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TruPS deferrals set stage for many more 363 reorganizations by 2014

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It seems the proposed sale of subsidiary banks by bank holding companies that have filed bankruptcy is getting more attention even though selling assets under Section 363 of the Bankruptcy Code is a commonplace occurrence. SNL has written extensively on the subject. Now, *The Wall Street Journal* has picked up the story. On Nov. 21, the *Journal* ran an article about the U.S. Treasury objecting to the planned sale of First Place Bank by First Place Financial Corp. to Wilbur Ross' Talmer Bank & Trust.

More interest will be forthcoming, especially if the issue continues to slow the pace of consolidation that has to occur in the industry. The 363 bank sale issue raises the challenge of resolving levered holding companies when troubled subsidiary banks have value to a buyer, but not enough to exceed the value of the parent company's liabilities. Overlaid are the complexities of pooled trust preferred CDO (TruPS CDO) structures that limit the parties' ability to rework parent capital structures.

Perhaps what makes bank holding company bankruptcy filings more controversial today are their stakeholders other than the common shareholders. They include secured creditors (e.g., banks that made loans to bank holding companies that were secured with the stock of the subsidiary bank), unsecured creditors such as TruPS CDO note holders, and the U.S. Treasury as an equity investor via TARP preferred. As an aside, I have always wondered if Treasury knew it was not pari passu with trust preferred investors when TARP preferred was frantically designed in October 2008. Banks issue junior subordinated debentures to trusts, which in turn issue trust preferred securities to investors or CDOs, which in turn issue notes to investors.

There have been two successful 363 sales of subsidiary banks by bank holding companies since 2010; there are four more pending 363 sales. The December 2010 sale of AmericanWest Bank NA to SKBHC Holdings LLC for $6.5 million of cash was the first 363 sale. The total price for SBKHC approached $200 million, including $185 million it injected into the bank to satisfy its capital deficiency. Even though the 363 sale occurred, creditors continue to litigate expenses and how to divide the parent's residual assets. AmericanWest Bancorp. did not obtain TARP, but it was an issuer of $40 million of trust preferred securities.

Issues raised in pending 363 transactions revolve around whether the boards should take more time to possibly obtain greater value for the subsidiary bank than obtained from the stalking horse bid. In addition, questions have been raised about the value of net operating loss (NOL) carry-forwards as a contingent asset and whether a parent company or the subsidiary bank is entitled to a pending tax refund.

Bankruptcy filings that do not involve prepackaged arrangements usually entail very troubled entities. AmericanWest Bank's leverage ratio was 2.21% on Sept. 30, 2010 — a level that was close to falling below the 2% "critically under-capitalized" threshold. Directors and executives are incented to find any way out under such a scenario, even if it means losing their investment in the parent, because the FDIC usually sues individuals that it believes led to the failure of a bank. In a few instances, it makes criminal referrals to the Justice Department.

The 363 bank sales that are pending do not appear to be as dire as AmericanWest's position, but all assume the investors will contribute additional capital to the subject banks. Nevertheless, some TruPS CDO note holders are challenging stalking horse bids in an effort to force the parent companies to try to obtain more value. Time will tell if their efforts will be successful.

In the case of First Place Financial, Talmer will acquire the bank for $45 million and inject up to $205 million into the bank to augment its capital. First Place Financial Bancorp's capital structure includes $60 million of trust preferred and $72 million of TARP preferred. Treasury is apparently arguing that the structure of the stalking horse bid, which will require a competing bid to exceed $51 million, will preclude additional offers. Ross notes a broad-based marketing effort has already occurred.

The First Place Financial situation and others raise the issue of the value of NOL carry-forwards, which are a contingent asset. I am not a tax expert, but my take is that NOLs have the greatest value if a previously unprofitable entity returns to profitability and can shelter current taxable earnings, subject to a 20-year time limit to fully utilize the NOL. The greater the current earnings that can be offset, then the higher the present value of the NOL. If there is a change of control, as defined in the tax code, through a sale of the company, a significant equity interest therein, or the equity of its subsidiary bank that accounts for some portion of the NOL, then the value of the NOL generally will be limited under Section 382. Given my understanding of the 382 rules, the nominal and especially present value of an NOL carryforward in a change-of-control has been significantly reduced since 1986 when the Internal Revenue Code was rewritten.

That said, in a reorganization in which creditors receive ownership with existing equity holders, the 382 devaluation of the NOL may be avoided or limited if certain benchmarks are achieved; however, it seems parties in evaluating such a scenario may need to weigh the potential for the IRS to challenge the structure and therefore might discount the value. CIT Group Inc. emerged from a prepackaged bankruptcy in December 2009 that saw creditors receive new equity and notes. Ultimately, CIT elected to take a more conservative stance under the 382 exemption when it filed its tax returns in September 2010 due to concerns about prospective changes in ownership — which may not apply in contemplated reorganizations of bank holding companies — to ensure that the tax benefits, while limited in annual usage, would not be lost.

By 2014, there could be many more 363 sales — or attempted sales. The reason is the presence of trust preferred securities, most of which were issued via a CDO pooling structure. Aside from once being an easy to raise source of Tier 1 capital, the beauty of trust preferred is that the coupon payment is tax deductible, while the payment can be suspended (but still accrued) for up to 20 consecutive quarters without creating a default event. Once the fifth anniversary passes, the note holders, or trustee for a TruPS CDO, can take legal action to enforce payment. In many instances, this should lead to a bankruptcy filing by the parent company if the parent cannot sell the company, the subsidiary bank or negotiate a restructuring with its creditors. This process is presently unfolding with Capital Bancorp Ltd.

According to Fitch Ratings, 1,813 banks, thrifts and bank holding companies issued $38 billion of trust preferred securities and other debt that was subsequently purchased by TruPS CDOs since 2000 when the pooling structure gained traction. (Note: total TruPS CDO issuance approximated $50 billion including insurers, REITs, specialty finance companies and homebuilders.) The average issuance was $18 million. Today, there is about $30 billion of outstanding bank collateral with most of the reduction due to redemptions.

The reason more 363 transactions will be forthcoming is because there were 352 deferring issuers representing $5.0 billion of collateral held by 83 TruPS CDOs at Sept. 30, plus there were 212 bank issuers representing $6.6 billion held in 83 TruPS CDOs that had defaulted. The greatest number of deferrals occurred during 2009 and 2010. As a result, we should see a spike in bankruptcy filings by 2014 as these issuers pass the five-year mark.

One caveat is important, however. Not all deferring banks are in dire shape. Most have been forced by their regulator to stop upstream dividend payments to the parent company in order to build capital. With gradually improving credit metrics and capital ratios, I suspect regulators will allow some deferring banks to resume upstream dividends and corresponding trust preferred (and TARP) payments before the five year anniversary passes. During the third quarter for instance, Fitch reports that 13 banks representing $475 million of collateral in 38 CDOs resumed interest payments and paid accrued interest, as compared to only five banks representing $57 million of collateral in 18 deals that deferred.

Notwithstanding technicalities surrounding 363 asset sales and negotiating with TruPS CDO note holders, the larger issue is the use of leverage — or at least capital other than common equity — by parent companies to create equity in a subsidiary. And leverage is easy to miss in the context of consolidated financial statements for a bank holding company because the subsidiary bank is normally levered around 12:1.

It is important to note that the use of trust preferred, TARP preferred and other noncommon capital to raise funds to inject into subsidiary banks is fine — at least to a point. The old rule of thumb with bank holding companies was that the double leverage ratio — defined as the parent's equity investments in its subsidiaries in relation to its equity — should not exceed 125%. One of the objectives of financial reform is to reduce parent company leverage, while at the same time regulators lean on parents to maintain two years of liquidity. The parent companies may be safer, but the cost may be an inability to earn a competitive ROE, which will matter the next time the industry needs to raise a large amount of capital.

Once a levered bank holding company is forced into bankruptcy in an effort to sell its subsidiary bank(s), the parent's common equity should be a lost cause; however, the issue points to the need in my view for equity investors to take an enterprise valuation approach where possible. In doing so, the subsidiary bank (i.e., the operating asset) is valued separately from the consolidated entity. Value is then sequentially allocated to the parent's debt, preferred and common equity investors.

Article amended at 7:00 p.m. ET on Nov. 30, 2012, to include expanded discussion of tax implications under section 382 for net operating loss carryforward treatment.

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