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AmericanWest Bancorporation: How a Section 363 Sale in Bankruptcy Provides a Viable Recapitalization Option for Troubled Banks

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Representing Morrison & Foerster LLP's Bankruptcy & Restructuring, Bank Regulatory, and M&A groups, Henry M. Fields, G. Larry Engel, Kenneth E. Kohler, Alexandra Steinberg Barrage, and associates Vincent J. Novak, Jonathan Keen, Kristin A. Hiensch, and Dina Kushner pioneered the use of section 363 of the Bankruptcy Code to effectuate the recapitalization of a bank and its sale to a private equity-backed buyer.

Morrison & Foerster represented AmericanWest Bank and its parent, AmericanWest Bancorporation, in the transaction. Our team effectively addressed various regulatory, public relations, legal, and procedural issues surrounding this transaction, obtaining bankruptcy court approval in 42 days for the sale and recapitalization of the bank and avoiding the failure of the bank. This private equity-backed deal was the first of its kind and illustrative of how the Bankruptcy Code can aid troubled banks seeking to recapitalize.

In the current economic environment, many banks have lost significant capital and are under immense pressure, regulatory and otherwise, to recapitalize. Failure to recapitalize within time frames set by bank regulators can result in a bank's seizure by its chartering authority and an FDIC receivership.

Such recapitalizations have been challenging for many financial institutions. All such recapitalizations carry with them the prospect of severe dilution for bank shareholders. In addition, a particular challenge is presented by holders of holding company trust preferred securities, or "TruPS." Those seeking to recapitalize financial institutions (or acquire undercapitalized financial institutions) often seek to reduce the position of TruPS in an institution's capital structure as a way of enhancing the value of each recapitalization dollar. In certain cases, recapitalization simply does not "pencil out" with the TruPS continuing to hold their full claim against the issuing parent holding company.

However, when TruPS are held in pools, as is often the case, there may well be no one with whom to negotiate the proposed revised capital structure. And even when the sources of recapitalization funding are fortunate enough to establish a dialogue with representatives of the TruPS, they often discover that the TruPS holders refuse outright to accept any dilution or reduced role. This stalemate can lead to the failure of recapitalization efforts—and the ensuing failure of the bank.

In certain cases, the blocking position of TruPS in recapitalization efforts at the parent holding company level has led to efforts to recapitalize at the bank level. But even in this situation, provisions in the indentures under which the TruPS are issued may provide the opportunity for TruPS holders to block recapitalization efforts.

This alert describes AmericanWest Bancorporation's ("AWBC") creative and successful Section 363 sale/recapitalization strategy, highlighting the advantages inherent in the process. Chief among these advantages are (i) a timely and cost-effective recapitalization, consistent with applicable banking laws and regulations and the fiduciary obligations of the directors of the holding company and the bank; and (ii) a process that overcomes the obstacles to recapitalization presented by holders of TruPS.

THE CHIEF ADVANTAGES OF A SECTION 363 SALE ARE A TIMELY AND COST-EFFECTIVE RECAPITALIZATION, AND A PROCESS THAT OVERCOMES THE OBSTACLES TO RECAPITALIZATION PRESENTED BY HOLDERS OF TRUPS.

AWBC: A Case Study

Background

AWBC is a bank holding company ("BHC") with a single bank subsidiary, AmericanWest Bank ("AWB"), headquartered in Spokane, Washington. Prior to its bankruptcy filing on October 28, 2010 (the "Petition Date"), AWB had incurred significant losses that had seriously depleted its capital. AWB had been in violation of a regulatory directive to raise capital for more than six months. As of September 30, 2010, AWBC maintained an approximate 2.2% Tier 1 leverage ratio. Failure to recapitalize AWB posed a risk of seizure at any time. Such action would have undoubtedly affected AWB's 540 employees and more than 77,000 customers across Eastern Washington, Northern Idaho, and Utah.

For nearly two years, AWBC's extensive and continuous efforts to raise capital on behalf of AWB and comply with applicable regulatory requirements had been unsuccessful. Beginning early in 2008, AWBC undertook extensive efforts to raise capital on behalf of AWB. Numerous potential investors and potential strategic partners were contacted by its investment bankers, Sandler O'Neill + Partners. Those efforts were thwarted, in part, because of AWBC's outstanding junior subordinated debentures issued to four statutory trusts, which in turn issued TruPS. Each of the four issuances of TruPS was placed into a corresponding collateral debt obligation ("CDO") trust along with TruPS of numerous other banks that had issued TruPS in the same time frame. Each CDO trust in turn issued CDO securities in multiple tranches with complex payment and priority terms. Payments on the CDO securities were defined with reference to, and funded by, payments on the underlying TruPS, and the TruPS contributed by AWBC and the other banks served as collateral for the CDO securities. As a result, any new investor in AWBC faced the prospect of seeing the first $41 million of its capital being used to enhance the standing of the TruPS. The TruPS position effectively discouraged prospective investors of new capital.

Initially, AWBC considered offering to repurchase the outstanding TruPS at a substantial discount reflecting their then-current value in AWBC's capital structure. This would have mitigated (or eliminated if entirely successful) the magnitude of the blocking position imposed by the TruPS. But experienced advisors disabused AWBC of this plan, in large part because of the way in which the TruPS were held. Specifically, the TruPS were owned and held of record in each case by the related CDO trust, rather than by the individual end investors in the CDOs. Therefore, only the trustee of the CDO trust (the "CDO Indenture Trustee") had the legal standing to sell or exchange the TruPS. However, these CDO trusts, like most CDO trusts backed by TruPS, were passive, fixed-investment trusts in which the assets were selected at the outset and not intended to be sold or exchanged. In contrast to "actively managed" CDO trusts more commonplace with respect to CDOs backed by bank loans or high yield bonds—in which an asset manager has the authority to sell, and in some cases work out, trust assets—the indenture provisions governing such passive trusts make it extremely difficult for the CDO Indenture Trustee to sell or exchange trust collateral on behalf of the trust and the CDO holders.

"THE PROVISIONS PREVENTING THE SALE OR EXCHANGE OF THE UNDERLYING TRUPS CAN BE OVERRIDDEN, IN MOST CASES . . ."

The provisions preventing the sale or exchange of the underlying TruPS can be overridden, in most cases, only if directed by a two-thirds supermajority of CDO holders and, if the change would result in a material change in the payment amounts or timing of payments due to any particular CDO holder, if consented to by that particular holder. These rules, intended to protect investors from the "tyranny of the two-thirds," make it almost impossible to obtain the consents necessary to effect a discounted repurchase or exchange of the TruPS.

The difficulty of obtaining the required consents is further exacerbated by the attitudes of some reluctant CDO Indenture Trustees, who reportedly may refuse to take any action unless directed by 100% of the CDO holders (even where the CDO indenture seems clearly to permit a two-thirds approval), and who are reluctant to pass on exchange and purchase offer materials from the issuer, reportedly out of concern that their liability to holders for acting may likely be greater than their liability for not acting.

Unable to attract capital for AWB through investments in AWBC, AWB started down a different road: it proceeded to seek a direct capital investment in AWB, which would have given the new recapitalization funders a direct interest in the bank, undiluted by the claim of the holders of the TruPS. Significant interest was shown in this recapitalization structure by a number of potential investors (including some private equity-backed groups), who would gain control of the bank by reason of the new recapitalization funds.

However, it soon became apparent that the amount of capital needed to adequately recapitalize AWB would have severely diluted AWBC's ownership interest down to a fraction of the shares of AWB, perhaps even below 5%. In this scenario, there was the potential risk that such a dilutive share issuance could have been construed to constitute a "sale of substantially all of AWBC's assets" requiring (essentially unattainable) approval by the TruPS holders and by a majority of AWBC's common stockholders. This issue was never fully confronted in AWBC's case because the private equity-backed group that expressed interest in the recapitalization eventually sought to acquire 100% of AWBC's equity ownership in AWB, a transaction clearly constituting a sale of all or substantially all of the assets of AWBC.

The Use of Chapter 11 and Section 363

AWBC concluded that the best way to provide for the recapitalization of AWB while avoiding the risk of its seizure by regulators, thereby preserving value for AWBC and its stakeholders, was to conduct a sale of AWB pursuant to Section 363 of the Bankruptcy Code. To this end, AWBC had already obtained a commitment from a private equity-led investor group, SKBHC Holdings LLC (together with its affiliates, "SKBHC"), whose investors are reported to include Goldman Sachs and Oaktree Management, with the requisite capital commitment, and sufficiently strong prospects of regulatory approval, to accomplish the sale/recapitalization of AWB.

Prepetition Discussions with Regulators and AWBC's Board of Directors

The core of AWBC's plan was for AWBC to institute a bankruptcy proceeding and sell the bank in a Section 363 sale. The prospect of a bankruptcy filing of a bank's parent naturally raised concerns regarding whether the filing would give rise to a run on the bank between the time of the filing and the completion of the sale and recapitalization. At the same time, a successful recapitalization and sale would avoid the failure of the bank and the unhappy prospect of large losses to the FDIC associated with the prospect of a bank failure.

Over the course of several months preceding the bankruptcy filing, AWBC and Morrison & Foerster engaged the relevant bank regulators in extensive discussions regarding such concerns and the various benefits associated with using Section 363. The benefits of a Section 363 sale included enabling AWBC potentially to:

- Avail itself of an expedited timetable for sale/recapitalization approval, thus limiting the time period during which the bank would be under the "shadow" of a holding company insolvency proceeding;
- Accomplish a timely and cost-effective sale and recapitalization of AWBC, consistent with banking laws and regulations and the fiduciary obligations of the directors of AWBC and AWB;
- Obtain a bankruptcy court order designed, in part, to protect the winning bidder/purchaser from liability and adverse claims;
- Address many of the common obstacles associated with traditional M&A transactions, such as delay, cost, and uncertainty in obtaining required approvals of creditors and shareholders, and the risk of shareholder and creditor litigation;
- Minimize the risk that TruPS or CDO holders would use "holdup tactics";
- Preserve the stability of AWB during the sale and recapitalization process, including AWBC's employees and customer base, in addition to the local community; and
- Sell the bank to SKBHC free and clear of all liens, claims, and encumbrances.

AWBC's plan included a highly targeted and multi faceted public relations strategy designed to allay any concerns regarding a potential deposit run in the wake of AWBC's proposed Chapter 11 filing. In addition, AWBC kept its regulators informed of every step in the process, including the steps needed to obtain bankruptcy court approval.

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Negotiation of Asset Purchase Agreement

For several weeks leading up to the Petition Date, AWBC and SKBHC negotiated an Asset Purchase Agreement ("APA") that generally provided a bid of $6.5 million to acquire AWBC's stock in AWB and a commitment to capitalize AWB with an investment of up to $200 million. The APA incorporated a number of bidding procedures and standard stalking horse buyer protections—such as minimum bid requirements and a break-up fee—as well as a modest debtor-in-possession financing commitment designed to permit AWBC to operate pending approval of the sale/recapitalization of AWB.

The Execution of the APA and Postpetition Events

On October 27, 2010, AWBC and SKBHC executed the APA, and AWBC, whose shares are publicly traded, issued a press release regarding the recapitalization and sale and the ensuing Chapter 11 bankruptcy filing that would be needed to implement the transaction. The proposed recapitalization was positive news for AWB and the local communities served by AWB, and was well received. The next day, AWBC filed for Chapter 11 protection in Spokane, Washington, and issued a second press release regarding the filing. This release made clear that despite AWBC's Chapter 11 filing, there would be no interruption in bank service and that customer deposits were unaffected.

Several days after the Petition Date, on November 2, 2010, several objectors, including Hildene Capital Management ("Hildene"), an investor in several of the CDO trusts holding the TruPS, objected to AWBC's motion to establish bidding procedures. Despite these objections, on the following day the bankruptcy court approved interim bidding procedures, allowing the open marketing of AWBC's equity ownership of AWB and the related due diligence process to begin. AWBC also moved immediately to remove Hildene from the bankruptcy case on the grounds that it lacked standing to participate in the case. On November 18, 2010, the court approved the terms of the debtor-in-possession financing agreement between AWBC and SKBHC. At the same time, in a negative development for the holders of CDO securities backed by pools of TruPS, the court granted AWBC's motion regarding Hildene, holding that Hildene and various other CDO holders did not have standing to participate as "parties in interest" in AWBC's Chapter 11 case.

On December 2, 2010, SKBHC received approval from the Federal Reserve Board to acquire AWB. One week later, on December 9, after an open bidding process that yielded no competing bids, AWBC received bankruptcy court approval for the sale and recapitalization of AWB, preserving value for AWBC's creditors, including the holders of the TruPS obligations. On December 20, 2010, after receipt of all regulatory approvals, the sale/recapitalization officially closed: SKBHC acquired AWB's stock and recapitalized AWB with $185 million.

Section 363: An Innovative Way of Addressing the TruPS Problem

One of the greatest advantages associated with AWBC's sale/recapitalization strategy was AWBC's ability to address effectively a practical problem historically faced by banks seeking to recapitalize: refusal by TruPS holders to consent to a sale or recapitalization unless they are repaid at par—even when failure to achieve the recapitalization would doom the bank to failure and an FDIC seizure.

By way of background, TruPS are hybrid securities that are often included in regulatory tier 1 capital structures of BHCs. However, dividend payments are tax deductible for the issuer, and their issuance does not dilute equity of the BHC. Traditionally, smaller BHCs sold their TruPS into CDO trusts, which combined TruPS issued by smaller banking organizations and other entities prior to issuing CDO debt obligations that were tranched and sold to investors.

As the FDIC recently noted, holders of TruPS have been an impediment to recapitalizations or sales of troubled banks for a number of reasons.[2] First, there are some instances where TruPS holders will not vote at all, or will not vote in favor of the recapitalization. In other cases, investors have made the closing of major investments in BHCs contingent on TruPS holders selling or exchanging their TruPS in tender offers or exchange offers to be made by the target BHC.

In the past year, TruPS holders have almost always refused to tender or exchange the requisite amount of securities at the required price or exchange ratio. Examples of this blocking behavior by TruPS holders include the Sterling Financial Corporation and Pacific Capital Bancorp transactions. In both cases TruPS holders refused a proposed exchange offer required by prospective investors as a closing condition to the investment, and the investors waived the closing condition and made the institution-saving investment with the outstanding TruPS intact. The intransigence of the TruPS was rewarded in these cases with a substantial increase in value because the likelihood of repayment of the TruPS in accordance with their terms had increased substantially as a result of the investment.

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Second, many TruPS issues are contributed to a CDO trust, where the CDO debt obligations are issued pursuant to a CDO indenture administered by an independent indenture trustee. In these cases, it is exceedingly difficult for the issuer to communicate directly with the holders of the CDOs to offer to purchase CDO interests (if that is part of the issuer's strategy), or to request holders to take concerted action in directing the CDO Indenture Trustee to take a specific action with respect to TruPS, because of the difficulty in identifying the CDO security holders, which usually hold their CDO securities anonymously in "street name."[3] In cases where the CDO Indenture Trustee refuses to assist the issuer in communicating with holders by passing on written materials—as has reportedly been the case in several recent situations—the issuer is left with only less desirable options, such as publishing notices to CDO holders in national financial newspapers, that are unlikely to obtain much market penetration.

Third, downgraded TruPS are frequently held by investors who have purchased the securities at a steep discount to par and may wish to hold out for a large "upside." In still other cases, trustees of the TruPS will not vote either for fear of litigation, or because the percentage of TruPS holders needed to vote in favor may be very high.[4]

Whatever the reason, troubled banks typically experience the same pattern. Initially, BHCs urge TruPS holders to sell TruPS back to them at a discount (or to accept a reduced capital position in undercapitalized BHCs). In many cases, the troubled BHCs have failed to attract any interest in any repurchases at a discount, and otherwise have failed to gain the requisite TruPS approval for a reduced role in the BHCs' capital structure. As a result, a number of troubled banks are unable to recapitalize and eventually fail, much to the detriment of taxpayers, bank employees, and local communities.

The success of the AWBC Section 363 transaction provides encouragement for recapitalization prospects in the face of TruPS holders' opposition (or failure to cooperate).

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The Right Conditions for a Section 363 Sale

While the AWBC Section 363 strategy provides numerous advantages to a host of stakeholders, including the FDIC, taxpayers, bank employees and customers, as well as local communities, a Section 363 sale/recapitalization technique is not a one-size-fits-all solution. Critical to AWBC's success were the presence of these key factors:

- A troubled bank with a solid franchise and core deposit base;
- A robust communications process with regulators to build mutual confidence in the Section 363 process;
- A well-articulated communications plan to explain to bank customers the consequences arising from a bankruptcy filing, including most importantly that deposit accounts will not be adversely affected; and
- A sophisticated private equity investor that had the ability to obtain all required regulatory approvals, sufficient capital on hand to carry out the sale and recapitalization, sophisticated legal counsel, and a respected management team.

Conclusion

Given the continued distressed state of many banks, the AWBC Section 363 transaction provides a potential solution that should be seriously considered by BHCs whose recapitalization is a prerequisite to survival. Although the Section 363 sale is likely not to provide any value at all for common stockholders of such holding companies, boards of directors, faced with the prospect of the possible seizure of the subsidiary bank, should consult with counsel about their fiduciary obligations.

We suggest that if boards of directors of such institutions determine, on advice of counsel, that their fiduciary obligations require them to take into account how best to maximize the value of the remaining bank franchise for stakeholders other than common stockholders, they should consider the Section 363 sale process as one of a number of potential alternatives to weigh in the balance. Ultimately, the survival of the subsidiary bank faced with the serious prospect of a failure will also serve to avoid possible action by the FDIC, as receiver of a failed bank, against its former directors and officers.

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[2] Supervisory Insights, Winter 2010, p. 11, http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin10/SI_Wtr10.pdf
[3] While the CDO Indenture Trustee also is unlikely to know the identities of the ultimate beneficial owners of the CDO interests, the Trustees may have the power to communicate with them by transmitting material through the DTC or other "front-line" nominee holders of the CDO securities and asking those holders to forward the materials to the next holder in the chain of ownership, and so on.
[4] See Supervisory Insights, Winter 2010, p. 13, http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin10/SI_Wtr10.pdf