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## M&A: Survival of the Fittest in the 21st Century, Strategic Positioning in the Banking and Communications Industries - Should a Bank Acquire, Merge, or Divest

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SHOULD A BANK ACQUIRE, MERGE OR DIVEST? \*

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*Keynote Speaker*

INTRODUCTION

I want to go through a specific bank's experience in evaluating its individual businesses and what led it to decide whether it should merge, spin-off, or acquire. In particular, I will focus on the legal implications of these decisions. The bank which I will use for this discussion will be U.S. Trust Company of New York ("U.S. Trust").

*I NON-DISCRETIONARY BUSINESSES*

U.S. Trust is an institution with capital assets of about \$4 billion and value to shareholders of approximately \$363 million.<sup>1</sup> Its businesses generally fit into two categories: discretionary and non-discretionary. The non-discretionary businesses involve back-office processing for unit investment trusts

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<sup>1</sup> Press Release from United States Trust Company of New York, *U.S. Trust Agrees to Sell Securities Processing Businesses to Chase Manhattan*, PR NEWSWIRE, Nov. 18, 1994 [hereinafter Press Release]; U.S. TRUST COMPANY OF NEW YORK, INC., Proxy Statement (Feb. 9, 1995) [hereinafter Proxy Statement], at 1 (indicating that the value on the closing date of the merger would be less than \$363.5 million).

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("UIT"), master trusts, and mutual funds.<sup>2</sup> The non-discretionary side is generally a high volume, back-office processing business with low profit margins.

### *A. UIT Business*

The UIT business is a closed-end investment securities portfolio, generally comprised of municipal bonds although some contain high-yield bonds. UITs are passive asset pools administered by a trustee, who serves as custodian, recordkeeper, income collector, disbursing agent, and transfer agent.<sup>3</sup> UITs have natural maturities and the individual investor buys a piece known as a unit.

The unit investment trustee retains custody of the units and receives payments from the various securities that are held by the UIT, but only makes disbursements to unit holders every six months. This creates a tremendous float for the trustee. While the trustee receives payments throughout each six month period, the trustee makes disbursements only twice a year. In the interim, the trustee retains the use of the cash and receives fees based on the amount of assets held. These fees gradually decrease throughout the term of the trust because the assets are disbursed as they mature.

UITs are not as popular today as in the past. The mutual fund, or open-end mutual fund, industry is much stronger and people tend to invest in them more than in UITs, which have an older, more conservative market.<sup>4</sup>

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<sup>2</sup> Proxy Statement, *supra* note 1, at 28 (regarding U.S. Trust's five lines of business). According to the Proxy Statement, U.S. Trust "conducts five principal businesses: asset management, private banking, special fiduciary, corporate trust and securities processing." *Id.*

<sup>3</sup> U.S. TRUST COMPANY OF NEW YORK, INC., U.S. TRUST: A HISTORY OF GROWTH WITH A COMMITMENT TO PERSONAL SERVICE, Jan. 1994, at 9 (unpublished document, on file with U.S. Trust Company of New York).

<sup>4</sup> See Chet Currier, *Funds Low-Key Relatives: Unit Investment Trusts*, CHI. SUN-TIMES, May 12, 1996, at 83.

*B. Master Trust Business*

The second non-discretionary business, the master trust, is a high volume business. To remain competitive in this business, you have to implement the latest technology in data processing. For U.S. Trust, this would have required a large investment to strengthen the global custody and multi-currency businesses.<sup>5</sup>

*C. Mutual Fund Business*

The mutual fund servicing business is also an operations oriented business with a low profit margin. Businesses with low profit margins rely on a high volume of transactions, with a large number of them being the same, so that they can build up their profit. Maintaining high volume is the key to non-discretionary securities processing business.

**II DISCRETIONARY BUSINESSES**

The other side of the business is discretionary in nature and yields high profit margins. It includes private banking, custody, and trusts and estates businesses. Private banking is involved in the more traditional banking businesses of accepting deposits, making loans, administering checking accounts and

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<sup>5</sup> See Proxy Statement, *supra* note 1, at 31. According to the Proxy Statement, the U.S. Trust board, in reaching this determination and recommendation considered the following factors:

(c) the scale required to maintain or improve margins in securities processing businesses generally, the growth prospects of UST with and without the Processing Business, UST's lack of an in-house global custody capability and other related revenue producing services that could improve the profitability of the Processing Business, and the potential for damaging the reputation of UST and its overall franchise business resulting from the relative difficulty faced by smaller institutions in managing the inherent operating risks in securities processing businesses generally.

*Id.*

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money market accounts. The trust business deals with personal trusts as opposed to employee benefit trusts.

The investment management business is highly discretionary and basically involves the management of money by investing in stocks and bonds. The corporate trust business is the least discretionary, but is appealing because of its cash management component.

These businesses are much more dependent upon the officers who are running them and especially upon their discretionary decisions. However, they do not require extensive back office processing staff or sophisticated computer systems to stay in them.

### *III SHOULD U.S. TRUST ACQUIRE, MERGE OR DIVEST?*

In 1993, U.S. Trust's profits were high and the market liked its stock. However, there were signs of trouble in the future. The non-discretionary processing businesses eventually would require large investments of capital to realize a good return, despite their low profit margins. U.S. Trust feared that if it did not do something about the large processing side of the business, the market might respond adversely, the stock price would go down, and someone would come in and acquire the institution.

U.S. Trust had three choices. The first was to purchase more processing businesses. Although it had the capital to do this, U.S. Trust, as an institution, was inclined toward the discretionary businesses, much more so than the processing businesses. U.S. Trust was expanding into the discretionary areas of business, and most of its senior officers were working in those areas.<sup>6</sup>

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<sup>6</sup> Press Release, *supra* note 1, at 2. According to the press release:

[t]he sale of our securities processing businesses and the outsourcing of our operational services will enable U.S. Trust to concentrate all of its resources on its core businesses-- asset management services for individuals, institutions and mutual funds, private banking, special fiduciary services and corporate trust -- where we have expanded nationally in recent years and where our growth prospects are very bright.

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The second possibility was to initiate a joint venture with, for example, a Japanese bank that might need additional computer capacity, but would not want to have its own platform. Joint ventures are risky, however, because their success is largely based upon mutual trust. There would be questions concerning who would use the platform when and who would get priority. Contractually binding two parties in a joint venture is also very difficult, particularly in the banking environment due to security concerns.

The third possibility was to sell the processing businesses. These businesses represented almost one-third of the capital of U.S. Trust and almost two-fifths of its employees. Making this decision was heart rending. After great angst, U.S. Trust decided to sell the processing businesses.

### IV DIVESTITURE

During the week of March 3 through March 9, 1996, the *New York Times* was replete with articles regarding how many people were being laid off.<sup>7</sup> Management at U.S. Trust, however, decided to sell its businesses only to institutions that would agree to take the employees along with the processing businesses. This narrowed the field of possible buyers.

U.S. Trust had a “dog and pony” show and had potential bidders sign the requisite letters of looking no further and agree to do nothing else than look at the material. These standstill agreements<sup>8</sup> continued for over four years. The last thing U.S. Trust wanted was to have someone come in and attempt to acquire the whole institution.

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*Id.*

<sup>7</sup> Louis Uchitelle & N.R. Kleinfeld, *The Downsizing of America: On the Battlefields of Business, Millions of Casualties*, N.Y. TIMES, Mar. 3, 1996, at 1 (seven-part article series analyzing how 43 million jobs were lost in the United States since 1979 as a result of corporate downsizing); David E. Sanger & Steve Lohr, *The Downsizing of America: A Search for Answers to Avoid the Layoffs*, N.Y. TIMES, Mar. 9, 1996, at 1 (last of seven article series). According to the article series, “[c]ounting only the lay-offs prominent enough to show up in newspapers around the country, the consulting firm Challenger, Gray & Christmas reported 15,962 workers have been cast out of their jobs in just the week since this series began.” *Id.*

<sup>8</sup> Louis Loss & Joel Seligman, SECURITIES REGULATION, at 6D.1 (1995), Standstill agreements are “contract[s] not to purchase any more shares of a target for a specified period of time.” *Id.*

Our efforts resulted in five institutions reviewing the deal. Three institutions, Chase Manhattan Bank, Northern Trust Company, and Bank of New York submitted bids. Ultimately, the bidding results were excellent for U.S. Trust and the eventual winner was Chase Manhattan Bank.<sup>9</sup> Chase made the acquisition to bolster its processing businesses. U.S. Trust's UIT business was the largest such business in the market.<sup>10</sup> This raised some antitrust issues since Chase's UIT business, when combined with that of U.S. Trust, totaled over 51 percent of the market and raised concerns of undue market concentration under the Sherman Act. Fortunately, this issue was overcome.

Chase had the platform, but needed the employees for the master trust business. Most importantly, the mutual fund servicing company was located in Boston, where Chase wanted a presence.

Prior to this acquisition, Chase did not have a mutual fund servicing component and this deal gave Chase a much larger presence in the processing business in general. Chase's desire to expand its processing business turned out to be the main reason they wanted the deal.<sup>11</sup>

#### *A. Structuring the Deal*

U.S. Trust's next issue was structuring the deal. Should it be an asset sale or should it be a spin-off, stock for stock? The decision to structure the divestiture as a spin-off entailed many legal questions.

The UIT business was very profitable and the sponsors, who package these investments, would have loved an opportunity to renegotiate the contract that established the fees paid to the trustee. The only

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<sup>9</sup> Steven Lipin, *Chase to Buy U.S. Trust Lines Handling Stock*, WALL ST. J., Nov. 21, 1994, at B4.

<sup>10</sup> *Id.* The article states that "[f]or Chase, the transaction bolsters its already strong presence in securities processing. Chase is a leader in the business of providing administrative and other recordkeeping services for investors and corporations." *Id.*

<sup>11</sup> *Id.* According to the article, Chase's acquisition of U.S. Trust's securities processing line "would strengthen the bank's [Chase's] position providing custodial services to mutual funds, while achieving significant economies of scale." *Id.*

way to avoid a renegotiation of these indentures was to have the entire corporate entity transferred rather than selling the indentures (assets) themselves.

U.S. Trust decided to effect the sale of the securities processing businesses in two simultaneous steps. First, U.S. Trust spun-off the asset management, private banking, special fiduciary, and corporate trust businesses to its shareholders in the form of a new holding company, U.S. Trust Corporation. A new bank subsidiary was created, United States Trust Company of New York. U.S. Trust shareholders received shares in the new holding company on a share-for-share basis.<sup>12</sup> U.S. Trust's second step was to merge the original holding company and its principal subsidiary, including the assets and liabilities of the securities processing businesses, with Chase.<sup>13</sup> As consideration for the original holding company, U.S. Trust received shares of Chase, which were immediately distributed to U.S. Trust's shareholders.

The law prevented U.S. Trust from transferring the trusteeship from one personal trustee to another without permission of the settler or the beneficiaries.<sup>14</sup> U.S. Trust had to obtain a *Morris Trust* ruling<sup>15</sup> in order to complete this transaction on a tax-free basis. If the ruling had not been obtained, enormous taxes would have to be paid which might have made the transaction less attractive to Chase. In addition, U.S. Trust had to obtain confirmation from the New York State Banking Board that all of the trusts which had named the original trust company as trustee should be transferred to new U.S. Trust. To obtain this confirmation, U.S. Trust had to convince the New York State Banking Board that the UIT and Master Trust businesses - which were not being transferred - were custodial, not fiduciary in nature, since New York law required that all fiduciary relationships be transferred.

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<sup>12</sup> Press Release, *supra* note 1, at 1.

<sup>13</sup> *Id.*, at 1 (explaining that Chase's acquisition included only the assets and liabilities of U.S. Trust's securities processing businesses).

<sup>14</sup> RESTATEMENT (SECOND) OF TRUSTS § 106(c) (1959).

<sup>15</sup> Commissioner of Internal Revenue v. Morris Trust, 367 F.2d 794, (4th Cir. 1966) (recognizing spin-off stock as a non-taxable gain); Proxy Statement, *supra* note 1, at 11.

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The custodial business was left in the original trust company in order to be merged with Chase while the fiduciary business was transferred from the original trust company to the new trust company.<sup>16</sup> The transfer of the fiduciary business was achieved, without the permission of the beneficiaries, under an exception in the New York Banking Law.<sup>17</sup> U.S. Trust obtained permission,<sup>18</sup> which was granted in the form of a letter from the New York State Banking Department agreeing with U.S. Trust's position.

The next step was to obtain approval from various regulators. The Federal Reserve authorized U.S. Trust to set up a new bank holding company and allowed for the transfer itself. The Office of the Comptroller of the Currency ("OCC") was also required to approve the transaction, since two of U.S. Trust's banking subsidiaries were national banks under the jurisdiction of the OCC. The New York State Banking Board granted U.S. Trust permission to transfer the discretionary fiduciary assets. U.S. Trust needed authorization from the Office of Thrift Supervision ("OTS") because within this corporation there was a thrift. The Federal Deposit Insurance Corporation ("FDIC"), insured U.S. Trust for all of the new entities. Ultimately, U.S. Trust received the *Morris Trust* ruling from the IRS.<sup>19</sup>

This process began on November 1, 1993 the day the contract was signed, and lasted until August 29, 1995, when the deal closed. Everyone was wondering how the market would react. The market capitalization of the stock, after the spin-off and the closing, was and still is today \$500 million. The value of the stock that was spun-off to the shareholders in the tax-free exchange was approximately \$363

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<sup>16</sup> Proxy Statement, *supra* note 1, at 28 (outlining U.S. Trust's pre-merger and post-merger corporate structure).

<sup>17</sup> N.Y. Banking Law § 604-a (McKinney 1995) (allowing a banking institution to transfer all or substantially all of its assets to another banking institution if the transferee agrees to assume all fiduciary relationships of the transferor).

<sup>18</sup> *Id.*, (requiring the approval of the Superintendent of the State Banking Board).

<sup>19</sup> *Morris Trust*, *supra* note 15.

million.<sup>20</sup> The market's reaction reveals that U.S. Trust is worth the same today as it was before and after the spin-off.

*CONCLUSION*

Contrary to what some describe as a purely rational, purely mathematical decision, in this case it was also an emotional one. It was a decision made by management which required the buyer to retain the employees' jobs. The divestiture affected 1,370 employees. Approximately 1,200 workers received jobs at the new company, while others found employment elsewhere or were severed.<sup>21</sup> The employees who were not offered jobs at Chase were given generous economic packages, which in several cases enabled them to retire. Thus, U.S. Trust was able to achieve its two aims in this transaction. First, it repositioned itself in the marketplace as a money manager, in the process enriching its shareholders for their investment in U.S. Trust. And second, it was able to protect the interests of its loyal workers, by either contractually providing for their continued employment with the new company - and this is the vast majority of workers - or economically providing for the remainder. Consequently, this was a win-win solution for all parties.

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<sup>20</sup> Proxy Statement, *supra* note 1, at 1.

<sup>21</sup> See Press Release, *supra* note 1 (regarding employee positions). The press release explained that:

[o]f U.S. Trust's total workforce of almost 2,700 people, approximately 1,150 employees currently working in the company's securities processing businesses, including computer services and securities operations, will become employees of Chase Manhattan as a result of the merger and outsourcing agreement.... Up to an additional 200 U.S. Trust employees in those businesses and in staff and support areas will be outplaced in the downsizing that will accompany the transaction.

*Id.*

