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Negotiating Termination Rights and Termination Payments in Merger and Acquisition Deals

by Jim White

On Sept. 29 Vulcan Materials Company, one of Alabama's small number of New York Stock Exchange listed companies, announced that Polaris Materials Corporation had terminated an agreement for the acquisition of Polaris by Vulcan. Vulcan had agreed to pay C$2.79 per share for all of the outstanding common shares of Polaris. Polaris had previously announced that it had received a higher offer of C$3.40 (some 22 percent higher) and that it deemed the higher offer to be a "Superior Proposal," giving Polaris the right to terminate its agreement with Vulcan. Vulcan declined to raise its offer, as it had a right to do in order to "save the deal," and received a C$10 million termination fee instead.

Clauses permitting termination upon payment of a termination fee are frequently included in merger and acquisition agreements. Once they decide to sell a company, directors of the seller have the obligation to get the best price possible for shareholders. Directors of the seller do not want the embarrassment or potential legal liability associated with announcing a sale of a company at a specific price and seeing another party publicly announce a higher offer that they are contractually obligated to reject. Buyers, on the other hand, are understandably reluctant to be treated as stalking horses for higher bidders. The compromise that is frequently struck is the right to terminate for a Superior Proposal (a defined term in the merger and acquisition agreement) coupled with an obligation to pay a termination fee.

At least one academic study has found that the right to terminate coupled with a termination fee has led to higher prices in announced sales. Bidders are thought to be willing to agree to a higher price if they know they are going to either close the deal or receive a termination fee if someone else makes a topping offer. A termination fee makes it more difficult for "spoilers" to enter the bidding for a company with a marginally higher price.

Buyers should assume that there is a limit on the size of the termination fee that can be exacted. If the termination fee is too large the deal may be subject to attack on the grounds that the directors of the selling company have permitted the buyer to "lock up" the seller for an inadequate price thereby rendering the deal subject to rescission or one or more of the companies liable for damages. Some commentators have said that the amount of the termination fee should be of the same order of magnitude as the expenses, direct and indirect, incurred by the buyer in pursuing the transaction and possibly also the opportunity cost incurred by the buyer in spending time and effort on the transaction. In the experience of Porter, White & Company a termination fee of approximately three percent of the deal consideration is frequently seen in community bank deals. Another authority has written that the average termination fee for merger and acquisition deals of all types is approximately 3.5 percent.

In some cases other techniques can be used to effectively “lock up” a seller. For example, where there is a large shareowner (who is not a director with a fiduciary obligation to minority shareholders), a buyer may be able to negotiate an option on a significant block of shares that makes it difficult for a competing buyer to close a deal.

Negotiation of acquisitions and divestitures involving rights to terminate and termination fees requires solid legal and investment banking work. Both the words and the numbers should be correctly done.

Since 1968 Jim White has advised businesses, individuals, non-profits and municipalities on a wide range of financial matters. He founded Porter White & Company in Birmingham in 1975 and presently serves as chairman. Jim can be reached at (205) 252-3681 or jim@pwco.com.

Data Breach Response: Managing Reputational Risk

by Paige M. Boshell

Financial institutions have become increasingly sophisticated about managing data breach risk and related regulatory and fraud risk. Reputational risk can be more difficult to quantify and remediate and is a critical part of any data breach response and recovery planning.

The post-breach environment tends to be extremely chaotic even under the best of circumstances and often involves multiple, and sometimes conflicting, efforts to contain the breach and identify and secure information and related systems, all at a crisis pace and with extremely stressed resources. Damage to reputation is not covered by cyberinsurance or addressed by contractual indemnities but can often result in significant and long-term adverse effects on the value of a breached institution.

Consumers have a heightened awareness of the identity theft and fraud loss risks resulting from a breach of their sensitive financial information. Media scrutiny is at an all-time high. Recent large breaches show that consumers are very attuned to a breached company’s actions – or inactions – in response to a breach. Even when notice is legally compliant, complaints about undue delay in notifying consumers and concerns that notices may appear inconsistent or incomplete all directly undermine the institution’s response and resiliency efforts and threaten the goodwill and reputation of the institution.

As a practitioner, my experience has been that breached financial institutions care deeply that their employees and customers be protected and highly prioritize ease and thoroughness of remediation.

There is a tension, however, between early notice and complete notice: between signaling the alarm and reassuring potentially affected consumers that the breach has been contained and remediation is possible. A premature and incomplete early notice, followed by a series of corrective notices, can be both insufficient to empower the consumer to protect him or herself and panic-inducing. There is also a tension between early notice and any approvals that may be required by legal, compliance, cyber or other insurance carriers, or delays requested by regulators or law enforcement.

In any event, insufficient, delayed or inconsistent notices can further undermine customer confidence in a breached financial institution. You are either on their side, a victim also of the crime, or an uncaring institution looking out for itself or, worse, an untruthful or incompetent actor that caused the breach or failed to prevent it.

It is critical that all external-facing messaging, whether to media, customers, regulators, or law enforcement be consistent, uniform and pro-customer. The content of the information shared with each may vary but the message must be the same.

In any data breach event, there are internal and external team members that may have competing, or inconsistent objectives that are top-of-mind. It is critical that there be structured coordination among the internal stakeholders (usually legal, compliance, IT, marketing, line of business management, and executive) and external stakeholders (typically outside counsel, forensic investigators or other external IS, remediation vendors, PR, and insurers). There should be a strict hierarchy of input from the various team members that is escalated to an executive of the institution who, together with legal and outside counsel, decides what the unified message should be – to regulators, law enforcement, employees, customers and the media. All internal and externally-facing communications should be accurate and consistent.

The customer who calls customer service may not receive the exact same message that legal provides to the regulators or that PR releases to the media, but the message should be the same. Centralization and consistency of messaging – whether evolving or not – is critical to reassuring customers that you are acting as quickly and decisively as possible to protect them and their information. Notice, remediation, and ongoing customer support should be on-point and consistent. In this way, the breached institution may maintain and repair its reputation commensurate with its remediation and resiliency efforts while at the same time protecting its employees and customers.

Paige Boshell is a partner in Bradley's Birmingham office and is leader of the firm's Cybersecurity and Privacy Practice. This practice includes 16 lawyers across the southeast from various disciplines who work together to assemble the most efficient team to support clients in breach response.

Forward Thinking: Ensuring ADA Website Compliance

by Sonny MacArthur

In June 2017, the U.S. Court for the Southern District of Florida ruled in favor of a disabled Winn-Dixie Stores, Inc. customer who had filed a complaint against the company under the Americans with Disabilities Act of 1990 (ADA). This complaint alleged that Winn-Dixie's website failed to reasonably accommodate their visual impairment and that the website could have been inexpensively updated using Web Content Access Guidelines 2.0 software (WCAG), a standard utilized by the U.S. government to ensure ADA compliance. In essence, the court determined that Winn-Dixie's website is a "place of public accommodation" and thus, pursuant to ADA regulations, ruled in favor of the plaintiff.

While this ruling has significant implications for all businesses, banks should pay particular attention. There has been a sharp increase in the number of individuals demanding organizations' websites be brought into compliance, but in a highly regulated industry like retail banking, banks must also consider additional regulatory oversight groups that may investigate these claims. While the Consumer Financial Protection Bureau (CFPB) – to date – has not indicated an intention to investigate this matter, for banks' websites that do not comply with the ADA, proper planning and preparation can support their efforts to avoid potential fines or future lawsuits.

First, bankers should familiarize themselves with Title III of the ADA, which mandates that all "places of public accommodation," or public businesses in this case, are legally required to remove any barriers that would hinder a disabled person's access to that business's goods or services. Historically for most businesses, these barriers have been largely physical (i.e., access ramps, bathrooms that accommodate wheelchairs, hand rails, etc.).

In today's digital age however, bankers must consider their online presence as a venue in which their customers gather.

Customers with vision disabilities often use assistive technology to enable their use of a computer. Technologies such as screen readers, text enlargement software and programs that facilitate computer functions through the user's voice provide a method to engage online and access services. With more and more of these technologies developed each year, a poorly designed website can create unnecessary barriers for people with disabilities, just as a poorly designed building does.

An ADA compliant website is all about making sure that everyone has equal access to all of the site's features and services. Some recommended steps to consider include:

- Pairing images on a website with alternative text (to be read by a screen reader) that clearly describe what the image or element is intended to do or convey;

- Providing alternative text-based documents in HTML or Rich Text Format, in addition to PDF format, which are compatible with assistive technologies; and

- Designing the bank's website so that it can be viewed with the color and font sizes programmed in to the users' web browsers and operating systems.

The WCAG 2.0 standard provides businesses and developers with a straightforward set of processes and guidelines to ensure simple and ready access for disabled individuals. And, even though the standard is only a set of guidelines or best practices, U.S. courts have used it as a frame of reference for whether or not a website is ADA compliant.

While it's true that there has been no definitive ruling yet on whether or not a business's website is a "place of public accommodation" and thus pursuant to the ADA, this June 2017 ruling does not bode well for businesses heading into 2018. By taking steps to maintain compliance with the ADA now, businesses can not only position themselves for long-term success, but also demonstrate their commitment to all of their customers.

Sonny MacArthur is risk advisory partner of Porter Keadle Moore (PKM), an accounting and advisory firm serving public and private organizations in the financial services, insurance and technology industries, as well as a diverse group of entrepreneurial small business clients. With more than 20 years of experience in accounting, auditing and financial reporting, MacArthur has in-depth experience serving companies in the financial services industry, including extensive experience working with SEC registrants in either an assurance or advisory capacity.

Supreme Court to Resolve State Court Jurisdiction Over Securities Class-Actions

by Michael A. Fant, Jr.

On June 27, the United States Supreme Court agreed to hear the case of Cyan, Incorporated, et al. v. Beaver County Employees, et al. The case is of particular importance to the financial services industry because the Supreme Court may close a legal loophole that plaintiffs' attorneys in California and other states are using to mire defendants in costly, state court class-action litigation over securities claims brought solely under the Securities Act of 1933 (the "1933 Act"). As discussed below, however, if the Supreme Court determines that the state courts do have jurisdiction over those claims, then states like Alabama may see a dramatic increase in state court litigation of those claims. As an example, California courts assert that they do have jurisdiction and as a result the filing of cases asserting 1933 Act class-action claims has exploded by 1,400 percent.

In its petition, Cyan argues that while state courts in the past had concurrent jurisdiction over the claims described above, the Securities Litigation Uniform Standards Act of 1998 (the "SLUSA") wiped out that jurisdiction. The respondents, Cyan's investors led by the Beaver County Employees' Retirement Fund, argue that the SLUSA did not impact the state courts' jurisdiction; that "state courts continue to possess concurrent jurisdiction over claims brought under the [1933 Act], just as they always have since that statute's [the 1933 Act's] enactment."

Cyan has argued that its petition presents the Court with "a rare opportunity to turn chaos into order and prevent circumvention of the [Private Securities Litigation Reform Act of 1995 (the "PSLRA")]" and that the current state of the law is so confused that the "absence of appellate guidance has left lower courts in disarray." Cyan's primary contentions are that the plaintiffs/respondents should not be allowed to bring their claims in state court and that courts, specifically in California, have misinterpreted the SLUSA and the PSLRA by allowing plaintiffs to circumvent their strictures by filing class-action 1933 Act cases in state courts. Despite the fact that this case presents no circuit level split in authority, only apparently a mess at the state court and federal district court levels, Cyan has persuaded the Supreme Court to finally settle this dispute of law.

Cyan's appeal arose from its effort to avoid the plaintiffs'/respondents' securities class-action case filed in California state court. The plaintiffs/respondents filed suit against Cyan and others alleging that the defendants/petitioners had made misrepresentations in initial public offering documents. Those misrepresentations allegedly concealed anticipated revenue stream issues which caused Cyan's stock to drop after going public.

On the grounds that the PSLRA and the SLUSA preclude state courts from entertaining class-action suits of 50 or more plaintiffs based solely on claims under the 1933 Act, Cyan moved to have the lawsuit dismissed for lack of subject matter jurisdiction. The California trial court denied Cyan's motion on the grounds that the court was bound by the decision of the Second District Court of Appeals of California in Luther v. Countrywide Financial Corporation. In that case, the California appeals court held that reading the SLUSA as a whole demanded that the state court's concurrent jurisdiction remained in effect even after SLUSA was enacted.

In its petition to the Supreme Court, Cyan argues that Luther and other California cases deciding the same issue are patently incorrect and that plaintiffs' attorneys have taken note. In illustrating its point, Cyan explains that plaintiffs-attorneys are exploiting the state courts' incorrect interpretation of the pertinent laws causing "class actions in California state court [to] have risen 1,400 percent" since those opinions were issued.

This petition and the Court's forthcoming resolution have generated substantial interest from third-parties and entities that might be sued for securities claims under the 1933 Act. Since the time that the Supreme Court granted certiorari, amicus briefs have been filed in the case by the Defense Research Institute, the Washington Legal Foundation, the New York Stock Exchange, the Securities Industry and Financial Markets Association, Alibaba Group Holding Limited, the Business Roundtable, and a litany of other entities. Of particular note is the argument presented by the New York Stock Exchange that the plaintiffs' bar has exploited the confusion of the state and federal courts and that exploitation has and continues to "hurt[] U.S. equity markets":

The United States is the preeminent destination for raising equity capital, but the litigation risk that companies must endure to access capital through U.S. markets remains a deterrent to companies considering a U.S. listing. Companies have other options – including foreign capital markets or private financing – and those options may appear more attractive as perceived and actual risks of abusive securities litigation increase.

The resulting effect on capital markets hurts both investors and the economy. The U.S. equity capital markets deliver unparalleled transparency and standardization to investors, ensuring that they are armed with reliable information to guide their investment choices. The more companies that list on U.S. exchanges, the more investors benefit from these safeguards, allowing for informed investment decisions. The U.S. economy also benefits from maximal participation in U.S. equity capital markets, as those markets fulfill the critical role of directing the efficient flow of capital in a complex economic landscape.

Congress understood all of this when it passed the PSLRA and SLUSA. Indeed, protecting U.S. equity capital markets is one reason Congress enacted those reforms. The Court should give effect to Congressional in-tent and enforce Congress' efforts to close the state-court loophole through the PSLRA's protections.

While we expect that the Supreme Court will resolve this question in favor of the plain language and intent of the SLUSA and in favor of defendants that seek only to avoid meritless and costly litigation under the 1933 Act, we will have to wait for the Court's opinion for a complete resolution of the issue.

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Lender Seeks Supreme Court's Ruling on Bankruptcy Trustee's Ability to Recover Wages Garnished Before Bankruptcy

by Evan Parrott

Under Section 547 of the Bankruptcy Code, a bankruptcy trustee (or a debtor-in-possession in a Chapter 11 bankruptcy case), is empowered to claw back certain payments made to or for the benefit of creditors within 90 days before the bankruptcy case is initiated. These voidable payments are known as "preferences." Historically, courts have disagreed whether an insolvent debtor's wages garnished within 90 days of the commencement of a bankruptcy case are considered preferences recoverable by the bankruptcy trustee.

In the 1980s, three circuit courts of appeals, including the Eleventh Circuit Court of Appeals, which has appellate jurisdiction over the federal courts within Alabama, Georgia and Florida, issued opinions ruling that wages garnished within ninety days of a bankruptcy case are not preferences if the corresponding garnishment order was served on the employer before the 90-day period commenced. Specifically, the Eleventh Circuit in In re Conner reasoned that state law governs the determination of when a transfer of property occurs for preference purposes. Under Georgia law, a lien attaches to garnished funds once the summons of garnishment is served. Thus, the Eleventh Circuit found that the date of service constituted the date the wages were "transferred." Since the date of service occurred prior to 90 days before the subject bankruptcy case was initiated, the garnished wages in question were not preferences subject to the trustee's avoidance power.

In 1992, the Supreme Court of the United States issued its decision in Barnhill v. Johnson holding that federal law determines the time a transfer of property occurs in a preference analysis. Since the Barnhill decision, several courts and commentators have criticized the decisions from the 1980s analyzing the timing of potential preferential transactions under applicable state law.
The most recent dispute, Tower Credit v. Schott (In re Jackson), arose in Louisiana, when a lender sought to collect a state court judgment against an individual by serving a garnishment order on his employer. After nearly a year of collecting garnished wages from the employer, the individual judgment debtor filed for Chapter 7 bankruptcy protection. The Chapter 7 bankruptcy trustee then sought to void the garnishments collected by the lender within 90 days prior to the commencement of the bankruptcy case. The bankruptcy court held that the wages were preferences subject to being clawed back by the trustee, and the lender appealed the decision to the Fifth Circuit Court of Appeals, which has appellate jurisdiction over the federal courts within Louisiana, Texas, and Mississippi. In March 2017, the Fifth Circuit held that controlling federal law provides that an individual cannot obtain rights in future wages until the individual performs the services that entitle him or her to receive those wages. Therefore, the transfer of the debtor's interests in the wages does not occur until the wages are earned. Accordingly, if the garnished wages are earned within ninety days of the bankruptcy case, they are considered preferences subject to the bankruptcy trustee's avoidance power.

In September 2017, the lender in Tower Credit v. Schott (In re Jackson) filed a petition for certiorari requesting that the Supreme Court exercise its discretion to review the case and decide whether state or federal law controls, resolving the ostensible split between the various circuit courts of appeals on the subject. The existence of an actual circuit split, however, is up for debate, as the three circuit courts of appeal holding that wages garnished within 90 days of a bankruptcy case are not preferences if the corresponding garnishment order was served on the employer before the 90-day period issued their decisions prior to the Supreme Court's Barnhill decision in 1992. Moreover, these pre-Barnhill decisions have been routinely criticized and distinguished over the past 25 years, even by courts bound by the precedent established by the respective circuit courts of appeal issuing the decisions.

Nonetheless, as the lender stated in its petition for certiorari, more than five percent of Americans had their wages garnished in 2013. Thus, this issue affects numerous debtors who file for bankruptcy protection, as well as the creditors who are collecting judgments against those debtors through wage garnishments. Once the bankruptcy trustee responds to the lender's petition, the Supreme Court will decide whether to grant the petition and hold oral argument on the matter. If the Supreme Court does grant the lender's petition, the matter could be heard during the Court's 2017-2018 term. If the petition is denied, the debate will continue in the Eleventh Circuit and in other jurisdictions where pre-Barnhill decisions remain the latest authority on this issue.

Evan Parrott is a member of Maynard Cooper's Bankruptcy and Restructuring Practice group. He represents banks, financial institutions, and other lenders as secured or unsecured creditors in various matters involving bankruptcy, commercial lending, debt collection, reorganization proceedings, foreclosure proceedings, loan workouts and debt restructuring. In addition, Evan assists with commercial litigation matters.

Responding to Subpoenas, Garnishments and Levies: A Banker's Guide

by Ryan Hendley

Whether in its role as a lender or a depository institution, banks routinely receive subpoenas, garnishments and levies in instances where the bank itself is not a party to the underlying litigation. These actions often call for customers' personal financial information or affect customers' personal property so it is critical for bank personnel to know how to correctly and timely respond to avoid penalties or unnecessary legal exposure. While we recommend that banks work with their counsel to ensure compliance with all applicable laws and procedures in responding to subpoenas, garnishments, and levies, this article is intended to provide a general framework for establishing a best practices policy.

As an initial matter, you should note that subpoenas, garnishments, summons, and tax levies ("Legal Process") require that the bank respond within a designated time period. To reduce redundancy and increase efficiency, your bank should designate one or more persons to coordinate the review of the Legal Process documents and quickly make a determination whether counsel must be consulted. These designated individuals must be well-versed and trained in the subject matter and should be aware of the deadlines for responding to each of the matters discussed below. We also recommend that any Legal Process issued by a state court or agency not located within the states in which you do business should be referred to counsel as a matter of course to determine whether the issuing court or agency has jurisdiction over the bank so as to require a response.

Garnishment of Bank Accounts

A garnishment is a legal procedure by which a judgment creditor attempts to collect a debt by reaching property of the debtor when the property is in the hands of a third party (in this case the bank). A typical garnishment action seeks to seize funds held in bank accounts.

The bank's first action should be to determine whether there are any protected funds in the account. Under the Treasury Department regulations [31 C.F.R. §§ 212.3, 212.6 (2017)] and subject to certain exceptions, banks must automatically protect two months of federal benefits from being frozen or garnished if such funds are direct deposits from an applicable federal agency such as in the case of social security benefits. If the account contains an amount exceeding two months of such protected deposits, the excess should be frozen and then it would be up to the defendant debtor to claim an exemption as to the excess. The bank of course must also include any additional deposits made through the date of the answer.

The next step is to file an answer with the court. The bank, as garnishee, has 30 days from the service of process to respond to the garnishment by filing a written answer with the court. The answer should state whether there are any funds in the account and the amount of such funds. Typically, the Garnishee's Answer is in the form of the standardized form C-22 available through the Alabama Administrative Office of the Courts. After the Answer has been filed, the non-protect funds in the account should remain frozen until further order from the court. Please note that while the example above involves accounts, a garnishment would also apply to safe deposit boxes and certificates of deposits.

The bank must timely respond to a garnishment otherwise a judgment may be rendered against the bank for the full amount of the underlying judgment, regardless of whether the bank held any funds of the defendant which could have been payable to the creditor that issued the garnishment.

Wage Garnishment

A bank, like any other employer, may be served with a wage garnishment against its employees. These matters are commonly handled through your human resource departments. With a wage garnishment and pursuant to Ala. Code § 6-10-7, the bank will be typically required to withhold 25 percent of disposable earnings for the week or the amount by which disposable earnings for the week exceed 30 times the federal minimum hourly wage in effect at the time the earnings are payable, whichever is less. An employee's "disposable earnings" means that part of earnings of an individual remaining after deduction of amounts required by law to be withheld such as federal income tax, federal social security tax, and state and local taxes

The bank is required, after a period of 30 days from the first retention of any sum from the employee's wages, salary, or other compensation, to begin paying the moneys withheld into court as they are withheld and continue to do so on a monthly or more frequent basis until the full amount of the garnishment is withheld. If employment of the defendant is terminated before the sum is accumulated, the bank is required to report the termination and pay into court within 15 days after termination all sums withheld in compliance with the garnishment.

Subpoenas for Production of Documents

The type of subpoena often served upon a bank is a subpoena duces tecum, which is a court summons for the bank to produce documents and/or appear as a witness to give testimony before the court. Given their very nature, bank records often play a crucial role in litigation as the subject of a civil or criminal matter, in either a state or federal court proceeding, including bankruptcy proceedings.

A bank may receive a subpoena that is overly broad in scope or requires the disclosure of confidential trade secrets, strategic planning, or other such proprietary information. Alternatively, the information requested may be appropriate, but does not afford adequate time in which to properly respond or appear. Rule 45 of the Alabama Rules of Civil Procedure requires that the party issuing the subpoena "take reasonable steps to avoid imposing undue burden or expense" on the recipient and, on timely motion, the bank may seek to quash or modify the subpoena in certain objectionable circumstances. As a practical matter, a telephone call with the attorney that issued the subpoena may be useful in narrowing its scope and the bank should require payment in advance for the time and expense of responding to the subpoena. When responding, the documents or records being produced should be produced in the same manner in which they are kept unless you are instructed to provide in different format. Failure to respond to the subpoena, however, may result in the bank or its representatives being held in contempt of court.

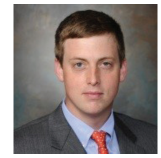
IRS Levies

In general, an IRS levy is a legal seizure by the IRS of the taxpayer's property in order to satisfy a tax debt. Upon receipt of the notice of levy by the IRS, the bank should freeze the customer's funds for a period of 21 days, after which time the funds should be turned over to the IRS. By doing so, the bank is discharged from any liability to its customer as well as the IRS.

The bank has a duty to freeze account funds even if the taxpayer is on a joint account and even if the funds in the account can be easily traced to that joint account holder. The test for freezing or not freezing the funds is whether the customer/taxpayer has an unrestricted right to withdraw funds. See Treasury Regulation 301.6332–1(c)(4). The joint account holder may, however, seek the return of the funds from the United States by making an administrative wrongful levy claim under IRC 6343(b) or file a suit under IRC 7426(a)(1). As we have seen with the other forms of process discussed herein, failure to respond to an IRS levy may result in the bank being liable for the amount that should have been frozen plus costs, interest, and a penalty equal to 50 percent of the levied amount.

In addition to IRS levies, there are many other types of levies issued by various state governmental agencies such as the Alabama Department of Revenue or pursuant to the uniform child support enforcement programs adopted by most states. This article does not address appropriate responses to such levies, and such matters should be referred to counsel on a case by case basis.

The penalties for an untimely response to the above forms of Legal Process, whether intentional or through procedural mismanagement, can be severe and costly. Working closely with bank counsel and having a designated person or team specially trained for handling and responding to garnishments, subpoenas and levies is critical for the effective operation of the bank and will significantly reduce the risks to the bank.



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Regulatory Consolidation Redux?

by Craig Landrum

As a banking lawyer who has ridden the waves of congressional responses to real or perceived voids in bank regulation, such as FIRA, DIDMCA, Garn-St. Germain, FIRREA, FDICIA, Riegle-Neal, Gramm-Leach-Bliley, FACT Act, Dodd-Frank, and numerous named legislation and acronyms in between since 1980, it is interesting to watch the recurring calls for a unified federal bank regulator. These calls appear about every eight to ten years, beginning with an effort at regulatory reform by then-Vice President George H.W. Bush during the Reagan administration. On the surface, regulatory consolidation appears to make sense—uniformity of rules and regulations as well as perceived cost reduction. However, such consolidation will not be beneficial to community banking.
The thrift industry serves as a historical example—and warning. The first of several blows to the thrift industry—deregulation of interest rates—occurred early in my career. There was one federal regulator of federal and state thrifts, the Federal Home Loan Bank Board (FHLBB), and one insurer, the Federal Savings & Loan Insurance Corporation. A single regulator seemed to do nothing to arrest the decline of the thrift industry. To the contrary, FHLBB action, with congressional help, seemed to hasten the industry's

decline. With a single regulator, there were no competing interpretations or ideas other than those offered by the industry regulated. Absolute power may not have corrupted absolutely, but it stifled discussion and ideas.

Commercial banks, on the other hand, have long had choices of federal regulators and the pendulum has swung many times from one preferred regulator to the other. The Office of the Comptroller of the Currency (OCC) was perceived as a way around local politics, and this proved true early in my career when a group attempting to organize a de novo bank was denied a state charter, the denial rumored to have been the result of political influence. Within weeks, the application was retooled and sent to the OCC, which granted a charter within a few more weeks. This action had a beneficial after-effect of causing the state chartering authority to be less politically invested. Likewise, the decisions by the OCC gave my state statewide branching and ownership of insurance agencies, among other powers to which the local chartering authority conformed in the interests of parity.

State chartered banks—like state governments—can be more innovative, but, as illustrated above, are subject to local politics, while the OCC has historically provided some insulation from local politics. On the other hand, the OCC as a department of the United States Treasury has been perceived as being subject to prevailing political winds at the federal level, whether it be fair lending enforcement, troubled bank resolution or large bank orientation. For the latter reason in particular, with elements of other reasons, we have seen a migration of community national banks to state charters.

State chartered banks may choose to be member banks regulated under the Federal Reserve System or nonmember banks regulated by the Federal Deposit Insurance Corporation (FDIC). Both the FDIC and Federal Reserve System were designed to be insulated to a degree from political influence at the national level. For years the FDIC was viewed as friendly to community banks, particularly in regard to problem bank resolution, but we have seen a migration of state nonmember banks to member banks in addition to the migration of national banks converting to state chartered banks—but choosing to retain Federal Reserve membership. The reason for this migration is primarily the perception of examination focus politically influenced by the composition of the Board of Directors of the FDIC.

The regulatory burdens on community banks are not a product of having three federal regulators. To the contrary, the nuances of regulatory interpretation and examination focus have been beneficial to community banks, offering a degree of regulatory relief in addition to what can be viewed as healthy discussions over regulatory interpretation and turf. This is evidenced by the number of national banks converting to state charters and state charters choosing between being members and nonmembers. Consolidation of bank regulators will eliminate those nuances—but will not lessen in any way the cost or scope of the regulatory burden. Let's not spend time debating regulatory agency consolidation. Let's focus instead on meaningful relief from the regulatory burdens that have accumulated over the years based on congressional reactions to perceived abuses by punishing wrongdoers and the innocent alike.

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The Looming End of LIBOR

by John Pickering

From time to time, a financial tool outlives its usefulness. For example, the Rule of 78s persisted in some contexts long past the need for a manual labor-saving device for interest calculations. Less common is the abandonment of a financial tool at the height of its popularity, yet the latter is exactly what's about to happen with the London Interbank Offered Rate interest rate index, or "LIBOR."

LIBOR is the average interest rate based on estimates from the leading banks in London of what rate each would expect to pay were it to borrow from other banks. It was developed in the 1980s by the British Bankers Association as a tool to promote uniformity in interest rate swap markets, but it has spread to a staggering array of transaction types and volumes, functioning today as a primary benchmark for short-term interest rates around the world. It is estimated that more than $350 trillion in derivatives and other financial products are tied to LIBOR. As interest rate indices go, it has been phenomenally successful.

So why are we talking about doing away with it? One might guess it has something to do with the 2008 scandal in which it surfaced that some of the bankers submitting estimates for LIBOR determination were fudging those estimates for their own benefit. That was a real problem, especially for the bankers on the wrong end of the eventual criminal settlements. But the scandal didn't seem to cause a drop off in LIBOR use, and the manipulation risk was mitigated by the transfer of LIBOR maintenance from the British Bankers Association to Intercontinental Exchange (ICE), an electronic trading platform, under the oversight of United Kingdom bank regulators.

Problem solved, right? Not so fast. The UK bank regulators announced in July 2017 that LIBOR will be phased out by 2021! The reason isn't the scandal, but rather the increasing rarity with which the 15 to 20 banks giving LIBOR estimates actually borrow from one another. More and more, LIBOR is becoming nothing more than an average guess by a bunch of bankers, with very few actual transactions for comparison or validation. ICE is even finding it difficult to coax estimates out of the bankers.

This is all well and good, but what about those $350 trillion in existing transactions, some of which will be in place long past 2021? Not to mention the billions or trillions more in new LIBOR transactions being closed this year! The Federal Reserve, cooperating with other bank regulators throughout the world, has been working on a solution since 2014 through the Alternative Reference Rates Committee (ARRC). In June 2017, the ARRC announced that it had chosen a "Broad Treasuries Financing Rate" (BTFR) as the new index for derivatives priced in US dollars. The BTFR is a repurchase transaction rate used for short-term "repos" secured by US Treasury securities. Some commentators anticipate that BTFR will emerge as the consensus favorite to replace LIBOR by the time LIBOR goes away in 2021.

A challenge for everyone is that, since BTFR is a secured rate and LIBOR is an unsecured rate, things won't be as simple as substituting the four new letters for the five old ones. LIBOR would need to be replaced with BTFR plus a margin or even a percentage of BTFR.

Another big question is how existing transactions will be transitioned. Loan and other transaction terms vary greatly, even within the same institution or portfolio, as to what happens if LIBOR becomes unavailable. Sometimes the documents permit the lender to choose another index, sometimes agreement between the parties is required, and sometimes the documents are silent. Many borrowers have historically paid little attention to these clauses in loan documents given the widespread popularity of LIBOR, but lenders may start to see pushback on clauses that let the lender pick the replacement rate. Of course, this will be happening at precisely the time such clauses will be more important to the lenders than ever!

Remember, if 2021 is like every year before it, it will be here before any of us are really ready for it! Start building awareness of the LIBOR termination issue within your organization, understanding what the documents in your loan portfolio say about LIBOR, and preparing your customers for the looming end of LIBOR.

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