Legal Status of Bank Holding Companies (BHCs): U.S. and European Bankruptcy Issues

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> "There need to be international standards when dealing with a global company that collapses, otherwise, every country acts like 'Every man for themselves.'"

Bryan Marsal, Lehman's chief restructuring officer and co-CEO of Alvarez & Marsal LLC

A. Introduction

Currently, about 84% of commercial banks in the U.S. are part of a Bank Holding Company (BHC) structure. More than 75% of small banks with assets of less than $100 million are owned by BHCs; this

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percentage increases to 100% for large banks with more than $10 billion in assets. About 60% of minority-owned banks are owned by BHCs.[1]

Based on this statistic one can assume how huge BHCs' participation in markets is and how much money and cash flow is behind their business. There have always been regulations concerning controlling and supervising the business of BHCs, but the effectiveness of this system has been revealed only after the danger of failure of the biggest investment enterprises, which have had significant assets not only in the U.S., but also around the world. After the world economic crisis more or less lost its peak, financial regulatory reform was introduced in the summer of 2009. Regulatory controls over BHCs and financial holding companies (FHCs) have been tightened, including supervision on the prebankruptcy stage. The evaluation of the effectiveness of such strengthening is highly controversial and discussion is taking place at the highest political level.

Keeping in mind these changes being made, it seems timely to analyze the legal nature of the BHC in its variety, its structural peculiarities, as well as its regulation by bankruptcy legislation in the U.S. The essential continuation of this kind of research is analyze how a BHC is usually treated in the case of bankruptcy. Problems usually arise from bankruptcy of the cross-border financial enterprises, which is almost always the case while talking about a BHC or a FHC as the head company of the group.

Thus, the main aims of this research include:

1. an overview on the legal status of BHCs and FHCs, including provisions introduced by Financial Regulatory Reform 2009;
2. analysis of possible problems arising while processing cross-border bankruptcy proceedings of an undercapitalized financial group using the *Lehman Brothers Group* case; and
3. offering some common solutions for resolving these problems.

B. Short Introduction to the History of BHCs

The history of BHCs began in the 19th century. In the early years of American banking, the common-law right of a bank to establish branches was rarely questioned; in fact, branches were considered the natural means of providing banking facilities to smaller communities. It should be noted, however, that many of these multiple-office systems have more closely resembled BHCs than branch banks. For example, branches of both the First and the Second Bank of the U.S. had their own directors and presidents and acted quite independently of each other.[2] This way, in early America's financial development the precedent for

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the BHC type was established. It should not be too surprising, therefore, that in the 1880s and 1890s, when bankers were faced with the problem of achieving expansion of their banking facilities while branch banking was prohibited in many states, limited in others, and not permitted in national banks, these men turned to what appeared to be a workable solution—independent banks with common ownership.[3]

One can see, therefore, that during the 19th century the American banking system moved from branch banking through unit banking to multiple-unit banking, while European countries, on the contrary, moved from unit banking to branch banking.

The growth of the BHCs stopped during the Great Depression. An additional reason why less and less BHCs were established was the relaxation of the legislation restricting branch banking.

A new era in the development of BHCs began in the 1950s when BHCs were expanding rapidly through merger. Two main elements of such development are: the fear of restrictive federal legislation and the effort to rebuild Transamerica following the sale of its interests in Bank of America. The growth of 15 leading groups by absorbing operating banks was almost exclusively concentrated in the period between January 1954, and June 1956. Over two-fifths of this expansion occurred during the six months immediately preceding the passage of the Bank Holding Company Act of 1956.[4]

This short introduction into the history of BHCs is followed by a discussion of the most important legislation and how this legislation influenced the development of BHCs. This will facilitate understanding BHC as a business unit to the fullest extent.

C. Legislative Framework of BHCs: History and Modern Stand

The first piece of legislation that has to be mentioned is the Banking Act of 1933. Development of the BHCs was influenced by economic growth in the U.S. in the 1920s. Thus, the lawmakers were under pressure to systemize the business of the BHCs and to give them a legal status.

The Great Depression brought new and more serious problems to the fore. Temporary, at least, legislation concerning group banking was limited to a few sections of the Banking Act of 1933. However, it was not only poor economic conditions that prevented the enactment of stronger legislation, but also the actions of numerous BHCs provided support in the legislature.

The Banking Act of 1933 was designed to bring under federal supervision those banking groups that included a member of the Federal Reserve System as a constituent bank. BHCs subject to regulation were

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required to register with the Federal Reserve Board in order to obtain a permit to vote their stock in the selection of directors of their affiliated banks.[5] In addition section 19 of the Banking Act of 1933 gave the Federal Reserve Board the power to revoke a voting permit if any holding company affiliate violates any of the provisions of the Act. The disadvantages of this law is that no consideration was given to the competitive position of the BHC in relation to other financial institutions serving in the same area.[6]

A small degree of additional control over BHCs was introduced by the Securities Act 1933 and 1934. Holding companies whose securities are registered on a stock exchange and holding companies that wish to offer sizable new issues in interstate commerce are required by these Acts to file periodic reports with the Securities and Exchange Commission (SEC). These reports together with a firm's application to be listed on a national securities exchange registration statements filed with the SEC disclose the company's financial structure, the nature of its business, the identity of holders of more than 10% of its stock, bonus arrangements, and balance sheet and income statement figures. The 1934 Act also controls proxy solicitations and trading profits by insiders.

BHCs are essentially investment companies whose portfolios contain a preponderance of bank stocks. Nevertheless, group systems were given a specific exemption from the provisions of the Investment Company Act of 1940—section 3(c)(4)—if they held a general voting permit from the Federal Reserve Board. The theory of this exemption presumably was because the holding company was subject to the regulation of one federal agency, there was no need in the public interest to duplicate this supervision. Thus, a BHC could not completely escape control, except in unusual circumstances, for if it were not registered with the Federal Reserve Board, it would become subject to the provisions of the Investment Company Act.[7]

There were plenty of bills introduced to almost every session of Congress between 1933 and 1955. It seemed to be impossible to bring supervisory authorities, independent bankers, and BHCs under one legislative "umbrella." The Bank Holding Companies Act of 1956 which was introduced was considered a compromise and was not completely satisfactory even to its most ardent supporters.[8] This law regulated only multi-BHCs—corporations that control 25% or more of the voting shares of at least two commercial banks.[9] The document was very important for the further existence and development of the BHCs. The main purpose of this Act was to limit the expansion of banking institutions into nonbanking activities.[10]

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So, section 2(a) defines a BHC as any company (1) which directly or indirectly owns, controls, or holds the power to vote 25% or more of the voting shares of each of two or more banks or a company that is or becomes a BHC, or (2) which controls the election of the majority of the board of directors of each of two or more banks, or (3) for the benefit of whose shareholders 25% or more of the voting shares of two or more banks or a BHC is held by trustees.[11] One can see from this definition that the legislature eventually wanted to cover the widest range of companies possible. Furthermore, the 1956 Act, which employs a 25% figure, includes a number of companies not covered by the Banking Act 1933, which seems to be an advantage. From the other side, by providing a two-bank rather than one-bank definition employed in the 1933 litigation, the Bank Holding Act 1956 fails to reach the great majority of BHCs.

However, despite such limited coverage, the 1956 Act accomplishes one of the main purposes for which it was designed—the control of expansion. Furthermore, to limit interstate banking operations by holding companies, the Act provides that a holding company operating in one state may not acquire a bank in a second state unless the second state expressly authorizes such acquisition by statute.[12]

Further achievement of this law was that BHCs were required to divest themselves of ownership or control of voting stock of companies that engage in any business other than banking, managing banks, or furnishing services to affiliated banks. Therefore one can clearly see how the federal control exercised divestment of nonbanking assets for the BHCs. Thus, with this provision the Bank Holding Company Act of 1956 set the first law distinguishing between banking and nonbanking holding companies.

Expansion of the control after the business of the BHCs can be seen in the provisions where it was against the law, unless approved by the Board, to take any action which results in a company becoming a BHC or for any BHC to acquire ownership or control of any voting shares of any bank if, after such acquisition, the company owns or controls more than 5% of the voting shares of such bank. Any merger and consolidation of two BHCs requires the Board's consent. The Board may not approve any acquisition that would result in a monopoly or that would substantially lessen competition.[13]

Thus, the provisions of the Bank Holding Company Act of 1956 endowed both state and national officials with substantial authority over group banking. This law and the prospect of new BHCs foreshadowed the end of the dual banking system in the U.S. and the advent of a new triple banking system.[14]

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Moreover, historically, the Bank Holding Company Act sought to provide for the separation of banking from commerce. In order to avoid any detrimental effects on the public interest, the activities of BHCs have been limited by law and regulation and transactions with banking subsidiaries are virtually prohibited. This basic rationale is the cornerstone for regulating the financial affairs of BHCs.

A further step in the legal regulation of BHCs was The Riegle-Neal Interstate Banking Act. This bill was introduced to amend the Bank Holding Company Act of 1956, the revised statutes of the U.S., and the Federal Deposit Insurance Act to provide for interstate banking and branching.

Factor in that banks had been required to set up separate subsidiaries in each state to conduct business and it was illegal for banks to accept deposits from customers out of their home states made business particularly difficult. It was necessary to regulate this area of banking law. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994[15] allowed interstate banking in the U.S. Furthermore, the legislation permitted banks to establish branches nationwide by eliminating all barriers to interstate banking at the state level. Of significant importance for this research is the provision of this bill to permit adequately capitalized and managed BHCs to acquire banks in any state one year after enactment.[16] On the one hand, after the enactment of the The Riegle-Neal Interstate Banking and Branching Efficiency Act the number of states permitting interstate banking had risen massively, while on the other hand, all states with the exception of Hawaii had passed laws allowing banks to be sold to holding companies based outside the state borders.[17]

The Gramm-Leach-Bliley Act of 1999 introduced the next branch of reforms. The most notable change brought about by the enactment of the Gramm-Leach-Bliley Act is the elimination of the legal separation between banks on the one hand and securities firms and insurance companies on the other hand. Specifically, the Act (section 101)1 repeals the Glass-Steagall Act prohibitions against affiliations and management interlocks between securities underwriting and dealing firms and banks, and allows (sections 103 and 104) banks and insurance enterprises to become affiliated with one another. It authorizes banks and their affiliates to engage in both securities and insurance businesses, among others, subject to certain limitations. Importantly, the Act also affords banking organizations significant organizational flexibility in conducting these activities, by allowing many (albeit not all) new activities to be conducted in bank subsidiaries as well as holding company affiliates.[18]

Following the subject of this research it is necessary to overview the changes this bill introduced in respect to BHCs.

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Section 103 of the Act amends the Bank Holding Company Act of 1956 to permit a FHC to engage in any activity or to acquire the shares of any company whose activities have been determined by the Board of Governors of the Federal Reserve System, after mandatory consultation with the Secretary of the Treasury, to be either financial in nature, or incidental or complementary to financial activities without posing a substantial risk to the safety and soundness of depository institutions, or of the financial system generally. Thus, a BHC may elect to become a FHC if all of its subsidiary banks are well capitalized and well managed. A BHC that meets such requirements may file a certification to that effect with the Board and a declaration that the company chooses to be a FHC. After the filing of such a declaration and certification, a FHC may engage either de novo, or through an acquisition, in any activity that has been determined by the Board to be financial in nature or incidental to such financial activity.[19]

Section 213 covers issues on board composition and prohibits a registered investment company from having a majority of its board of directors composed of personnel or senior officers of the subsidiaries of any one bank, or of any single BHC, its affiliates, and subsidiaries.

Subtitle B of Title I of the Act is dedicated to streamlining supervision of BHC. Namely, in keeping with the Federal Reserve Board's role as an umbrella supervisor, the legislation provides that the Board may require any BHC or subsidiary thereof to submit reports regarding its financial condition, systems for monitoring and controlling financial and operating risks, transactions with depository institutions, and compliance with the BHCA or other Federal laws that the Board has specific jurisdiction to enforce. The Board is directed to use existing examination reports prepared by other regulators, publicly reported information, and reports filed with other agencies, to the fullest extent possible.

Subtitle C of Title II of the Act amends the Exchange Act to permit certain investment BHCs without a bank or savings association affiliate to elect SEC supervision. This subtitle was designed to implement a new concept of SEC supervision of broker/dealer holding companies (that do not control depository institutions with certain exceptions) that voluntarily elect SEC supervision. This provision is designed to assure that the supervision of an investment BHC by the SEC is a meaningful option. Non-U.S. financial institution supervisors, when reviewing regulatory applications or notices submitted by a U.S. financial institution supervised in the U.S. as an investment BHC by the SEC under section 231, shall treat the SEC as the principal U.S. consolidated home country supervisor of such financial institution on the same basis and terms as

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if the Federal Reserve Board were the principal U.S. consolidated home country supervisor.

During and after the mortgage crisis of 2007 the Gramm-Leach-Bliley Act (GLBA) went through significant criticism. Among others, economists Robert Ekelund and Mark Thornton have criticized the Act as contributing to the crisis. They state that while "in a world regulated by a gold standard, 100% reserve banking, and no FDIC deposit insurance" the Financial Services Modernization Act would have made "perfect sense" as a legitimate act of deregulation. Under the present fiat monetary system it "amounts to corporate welfare for financial institutions and a moral hazard that will make taxpayers pay dearly."[20] Critics of the legislation feared that, with the allowance for mergers between investment and commercial banks, GLBA allowed the newly merged banks to take on riskier investments while at the same time removing any requirements to maintain enough equity, exposing the assets of its banking customers.[21] As an answer to this criticism in February 2009, one of the Act's co-authors, former Senator Phil Gramm, wrote in its defense that:

> if GLB was the problem, the crisis would have been expected to have originated in Europe where they never had Glass-Steagall requirements to begin with. Also, the financial firms that failed in this crisis, like Lehman, were the least diversified and the ones that survived, like J.P. Morgan, were the most diversified… Moreover, GLB didn't deregulate anything. It established the Federal Reserve as a superregulator, overseeing all Financial Services Holding Companies. All activities of financial institutions continued to be regulated on a functional basis by the regulators that had regulated those activities prior to GLB.

Thus, highly controversial provisions, introduced by the Gramm-Leach-Bliley Act of 1999, covered new opportunities for investment BHCs to broaden their business in different ways including mergers and acquisitions options. Moreover, the Act provided requirements for corporate governance and determined supervisory rules for the BHC.

1. Legislative Framework of the Financial Regulatory Reform as a Result of the World Financial Crisis of 2008/2009

The financial crisis of 2008/2009 forced U.S. legislators to improve and amend some provisions concerning BHCs. The opportunity for banks and their affiliates to engage in both securities and insurance businesses, as well as the option to elect to become a FHC, made the activities of BHCs highly complex and tangled. The level of complicity showed up

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when large BHCs went bankrupt after financial markets broke down. Notwithstanding with the fact, that BHCs supervision by the Federal Reserve and the SEC is well regulated, for example, during the bankruptcy proceeding of Lehman Brothers Holdings Incorporated, it took a significant amount of time and money to determine the ceased financial connections and cash flow corridors between subsidiaries and the BHC itself and the success of these actions is controversial. The system of state supervision, therefore, showed its weakness against the complex structured BHC (FHC), and the need for reform has been obvious.

As a result, the U.S. government in the summer of 2009 undertook financial regulatory reform "to reform financial regulatory system and put economy on track to a sustainable recovery."[22] The following drafts were introduced as a part of Division A of the Reform—Improvements to Supervision of Financial Firms—and are relevant in the course of this research: The Bank Holding Company Modernization Act of 2009 (the "Modernization Act"), the Bank Holding Company and Depository Institution Regulatory Improvements Act of 2009 (the "Regulatory Improvements Act"), and the Resolution Authority for Large, Interconnected Financial Companies Act of 2009 (the "Resolution Authority Act"). According to George Williams, common to all of these Acts is the apparent belief that the financial system as a whole can best be regulated by treating complex or important financial institutions as if they were BHCs, even if they are not. By implication, this means imposing (to some extent) the U.S. separation of banking from commerce on all participants in the U.S. financial system. That principle is fundamental even to the somewhat relaxed regulatory requirements established by the Gramm-Leach-Bliley Act in 1999 that imposed this separation even on the BHCs with the greatest regulatory flexibility, namely the so-called FHCs.[23]

While introducing the Modernization Act, Congress found that inadequate consolidated supervision and regulation of large, highly leveraged, and substantially interconnected financial companies was a key contributor to the recent financial crisis. Furthermore the sudden collapse of large investment banks and insurance companies based in the U.S. was among the most destabilizing events of the financial crisis. These companies were ineffectively supervised and regulated on a consolidated basis, and, as a consequence, did not have sufficient capital or liquidity buffers to withstand the deterioration in financial conditions that occurred in 2008. Also, although most of these financial companies owned federally insured depository institutions, many chose to own depository institutions that were not considered banks under the Bank Holding Company Act of 1956. By doing so, these financial companies chose to be subject to consolidated supervision and regulation

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under statutory frameworks or voluntary agreements that were inherently weaker than the framework applicable to BHCs. Based on these conclusions, the purpose of the Modernization Act includes: to help ensure the financial distress, rapid deleveraging, or disorderly failure of large, highly leveraged, and substantially interconnected financial companies does not harm the financial system or the U.S. economy; and to mitigate threats to financial stability by subjecting all large, highly leveraged, and substantially interconnected financial companies and their subsidiaries to comprehensive and robust prudential supervision and regulation by the Board of Governors of the Federal Reserve System.[24]

With section 204 of the Modernization Act the legislation introduces a new type of FHC, Tier 1 FHC, defined as:

> [The Board] may designate… any U.S. financial company as a U.S. Tier 1 financial holding company ("Tier 1 FHC"), if it determines that material financial distress at the company could pose a threat to global or U.S. financial stability or the global or U.S. economy during times of economic stress based on a consideration of the following criteria: the amount and nature of the company's financial assets; the amount and types of the company's liabilities, including the degree of reliance on short-term funding; the extent of the company's off-balance sheet exposures; the extent of the company's transactions and relationships with other major financial companies; the company's importance as a source of credit for households, businesses and state and local governments and as a source of liquidity for the financial system; the recommendation, if any, of the Financial Services Oversight Council; and any other factors that the Board deems appropriate.[25]

In addition the Board shall at least annually reevaluate its designations for U.S. financial companies and foreign financial companies. Furthermore, the Board shall, by providing a company notice of the Board's proposed determination, rescind a designation of a company as a Tier 1 FHC if it determines that the company no longer meets the appropriate standards.[26] If the company has at least one functionally regulated subsidiary, the Board consults with the primary federal regulatory agency for each subsidiary before making any determination.[27] The Act also foresees that if the Board is unable to determine whether a U.S. financial company's financial activities pose a threat to financial stability based on regulatory reports, namely the most recent audited or unaudited financial statements available, discussions with management, and publicly available information, the Board may conduct an examination of the U.S. financial company for the sole purpose of determining

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whether to designate the company as a U.S. Tier 1 FHC. [28] In order to mitigate the risks to U.S. financial stability and economy posed by U.S. Tier 1 FHCs, the Board shall prescribe, by regulation or order, prudential standards for U.S. Tier 1 FHCs to maximize financial stability at the least cost to long-term financial and economic growth. These standards, stipulated in the Act, according to the legislation shall be more stringent than the standards applicable to BHC to reflect the potential risk posed to financial stability by U.S. Tier 1 FHC and shall include, but not be limited to—risk-based capital requirements, leverage limits, liquidity requirements, and overall risk management requirements.[29] Furthermore, the Act delegates to the Board the power to take prompt corrective action to resolve the problems of a U.S. Tier 1 FHC,[30] moreover, it prescribes the Board, not later than in 90 days after a Tier 1 FHC becomes critically undercapitalized, whether to require the Tier 1 FHC to file a petition for bankruptcy under 11 U.S.C.A. §301 or file a petition for bankruptcy against the Tier 1 FHC under 11 U.S.C.A. §303.[31]

From the summary above it is clear that the main aim of the Modernization Act was to expand the definition of BHC to give the state an opportunity to exercise more powers and controls over FHCs. This step was needed and the introduction of the new class of companies—Tier 1 FHCs—is a "legislative answer" to difficulties specialists faced during the investigation of bankruptcy procedures of the corporation that used to be called "too big to fail." Extremely high leverage rates, relying on the short-term debt and trading highest risk securities brought markets and economy to a deep depression and needed to be regulated more strictly. These tendencies became usual for the times of economical distress and have to be resolved with new legislative instruments.

The next draft introduced is the "Regulatory Improvements Act." This Act would contribute to the expansion of BHC regulation by eliminating several types of entities as exceptions to the definition of "bank" in section 2 of the Bank Holding Company Act (the "BHCA"), in particular: specialized state banks held by thrifts and certain grandfathered banks; thrifts and certain homestead associations and cooperative banks; trust companies that do not market deposits or offer transaction accounts; credit card banks; and industrial loan companies.[32] The provisions of the Act require BHCs that became BHCs after the enactment of the Modernization Act of 2009 to register as BHCs with the Board of Governors of the Federal Reserve System ("Board") within 180 days of the enactment of the Act.[33] The Act, furthermore, amends the BHCA of 1956 and requires all FHCs engaging in expanded financial activities to remain well capitalized and well managed.[34] Moreover, the Act amends section

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5(b) of the BHCA of 1956 to clarify that the Board may also adopt rules governing the capital levels of BHCs.[35]

Finally, the Resolution Authority Act in its provisions has widened the definition of BHC by including Tier 1 FHCs in its scope. One has to mention that the Act does not automatically apply to BHCs. Its application must be invoked by the Secretary of the Treasury (in consultation with the President) upon the recommendation of the Federal Reserve Board and either the FDIC or the SEC.[36] The Act also introduces such definition as "bridge bank holding company," which means a new BHC organized by the appropriate federal regulatory agency: FDIC or SEC (if the BHC, or an affiliate thereof, is a broker or dealer registered with the Commission under section 15(b) of the Securities Exchange Act) appointed by the Secretary. The appropriate federal regulatory agency as receiver of at least one covered BHC or in anticipation of being appointed receiver of at least one BHC, may organize at least one bridge BHC. Through a bridge BHC the appropriate federal regulatory agency can exercise particular actions according to section 1209(h) of the Act. Thus, the Act allows the FDIC to lend to the BHC (including any Tier 1 FHC), purchase assets from it, assume its obligations, and acquire equity interests in the BHC or any of its subsidiaries (other than depository institutions, broker-dealers, and insurers). The taking of these actions by the FDIC requires a determination by the Secretary of the Treasury that the BHC is in default or in danger of default, that its failure would have serious adverse effects on the financial stability or economy of the U.S., and that the FDIC's provision of assistance would mitigate the adverse effects without being overly costly or creating unacceptable moral hazard.[37] Furthermore, upon its establishment, a bridge BHC shall be under the management of a board of directors appointed by the appropriate federal regulatory agency. If permitted by the appropriate federal regulatory agency, a bridge BHC may operate without any capital or surplus, or with such capital or surplus determined to be appropriate by this agency.

Thus, this piece of legislation—as a part of Division D of the reform concerning "improvements for financial crises management"—gives to the regulatory agencies a scope of new functions, which concern financial instability which financial companies can face. These provisions filled the loop which was obvious when it came to analyzing the causes of bankruptcy of Lehman Brother Holdings Incorporated (LBHI). As LBHI was a BHC under the law of the state of Delaware, it did not fall within the scope of FDIC measures concerning commercial banks' financial rehabilitation and bankruptcy procedures. As a result, during the prebankruptcy period, it did not fall within the financial regulation

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of the control of assets and the monitoring of money-flows, which are the most important functions exercised by the company's management, when the collapse of the enterprise is as obvious to them as to insiders. With creation of this Act, FDIC and SEC finally have the power to not only oversee the BHC, but also to interfere in their activities by creating a bridge company for these purposes and to prevent bankruptcy in the first stage.

Conclusions: The meaning of the Acts, described above is difficult to overestimate. These core Acts regulate the most problematic period—the prebankruptcy period, which, as experience showed, is often hidden from supervisory authorities and this fact causes problems in creditor's satisfaction through the bankruptcy procedure later. Creation of these draft bills clearly shows what has to be changed and improved: there was no need to reform bankruptcy laws whose legal mechanisms are functioning effectively. Much more important was, first, the strengthening of supervision of financial institutions which are going to have financial difficulties and these difficulties can damage the U.S. financial stability and, second, the introduction of new definitions in the scope of BHC, and this measure was the answer to the developing sector of financial corporations and conglomerates. It is clear that this legislation (which was passed by the House and is waiting to be heard in the Senate) will need time for improvement and "application examination"; however, taking direction to control financial conglomerates from failure, American State, somehow breaking the typical policy of noninvolvement in the commercial sector, shows how important these enterprises really are in the global dimension and that the time for rapid legal action has come.

2. BHCs as a Managerial Structure: Advantages and Disadvantages

Before turning to characteristics of the BHCs, it is necessary to make an introduction into the institute of holding companies as a managerial form.

In one of the recent researches Anjali Kumar[38] is pointing out that within the context of a market economy, the holding company was characterized as a loosely divisional structure, in which the controls between the headquarters unit and the separate operating units are often weak and unsystematic. The divisions thus enjoy a high degree of autonomy under a weak executive structure. Moreover, he underlines that the general office or headquarters unit is no more than an administrative office for the collection and aggregation of financial reports and earnings. These problems often show up when the company is facing financial difficulties or is reorganized under the bankruptcy law.

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It has already been mentioned above that official definition of the BHC was given by the BHCA of 1956.[39] One can also find a definition of a BHC on the official Web site of the Federal Reserve and it is as follows: BHC is a company that owns and/or controls at least one U.S. bank or one that owns, or has controlling interest in, at least one bank. A BHC may also own another BHC, which in turn owns or controls a bank; the company at the top of the ownership chain is called the top holder.[40] This definition of BHC shows that in the last 50 years BHCs became highly complex institutions, where bank and nonbank activities are combined into multi-level groups.

A typical BHC consists of the parent holding company and at least one subsidiary bank and nonbank subsidiary. Second-tier BHCs frequently are inserted between the top tier parent company and the subsidiary bank and nonbank for internal organizational purposes unique to each organization. Large BHCs may have hundreds of subsidiary banks and nonbanks, although the trend of the 1990s has been toward consolidation in order to achieve operating efficiencies. As a result of changes in the law legalizing interstate branching, many BHCs have consolidated all of their subsidiary banks to a single bank with interstate branching. A BHC and its subsidiaries sometimes are referred to as a "banking organization."[41] This term usually makes it complicated to understand what is meant by banking organization or bank, while in reality it speaks to financial conglomerates in general or about BHC as a holding company for the groups of companies with different business areas like insurance or securities trading. Therefore it is necessary to describe the legal nature of BHCs.

While the general "model" of the corporate structure of holding companies is relatively clear, one can continue by emphasizing the legal nature of the BHC. A BHC organization, according to the research of Ronald L. Schillereff,[42] is essentially a form of bank ownership. Any corporation, business trust, association, or similar type of organization which owns or controls at least one bank is classified as a BHC. Subsidiary banks (or affiliates) of a BHC are independently chartered banks that possess varying degrees of autonomy depending upon the organization and operating policies of the holding company.[43]

There are two types of BHCs: a multi-bank holding company (MBHC) and a one-bank holding company (OBHC).

Talking about OBHC and MBHC one can emphasize several main characteristics of these forms. It was mentioned before that the holding company structure allows certain entities to avoid some of the constraints of regulation. In this perspective, BHCs have been created for essentially the same reasons that holding companies were created in

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other industries: to expand geographically, to move into other product markets, and to obtain greater financial flexibility and tax benefits. Ronald L. Schillereff also notices that the main reason for growing OBHC is the fact that the OBHC corporate structure possesses significant tax advantages for the owners of that corporation.[44] MBHC are establishments that own or control at least 25% of the stock of two or more banks. It was already mentioned above that since the Law on Bank Holding Companies of 1956 came into force MBHCs became an increasingly significant element in the America banking system. As a result, according to Ronald L. Schillereff, at year-end 1965 there were 53 BHCs in the U.S. and they controlled approximately 8% of all commercial bank deposits. The growth of MBHCs has been geographically widespread, with MBHCs having increased their share of offices and deposits in 32 states in the period 1965 to 1976. As of December 31, 1973, multibank groups controlled over 30% of bank deposits in each of 24 states.

After the introduction of small statistics one can underline the reasons, which caused such a rapid growth and increasing popularity of MBHC as a managerial structure. Ronald L. Schillereff in his research points out the following: MBHCs have been an effective way to circumvent the branch banking restrictions that existed in many states. Furthermore, the use of the MBHC has facilitated the ambitions of banks to expand into approved nonbanking activities and to expand the market area for their banking services.

As the next step, one more separate corporate form that is relevant to the BHC should be noted, a FHC. Under the BHCA, BHCs may elect to be FHCs.[45] According to section 2 of the BHCA(4)(p) the term financial holding company means a BHC that meets the requirements of section 4(l)(1). Section 4(l)(1) defines the requirements that a FHC must meet in order to engage in expanded financial activities. Those requirements are as follows: (A) all of the depositary institution subsidiaries of the BHC must be well capitalized; (B) all of the depositary institution subsidiaries of the BHC must be well managed. Also, the BHC must file with the Board—the declaration that the company elects to be a FHC for engage in activities to acquire and retain shares of a company that were not permissible to a BHC to engage and acquire before enactment of the Gramm-Leach-Bliley Act, and a certification that the company meets the requirements of (A) and (B). Thus, one can see that the law does not give clear legal definition of the FHC, but revises the language of the section defining the BHC. One of the reasons could be that the FHC possesses a highly complex structure and the wide range of different activities that make it complicated to determine is unambiguous. In this case the broader definition is more effective and the legislature

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takes advantage of this legal instrument. On the official Web site of the Federal Reserve, a FHC is determined as follows: a financial entity engaged in a broad range of banking-related activities, created by the Gramm-Leach-Bliley Act of 1999. These activities include: insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, issuing or selling securitized interests in bank-eligible assets, and generally engaging in any nonbanking activity authorized by the BHCA. Similarly, any nonbank commercial company that is predominantly engaged in financial activities, earning 85% or more of its gross revenues from financial services, may choose to become a FHC. These companies are required to sell any nonfinancial (commercial) businesses within 10 years.[46] George Alexander Walker considers a FHC to a large extent to be regarded as being a simple subset of a BHC.[47]

The satisfactory Community Reinvestment Act rating[48] is effectively an additional requirement for FHC status. Section 4(I)(1) of the BHCA requires the Board to prohibit a FHC from engaging in, or acquiring a company engaged in, any new activity authorized under section 4(k) or 4(n) of the BHCA if any insured depository institution subsidiary of the holding company had received a less than satisfactory rating at the most recent examination under the Community Reinvestment Act.[49] The Federal Reserve Board has adopted a rule adding subpart I to Regulation Y "Bank Holding Companies and Change in Bank Control" which elaborates on the definition of a FHC. Specifically it states that the depositary institution is "well managed" if it has at least a satisfactory composite rating and a satisfactory rating for management.[50] According to the list, represented on the Web site of the Federal Reserve there are a lot of BHCs whose elections to become or be treated as FHCs are effective: e.g., Barclays PLC, Bayerische Hypo- und Vereinsbank Aktiengesellschaft, Allianz SE, Commerzbank AG, etc.[51] Based on the facts above, one can state that introduction and legal determination of such a form as a FHC[52] was necessary and the proof of it is that a lot of huge transnational corporations found this enterprise form convenient and are successfully using this structure.

The paragraph above was dedicated to the treatment and definition of FHCs under U.S. law. In European law this definition is stipulated in the Consolidated Supervision Directive which defines a FHC as a financial institution with "exclusively or mainly" credit institution or financial institution subsidiaries, but no further guidance is provided. In European legislation and literature one can find other types of FHCs, namely mixed FHCs. This structure relates to the law of financial conglomerates. Frank Dierick states as follows: if the group is not headed

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by a regulated entity, which is the case when it is headed by a nonregulated entity or does not have a parent company (a "horizontal group"), the group's activities should mainly occur in the financial sector. When a nonregulated entity heads a financial conglomerate, its parent is called a mixed FHC.[53] Lutgart Berghe states that the criterion to distinguish between a FHC and a mixed activity FHC is the amount of financial activitiy within the group led by the holding company. The subsidiary undertakings of a FHC must be "either exclusively or mainly" credit institutions (investment firms) or financial institutions. On the other hand, the definition of a "mixed activity holding company" requires the presence of at least one credit institution (investment firm) subsidiary.[54] In terms of this research it is not necessary to go into further details about the classification of BHCs, but instead concentration should be placed on the issues that arise when a BHC goes bankrupt.

i. Advantages and disadvantages of the structure of BHCs

It was already mentioned above that in 2009 many large financial institutions lined up to become BHCs or FHCs, e.g., Goldman Sachs Group Inc. This tendency can be explained by the number of advantages for BHCs and FHCs. Thus, it could be interesting to illustrate the main issues which make the BHC structure attractive. Peter G. Weinstock[55] gives a full list of those advantages. First, the main advantage of this structure is the possibility for the BHC to assume indebtedness from shareholders on a tax-free basis. Thus, the BHC can repay the interest portion of the indebtedness with pre-tax dollars. Second. The BHC structure is profitable because of convenient borrowing capacity, namely a BHC can fund an acquisition, buy back stock, or raise its capital for a subsidiary bank without diluting shareholders interests. Moreover, a BHC has the ability to raise capital in forms other than common stock, for example the issuance of trust-preferred securities. Third, a BHC has much greater legal authority to purchase or redeem its own stock, using life insurance proceeds, borrowed funds, or dividends from its subsidiary bank, subject to certain limitations. A further positive factor when talking about the structure of BHCs is greater flexibility for compensating individuals who provide strategic direction for the bank. Because there are fewer regulatory requirements for deferred compensation plans (e.g., salary continuation plans) offered at the BHC level, the administrative costs of those plans may be lower. A very important issue is, according to Mr. Weinstock, the high level of flexibility. The BHC would own 100% of the bank stock. Accordingly, the BHC´s board can amend the bank's articles without incurring the time and expense required to obtain shareholder approval to effect many changes,

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including: changing the bank's name, domicile, or head office; expanding indemnification rights; staggering the terms of the directors (e.g., in the state bank); and limiting director liability. The next feature is that banks can use a BHC as a vehicle for making acquisitions; a BHC gives banks the option of acquiring another institution and operating it as a separate entity, on a stand-alone basis. In addition to merging a bank into a BHC's subsidiary bank, a BHC can acquire an additional bank and operate as a multibank BHC. A BHC can also establish or acquire nonbank subsidiaries and operate them as entities separate from the bank. Furthermore, BHCs generally have greater authority, under the BHCA, to conduct permitted nonbanking activities, which can generate more fee income for the financial institution. Finally, state regulators and the comptroller of the currency impose fees on a wide range of corporate activities, which the Federal Reserve does not impose on BHCs. For example, there is no fee for a change in control of a BHC or for a merger of BHCs, but the filing fees for such activities at the bank level can be substantial.

In general BHC formation is often deferred until there is a clear purpose or need for it. The main reason for that is that a BHC would likely need to increase the organization's initial capital offering by at least several hundred thousand dollars in order to provide working capital for the BHC. Besides, there are additional costs and more complexity in the start-up phase associated with the formation of a BHC, there are ongoing costs related to Federal Reserve supervision and reporting requirements and, additionally, a BHC may be subject to additional cost and regulation related to SEC registration. However, SEC registration is not required if the BHC stock is sold through a private offering or sold only to residents of the BHC's home state.[56]

D. Application of the Bankruptcy Legislation on BHCs: Main Issues Arising During Processing of the Bankruptcy Procedure

First, it is necessary to point out the significant differences between laws applicable to bankruptcy of corporations and banks. The insolvency law applicable to U.S. commercial banks is an entirely different body of law from that applicable to other commercial enterprises. A commercial bank under U.S. law is a legal entity which is able to exercise the following types of business:

> the exercise, by its board of directors, or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; the discounting and negotiating of promissory notes, drafts, bills of exchange, and other

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> evidences of debt; the receiving deposits; the buying and selling and exchange of coin and bullion; the loaning of money on personal security; and the obtaining, issuing and circulating of notes.[57]

If a commercial bank goes bankrupt it falls within the competence of the Federal Deposit Insurance Corporation. Commercial enterprises other than commercial banks are liquidated and reorganized under the Federal Bankruptcy Code. Thus, any person who qualifies as the "debtor" under the Code may be subject to its provisions. Significantly, a bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, credit union, industrial bank, or similar institution, which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act,[58] is expressly excluded from the definition of debtor in the Bankruptcy Code.[59] Since a BHC is not on this list, it underlies the provisions of the Bankruptcy Code.

It is obvious that most BHCs are at the top of huge financial conglomerates and groups of companies. Also, it is seldom the case that a bankruptcy of a BHC is restricted to the territory of one country. Moreover, where the cross-border insolvency involves a corporate group, the different attitudes evidenced by courts and governmental authorities regarding group trading and the varying levels of respect shown towards the entity principle in different countries, combine to create virtually irreconcilable conflict situations.[60] In this section of the article, the general peculiarities that are typical during bankruptcy of a BHC will be discussed with concentration on the issues insolvency administrators face while working with an insolvent BHC on schemes to satisfy creditors' claims.

First, the main peculiarity of a BHC is its extremely complicated corporate structure. The legislation allows mergers and acquisitions inside the corporate group or involving companies from "outside." According to this, banks can use a BHC as a vehicle for making acquisitions—this way a BHC can turn to a Multi-BHC.

One of the first steps of an insolvency administrator and his team is to determine the internal connections between entities, i.e., to define the corporate structure of the insolvent enterprise. The main fact that distinguishes a BHC from another commercial corporation is that connections between companies in the same group cease very quickly. It is almost impossible to restore them, i.e., because of employee termination. This was the case with the bankruptcy trustee of Dutch LBHI Subsidiary "Lehman Brothers Treasury Co. B.V." Mr. Schlimmelpenninck faced while trying to obtain information about notes issued by subsidiary from the UK joint Administrators PWC. Another big problem arising from this fact is the communication of trustees with each other. In

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the case of Lehman Brothers, the Cross-Border Protocol was compiled by several trustees of insolvent Lehman subsidiaries. The importance of this document is beyond controversy. However, the effectiveness of its' provisions can easily be decreased by nonacceptance of the document by some insolvency administrators, like, for example, the *Lehman* case UK administrators did. The question arises, can this document be made binding for all administrators of the group subsidiaries? Maybe it could be a solution to build, in every huge cross-border case which is so significant that it becomes a political issue, a council composed of all insolvency administrators of the group's companies and to decide about the binding effect of the Cross-Border Protocol? The condition for that could be the preliminary approval of the Protocol by the bankruptcy court in each county where a proceeding is open. The decision of council could be made by voting the value of each vote, depending on the amount of assets each particular subsidiary has in the total of the groups' equity. However, since at this time there is no power which can bind the representatives of different jurisdictions to provisions of the particular document, this problem will remain as a lack of such legal instrument as a Cross-Border Protocol.

Second and maybe the main problem that rises from the first conclusion is determination of the financial state of the enterprise. A group of companies with a BHC at the top usually have a consolidated balance sheet for all group companies. Sometimes, as in the Lehman Brothers case, the complex information technology and internal control systems of the group were not designed to draw up interim balance sheets, except at the end of each month. Additionally, the production of administrative data was made difficult by the disintegration of the organization of the Lehman Brothers group as a result of the various insolvency proceedings. Following these statements one can emphasize the fact that the process of determining and repairing the monetary transactions system between group entities can take a very long time, up to a year or more. Aiming to follow the universality doctrine while satisfying creditors' claims, at the stage of collecting debtors' assets and financial resources, the cooperation between insolvency administrators should play the main role. The quality of this cooperation depends on the creditors' satisfaction.

The third problem results from the freedom given to BHCs' boards of directors by introducing amendments in articles of incorporation without waiting for approval of the shareholders. This quality is being put into a list of BHC advantages; however, such amendments as a bank's change in name, domicile, or head office can cause problems during an insolvency procedure. Sometimes directors use multiple changes of domicile and name of the company as a way to "hide" from creditors

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and to tangle the insolvency administrator. Furthermore, especially in cross-border cases, change of domicile or head office of the company can be seen as forum shopping and entail change of jurisdiction.

The next fact which makes the insolvency of a BHC particularly challenging is the value of its assets. This is almost always a problem when a BHC is a FHC and specializes only in financial services, like issuance of notes or investment activities. In this case, after a FHC becomes insolvent the value of its shares decreases, and company cannot provide the guarantee of its notes; thus, they will depreciate. In this situation it is very important for the insolvency administrator to wait until the position of the enterprise on the market will stabilize and one can derive profits for creditors. This process however is very risky and can take several years. For example, the Australian Voluntary Administrators of Lehman subsidiary in the second Report to Creditors pointed out that the main asset of the company that is available to meet creditor claims is a proprietary book consisting of corporate bonds and CDOs (Collateralized Debt Obligations). They emphasized, that because of that, the value of these assets is difficult to determine due to a severe lack of liquidity in financial markets at present. As a result, it was noticed that both the recoverable value of assets, and the value of potential contingent claims will be materially impacted by future market changes (both improvements and deteriorations).[61] However, this problem is only the case when one is talking about a BHC involved exclusively in financial operations and not possessing any intangible assets.

Finally, being an interesting observation more than a problem, in the case of handling a cross-border BHC different subsidiaries are set up under different corporate forms in different countries. It may be that insolvency procedures in these countries are totally opposite. In one country a subsidiary could be registered as a bank, in another—as a corporation, depending on the jurisdiction. E.g., the filing of the insolvency of the German Lehman subsidiary Lehman Brothers Bankhaus AG was supervised by the special authority—the Federal Banking Oversight Agency (BaFin); thus, it is being liquidated as a bank. Almost all of its large creditors (such as German Pension Fund) received compensation from the State Deposit Insurance Fund. In the Netherlands, Lehman Brothers Treasury Co. B.V. is being liquidated as a private company with limited liability (Besloten Vennootschap met beperkte annsprakelijkheid); thus, following the common rules for corporations. In the UK Lehman Brothers International Europe was put into administration—a typical procedure for corporations in the UK, which has much in common with reorganization procedure, but with several differences. Thus, one can see that treating BHC subsidiaries differently can

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cause significant differences in how soon reorganization procedures will end and creditors' claims will be satisfied.

E. Conclusions

As a result of this it is obvious that BHCs have a very special position in the banking system of the U.S. The development of such a legal form is unique when compared with the European model. This is the reason why the legislation tried to undertake BHCs under the state´s supervision and to strengthen it, at the same time, allowing BHCs to exercise more and more activities on the markets. The extremely complicated corporate structure causes difficulties even in the case when one of the mere subsidiaries is being undercapitalized. The economic crisis taught politicians, bankers, and legislators that principle "too big to fail" only works when the bankrupt enterprise is getting financial aid from the treasury. This was the case with Goldman Sachs and General Motors. Enterprises that did not get financial support from the state went bankrupt. Bankruptcy procedure involving huge transnational enterprises represents an extremely complicated nexus of problems, for which, first of all, legislative solutions are needed, especially while talking about BHCs or FHCs possessing assets, including mainly financial products.

The presence of various problems in handling cross-border insolvencies of groups of companies headed by the BHC or FHC, as discussed above, require the introduction of serious legal instruments. To avoid these difficulties, which are impossible to overcome when a BHC has already been brought to bankruptcy, the prevention of undercapitalization in the weak economic environment seems to be the most important aim. Among the effective legal solutions for that problem was the introduction by the U.S. government of the new type of BHC, Tier 1 FHC, in the Bank Holding Company Modernization Act of 2009. It allows the state to exercise control over huge FHCs in the dangerous prebankruptcy period and hence not permit the situation to go out of control as it did in the *Lehman Group* case.

Thus, the need for harmonization of cross-border bankruptcy legislation on the international level concerning companies exercising mainly financial services is obvious. European countries are also planning to introduce reforms on bank insolvencies and insolvencies of financial institutions, Germany being one of them.

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