Hedge funds start banking on TruPS

By Lisa Allen

Hedge funds and alternative asset managers are common participants in bankruptcies, but two recent involuntary Chapter 11 filings suggest that their roles are likely to get much larger. Both involve a financing tool heavily used by bank holding companies that many observers expect to produce a wave of restructurings.

The cases involving **American Bancorp** and **FMB Bancshares Inc.** last spring center on those bank holding companies' issuance of trust-preferred securities, or TruPS, which are hybrid securities with debt- and equity-like characteristics. They were a popular capital-raising tool for community banks in the 2000s.

But a day of reckoning for TRuPS issuers is approaching.

TRuPS have maturity dates that are long, typically 30 years. But they allow for a five-year period of deferral on interest payments after their issuance. Many bank holding companies issued them in the 2000s and took advantage of the deferral period during the financial crisis. The problem: some 51 issuers in 41 TruPS collateralized debt obligation pools, or CDOs, with some $400 million alone coming due will reach the end of their deferral period before the end of 2014, according to **Fitch Ratings Inc.** data. (This doesn't count the TruPS that were issued that aren't in CDOs.)

Many lawyers and advisers believe a full slate of out-of-court restructurings and bankruptcies lies ahead as a result.

"I've never seen anything like this, or anything as difficult to work through and restructure as this," said Jerry Blanchard, a lawyer who specializes in financial institutions at **Bryan Cave LLP**.

The root of his apprehension is the fact that so many TruPS were put into CDOs, meaning the ownership of the securities is widely distributed and very much obscured, making restructuring talks more difficult to arrange. An underwriter might have the names of the original investors, but there's no way to know if the securities have changed hands. Also complicating the picture is that many of the CDOs don't have a collateral manager or trustee, so there's no overseer to contact investors.

REGULATORS AREN'T LIKELY to provide much help, either. The TruPS CDO market issued $59 billion in securities between 2000 and 2007, according to a 2011 report by the Chicago **Federal** Reserve Bank, as many banks took advantage of the securities' status as Tier 1 Capital. TruPS were almost unseated from their Tier 1 capital status by the Volcker Rule, but a January decision allowed banks with less than $15 billion in assets to continue recording their holdings of most TruPS issued before May 19, 2010, as Tier 1 capital. But the only regulatory involvement with the securities seems to be prohibitions on how bank dividends to their parents can be used to make good on them.

"I believe the bulk of the defaulted dollars are happening this past quarter and in the coming quarters, so I think [regulators are] a little behind the curve," said Bill Herrell, a principal and co-founder at Atlanta advisory firm Burke Group LLC.

Herrell, for one, is disappointed that regulators haven't proposed measures to support these troubled community banks.

"The regulatory environment is making it very difficult," Herrell explained. "The Fed is proactively calling holding companies and expressing their desire for the holding companies to not have those interest payments they've accrued paid."

For hedge funds, the uncertainty is creating a grand opportunity, especially since most TruPS CDO indentures don't provide a mechanism for investors to take action unless the security has defaulted. As a result, the end of the deferral period gives hedge funds that invest in TruPS CDOs leverage to work out restructuring plans — or land bank holding companies in involuntary bankruptcy.

So it's not surprising that, since the financial crisis, hedge funds have been taking positions in those CDOs and are beginning to proactively contact banks to work out arrangements to make sure they will get paid.

Seeing this, Dave Jefferds left his role as a hedge fund trader in the structured credit world to co-found DealVector Inc., a communications platform designed to help issuers of and investors in CDOs, mortgage-backed securities and municipal debt to find each other and communicate.

Based on his conversations with banks and hedge funds, Jefferds expects that the majority of restructuring situations involving TruPS are yet to come.

"We are starting to see more [bankruptcy filings], but when I step back, I'm a little bit surprised that there hasn't been more of that to date than we've actually seen," Jefferds said. "A lot of these creditors have rights that they can assert. I imagine there are a lot of discussions going back and forth in terms of actual filings occurring."

Others believe that the debate is already active, with the options being involuntary bankruptcies and sales under Section 363 of the federal bankruptcy code, or out-of-court settlements, or waivers allowing bank holding companies to go about their business until economic conditions improve enough to make TruPS payments.

"That's the million dollar question right now," said Greyson Tuck, a lawyer at Gerrish McCreary Smith PC. "Will we see more bankruptcies? Absolutely."

But he said he believes some TruPS CDO investors will hesitate to push for a bankruptcy. For one thing, bank holding companies aren't easy to value, making a Section 363 sale tough. For another, bankruptcy is an an expensive way to restructure.

OUT-OF-COURT workouts won't be a walk in the park, either. The indentures for TruPS CDOs are not consistent, which makes it difficult to generalize about the mechanics of restructuring them. The untested nature of TruPS CDO restructuring creates uncertainties that make investors nervous about potential liabilities that could stem from amending agreements or doling out haircuts outside of a bankruptcy court proceeding.

Observers also said it's common in such workouts to require the approval of 100% of investors if the security is not in default — rendering it a practical impossibility. Only once a bank defaults, as many are in a position to do, will indentures often lower the threshold for approval of an out-of-court settlement to 66.6% of the face value of the most senior tranche within the CDO.

Some bank holding companies may not even have the option to pursue an out-of-court solution. Burke Group's Herrell noted that some indentures may require a court-ordered plan in order to restructure. (One key thing to remember is that bank holding companies can file for bankruptcy, but banks can't.)

Either way, there's a leadership void among investors that hedge funds are now eager to fill. They are assuming the role of collateral manager, which is an agent who is authorized to negotiate on behalf of TruPS investors.

"In the platforms that have a collateral manager, where there's actually somebody who's empowered and who we can speak to, we can potentially strike a reasonable transaction," Herrell asserted. "In the situations where the CDO platform does not have a collateral manager, it's very difficult, although that's changing."

Stamford, Conn., and New York hedge fund **Hildene Capital Management LLC**, for example, succeeded in getting voted in as the agent for one CDO, and subsequently filed suit against Fayetteville, Ark.-based **Arvest Bank** on Sept. 26 in the U.S. District Court for the District of Connecticut.

The problem? Arvest had acquired Bannister **Bancshares Inc.** in 2012. Bannister, the holding company for **Union Bank**, issued $20 million in TruPS in 2003 but deferred payments. When Arvest acquired Bannister, it claimed it wasn't liable for the TruPS.

Hildene saw things differently, and is now seeking $25 million, including interest, from Arvest. The hedge fund alleges that Arvest is skirting its obligation under the TruPS indenture that requires an acquirer to repay the securities issued by its target.

With hedge funds getting appointed as CDO agents, Herrell expects that "the hedge funds will probably be flexing their muscles a little bit" as TruPS deferral periods come to an end.

One of Herrell's clients is trying to reach a deal outside of court, but those efforts are complicated by the fact that one portion of its TruPS were pooled into a CDO with a collateral manager, while another is languishing in an unmanaged CDO.

If there is no senior lender in the capital structure, then the creditors in the most senior piece of the CDO are in the driver's seat in any restructuring, DealVector's Jefferds said.

EVEN IF A SENIOR LENDER drives a restructuring process, TruPS holders may revolt. Witness the situation involving Minneapolis-based **Johnson** Holdings Inc., which owns **Landmark Community Bank** and issued $4 million worth of TruPS. St. Croix Falls, Wis.-based Eagle **Valley Bank** NA, Johnson's senior lender, is foreclosing on a loan it made to Johnson because the borrower hasn't paid the interest, but Hildene, which is an investor in the Johnson TruPS CDO, wants to put the bank holding company into an involuntary bankruptcy instead.

Bryan Cave's Blanchard said he came across a notice on DealVector in which Hildene sought support from CDO investors to be appointed the agent of the CDO in order to pursue the involuntary bankruptcy. If Eagle Valley takes control of Landmark Community Bank, then Johnson would have no chance of ever repaying its TruPS. So by pushing for an involuntary bankruptcy proceedings, Hildene is seeking to ensure a competitive bidding process and distribution of proceeds to creditors according to seniority rather than a private sale to the senior lender.

If Hildene succeeds, it would follow in the footsteps of other TruPS-holding hedge funds that have put bank holding companies into bankruptcy.

American Bancorp, the holding company for **American Bank of St. Paul**, Minn., which has six branches in the state, was put into Chapter 11 involuntarily on May 1 by CDO managers **ATP** Management LLC, an affiliate of alternate asset and hedge fund manager **Fortress Investment Group LLC**, and **Cohen & Co.** Financial Management LLC, an investment bank. These creditors listed $48.1 million in claims owed to three different CDOs. American Bancorp then put itself into Chapter 11 voluntarily in the U.S. Bankruptcy Court for the District of Minnesota in **St. Paul** on May 23.

Only weeks later, another bank that landed in involuntary bankruptcy because of its TruPS CDO agent appealed the filing, to no avail. Trapeza Capital Management LLC, the manager for **Trapeza CDO XII Ltd.**, placed FMB Bancshares Inc. in an involuntary Chapter 7 on June 9 in the U.S. Bankruptcy Court for the Middle District of Georgia in Valdosta. FMB is the holding company for**Farmers & Merchants Bank**, which has six branches in Georgia; one each in Conyers, Homerville, Lakeland and Nashville, and two in Valdosta.

Fitch Ratings suggested in the Sept. 9 report that the court's decision to uphold FMB's bankruptcy favored TruPS holders and cleared the way for more involuntary bankruptcies.

"It's anyone's guess as to how much money they will actually receive in these situations, since forcing a bank to be sold quickly is different from a bank planning to be sold in a long, thought-out process," said Bryan Cave's Blanchard.

He believes TruPS CDO investors are watching these two involuntary bankruptcies closely. Whether or not more investors pursue a similar course "will depend on how these two cases go," he said.

THERE HAVE BEEN out-of-court successes that such investors may try to emulate. One example involves **Broadway Financial Corp.**, the holding company for Los Angeles's **Broadway** Federal Bank FSB. Broadway Financial struck a recapitalization deal involving $4.24 million in new equity in September 2013 with help from a group led by alternative investment firm Gapstow**Capital Partners LP** and California-based community development nonprofit lenders. Broadway Financial on Oct. 16 said it had closed a $9.27 million capital raising from a Gapstow-led group and was also able to get an extension on the maturity date on its floating-rate TruPS another 10 years from their original March 17, 2014. For the next five years, Broadway Financial will only pay interest and then will pay interest and principal starting in 2019. As a result, the TruPS holders didn't take any haircut, but instead, the extended maturity will give them more interest payments over time.

"Ultimately, the bank won and the investors won, so that's the big success story out there right now," said Jim Kranz, DealVector's vice president of business development.

But for banks that can't attract recapitalization dollars and are unlikely to fetch a good price in an M&A deal, the best solution may be to do nothing at all.

In one case, the management team from a troubled bank holding company asked Gerrish McCreary's Tuck for guidance. "They said, 'We've got these

TruPS holders breathing down our necks, what should we do?'"
Tuck determined that the bank wouldn't sell for much in a bankruptcy auction. His advice? Do nothing. When he talked to the TruPS holders, they admitted that he had called their bluff. They weren't planning to take action against the bank or push for involuntary bankruptcy.
Inaction also can be the best strategy for companies on the mend.
Kranz tells the story of one bank holding company that is essentially healthy, except that its equity ratio is a fraction below regulatory requirements. As a result, the bank holding company, which he wasn't at liberty to name, was still prohibited from making TruPS payments when it reached the end of its deferral period.
The bank holding company began working on a plan to raise equity and use the funds to pay the deferred interest, and its management turned to DealVector to help contact and reassure investors.
The bank holding company disseminated a notice alerting investors that it expects to be able to pay them in full, and explained that it is awaiting regulatory approval for an equity raise that would be used to fund deferred interest payments.
When Kranz talked to TruPS CDO investors who saw the notice, he got good feedback.
"What they felt was, 'Look, here's a bank that communicated with us. They pitched a compelling story to us, they want to pay us back, so we're willing to go forward at this point and wait it out and see what happens ... we are not going to force a default and take them to bankruptcy court.'"
BUT WILL HEDGE FUNDS jumping into the TruPS fray be so patient?
Observers said many hedge funds bought into the TruPS CDO market after the financial crisis for 10 cents to 15 cents on the dollar. These days, depending on factors such as the seniority of the security, some pieces of TruPS CDOs are trading in the range of 30 cents to 40 cents on the dollar, according to Aaron Wong, a product specialist at fixed-income advisory firm Black Swan Consulting Group.
In addition to normal trading in secondary markets, investors have had an additional opportunity to buy into TruPS CDOs in recent months through a series of private auctions run by the **Federal Deposit Insurance Corp.**, which is selling off TruPS held by failed banks.
Black Swan is advising the **FDIC** on its private TruPS auctions since one of the firm's specialties is TruPS valuation, and Wong said prices have risen substantially since the financial crisis. He has even seen some securities trade at par, or slightly above par, but he noted that those were "exceptions to the rule" — mostly securities that might be in the most senior tranche of

a CDO, or in a mezzanine tranche with a good fixed-rate coupon.
Although some new hedge funds have entered the ring recently, "most of the activity in the market is driven by a handful of dedicated hedge funds that have been in the market [for a while]," Wong said, declining to name specific funds.
He added that the core distress-focused funds that have dedicated themselves to analyzing TruPS CDOs have a natural advantage over new entrants, given the time commitment necessary to gain a strong understanding of these deals and how they are likely to perform.
Some sources said Hildene is the most active player in the space, while Arlington, Va.-based EJF Capital LLC and New York-based **StoneCastle Partners LLC** are also important participants.
"Hedge funds are the only parties trying to pull people together to take action, so it gives them outsized influence," Blanchard explained.
Observers agreed that hedge fund investors in TruPS are in a mindset to be paid out at par. "My feeling on haircuts is, it's not going to happen," Kranz said, explaining that investors who have suggested below-par settlements on DealVector have met with strong resistance. "Most of the messaging I saw [on DealVector] was pretty consistent, which is, 'Why would we take a haircut? You owe us that money, we can force you into bankruptcy, we will force you into bankruptcy. There's no reason for us to take a discount.'"
Meaning that there aren't likely to be any easy days for TruPS issuers ahead.