation (a recapitalization led by Thomas H. Lee and Warburg Pincus), Hampton Roads Bancshares (a recapitalization led by Carlyle and Anchorage) and South Financial (an acquisition by Toronto Dominion).

These are complicated and difficult transactions. Some, such as Sterling, have required the continued availability of the company's deferred tax assets and substantial concessions from the US Treasury on its preferred stock. Investors must carefully evaluate shareholder vote requirements, including the availability of sufficient shares to effect a transaction, stock exchange voting requirements and the possible availability of the financial viability exception to those requirements.

This structure, as with the bankruptcy structures and the direct investment at the subsidiary bank level described below, has the advantage of avoiding the disruption of an FDIC receivership and the associated competitive bidding process. On the other hand, the recapitalized company will not receive the indemnification, loss protection and other advantages that come with an acquisition from receivership.

Prepackaged Bankruptcy Transaction

Other transactions have used procedures available under the Bankruptcy Code to reduce holding company indebtedness. CIB Marine and Nexity Financial used prepackaged bankruptcies to force concessions on holding company creditors. A prepackaged bankruptcy requires consents from one or more classes of senior creditors, but once such consents are obtained, certain junior creditors can be squeezed into accepting more realistic values in exchange for their debt. In particular, if holders of debt senior to the subordinated debt underlying trust preferred securities are able to provide the requisite consents, the trust preferred holders that have proven to be an obstacle to a successful recapitalization can be restructured.

The disadvantages of the prepackaged bankruptcy include the potential delays associated with obtaining the necessary consents and concerns about the effect of the holding company bankruptcy on the underlying bank franchise, particularly if the new capital has not been lined up at or within a short time of the bankruptcy filing. Unless "old and cold" creditors (*e.g.*, holders of trust preferred or other holding company debt obligations, other than vulture or similar investors) and existing common stock holders receive at least 50% of the equity in the holding company, and thus new money is confined to a minority position, the company's ability to use the net operating losses, built-in losses and certain other deferred tax assets of the company may be significantly limited. While as a technical matter the consent of the US Treasury for any preferred stock it owns will not be required, the investor will want to evaluate how best to deal with the Treasury in any event.

One significant advantage of the prepackaged bankruptcy is that the court will bless and approve the transaction, insulating the investor from liability associated with the transaction. The court can also address many of the corporate issues that bedevil non-bankruptcy transactions, such as the need for new authorized shares, shareholder vote requirements and the like.

Section 363 Sale

The recent AmericanWest transaction used a different bankruptcy procedure, an asset sale pursuant to Section 363 of the Bankruptcy Code. In a Section 363 sale scenario, the bankruptcy court approves the sale of the bank from the estate of the bank holding company, which will have filed a bankruptcy case. Often a stalking horse bidder is identified and a sale transaction is negotiated and documented before the parent company files for bankruptcy. After the parent company files, the stalking horse bid, which can

include modest deal protections for the potential acquiror, is subjected to an auction overseen by the bankruptcy court. If no higher or otherwise better bid is indentified through the auction, the stalking horse's deal can be closed expeditiously with the court's blessing and all of the advantages that come with it.

The Section 363 sale presents many of the same challenges and advantages as the prepackaged bankruptcy; however, from the acquiror's perspective, it can be less expensive, take less time and be more efficient than a prepackaged bankruptcy.

From a tax perspective, certain tax assets of the holding company generally will not travel with the bank assets and thus will not be available to the acquiror. These include net operating losses attributable to interest deductions from holding company debt and any other deductions associated with holding company assets or liabilities. The use of built-in losses and other deferred tax assets of the subsidiary bank will generally be subject to limitations similar to those described above.

Direct Dilutive Share Issuance by the Subsidiary Bank

We have been involved in proposed transactions where the new investors have determined to invest directly in the bank holding company's subsidiary bank. In that structure, the subsidiary bank issues shares to the new investors, substantially diluting the holding company's ownership interest in the bank. Holding company debt remains at the parent level. However, as the subsidiary bank is often the sole viable asset of the holding company, instead of a 100% interest in that bank, the holding company often would be left with a 5% or less interest. This structure raises substantial questions regarding the ongoing viability of the holding company.

A virtue of this method is that it avoids the disruption of receivership and bankruptcy, minimizes exposure to the competitive environment of a Section 363 sale, and avoids the hold-up value and delay that holders of holding company trust preferred securities or other holding company securities may seek to extract in a pre-packaged bankruptcy or Section 363 sale. Traditionally, this technique has been disfavored, largely because of a perceived risk that the primary issuance structure might be recharacterized as a sale of all or substantially all of the holding company's assets for purposes of shareholder approval or covenants in trust preferred securities (or other holding company securities). While this issue can continue to present some risk of preliminary injunctive relief prior to the closing of the transaction, we believe that in certain cases this risk may be either negligible or manageable in light of the likely alternative of a seizure and receivership of the bank.

Based on this analysis, we have concluded that, in the right circumstances and if properly organized and executed, the dilutive primary issuance structure is viable and can present an acceptable level of legal risk, with other characteristics superior to those of an acquisition from an FDIC receivership, a prepackaged bankruptcy or a Section 363 sale. Notably, this structure has been reviewed with Federal banking regulators, who have confirmed its regulatory acceptability. In addition, we have developed several "take-out" methods for increasing an acquiror's or acquiror group's aggregate ownership to 100% of the acquired depository institution, to permit the immediate or later realization of synergies from larger scale combinations.

There are trade-offs with each of these approaches. While it can be extremely beneficial to have the bankruptcy court approvals that come along with a Section 363 sale or a prepackaged bankruptcy and the associated reduction in holding company debt that comes along with a prepackaged bankruptcy, the cost and uncertainties surrounding both must be considered. In most instances, the use of the bankruptcy process will substantially limit the use of net operating losses, built-in losses and certain other deferred tax assets as a result of Section 382 of the Internal Revenue Code. Investing in the subsidiary

bank requires careful consideration of the litigation risk, and every structure requires careful evaluation of accounting and other issues.

Often, of course, the only viable choice is to await the FDIC receivership process. The receivership wipes out all holding company debt and equity claims, as well as virtually all non-deposit debt at the bank level. No shareholder vote is required. All contingent claims are eliminated, and the FDIC provides not only indemnification, but typically loss-sharing protection on the troubled assets. The problem from an investor's standpoint, however, is that the FDIC must conduct a bidding process for the failed institution, and financial buyers such as private equity firms face substantial financial disadvantages compared to existing banks or bank holding companies as strategic buyers.

Our financial institutions, restructuring, tax and M&A groups have been involved in most of the troubled bank recapitalizations of the past three years, and we would be pleased to discuss these and any other issues at your convenience.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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