

## Strategic Growth Bancorp's Acquisition and Recapitalization of Mile High Banks in a Section 363 Sale

February 13, 2013

On December 31, 2012, Strategic Growth Bancorp Inc. ("**Strategic Growth**"), an El Paso, Texas-based bank holding company, acquired Mile High Banks (the "**Bank**"), a Colorado community bank, from the Bank's parent, Big Sandy Holding Company ("**Big Sandy**"), through an auction process conducted pursuant to section 363 of the Bankruptcy Code. Davis Polk represented Strategic Growth and advised on the complex and overlapping bankruptcy, mergers and acquisitions, credit, tax and bank regulatory issues presented by the transaction.

### Background

Beginning in 2009, Big Sandy with the help of an investment banking firm undertook extensive but ultimately unsuccessful efforts to identify investors or an acquiror. Big Sandy's capital structure proved to be a major impediment. Big Sandy's creditors included holders of approximately \$40 million in principal amount of unsecured debt, mostly in the form of trust preferred securities ("**TruPS**"), junior subordinated debentures issued to statutory trusts that in turn issue preferred securities. Absent consent from a sufficient number of TruPS holders or a bankruptcy filing, Big Sandy's TruPS debt would have survived and diluted or eliminated the returns for the investors or acquiror.

In 2010, due to its deteriorating financial condition, the Bank became subject to the first of several increasingly severe FDIC supervisory actions. In late 2011, the FDIC issued a prompt corrective action directive to the Bank, notifying the Bank that it was "significantly undercapitalized" and requiring the Bank to recapitalize within 30 days or take any necessary action to be acquired by or to merge with a healthy bank. From this point forward, the Bank was at severe risk of being placed into receivership by the FDIC.

On September 27, 2012, after having that day entered into an acquisition agreement with Strategic Growth, Big Sandy filed for chapter 11 bankruptcy protection in the District of Colorado, proposing to sell the stock of the Bank through a court-supervised auction process pursuant to section 363 of the Bankruptcy Code, with Strategic Growth acting as the "stalking horse" bidder. As part of the process, Strategic Growth had agreed to provide a \$1 million debtor-in-possession loan (the "**DIP Loan**") to finance the bankruptcy and sale process.

### Parallel Bankruptcy and Regulatory Paths

In light of provisions under applicable federal and Colorado bank regulatory law requiring prior approval of the Federal Reserve and the Colorado Division of Banking for a bank acquisition, Strategic Growth took steps early in the process to engage the relevant agencies and familiarize them with the proposed transaction. Among other things, Strategic Growth furnished Federal Reserve staff with drafts of the definitive agreements in advance of filing its application to troubleshoot any potential regulatory issues that could otherwise delay the approval process. Strategic Growth also timed the filing of its regulatory applications to occur immediately after Big Sandy's bankruptcy filing, which allowed a single public announcement of the proposed transaction.

Approximately one month after Big Sandy's bankruptcy filing, on October 25, 2012, the bankruptcy court approved Big Sandy's proposed auction procedures over the objection of Wells Fargo, the trustee for certain of the TruPS. During the ensuing multi-week auction process, Big Sandy identified one competing bidder. An auction was ultimately conducted on November 29, 2012, and Strategic Growth was declared the winning bidder.

Strategic Growth's winning bid included a \$5.5 million payment (inclusive of a credit bid of the DIP Loan and payment of certain broker fees), an allocation between the Bank and Big Sandy of an anticipated \$21 million federal tax refund belonging to the Bank (which resolved Wells Fargo's objection to the sale) and a contribution of \$90 million in equity to recapitalize the Bank. Approximately one week after the bankruptcy court entered the order approving Strategic Growth as the winning bidder, the Federal Reserve approved Strategic Growth's application, and the Colorado Division of Banking issued its approval shortly thereafter.

## Benefits of the Section 363 Approach to Acquiring and Recapitalizing Distressed Banks

The section 363 sale of the Bank to Strategic Growth and its concurrent recapitalization resulted in a series of outcomes that had proven impossible outside of the bankruptcy process:

- restoring the Bank to "well capitalized" status on a quantitative basis;
- allowing the Bank to continue operating without FDIC assistance and without any disruption to its customers or employees;
- providing leverage to negotiate a satisfactory accommodation with Big Sandy's TruPS holders;
- ensuring a recovery for Big Sandy's TruPS holders and other creditors; and
- facilitating a speedy regulatory approval process for Strategic Growth, as well as the certainty of a court-approved sale.

## Bankruptcy Techniques for Recapitalizing Distressed Banks

A section 363 sale is one of two main bankruptcy techniques used to recapitalize distressed banks. The alternative is a sale of a bank or bank holding company through a plan of reorganization of the bank holding company. This alternative approach is typically achieved through a prepackaged or pre-negotiated bankruptcy filing and requires the support of a sufficient number of TruPS holders and other creditors, as well as a capital contribution from an acquirer or new investors.

In Big Sandy's case, the TruPS holders advocated for a variation on the plan of reorganization process. They argued that a recapitalization could be structured to maximize the Bank's and Big Sandy's net operating loss tax benefits, resulting in an increased recovery for the TruPS holders while still recapitalizing the bank and bank holding company to the regulators' satisfaction. However, this favorable tax treatment would require that new investors acquire less than a majority of the common equity of the reorganized bank holding company. Were such investors to acquire all of the equity of the bank or bank holding company through a plan of reorganization process, the economic value of these tax assets would be reduced or eliminated. This less-than-a-majority limit can be unattractive to potential new investors.

The difficulties attending this approach can be seen in the ongoing case of Capitol Bancorp,<sup>1</sup> a bank holding company that owns a number of community banks. There, the debtor holding company negotiated a reorganization plan with TruPS holders and other creditors before filing for chapter 11 protection. At the date of its bankruptcy filing, however, the debtor had not yet identified new investors willing to infuse adequate new capital to recapitalize its bank subsidiaries in return for less than a majority of the common equity of the reorganized enterprise. Since filing for bankruptcy on August 9, 2012, Capitol

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<sup>1</sup> See *In re Capitol Bancorp Ltd.*, Case No. 12-58409 (Bankr. E.D. Mich.).

Bancorp has repeatedly delayed confirmation of its plan. As of the time of this writing, Capitol Bancorp has evidently not been able to secure sufficient new equity investors.<sup>2</sup>

## TruPS Holders Exert Significant Influence

Big Sandy's bankruptcy illustrates the importance and growing influence of TruPS holders in bank holding company reorganizations.

TruPS, a form of deeply subordinated debt commonly issued by bank holding companies prior to passage of the Dodd-Frank Act<sup>3</sup> because of favorable regulatory capital treatment afforded TruPS, can be a formidable obstacle in bank holding company restructurings. This is in part because TruPS are often held by collateralized debt obligation trusts ("CDOs") that securitize pools of TruPS instruments and sell them to other investors. The ultimate beneficial holders of bank holding companies' TruPS can therefore be widely dispersed investors with only small slivers of individual TruPS exposure. The CDOs that actually hold the TruPS directly may be unwilling to take any action without direction from their investors, which typically cannot be secured in an efficient or timely manner.

In recent years, sophisticated distressed investors have purchased large TruPS positions, often at significantly discounted prices, and have become vocal creditors in many bank holding company restructurings, willing to employ litigation and other tactics to protect their interests. In the Big Sandy bankruptcy, certain TruPS holders, acting through Wells Fargo as trustee for one of the CDOs, objected to Big Sandy's proposed bidding procedures, arguing, among other things, that seizure of the Bank by the FDIC was not imminent, that the auction timeline was too short, and that Big Sandy should pursue alternative restructuring proposals that Wells Fargo argued would result in a more favorable recovery for TruPS holders. Later, the TruPS holders challenged the sale to Strategic Growth, arguing that it unfairly allocated the anticipated tax refund to the Bank, thereby depriving Big Sandy's creditors of the refund's value.

These disputes were ultimately consensually resolved before the sale hearing through an improved bid by Strategic Growth. However, in at least one recent section 363 bank recapitalization case where TruPS holders' objections were not consensually resolved,<sup>4</sup> the TruPS holders have sought discovery against the debtor bank holding company to determine whether to bring actions against the debtor's directors and officers for alleged breaches of fiduciary duty.

## Bankruptcy, Mergers and Acquisitions, Tax and Bank Regulatory Issues Predominate

Strategic Growth's successful acquisition and recapitalization of Mile High Banks illustrates the potential advantages of undertaking a distressed bank recapitalization in the context of a section 363 sale. The 363 sale process is a complex one, however, and requires the near-seamless integration of bankruptcy, mergers and acquisitions, tax and bank regulatory expertise.

Navigating the 363 sale process, including structuring the "stalking horse" bid protections and a fair auction process that will be acceptable to the bankruptcy court, requires expertise in bankruptcy law and practice.

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<sup>2</sup> In October 2012, Capitol Bancorp announced an agreement with a private equity investor involving a substantial equity contribution and concurrent acquisition of a portfolio of nonperforming assets, but the agreement was reportedly terminated.

<sup>3</sup> Section 171 of the Dodd-Frank Act (referred to as the Collins Amendment) provides that, subject to a phase-in period, TruPS no longer qualify as an element of Tier 1 capital. Similarly, TruPS no longer qualify as Tier 1 capital under the Basel III capital framework and the U.S. banking agencies' proposed rules implementing Basel III.

<sup>4</sup> See *In re Premier Bank Holding Co.*, Case No. 12-40550 (Bankr. N.D. Fla.).

Tax law also figures prominently. Wells Fargo and the TruPS holders' main objection to the sale was that Big Sandy, not the Bank, was entitled to keep a significant anticipated federal tax refund that was largely attributable to the carry-back of the Bank's losses and was recorded as a receivable on the Bank's balance sheet. This complicated issue turns on issues of tax group agency, interpretation of tax allocation agreements between the bank and holding company entered into for bank regulatory reasons, and bankruptcy law. As noted above, the TruPS holders also argued that a restructuring at the holding company would increase recovery for the TruPS holders by maximizing the bank's and bank holding company's tax assets.

Finally, as discussed above, gaining regulatory approval concurrently with the chapter 11 proceeding was a prerequisite to a successful transaction.

### **Distressed Bank Opportunities Still Abound**

While bank failures have declined since their 2010 peak, a significant number of distressed banks remain, many of which are deferring TruPS payments and will reach the five-year deferral limit on such TruPS in the next few years. In its most recent quarterly survey of the banking industry, the FDIC identified 694 "problem" banks, that is, banks with a composite CAMELS ratio of 4 or 5, with financial, operational or managerial weaknesses that "threatened their continued financial viability."<sup>5</sup> Of these banks, a significant percentage are subject to prompt corrective action directives and therefore face likely failure in the near term. For bank holding companies that have negative equity value because of bank holding company debt but own a bank with positive equity value and a franchise that is worth recapitalizing, the chapter 11 bankruptcy process can be an effective tool for selling the bank while discharging TruPS and other obligations in an efficient manner.

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<sup>5</sup> See FDIC, *Quarterly Banking Profile: Third Quarter 2012*, available [here](#).

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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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