THE BANKING LAW JOURNAL

VOLUME 129 NUMBER 7 JULY/AUGUST 2012

THE BANKING LAW JOURNAL (ISSN 0005 5506) (USPS 003-160) is published ten times a year by A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices. For subscription information and customer service, call 1-800-572-2797. Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., PO Box 7080, Miller Place, NY 11764, smeyerow@optonline.net, 631.331.3908 (phone) / 631.331.3664 (fax). Material for publication is welcomed — articles, decisions, or other items of interest to bankers, officers of financial institutions, and their attorneys. This publication is designed to be accurate and authoritative, but neither the publisher nor the authors are rendering legal, accounting, or other professional services in this publication. If legal or other expert advice is desired, retain the services of an appropriate professional. The articles and columns reflect only the present considerations and views of the authors and do not necessarily reflect those of the firms or organizations with which they are affiliated, any of the former or present clients of the authors or their firms or organizations, or the editors or publisher.
POSTMASTER: Send address changes to THE BANKING LAW JOURNAL, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207.

Delaware Chancery Court Affirms Rights of TruPS Holders

JEFFREY M. BERMAN, GREG B. CIOFFI, JEFFREY M. DINE, AND MARK J. HYLAND

The authors discuss a Delaware court decision that one global ratings agency has said "is likely to have favorable implications on the structure of future bank sales."

In years past, trust preferred securities ("TruPS") were a significant means for bank holding companies ("BHCs") to raise funds, particularly for small and mid-sized BHCs between 2000 and 2007.[1] Structured as trust-issued notes supported by junior BHC debt, TruPS issuances historically could be counted as Tier 1 capital on corporate balance sheets, but otherwise were treated as debt for accounting, tax and governance purposes. As part of the regulatory response to the financial crisis, where many issuing BHCs have been substantially weakened or failed, the favorable capital treatment of TruPS was eliminated for BHCs with more than $15 billion in assets.[2] This led to two consequences: first, interest deferral or default by many BHCs on their TruPS obligations, and second, the emergence of TruPS as an unfavorable element of a bank's capital structure when a large bank is considering acquiring a smaller bank, as there is no longer a bank capital advantage. Thus, the presence of TruPS is often an important consideration in structuring the sale of a bank or its assets.

Mark Hyland is a partner, and Jeffrey Dine a senior associate, in the litigation department of Seward & Kissel LLP in New York. Greg Cioffi and Jeff Berman are partners in Seward & Kissel's corporate finance department. Seward & Kissel represented Wells Fargo Bank, N.A., as institutional trustee, in the *BankAtlantic* case. Celinda Metro and David Sagalyn, associates at Seward & Kissel, assisted in the preparation of this article.

Published by A.S. Pratt in the July/August 2012 issue of *The Banking Law Journal.*

In *In re BankAtlantic Bancorp., Inc. Litigation*,[3] the Delaware Court of Chancery enjoined a BHC's proposed sale of the assets of its thrift subsidiary and upheld the contract rights of TruPS holders; holding that under the applicable indenture's successor obligor provision, where the BHC seeks to transfer substantially all of its property, the TruPS must either be redeemed or assumed by the acquirer. In reliance on this reasoning, the court enjoined an announced asset sale that would have resulted in the TruPS remaining an obligation of the selling BHC. As a result, the BHC and the acquirer subsequently renegotiated the transaction to provide for the acquirer's assumption of the TruPS in exchange for additional consideration.[4]

BACKGROUND OF TruPS ISSUANCES

In the typical TruPS issuance, the BHC issues long-term subordinated debentures, which are purchased and owned by a special purpose subsidiary, such as a statutory trust. The trust then issues trust preferred securities, the payments and term of which are matched to the debentures it holds.[5] Beginning in 1996, the Federal Reserve System permitted BHCs to use of TruPS for up to 25 percent of Tier 1 capital. To be eligible for such treatment: (i) the underlying debentures were required to be subordinated to all other forms of debt and to "have the longest feasible maturity" (typically 30 years and non-amortizing), and (ii) the TruPS were required to provide for a minimum five year consecutive deferral period on distributions to investors and a call option for the issuers, typically beginning at five to 10 years after issuance.[6] While the Federal Reserve afforded Tier 1 capital treatment relating to TruPS at the BHC level, the FDIC did not approve Tier 1 capital treatment relating to TruPS for banks themselves. It took the position that, even though they were subject to deferral, the debentures underlying the TruPS still had the basic attributes of debt, and were treated as such by rating agencies and under GAAP. As BHC debt, TruPS obligations put pressure on bank subsidiaries to pay dividends to the BHC to be used to pay debt service on the TruPS.[7] There were, however, also key advantages to TruPS, namely that interest payments were treated as tax-deductible expenses (rather than as non-deductible dividends) and that such obligations did not dilute existing shareholders.[8]

TruPS CDOs

Due to regulatory developments, TruPS eventually became more attractive to smaller banks than larger ones. Consequently, many BHCs that issued debentures supporting TruPS were small, and often unrated or too poorly rated to access public debt or private placement markets.[9] Hence the creation of TruPS CDOs, which both allowed issuers to gain access to capital markets, and satisfied the desire of investors to diversify their investment in TruPS instruments. Under the TruPS CDO structure, a bankruptcy-remote special purpose entity would issue notes, the proceeds of which were used to purchase TruPS supported by debentures of a diverse pool of BHCs. The first such CDO was issued in 2000, and between 2000 and 2007, there were 108 privately placed CDO issuances totaling $58.9 billion. [10]

A significant feature of TruPS CDOs was that they were issued as "blind pools," so that the identity of TruPS obligors within the CDOs was not disclosed to investors. A number of BHCs issued TruPS that were sold into multiple CDOs. Indy Mac (which failed in July 2008), for example, issued TruPS into 28 separate TruPS CDOs.[11] In addition, a limited number of TruPS dealers and collateral managers created a narrow TruPS CDO investor base. The primary investors in TruPS CDOs were the banks themselves, with investments amounting to an estimated $12 billion, primarily in mezzanine tranches.[12]

Today, numerous TruPS CDOs are either deferring interest or have defaulted on interest payments, and many BHCs that issued debentures supporting TruPS have failed. As of March 2011, the default/deferral rate was 41 percent for pure bank TruPS CDOs, 38 percent for bank and thrift TruPS CDOs, and 30 percent for TruPS CDOs generally. According to Fitch Ratings, as of March 2012, some 16.82 percent of TruPS CDO obligations were in default and 15.89 percent were deferring interest.[13] Notably, the failure rate of banks and thrifts that issued debentures supporting TruPS appears to be approximately double that of bank failures in general.[14] In mid-2011, Federal Reserve research suggested that the ultimate loss on TruPS CDOs will be over $21.4 billion.[15] It was against this backdrop that BankAtlantic Bancorp, Inc. ("BBX") entered into the proposed asset sale that the Delaware Chancery Court would ultimately enjoin.

BANKATLANTIC BANCORP, INC. SUFFERS FINANCIAL REVERSAL

BBX is a BHC. Its principal asset is BankAtlantic Bank ("BankAtlantic"), a thrift founded in 1952 with branches in the Miami and Tampa areas of Florida. Between 2002 and 2010, BankAtlantic increased its core deposits from about $600 million to $2.8 billion.[16] Between 2002 and 2007, BBX issued over a dozen series of debentures supporting TruPS obligations (one of which series of TruPS is publicly traded), amounting to approximately $285 million in principal outstanding in 2011. After a long period of substantial growth, BankAtlantic suffered a major reversal with the financial crisis, as its asset portfolio, particularly its commercial real estate holdings, suffered heavy losses. From 2008 through 2010, BBX reported losses of over $500 million and its stock price declined from $142.42 at the beginning of 2007 to $1.39 in March 2009. In the first quarter of 2009, BBX began deferring payment on its TruPS. In February 2011, the Office of Thrift Supervision required BBX and BankAtlantic to enter into a cease and desist order that, among other things, imposed regulatory capital requirements and forbade BankAtlantic from paying dividends or otherwise transferring assets to BBX. The cease and desist order thus effectively prevented BBX from accessing funds necessary to pay deferred interest on the TruPS.

BBX'S EFFORTS TO RAISE CAPITAL OR SELL

From 2009 to 2011, BBX sought to raise capital through rights offerings to its shareholders, as efforts at raising money in the public markets had failed. When BBX fell $49 million short of the $155 million it intended to raise, it next sought to sell BankAtlantic's Tampa branches and some $240 million in deposits. Although the effort garnered significant interest, BBX only received two bids, reflecting a deposit premium of two percent and four percent, respectively.[17] After deeming those bids inadequate, BBX sought to sell substantially all of its assets — performing, criticized and nonperforming — in the fall of 2010. Due in part to a significant loss by BBX in a securities fraud case, only one bidder came forward, with a bid for $50 million, which BBX rejected. Later, PNC Bank inquired about purchasing the Tampa branches and deposits. BBX asked for a 10 percent deposit premium, which PNC accepted.

THE PROPOSED TRANSACTION

Inspired by the sale of its Tampa branches, BBX determined to sell BankAtlantic's performing assets and deposits, and retain its criticized and nonperforming assets and its TruPS related liabilities, in a "good bank/bad bank" transaction, in hopes of gaining a 10 percent deposit premium. BBX proposed to spin-off its poor quality assets, representing approximately $600 million in book value (the "Retained Assets"), to a limited liability company to be wholly owned by BBX, and to sell the stock of BankAtlantic, effectively transferring $3.1 billion in assets and $3.4 billion in liabilities (primarily deposits) to the purchaser. Following the sale, BBX proposed to continue to manage the Retained Assets with a view toward utilizing their cash flows to pay off the TruPS obligations. When BBX's investment bankers put the proposal to the market, BBX indicated that it was not willing to change the terms or adjust its accelerated timeline to accommodate all prospective bidders. Ultimately, BB&T Corporation ("BB&T") accepted BBX's demand for a 10 percent deposit premium, and BBX and BB&T entered into a Stock Purchase Agreement on November 1, 2011 that incorporated the terms of BBX's proposal.

INVESTORS AND TRUSTEES SUE TO ENJOIN THE TRANSACTION

A number of CDO issuers and investors promptly sued BBX and various TruPS issuers in Delaware Chancery Court to enjoin the BB&T transaction, and were joined by the trustees under the indentures of several of the TruPS issuances in short order.

The plaintiffs contended that the transaction constituted a sale of substantially all of the property of BBX. The plaintiffs argued that, under certain covenants in the indentures governing the junior debentures supporting the TruPS, BB&T was required to assume the TruPS. The plaintiffs sought a permanent injunction, arguing that the transaction would be a default under the indentures, causing irreparable harm to the Plaintiffs and, ultimately, the CDO investors. The plaintiffs also claimed that the change in business of BBX from BHC to distressed asset manager represented a fundamental shift in the risk the investors had contracted for, and itself constituted irreparable harm.

BBX contended that the transaction did not constitute a sale of substantially all of its property, in that the book value of BankAtlantic's stock, after giving effect to the transfer of the Retained Assets but immediately prior to the transfer of the stock to BB&T, would be approximately negative $300 million ($3.7 billion in book value of total assets pre-transaction, minus the $600 million in Retained Assets, minus $3.4 billion in deposits and other liabilities). BBX thus looked at the transaction as essentially taking place in three separate steps: the spin off of the Retained Assets to a new entity owned by BankAtlantic, the transfer of ownership of that entity to BBX, and the sale of BankAtlantic's stock to BB&T. If BBX, as it claimed, was transferring no value to BB&T in the third step, then it could not be transferring substantially all of its assets. BBX therefore contended that it would emerge from the sale holding assets — the Retained Assets — worth over $600 million in estimated book value.

After expedited discovery, the case was tried at the end of January 2012. The court issued its decision a month later, prior to the proposed closing date of the sale.

THE PROPOSED TRANSACTION WOULD BE A SALE OF SUBSTANTIALLY ALL OF BBX'S PROPERTY

After examining the history of BBX's sales efforts, the proposed sale, and the relevant indenture provision, the court turned to the threshold question of whether the proposed sale in fact constituted a sale of substantially all of BBX's assets. Using the history of the successor obligor provisions in bond indentures as a guide, the court found that the disputed language was "market-facilitating boilerplate language" and, as such, the court need not look to any "particularized intentions" of the parties to the agreement.[18] The court cited consistency and uniformity as its goals in interpreting such clauses, drawing in the first instance from commentary on model indenture provisions.

According to the court, successor obligor provisions are designed to safeguard investors from fundamental changes in the characteristics of the company in which they invested. While companies are not prohibited from changing their business, they must pay off their existing debts (or cause the purchasers of their assets to assume their debt obligations) in order to do so.[19] The court further held that the determination of whether a sale is of substantially all of a company's assets has both a quantitative and qualitative aspect.

Quantitatively, the court found that BBX was selling (at a conservative book value measure) 85 percent to 90 percent of its assets. The court rejected BBX's three-step transaction analysis, finding that, while the transaction in fact had three steps, those steps all occurred together within "the lifespan of a decaying muon" and could not be viewed as discrete events. Further, the components of the transaction were inseparably contained in the same contract, and, in order for the transaction to satisfy regulatory requirements under the cease and desist order, all the components were required to occur.[20] Moreover, the court found that BBX's underlying contention, that the "good bank" (performing loans and low-cost deposits) was worth nothing and the "bad bank" (nonperforming loans and other criticized assets) constituted the value of BankAtlantic was "illogical and counter-factual," and belied by both the documents of the deal negotiation and BBX's principals' testimony.[21] In fact, the Retained Assets constituted part of the consideration to BBX for the sale, and as consideration had to be counted as part of the assets transferred, not part of the assets retained. That is, "a court cannot count the consideration the seller received when determining whether a transaction constitutes a sale of substantially all of the seller's assets."[22] The court concluded that "[c]hanneling the consideration through a subsidiary does not change the nature of the deal."[23]

Qualitatively, the court found that "BankAtlantic has always been [BBX]'s principal asset and, since February 2007 [when BBX sold another, smaller operating subsidiary] has been [BBX]'s only operating asset."[24] The court then looked at BBX's operations before the sale (including a valuable banking brand with $3.3 billion in deposits, a large performing loan portfolio, numerous employees and branches, and a large headquarters) and after (no bank, no deposits, no performing loan portfolio, few employees, and a small office). The court dismissed BBX's contention that, in managing the nonperforming

Retained Assets, it was operating the same business as prior to the sale. While "there are high-level similarities between the lines of business that BankAtlantic currently conducts and the lines of business in which [the] Retained Assets [entity] will engage," the court held, "a continuing conceptual resemblance is not sufficient."[25] The fundamental question in qualitative analysis was, according to the court, whether the issuer was, as a practical matter, ceasing the operation of the business that the investors expected would pay their bonds.[26] The old and new businesses might have had some similarities, but:

> The Cunard Line and the Cape May-Lewes Ferry both operate ships. Le Bec Fin and Lucky's Coffee Shop both serve dinner. The Massachusetts Institute of Technology and Mt. Pleasant Elementary School both teach students.[27]

That BBX would continue to be a type of financial institution was therefore not enough; the character of its business would change entirely after the transaction. Indeed, that the CEO of BBX testified that he found the sale of BankAtlantic "'incredibly distressing'" was itself evidence of the magnitude of this fundamental transformation.[28]

THE PROPOSED TRANSACTION IS ENJOINED

Having found that the proposed transaction would breach the indentures, the court turned to the Plaintiffs' request for an injunction, which required a finding of success on the merits, irreparable harm to Plaintiffs, and a balance of the hardships weighing in favor of an injunction. Here, of course, the court found success on the merits.

The court found two forms of irreparable harm. First, the proposed transaction would breach the indentures, triggering acceleration of the principal of the TruPS obligations. Whatever the ultimate value of the Retained Assets in a long-term workout (the subject of contentious testimony) would have been, the evidence was unequivocal that their short-term liquidation value would not be sufficient to pay off the TruPS.[29] Further, because BBX would not be able to pay the accelerated debt, the proposed transactions' planned payments to BBX's controlling shareholders would violate the absolute priority rule (which forbids paying shareholders ahead of other creditors). Second, the court found that "New York law recognizes that 'a shift in bargained-for risk may constitute irreparable harm where the lender's only recourse is against the borrower.'"[30] The proposed transaction, by transforming the nature of BBX's business, would "alter fundamentally the risk profile of [BBX] as a borrower and shift to the holders of the [TruPS] risks they did not contract to assume."[31]

As to the balance of the hardships, BBX argued that enjoining the proposed transaction would harm all of BBX's constituencies, as it was the best deal going. The court refused to credit BBX's arguments, finding that the proposed transaction structure, when marketed, had not been presented to BBX's board in such drastic terms; rather, the board was told that if no satisfactory deal could be reached, BBX would wait until the market improved further.[32] Moreover, the court found that BBX's rejection of the proposed sale of the entire company for $50 million (a reasonable price under the circumstances) — driven by BBX's CEO's desire for personal benefit and his corresponding failure to present the terms of that transaction fairly to the board — suggested that a whole company transaction remained a fair possibility.[33]

The court further found that, as a matter of policy, injunctive enforcement of bond indenture provisions benefits both investors and borrowers. The simple proposition that parties to contracts should be able to enforce their rights is particularly relevant to bond indentures, as "[c]ompanies will find it more costly and difficult to raise financing if the contractual protections in an indenture can be ignored when the issuer faces financial difficulty."[34] For that reason, the court also rejected BBX's argument that, because some TruPS investors had purchased at a discount from par after BBX's troubles became apparent, they were "'vultures' who should not be granted equitable relief."[35] Noting that BBX itself had earlier offered to redeem its TruPS obligations at twenty cents on the dollar, the court recognized that allowing selective contract enforcement would also harm debt issuers, as "[i]nitial purchasers would pay less knowing that secondary purchasers would discount the securities for the less valuable rights they would receive."[36] Finding all the requirements for an injunction satisfied, the court enjoined the transaction.

LESSONS FROM THE DECISION

According to Fitch, "the ruling is likely to have favorable implications on the structure of future bank sales and lead to better terms for TruPS holders."[37] The *BankAtlantic* decision is likely to echo not only with respect to matters involving TruPS obligations, but to other successor obligor cases as well. In the larger arena of transactions implicating successor obligor provisions, the decision represents a significant addition to the rather small body of case law on interpretation and enforcement. Finally, the decision affirms that vultures must be treated the same way as every other bird, which ought to be a source of comfort to distressed debt investors generally.

NOTES

[1] TruPS were also issued by REITS and insurance companies.

[2] *See* Larry Cordell, et al., Working Paper No. 11-22: The Trust Preferred CDO Market: From Start to (Expected) Finish (Fed. Reserve Bank of Phila. Working Papers Research Department, June 2011), at 7-8. TruPS held by smaller banks were grandfathered under the provisions.

[3] 2012 Del. Ch. LEXIS 40 (Del. Ch. Feb. 27, 2012).

[4] As of this writing, the transaction is awaiting certain regulatory approvals.

[5] *See* Cordell, *supra* n.2, at 44 (fig 1).

[6] *Id.* at 4 (citing Fed. Reserve press release, Oct. 21, 1996).

[7] *Id.* at 4.

[8] *Id.* at 5.

[9] *Id.* at 5.

[10] *Id.* at 5.

[11] *Id.* at 6.

[12] *Id.* at 5-6.

[13] Tess Stynes, *Fitch: High Yield, Trust-Preferred CDO Defaults Rose in March*, Dow Jones Newswires, Apr. 19, 2012.

[14] Cordell et al., *supra* n.2, at 39 (Table 7)

[15] *Id.* at 41 (Table 9).

[16] 2012 Del. Ch. LEXIS 40, at *13.

[17] The deposit premium in a bank asset sale transaction is the difference between the liabilities (deposits) and assets (such as loans) acquired. Although deposits are a liability on a bank's balance sheet (because they represent money owed to depositors), core deposits (such as checking and savings accounts) are highly valued because they

represent a stable, low cost source of funds for asset development. *See id.* at *15-17.
[18] *Id.* at *34 (citing *Bank of N.Y. Mellon Trust Co. v. Liberty Media Corp.*, 29 A.3d 25, 241 (Del. 2011) and *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982). *Sharon Steel* is the leading case on successor obligor provisions.
[19] *Id.* at *36.
[20] *Id.* at *43-44.
[21] *Id.* at *40-43.
[22] *Id.* at *46.
[23] *Id.* at *47.
[24] *Id.* at *48.
[25] *Id.* at *50.
[26] *Id*. at *50.
[27] *Id.* at *50.
[28] *Id.* at *51.
[29] *Id.* at *53-54.
[30] *Id.* at *55.
[31] *Id.* at *56.
[32] *Id.* at *57-58.
[33] *Id.* at *58-59.
[34] *Id.* at *61.
[35] *Id.* at *61.
[36] *Id.* at *62.
[37] *Fitch: BankAtlantic Ruling a Potential Plus for U.S. Bank TruPS CDOs*, BusinessWire, Mar. 28, 2012.