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Constructing a Bank Holding Company Insolvency Model: Part II

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Part I discussed the factual and legal bases for the fraudulent-transfer claims the chapter 7 bankruptcy trustee of the Bank of New England Corporation (BNEC) brought against the Federal Deposit Insurance Corporation (FDIC). It also explained that the trustee's insolvency model was a key to his success in the FDIC litigation and discussed the applicable legal standards for establishing BNEC's insolvency.

Part two explains the components of the insolvency model that the trustee developed in the FDIC litigation. It covers the data that was available for review by the trustee's experts, why and how certain valuation methodologies were employed, and how banking laws shaped the contours of the model. It also discusses how a market capitalization approach, approved by the Third Circuit in the circumstances that existed in *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d. Cir. 2007), would not have been a reliable methodology for valuing the loan portfolios of BNEC's subsidiary banks or BNEC as a whole.

Materials Considered by the Trustee's Experts

In addition to materials that were available to the public at the time, the trustee's experts had vast amounts of nonpublic information to consider in connection with their analyses. For example, the trustee painstakingly reviewed loan files of the BNEC Banks. Such files

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are the best indicators of the value of a bank's loan portfolio and are what potential purchasers of a troubled bank ask for and review when they were assessing whether to purchase the bank or its loans. As shown below, the Bank of New England NA

identify numerous reports, analyses and other materials that the regulators generate to quantify and predict risk and value in the institutions over which they have supervisory responsibility.³ The OCC, for example, has a "Canary" Web-based early-warning system that provides benchmarks, credit risk analysis, market barometers and predictive models.⁴ Numerous other reports contain unvarnished analyses regarding the condition and prospects of troubled banks, which would be extremely helpful to anyone performing an insolvency analysis or looking for support for an actual-intent fraudulent-transfer claim.⁵

The BNEC Model

Although there was convincing evidence to the contrary, to be conservative

Financial Statements

(BNENA) loan files were a central part of the trustee's insolvency model.

The trustee's experts also were able to review nonpublic information contained in the files of the bank regulators.¹ These contemporaneous materials were generated by government experts with the best knowledge available regarding the condition of BNEC and the BNEC Banks, and provided unbiased support for the trustee's valuation model.² While protective orders issued in connection with the production of the regulators' files prevent the trustee from disclosing their contents, public documents issued by the Office of the Comptroller of the Currency (OCC)

the trustee's model presumed that at all relevant times BNEC and the BNEC banks were not in immediate danger of failure and liquidation. This ruled out a "liquidation" valuation methodology based on what would be generated in a short-term, forced sale. Instead, a going-concern approach was used to determine the fair-market value of BNEC's assets if converted to cash in a prudent manner over a 12- to 18-month period.

The trustee's experts first considered whether BNEC was an entity for which a buyer in an arm's-length transaction who had the opportunity to perform adequate due diligence would pay a premium over and above the value of the sum of its parts. They concluded that it was not, based on factors such as BNEC's inability to find a merger partner or sell itself for

¹ The trustee was able to overcome the regulators' assertions of the deliberative process privilege and obtain unfettered access to the regulators' files relating to the supervision of the BNEC system. Although this was an arduous process involving motion practice in multiple courts, it was worth the effort because it provided a treasure trove of documents for the trustee and his experts.

² The regulators' files also provided strong evidence in support of the trustee's actual intent claim because it showed the regulators' intent when they encouraged or compelled the transfers.

³ See "An Examiners Guide to Problem Bank Identification, Rehabilitation and Resolution," p. 18-26.

⁴ See *id.* at 19-20.

any price after concerted efforts to do so, and contemporaneous opinions by informed expert observers that BNEC was not salable as a whole and had a high likelihood of near-term failure. Once it was determined that BNEC was not salable for a premium, a fair-market value analysis was performed on its individual assets. BNEC's assets included cash, interest-bearing deposits, investment securities, investments in and advances to bank subsidiaries, investments in and advances to nonbank subsidiaries, other assets and intangible assets.

Valuing BNEC's Subsidiary Banks

BNEC's investments in and advances to its subsidiary banks accounted for about 90 percent of the value of the assets on its balance sheet, so the lion's share of the valuation work focused on the banks.⁶ Each bank was evaluated independently. Numerous data points reflecting on market value were considered, including any offers (or lack thereof) to buy all or parts of the banks, contemporaneous reports on asset quality and value generated by OCC and FDIC examiners and analysts, contemporaneous analyses performed by experts retained by BNEC and regulators, and numerous other factors, depending on the unique circumstances presented by each bank.

BNEC's largest bank on a book-value basis was BNENA. Extensive efforts had been made to sell BNENA during the relevant period. Potential buyers performed varying levels of due diligence, but for a variety of reasons relating to asset quality and control problems, no offers were forthcoming for any price.⁷ Furthermore, numerous knowledgeable observers determined at the time that BNENA's loan portfolio was in catastrophic condition, and that BNENA was insolvent and doomed to fail. Under these circumstances, assigning a premium value to BNENA was not appropriate, so its assets were valued individually.

As with most banks, BNENA's most valuable asset was its loan portfolio. Bank loan portfolios are monitored, reserved and valued by using risk-rating systems that categorize loans from the highest

quality (secured by cash on deposit) to the lowest quality (write-off). While such a system can be an effective tool in assessing loan portfolio value, BNENA's loan ratings were not only completely unreliable, but also substantially understated the risk in the loan portfolio.

Since the risk rating system and other value indicators were unhelpful or unreliable, a bottom-up approach had to be implemented. Pursuant to this approach, 56 percent of the loan portfolio, including virtually all of the troubled real estate loans and all commercial loans above a certain dollar amount, was reviewed. Using information that was available, the loans were re-rated and re-reserved. Discounts were then applied to reflect collection costs, the cost of funds and an expected return on investment to determine the fair-value amount that a buyer would actually pay for the loan portfolio considering the market conditions that existed at the time. When BNENA's liabilities were subtracted from the fair value of BNENA's assets, BNENA was shown to be insolvent by in excess of \$1.5 billion. BNENA's smaller sister banks also were valued. Three of those banks, BNE-West, Old Colony and Maine National Bank, were found to have positive fair market values on a stand-alone basis.

The Cross-Guarantee Provision

The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) "Cross-Guarantee Provision" states that any FDIC insured bank is liable to the FDIC for losses that the FDIC reasonably anticipates incurring in connection with a default of a "commonly controlled insured depository institution" (*i.e.*, a sister bank owned by the same bank holding company).⁸ In the event that the FDIC reasonably anticipated a default by BNENA, the FDIC could turn to BNENA's sister banks for payment of the amount of the anticipated loss.⁹

The trustee's experts concluded that the FDIC's reasonably anticipated loss for BNENA during the relevant period was at least \$1.5 billion, the amount by which BNENA was insolvent. Applying just 20 percent of the cross-guarantee liability to BNENA's solvent sister banks wiped out all of their positive value, leaving BNEC's investments in its bank subsidiaries at \$0.¹⁰

⁸ 12 U.S.C. §1815(e).

⁹ BNEC acknowledged the contingent liability the cross-guarantee provision imposed on its subsidiary banks in its 1989 Form 10-K.

BNEC's Nonbank Assets

After investments in bank subsidiaries, the largest category of BNEC assets on a book-value basis was investments in and advances to nonbank subsidiaries. These companies were engaged in various lines of business, including data services, commercial finance, investment banking, investment management and lease management services. A fair-market valuation was performed for each entity using methodologies ranging from cash generated from actual sales, to discounted cash flow analyses, to an examination of comparable sales data. The fair-market value of these assets was determined to be approximately \$310 million, well in excess of the \$138 million book value assigned to them. The combined value of BNEC's other nonbank assets, including cash, interest-bearing deposits, investment securities, other assets and intangible assets, was just less than \$100 million, bringing the total value of BNEC's nonbank assets to approximately \$409 million.

BNEC and Its Transfers to BNENA

BNEC had debt consisting of commercial paper, other short-term borrowings, notes and debentures, and other liabilities, totaling approximately \$837 million. Since the fair value of its assets was approximately \$409 million, the trustee's model showed that BNEC was insolvent by approximately \$428 million. In addition, because the model demonstrated that BNENA was deeply insolvent, it provided strong evidence BNEC did not receive reasonably-equivalent value in exchange for its transfers to BNENA and its sister banks.¹¹

Campbell Soup and Market-Capitalization Analysis

In *VFB LLC v. Campbell Soup Co.*, the Third Circuit held that it was not clearly erroneous for the trial court to rely primarily on market capitalization data to determine whether reasonably

¹⁰ In the FDIC litigation, the FDIC moved to dismiss the trustee's §548(a)(1) (B) claims to avoid transfers to two of the sister banks on the grounds that those banks were solvent on a stand-alone basis at the time of the transfers and that BNEC thus received reasonably equivalent value in exchange for the transfers. *Branch*, 825 F.Supp. at 399-40. The court noted that while there is a presumption of reasonably-equivalent value when a company transfers assets to a solvent subsidiary, the trustee had alleged that BNENA was deeply insolvent at the time of the transfer and that a contingent liability that arose from a possible cross-guarantee assessment rendered the sister banks insolvent. *Id.* The FDIC's motion was denied on the basis that transfers to sister banks rendered insolvent by cross-guarantee liability may not have been for reasonably equivalent value. *Id.*

¹¹ See *In re First City*, 1995 Lexis 1683 at n. 9; *Branch v. FDIC*, 825 F.Supp. 384, 399-400 (D. Mass. 1993), 825 F.Supp. at 399-400; *Commerce Bank v. Achtenberg*, No. 90-0950-cv-w-6, 1993 WL 476510 (W.D. Mo. 1993), at *2; *In re Rodriguez*, 77 B.R. 939 (Bankr. S.D. Fla. 1987).

equivalent value was exchanged in connection with a leveraged spinoff transaction.¹² Some have claimed that *Campbell Soup* indicates that the Third Circuit abandoned a flexible, fact-and-circumstance valuation approach in favor of a rigid market-capitalization methodology. This argument has, however, been specifically rejected by the Delaware District Court.¹³

While a detailed discussion of *Campbell Soup* is beyond the scope of this article, it bears noting that market capitalization data would not have been a reliable indicator of the market value of the assets of BNEC or BNENA for at least two reasons. First, the public market in which BNEC's securities traded during the relevant period did not have access to complete or reliable information. Testimony from BNEC's underwriter and its chief financial officer revealed that they (and the public) were unaware of material control deficiencies that understated the risk inherent in the loan portfolios of BNENA and the other BNEC banks, and the amount that was necessary to reserve adequately for losses in those portfolios. The trustee's experts, on the other hand, had access to extensive amounts of internal BNEC and BNENA documents, materials generated by BNENA's bank regulators and other reliable nonpublic information that supported the conclusion that BNEC and the BNEC banks were deeply insolvent.

Second, the market-capitalization value of BNEC's publicly-traded stock was dramatically different from contemporaneous market valuation assessments performed by unbiased experts based on information that was vastly superior to what was available to the public market. These potential purchasers, bank regulators and other experts reached conclusions regarding the value of BNEC and BNENA that were starkly inconsistent with a market capitalization valuation.

Although there may be instances in which a market capitalization valuation may provide a useful data point for a solvency analysis of a bank holding company and its subsidiary bank(s), it likely will not be the best indicator of the fair-market value of their assets. The public market does not have access to material information like, for example,

bank regulators' assessments of financial condition and viability, materials relating to efforts to sell the holding company or its subsidiaries, valuation and solvency analyses performed by regulators and/or their outside experts, and loan files and other information that may be essential to valuing loan portfolios. This type of nonpublic information is, in most instances, going to be a far superior indicator of value than the public share price, which is set without the benefit of such data.

Conclusion

When a bank becomes troubled, the interests of the bank's regulators and those of the bank's holding company and its creditors, which typically are aligned, can dramatically diverge. Regulators, concerned about protecting the FDIC bank insurance fund and the stability of the banking system, often require bank holding companies to act as a source of strength and downstream funds and other property to their distressed banks. If a troubled bank fails and is placed into FDIC receivership after receiving holding company assets, such transfers end up benefitting the FDIC at the expense of the holding company's creditors. In the BNEC bankruptcy, the trustee sued the FDIC and subsequent transferees to avoid fraudulent transfers to BNEC subsidiary banks that were seized by the FDIC. The trustee's insolvency model supported both "actual" and "constructive" fraudulent intent claims and was a fundamental driver of the trustee's \$140 million recovery from the FDIC.

Here are major factual and legal considerations and components of the BNEC insolvency analysis.

- To pass a *Daubert* muster, an insolvency model must contain a reliable estimate of the amount of cash that would be generated if the debtor's assets were converted to cash over a reasonable period of time to pay creditors.
- There is no one-size-fits-all valuation methodology that is applicable to all insolvency analyses. What is appropriate depends on the nature of the asset, the market conditions that existed during the relevant period and any other circumstances that may be relevant to calculating the amount of cash that would be generated in a hypothetical sale.
- Despite concerted efforts to sell BNEC and BNENA, no offers were made for the entities as whole,

operating businesses. The lack of offers not only showed that a premium over and above the value of their individual assets was not justified, it provided direct evidence of the insolvency of BNEC and BNENA.

- The value of BNEC's nonbank assets was small in relation to the book value of its investments in its banks and in proportion to BNEC's outstanding debt. This meant that if the BNEC banks were insolvent or their fair value was substantially less than their book value, then BNEC was insolvent.

- FIRREA's cross-guarantee provision provides that if a bank is placed in FDIC receivership, the FDIC can turn to the failed bank's sister bank(s) for payment in full of the amount the FDIC expects to incur in connection with the failure.

- Since BNENA was so deeply insolvent, the contingent liabilities that arose as a result of the cross-guarantee provision rendered all of BNENA's smaller sister banks insolvent and, in turn, made the value of BNEC's investment in its subsidiary banks "zero."

- The insolvency of the BNEC banks was strong evidence that transfers to those banks were for less than reasonably equivalent value.

- The conclusions that BNEC was insolvent and received less than reasonably equivalent value in exchange for the transfers in question provided strong evidence in support of both its actual and constructive intent fraudulent transfer claims.

Banks and bank holding companies typically follow similar paths through decline and failure. The same palliative efforts, including the transfer of holding company property to banks doomed to FDIC receivership, have been employed multiple times. The issues discussed above, therefore, likely will be relevant in connection with the current cycle of bank failures. ■

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¹² 482 F.3d 624, 627-34 (3d Cir. 2007).

¹³ *In re American Classic Voyages Co.*, 384 B.R. 62, 65 (D. Del. 2008) (noting that *Campbell Soup* does not require market-capitalization approach in all instances). See *LaSalle Nat'l Bank Ass'n v. Palojan*, 406 B.R. 299, 351 (N.D. Ill. 2009) (discussing *Campbell Soup* and holding that even where contemporaneous market data is available, court may assign greater weight to expert testimony, particularly if contemporaneous methodology was faulty or biased).