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Bank Holding Company Bankruptcy: Enabling the Recapitalization or Sale of "Zombie Banks"

Mark R. Ruh, CIRA
Mission Community Bancorp/Bank

Individual bank failures are very visible events to the public eye in the communities and regions they serve. Bank failure cycles garner significant political attention and unleash dramatic regulatory reform. Now in the fifth year of this current cycle, the number of bank failures this year has significantly decreased from the 2009-2010 peak in both the number of failures and in the total magnitude of assets at failed banks. Banks, as highly regulated entities, cannot utilize the Federal or state bankruptcy systems to liquidate or restructure their balance sheets because most of their balance sheet liabilities - customer deposits - are insured and thus regulated by the Federal Deposit Insurance Corporation (FDIC). However, bank holding companies (BHCs), the parent companies of banks, can utilize both Chapter 7 and Chapter 11 bankruptcy.

During this current bank failure cycle, the use of Chapter 11 bankruptcy by BHCs with active bank subsidiaries has been limited. However, the use of the Chapter 11 process by financially distressed community bank BHCs with active bank subsidiaries can be an attractive option, and there are reasons to believe that the use of this option will grow over the next few years.

REGULATORY AND BHC BASICS

The FDIC's primary mission is to promote a safe and sound banking system, and thus it acts as a deposit insurer, bank regulator, and as required, a bank receiver. Depositors of an insured bank are generally protected by the FDIC for up to $250,000 per customer relationship. However, when credit performance deteriorates and the capital level of a bank is at or near being critically undercapitalized, putting customer deposits at risk, a bank is forced into FDIC receivership by its regulatory agencies (the Federal Reserve District Banks (FRBs), the Office of the Comptroller of the Currency (OCC), various state banking authorities, and/or the regulatory arm of the FDIC). Bank receivership by the FDIC can lead to significant personal liability and a ban from the industry for the bank's officers and directors should the FDIC determine gross negligence or wrong doing occurred in operating or overseeing the bank.

Community banks are usually defined as having less than $10 billion in assets. Most banks larger than $100 million in assets are subsidiaries of BHCs. BHCs are also regulated entities - typically regulated by the FRBs. Banking companies are by nature highly levered, and BHCs are used to manage leverage at their subsidiary bank(s) while complying with banking regulations. The asset side of a community bank BHC balance sheet is usually simple. By far the largest asset is the BHC's investment in its bank subsidiary. The liability/equity side of a community bank BHC balance sheet can be rather complex, with a variety of debt and equity types used to attract investors with different investment horizons and risk appetites, and to meet the regulatory requirements pertaining to Tier 1 Capital (also known as Core Capital). More specifically, the liability/equity side of a BHC balance sheet can contain the following in its capital structure:

- Senior Secured Debt—Colloquially known as "holding company loans" or "bank stock loans." Some or all of the common stock of the subsidiary bank collateralizes these loans to BHCs. However, should the FDIC seize a subsidiary bank in a receivership action, this collateral evaporates. These loans are still offered by some of the largest banks and a handful of banker's banks (banks that specialize in providing financial services to community banks). However, the most aggressive holding company/bank stock lenders have either exited the market or significantly curtailed their lending activities due to poor returns on the loans they placed prior to the start of the financial crisis.
- Senior Unsecured Debt
- Subordinated Debt

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A Letter from the President

Anthony V. Sasso, CIRA
Deloitte CRG

As we move into the month of December and I write my last letter of the year, I'd like to recap our last big event, provide a little more detail on our upcoming Annual Conference next June, and remind you of some other events that will be happening early in 2013.

AIRA 11th Annual Advanced POR Conference—On November 19th we held the AIRA 11th Annual Advanced Plan of Reorganization Conference at the Union League Club in New York. Special thanks to our 2 co-chairs, Walter Greenhalgh of Duane Morris and Brian Ryniker of CBIZ for their hard work in organizing an outstanding event. Our lunch speakers included not one, but two economists. Adolfo Laurenti of Mesirow Financial and Patrick O'Keefe of CohnReznick shared their views on the post-election state of the economy and what needs to be done to "right the ship". Their discussion was both insightful and entertaining!

Among the many people who contributed their valuable time to the day, seven Federal Bankruptcy judges graciously participated on the panels, sharing their experiences regarding recent events and continuing challenges for our profession. In addition, I had the distinct honor of presenting the 2012 AIRA Judicial Service Award to the Honorable Mary Walrath at our post-conference reception, in recognition of 30+ years of distinguished service including 15 years on the bench of the U.S. Bankruptcy Court in the District of Delaware. Mike Lastowsky, Judge Walrath's longtime friend, provided heartfelt remarks that truly enhanced the event. Thanks to Mike and congratulations to Judge Walrath!

Left: AIRA's 2012 Judicial Service Award recipient, Hon. Mary Walrath (U.S. Bankruptcy Court, Dist. of Delaware), with Michael Lastowsky

AIRA's 29th Annual Bankruptcy and Restructuring Conference—As planning continues for our 29th Annual Conference in Chicago, please remember to mark your calendars for June 5-8, 2013 at the Westin Chicago River North. The conference is shaping up to be another great event—for a couple of teasers, let's start with the social calendar which will offer great choices including a golf outing, MLB baseball game, kayaking, biking, 5k run/walk, fireworks and a dinner cruise. The keynote speaker for Thursday's annual banquet will be world renowned chef Grant Achatz. Achatz has won numerous awards including Rising Star Chef of the Year Award, Best Chef in the United States, and Restaurant Magazine's Best 50 Restaurants in the World. Reservations at his restaurant Next are so sought after that tickets on Craigslist go for $500 per person and in February 2012, Achatz auctioned tickets for charity, raising over $275,000 in two days! A major conference highlight will be the Opening Session address by Bob Wiedemer, economist and co-author of the book Aftershock. Session topics will include future prospects for our industry, impacts in the wake of the Fiscal Cliff, FDIC's "Too Big to Fail" strategy, several small business topics, and many more.

New York Institute of Credit / AIRA Joint Event—NYIC and the AIRA will co-sponsor their 8th annual bankruptcy & restructuring event at Arno's Restaurante in New York on January 31st from 11 am to 2:30 pm. The program will include 3 panels discussing "Hot Issues in Bankruptcy and Restructuring", "Interim Management in Bankruptcy & Reorganizations" and "Current Legal Issues and Bankruptcy Developments Confronting Bank Agents and Indenture Trustees." The program includes an impressive slate of Federal Bankruptcy judges, attorneys and financial advisors. See www.AIRA.org. for more information.

VALCON 2013—As I mentioned in my last letter, the AIRA is again co-hosting this conference with The University of Texas Law School and ABI. Valcon 2013, with the theme

"Contested Valuation Issues in Bankruptcy," will take place February 20-22 at the Four Seasons Las Vegas. Beat the winter blues, book your tickets to Las Vegas today, and have an opportunity to earn up to 15.25 CPE/18 CLE credits, including 1 hour of Ethics! See www.abiworld.com to register and obtain more details as they become available.

Before I sign off, I'd like to wish everyone a joyous holiday season and best to all in the New Year! I hope to see you in Las Vegas or Chicago or both!

Tony Sasso

Anthony Sasso

Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

On December 4, 2012, AIRA held a regional seminar at the InterContinental Los Angeles-Century City, in conjunction with a simultaneous live webcast, on the topic "Update on Bankruptcy Law and Restructuring Environment in China." The speakers were Professor Charles D. Booth (Carlsmith Ball Faculty Scholar, Richardson School of Law, Univ. of Hawaii; and Senior Advisor, SNR Denton) and Brent Carlson, CIRA (Director, AlixPartners). The presentation was moderated by Teri Stratton, CIRA (Managing Director, Restructuring and Recapitalizations, Piper Jaffray).

Professor Booth explained that even though the new bankruptcy law for China was enacted in 2006 and became effective in June of 2007 there has been delayed implementation of the new bankruptcy law for a number of reasons including:

- events taking place in China that overtook the law
- a decrease in the anticipated effective scope of the law
- low number of cases filed
- delay in drafting and implementing rules and regulations (however, new regulations have recently been issued)
- judges reluctant to accept bankruptcy cases
- lack of framework for interaction among insolvency and other laws as well as undeveloped secured transaction laws
- absence of effective legal enforcement mechanisms
- lack of well-trained, experienced judiciary
- general lack of creditor confidence in the impartiality of courts and rule of law

Prior to discussing the provisions of China's revised bankruptcy law, Professor Booth summarized the problems associated with China's State Owned Enterprises (SOEs).

Brent Carlson, CIRA, discussed significant indicators, implications and observations regarding China's structural economic slowdown, including:

- The IMF estimates that the Chinese economy will overtake the U.S. by the end of this decade; however, China's leadership recognizes the challenges for continued economic growth. Former Premier Wen Jiabao stated, "The biggest problem with China's economy is that the growth is unstable, unbalanced, uncoordinated and unsustainable." China's investment grown as a percent of GDP (approx. 50 percent) is higher than Japan (33 percent) and Korea (38 percent) at the peak of their growth booms.
- China is becoming an aging nation due to the one-child policy.
- China's economy is stuck in transition, with owned or controlled companies which represents between 45 and 50 percent of GDP.
- Structural trends are resulting in a shift away for China as the low-cost country of choice.

Carlson concluded his presentation with a summary of the key operational challenges currently facing companies in China.

- Shortage of Management Talent—Shortages of managers and employees with the professional and technical skills to fill key roles are common. High turnover is the norm across all businesses.
- Weak Accounting and Finance Function—This is a common characteristic among emerging growth companies. Combined with a general shortage of management talent, it creates a general lack of transparency and visibility into operations and tends to result in less-than-robust internal controls.
- Fierce Competition and Overcapacity—Multinationals face both domestic competitors and other foreign multinationals ramping up operations. Competition is often greater than anticipated, particularly from the state-owned sectors.
- Restrictive Regulatory Environment—Depending on the business and industry, some foreign companies are required to work with certain state-owned partners or are completely shut out of the market.

Despite these challenges in the short and medium term, Carlson noted, "China's best days lie ahead as long as reforms continue."

The presentations by Professor Booth and Brent Carlson are available as an AIRA Self Study course with the same title at www.AIRA.org. ■

Zombie Banks *continued from p. 1*

- Trust Preferred Securities (TruPS)—Hybrid securities that incorporate features of preferred equity and subordinated debt. TruPS will be described in greater detail below.
- Preferred Equity—Typically cumulative or noncumulative perpetual preferred stock. The cumulative or noncumulative features result in different treatments for Tier 1 Capital calculations.
- Common Equity

A primary benefit of a BHC to a community bank is the separation of this complex BHC liability/equity structure from the balance sheet of the bank. When debt, equity or a hybrid instrument is brought onto a BHC balance sheet for use at the subsidiary bank, it is pushed down to the subsidiary bank as common equity. At most community banks, common equity is the only capital component of the subsidiary bank Tier 1 Capital.

TRUST PREFERRED SECURITIES

TruPS are 30 to 60 year term, fixed or floating rate securities treated as debt for tax purposes but capped at 25% of Tier I Capital for regulatory purposes. TruPS are issued by a special purpose trust, often called a "Capital Trust," that is a BHC subsidiary. The proceeds from the sale of TruPS to investors are used to purchase deferrable subordinated debt from the BHC. Should the BHC need to conserve cash in times of financial distress, the BHC may defer interest payments on the deferrable subordinated debt. When this happens, the trust will in turn defer distributions to the TruPS holders. Deferrable subordinated debt interest payments and their corresponding TruPS distributions can typically be deferred for up to 20 consecutive quarters (5 years) without causing an event of default and the possible acceleration of the deferrable subordinated debt (some issuances allow for deferrals of up to 40 consecutive quarters (10 years)).

TruPS are widely regarded to have "added fuel to the fire" of the recent financial crisis because they were so widely used to create Tier 1 Capital. This allowed banks to grow rapidly and exacerbated the nationwide credit bubble. The regulatory backlash to this has resulted in significant changes to the capital treatment rules for TruPS. According to the final provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, when calculating consolidated entity regulatory capital ratios:

- BHCs with less than $15 billion in assets prior to December 31, 2009, will be permitted to include TruPS as Tier 1 Capital provided such TruPS were issued before May 19, 2010;
- BHCs with greater than $15 billion of consolidated assets will see a phase out of Tier 1 Capital treatment for TruPS beginning January 2013;
- Consolidated bank entities with less that $500 million will be able to continue to use TruPS and have them apply toward Tier 1 Capital; and,
- TruPS will still be entitled to Tier 2 Capital treatment.

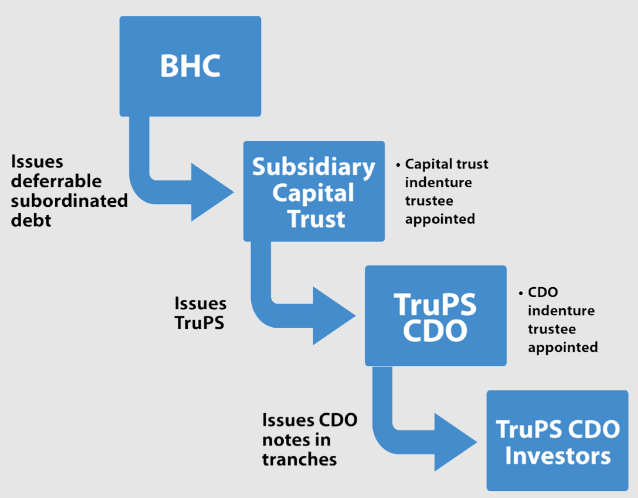
Currently the U.S. regulatory agencies are proposing rules intended to bring the U.S. banking system in line with the Basel III capital and liquidity requirements. Should these rules become law, they will result in a gradual phase-out of the Tier I Capital status for TruPS issued by banks with assets over $500 million, with a complete phase-out by 2022. This proposal is subject to public comment and as such, is not final. However, it should be noted that the Basel III requirements are not consistent with the Dodd-Frank rules.

No matter which rules are ultimately implemented, the eventual phase-out of the Tier I Capital status for TruPS has generally rendered them unattractive for all but the smallest BHCs. BHCs with higher rate TruPS and the ability to raise capital are redeeming these issuances. Distressed community banks, however, typically lack the ability to raise new capital to redeem their TruPS.

Most community bank issued TruPS were packaged into collateralized debt obligations - TruPS CDOs **(see Exhibit 1)** - but some were offered directly to public investors by the subsidiary trust (referred to as "single issuer") and exchange traded. According to Fitch Ratings, since 2000, there were 1,813 banks and thrifts that issued $37.7 billion of TruPS into 85 TruPS CDOs. Of those issuances, approximately 1,340 (with $29.9 billion outstanding) remain as of September 30, 2012 and include:

- 352 deferring interest payments;
- 196 defaulted (BHC filed bankruptcy);
- 77 cured (a previously deferring issue that has resumed payments and paid all accrued and unpaid interest); and,
- 12 cured through a sale or other disposition.

EXHIBIT 1 - POOLED TRUPS STRUCTURE



An October 22, 2012 press release from Fitch Ratings stated, "Quarterly defaults and deferrals for U.S. bank TruPS CDOs fell to levels not seen in over four years, according to the latest index results from Fitch Ratings." While this is positive news and a sign of banking industry stabilization, there are still many difficult BHC situations with excessive leverage from TruPS that must be resolved.

BHCS IN CHAPTER 7

Chapter 7 liquidation is a relatively common tool for BHCs that become highly insolvent in effect instantaneously after an FDIC receivership action. An interesting example of a highly insolvent BHC that was ultimately liquidated in Chapter 7 (although the initial petition was filed under Chapter 11) is Vineyard National Bancorp, formerly headquartered in Rancho Cucamonga, California. Vineyard National Bancorp's subsidiary bank, Vineyard Bank, operated mainly in Riverside County, California which experienced one of the most dramatic real estate development bubbles in the United States during the recent financial crisis. When Vineyard National Bancorp filed its initial Chapter 11 petition, it claimed $2.1 million of assets and *$181.7 million of liabilities.* The liabilities included:

- $50.8 million of secured senior debt (a holding company loan) and accrued interest collateralized by 100% of the common stock of Vineyard Bank (this stock was seized as part of the FDIC receivership action on Vineyard Bank, and the FDIC entered into a purchase and assumption agreement for Vineyard Bank's deposits with California Bank & Trust of San Diego);
- $5.2 million of junior subordinated debt and accrued interest; and,
- $122.5 million of junior deferrable subordinated debt and accrued interest issued to statutory trusts in connection with the issuance of *ten* different series of TruPS.

Vineyard National Bancorp had also issued two series of perpetual preferred stock totaling $31.6 million. This BHC capital structure was very complex for a bank that peaked at only $2.1 billion in total assets. Vineyard Bank failed in July 2009, ultimately brought down by its extensive lending to residential developers and builders, at a cost estimated at the time of failure to be a $470 million loss to the FDIC insurance fund. It is not surprising that Vineyard Bank was a relatively early casualty on the list of bank failures in the recent financial crisis. Less complex capital structures enabled rapid growth and high risk lending at other banks during the previous financial boom, but with similar results.

BHCS IN CHAPTER 11 WITH ACTIVE BANK SUBSIDIARIES

Chapter 11 filings by BHCs with active bank subsidiaries are much less common. From the start of the most recent financial crisis through mid-November 2012, only nine Chapter 11 cases have been filed where the BHC had an active bank subsidiary. Six of these nine cases were filed for the purpose of effecting a sale of a subsidiary bank under Section 363 of the Bankruptcy Code to facilitate a recapitalization of the struggling subsidiary bank by the new owner. Of the six attempted Section 363 subsidiary bank sales:

- Four sales have been successful (AmericanWest Bancorp sale of subsidiary AmericanWest Bank, Outsource Holdings Inc. sale of subsidiary Jefferson Bank, Premier Bank Holding Company sale of subsidiary Premier Bank, and Big Sandy Holding Company sale of subsidiary Mile High Banks);

Zombie Banks *continues on p. 6*

2013 Course Schedule

CIRA

Part 1
March 18-20; Atlanta
April 8-10; New York
May 15-17; San Diego
June 3-5; Chicago
Sept 30-Oct 2; Dallas
Oct 30-Nov 1; New York

Part 2
Jan 9-11; New York
May 20-22; Atlanta
June 24-26; New York
July 22-24; Malibu
Aug 14-16; Chicago
Dec 16-18; Dallas

Part 3
Jan 28-30; Ft. Lauderdale
March 4-6; New York
July 10-12; Atlanta
Aug 26-28; New York
Oct 14-16; Malibu
Oct 28-30; Chicago

CDBV

Part 1
*Offered in conjunction with **CIRA Part 2**; see schedule above*

Part 2
April 9-12; New York
May 6-9; Malibu
Aug. 27-30; Chicago

Part 3
June 25-28; New York
Oct 8-11; Malibu
Dec. 10-13; Chicago

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- One sale failed when the bank was placed into FDIC receivership prior to completion (Blossman Bancshares attempted sale of subsidiary Central Progressive Bank); and,
- One sale is currently in progress (First Place Financial Corporation sale of subsidiary First Place Bank – expected to close mid-December 2012).

The other three cases were filed to facilitate a balance sheet restructuring, which included the restructuring of BHC TruPS liabilities. Of the three attempted Chapter 11 restructurings:

- One was successful (CIT Group with subsidiary CIT Bank);
- One failed when the bank was placed into FDIC receivership prior to completion of the process (Nexity Financial Corporation with subsidiary Nexity Bank); and,
- One is currently in progress (Capitol Bancorp with thirteen active bank subsidiaries in multiple states).

Except CIT Group, all of these cases were initiated to manage overwhelming TruPS liabilities at the BHC.

SECTION 363 SALES – INITIAL ISSUES ADDRESSED BY AMERICANWEST BANCORP

In July 2008, the picture of IndyMac Bank depositors standing in line in Pasadena, California to withdraw deposits became global front-page news. Twenty-seven months later, in October 2010, the Chapter 11 case to facilitate the Section 363 sale of AmericanWest Bank by AmericanWest Bancorp (AWBC) was filed. This case is notable because it was the first use of Chapter 11 by a BHC with an active bank subsidiary to address consolidated entity insolvency (caused by excessive TruPS leverage) with a Section 363 sale of the subsidiary bank. The case addressed the pre-bankruptcy unwillingness of the TruPS CDO trustee to make decisions for the CDO without the written approval of 100% of the ultimate TruPS holders (i.e., all CDO tranche note holders of CDOs holding AWBC TruPS). The 100% hurdle would have been essentially impossible to achieve because of:

- The difficulty in identifying 100% of the TruPS CDO note holders;
- The difficulty in obtaining approval from the most junior tranches of TruPS CDO note holders who would receive nothing in a discounted tender offer, and thus have no incentive to approve; and,
- Unreasonable positions taken by TruPS CDO investors who, prior to bankruptcy, demanded par value on the AWBC TruPS embedded in their CDO notes.

This case also addressed these important issues:

- The initial unresponsiveness of indenture trustees for deferrable subordinated debentures of the BHC;
- TruPS CDO note holders agitating in bankruptcy court to stop the Section 363 sale process by requesting sale procedures they argued would better maximize TruPS recoveries. (In this case, the judge characterized the TruPS CDO note holders as "a creditor of a creditor of a creditor of the debtor" with "its interest . . . not just remote from the debtor, it is peripheral to the debtor." TruPS CDO note holders were thus not given standing in this case, and an important precedent regarding the treatment of TruPS CDO note holders in bankruptcy proceedings was established);
- FDIC and management concerns regarding bank depositor misunderstanding of a BHC bankruptcy that could result in a "run on the bank" at the active subsidiary bank;
- Regulatory approval of a subsidiary bank sale utilizing Section 363; and
- Management concerns that the subsidiary bank could avoid FDIC receivership long enough for the sale process to finish.

These issues were successfully managed through the bankruptcy process, and AmericanWest Bank was ultimately sold to a subsidiary of SKBHC Holdings, LLC on December 21, 2010.

The use of Chapter 11 by BHCs with active bank subsidiaries continues to be perceived as a daunting process as typical debtor/creditor issues are compounded by the relative intransigence of capital trust indenture trustees and TruPS CDO trustees, coupled with the inherent difficulties of managing multiple regulatory agencies who oversee both the BHC and its subsidiary bank.

CREATIVE STRUCTURES INITIATED BY TRUPS CDO NOTE HOLDERS

Since TruPS CDO note holders were ruled to have no creditor standing in the AmericanWest bankruptcy case, some of the most active investors in TruPS CDOs have since developed a creative structure to maximize their recovery in a pre-packaged bankruptcy scenario. This structure is currently being tested in the Capitol Bancorp Ltd. (Capitol) Chapter 11 proceedings.

At its peak in 2008, Capitol was comprised of a nationwide web of thirty-eight subsidiary banks (over $5 billion in consolidated assets) and a very complex capital structure that included *eleven* different series of TruPS (with nine of these issuances held by TruPS CDOs). Many of the Capitol subsidiary banks have faced considerable asset quality issues. Since 2008, Capitol has divested twenty-three banks and has two additional divestitures pending. Capitol currently operates thirteen banks located in Arizona, Georgia, Indiana, Michigan, Missouri, Nevada, New Mexico, North Carolina, Ohio and Oregon. On a consolidated basis, Capitol is insolvent ($131.9 million equity deficit at June 30, 2012), and several of its subsidiary banks are at or slightly above the critically undercapitalized Tier 1 Capital threshold of 2.00%.

In August 2012, Capitol filed a pre-packaged Chapter 11 case with $112.6 million in assets, $195.6 million in liabilities and which called for a $70-115 million capital raise. Liabilities to the TruPS CDO note holders comprised $188.6 million of the liabilities. To preserve the value of the nine pooled Capitol TruPS issuances held in various CDOs, a structure was proposed in the plan whereby the TruPS were considered a class of creditors, when in reality, the TruPS CDO note holders are the actual economic beneficiaries. Upon plan confirmation, the TruPS held in CDOs would receive New Class C Redeemable Common Stock (in the plan named "HoldCaps Common," or HoldCaps). These HoldCaps would be managed in a newly formed trust for the benefit of the former TruPS holders (i.e., the TruPS CDOs), and could be redeemed for New Class B Common shares not earlier than the fourth anniversary of the HoldCaps issuance. The HoldCaps are designed to:

1. Be considered Tier 1 Capital;
2. Preserve the tax loss carry-forward managed under IRS Section 382; and,
3. Avoid greater than 9.9% aggregate voting control as evaluated by the FRB regulators, thus preventing designation of the HoldCaps trust as a Capitol control party.

As of publication, the outcome of the Capitol case is pending and the proposed structure remains untested.

THE OPPORTUNITY

The community banking industry is healing. The number of banks on the FDIC problem institution list is dropping, industry capital levels are at their highest levels in over 10 years, non-performing asset levels continue to decline, and industry profitability continues to increase.

There are, however, a number of community banks that have emerged from the financial crisis with impaired balance sheets, but have thus far avoided FDIC receivership. Some of these subsidiary banks are considered Adequately Capitalized or even Well Capitalized per banking regulation. But their weakened balance sheets, when consolidated with their BHC leverage, result in a consolidated equity deficit. A consolidated equity deficit, or an elevated BHC debt/equity ratio, make these community banks unattractive candidates for recapitalization in a capital market where equity capital is difficult to find for even above-average performing community banks (**see Exhibit 2**). The colloquial term "zombie bank" is often used for such banks.

It is important to note that BHCs with impaired bank subsidiaries have typically stopped interest payments on their deferrable subordinated debt, and thus the associated distributions to TruPS, to conserve desperately needed BHC cash. Most deferring banks stopped such payments in the 2008-2010 window. With an interest/distribution deferral usually limited to 20 quarters for TruPS in CDOs, many BHCs will soon trigger an event of default and the possible acceleration of their deferrable subordinated debt held by the subsidiary trust. BHCs could find protection from such a crisis situation in Chapter 11 bankruptcy, and for many BHCs this scenario is rapidly approaching.

According to Kurt Plumer, a Managing Director & Portfolio Manager on the Credit Opportunities fund team at Commerce Street Investment Management in Dallas, "TruPS deferrals peaked in 2009, so many bank holding companies are now 3-4 years into their five year deferral window. Thus, we think that over the next 12-18 months, literally hundreds of bank holding companies will have to decide whether to catch up or "cure" their TruPS deferrals, or risk having their subordinated debt accelerated and the bank holding company likely forced into bankruptcy."

In the midst of an industry recovery in which nine BHCs with active bank subsidiaries have used the Chapter 11 process, there is now clarity that a BHC bankruptcy filing does not automatically create a run on a subsidiary bank. Regulatory agencies have also had significant experience with BHC bankruptcy proceedings. With many of these impaired banks showing reasonably stable asset performance and liquidity, the urgency to complete a Chapter 11 process in advance of an FDIC receivership may not be a factor, thus favoring the often lengthy time frame of a Chapter 11 proceeding.

For impaired financial institutions, a BHC Chapter 11 bankruptcy offers an attractive option to facilitate the sale of impaired subsidiary banks that would ultimately fail. A successful court supervised Section 363 sale will remove the threat of FDIC liability from an oftentimes fatigued board of directors and management team. Chapter 11 can also offer an attractive option to facilitate a balance sheet restructuring for motivated bank boards and management teams who believe the subsidiary bank has both franchise value and the ability to attract new capital to the BHC if TruPS liabilities were to be reduced. ■

Mark Ruh, CIRA, *recently completed an assignment as the turnaround CFO at Mission Community Bancorp/ Bank. Prior to this, Mr. Ruh spent 11 years as a Director at private equity firm Castle Creek Capital LLC. His extensive financial advisory and transaction work at Castle Creek included C-level operating and board positions at distressed portfolio companies (including a 4+ year restructuring/ recapitalization effort). Prior to this, he was an IT consultant and U.S. Navy submarine officer. He holds a BS, Industrial Engineering from the Pennsylvania State University and graduate degrees from Northwestern University - an MBA, Kellogg School of Management and a Masters of Engineering Management. He can be contacted through LinkedIn.com.*

EXHIBIT 2: TRUPS STATISTICS FOR BHCS OF COMMERCIAL BANKS

# of TruPS BHCs (commercial banks with TruPS outstanding) = 1,297

# of TruPS BHCs with a consolidated company equity deficit = 51

Non-consolidated (BHC-only) D/E ratio*	>0.6	>1.0	>2.0	>3.0
# of TruPS BHCs	227	102	37	19

Consolidated Texas Ratio**	>75%	>100%	>200%
# of TruPS BHCs	115	97	48

Figures derived from June 30, 2012 FRB holding company reports and FFIEC bank call reports, as reported by SNL Financial LC.

*"Debt" defined as: TruPS + long term senior debt + subordinated debt

**Texas Ratio (common version) defined as: NPA + (Loans 90+ Days PD / Tangible Common Equity) + LLR. (In other words: Nonperforming assets + loans 90 days or more past-due / tangible common equity + loan loss reserves). A bank Texas Ratio of greater than 100% is widely considered to be a strong indicator of severe financial distress.

Avoiding a Receivership Nightmare†

S. Gregory Hays, CIRA
Hays Financial Consulting, LLC

A properly structured receivership can provide a cost-effective, efficient, and flexible vehicle to protect the assets of a financially distressed or otherwise troubled entity and allow stakeholders to minimize losses and obtain the greatest return from the assets subject to the receivership. As receiverships have become more popular in recent years due to the potential benefits, property managers, accountants, and other parties have increasingly sought to obtain receivership skills[1] and appointments as a receiver in order to acquire new business opportunities. Inexperienced receivers, however, often encounter difficulty in navigating the vague rules and regulations governing receiverships, which can cause various adverse consequences for lenders, creditors, and even the receiver. Such consequences may be magnified in instances where property in receivership is subject to a subsequent bankruptcy case and the receiver is caught between the two proceedings.

This article will discuss selected practices to attempt to avoid adverse consequences in a receivership and the associated potential liability and loss of value. First, this article will examine an example of a nightmare receivership superseded by a bankruptcy case in which creditors incurred additional fees and expenses and the receiver was subject to a finding of contempt and conflicting instructions in the different proceedings. Next, best practices will be recommended for: 1) the preliminary stage of a receivership; 2) the operation of the receivership; and 3) a receivership encountering a subsequently filed bankruptcy case.

A RECEIVER'S UNFORTUNATE EXPERIENCE

In *In re Golden Grove Pecan Farm, et al.*, a CPA with little prior receivership experience was appointed as the receiver (the "GG Receiver") of five separate business entities located in different counties in Georgia (collectively, the "GG Receiverships").[2] While an experienced receiver may have quickly recognized that the businesses were not viable operations, the GG Receiver attempted to operate the businesses and struggled to effectively manage the GG Receiverships.[3] At the request of a creditor inquiring as to the status of the GG Receiverships, the supervising court in two of the counties responsible for the GG Receiverships (the "Superior Court") held a status hearing.[4] Parties present at the status hearing disagreed as to whether the Superior Court dissolved the GG Receiverships at that hearing and no recording, transcript, or other written record of the hearing exists to clarify the oral ruling of the Superior Court.[5] The confusion that ensued created additional costs for the receivership and (ultimately) the receiver in unpaid fees and defense costs.

After the status hearing with the Superior Court, the GG Receiver relied on authority contained in the order appointing the GG Receiver and filed Chapter 11 petitions for each of the entities in the GG Receiverships (the "GG Bankruptcy Cases") without previously seeking any instruction or guidance from the Superior Court with regard to such action.[6] The Superior Court subsequently entered written orders several months after the filing of the GG Bankruptcy Cases to: 1) terminate the GG Receiverships; 2) order the GG Receiver to return certain property in the GG Receiverships to the defendants in the litigation underlying the GG Receiverships; 3) find the GG Receiver to be in civil and criminal contempt for filing the GG Bankruptcy Cases; and 4) order that the GG Receiver be incarcerated for five (5) days and pay two $500.00 fines.[7] Although the orders of the Superior Court conflicted with the duties of the GG Receiver pursuant to the Bankruptcy Code, in order to avoid further sanctions, the GG Receiver filed in the GG Bankruptcy Cases a notice of intent to comply with the orders of the Superior Court.[8]

In response to the notice by the GG Receiver, the bankruptcy court responsible for the GG Bankruptcy Cases (the "Bankruptcy Court") asserted exclusive jurisdiction over the property of the estates in the GG Bankruptcy Cases and found that the orders of the Superior Court were entered in violation of the automatic stay and therefore of no effect.[9] The GG Receiver subsequently delivered the property subject to the conflicting orders to an experienced trustee (the "Trustee") appointed in the GG Bankruptcy Cases who: 1) generated substantial benefit for the estates by quickly liquidating certain property; and 2) evaluated potential claims against the GG Receiver.

Although the GG Receiver avoided: 1) incarceration and sanctions by successfully appealing the finding of contempt by the Superior Court;[10] and 2) extensive litigation with the Trustee, the

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1 According to social media web site Linked-In, receiverships skills have a year-to-year growth rate of approximately 60% and are the 15th fastest growing skill set on the Linked-In network with over 5,000 members listing receivership as a skill. *See* Linkedin, Skills & Expertise, Receiverships (January 15, 2012), http://www.linkedin.com/skills/skill/Receiverships?trk=skills-hp-search.

2 *See In re Golden Grove Pecan Farm*, *et al.,* 2010 Bankr. LEXIS 2776 at *2 (Bankr. M.D. Ga. Sept. 2, 2010).

3 *See id.* at 3.

4 *See Newton v. Golden Grove Pecan Farm, et al.,* 711 S.E.2d 351, 352 (Ga.App. 2011).

5 *Id.* at 353; *In re Golden Grove Pecan Farm*, *et al.,* 2010 Bankr. LEXIS 2776, at *3 (Bankr. M.D. Ga. Sept. 2, 2010).

6 *See Newton,* 711 S.E.2d at 353-54.

7 *See Golden Grove,* 2010 Bankr. LEXIS 2776 at *3.

8 *Id.* at *4-5.

9 *Id.* at *10-14.

10 *See Newton,* 711 S.E.2d 351.

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GG Receiver will likely incur a loss in excess of $100,000 in lost reimbursement for certain fees and expenses incurred by the GG Receiver. Creditors will also suffer a substantial loss as a result of the cumulative impact of the proceedings due to among other things, the double layer of administrative expenses of both the Trustee and the GG Receiver.

PROCEDURES DURING PRELIMINARY STAGES OF A RECEIVERSHIP

The court appointing a receiver as an equitable form of ancillary relief has wide discretion in selecting, empowering, controlling, and replacing a receiver.[11] Few limitations generally restrict a court in selecting a receiver,[12] and the selection of a particular party as a receiver is generally not a basis for appeal where the appointing court had an opportunity to review the purported qualifications of the receiver.[13] Because the selection and installation of an appropriate receiver are critical elements to the ultimate success of a receivership, parties-in-interest are encouraged to nominate a receiver and assist in structuring the receivership to be created by the court.[14] During the preliminary stage of a receivership, the party seeking the appointment of a receiver and other stakeholders are best served by performing due diligence and focusing on obtaining: 1) a receiver who is and will remain a neutral third-party; 2) the appointment of the most cost-effective receiver with a sufficient amount of relevant knowledge and experience; and 3) appropriate content, procedures, and liability protections in the order appointing the receiver.

1. Selection of a Neutral Third Party Receiver

The appointment of a receiver who is and will remain a neutral third party is critical to maintaining the integrity of the process and avoiding liability for all involved. A receiver is an officer of the court with the fiduciary responsibility to act in the best interests of all parties involved in the receivership rather than any particular party-in-interest.[15] "A receiver may not subordinate the interest of one creditor in favor of those of another creditor."[16] Accordingly, a party seeking the appointment of a receiver is generally prohibited from directly or indirectly requiring any understanding or agreement with the potential receiver.[17] To the extent that a receiver acts contrary to the duty of the receiver to act in the best interests of all parties, such receiver may be subject to a surcharge by the court.[18] Similarly, interference by lenders, creditors, and other parties-in-interest with the functions of a receiver is punishable by contempt.[19]

In addition to being held in contempt for interfering with the functions of a receiver, a party such as a lender attempting to secretly conspire with or inappropriately control or partner with the receiver may be exposed to additional liability. Lenders seeking to avoid taking title to financially distressed property are increasingly seeking the appointment of a receiver to reduce exposure and preserve collateral; however, lenders new to the receivership process may not fully understand or appreciate the role of a receiver. Some inexperienced lenders incorrectly view the receiver as working for the lender rather than functioning as a fiduciary responsible to the court and not to any particular party. Such lenders may seek to control the conduct of the receiver and an inexperienced receiver may not object to such conduct as a result of not comprehending the gravity of the situation. If the lender inappropriately controls the receiver, the lender may be exposed to potential lender liability claims seeking to hold the lender liable for losses resulting from the enterprise controlled by the lender through the receivership.[20] Accordingly, in order to actually reduce and limit exposure in a receivership, a lender and all parties in interest in a receivership should seek to: 1) obtain a neutral receiver; and 2) act throughout the receivership in a manner consistent with the receiver functioning as an independent fiduciary.

2. Selection of a Cost-Effective Receiver

A receiver takes possession of and manages property in receivership as a fiduciary at the direction of the court that appointed the receiver.[21] As an officer of the court, the receiver answers to the court as an agent of the appointing court.[22] A receiver acting within the scope of the authority of the receiver

11 *See United States v. Bradley*, 2009 U.S. Dist. LEXIS 36465, at *5-6 (S.D. Ga. Apr. 29, 2009) (removing receiver due to misfeasance, appointing new party as receiver, and ordering that old receiver to retain fiduciary responsibility until the property in receivership is delivered to the new receiver); *Cavanagh v. Cavanagh*, 118 R.I. 608, 375 A.2d 911 (R.I. 1977) (indicating that the selection and removal of a receiver is a matter for the discretion of the court appointing the receiver).

12 *See Dinsmore v. Barker*, 212 P. 1109, 1111 (Utah 1923) ("The court may appoint any proper person not prohibited by law.").

13 *See Herzfeld v. Herzfeld*, 285 S.W.3d 122, 131 (Tex.App.–Dallas 2009) (finding that the failure to hear appeal regarding appointment of receiver did not result in improper judgment even though receiver had no prior receivership experience, "did not understand the transaction she was to undertake, prepared erroneous documents, improperly joined motions filed by appellee in the trial court, and caused or contributed to delay in resolving the parties' dispute").

14 *See First American Development Group/Carib, LLC v. WestLB AG*, 2010 WL 1552320, at *13 (V.I.Super. 2010) (indicating an intent to "order the parties to brief the question of who ought to serve as a receiver and what powers that receiver should have.").

15 *See City of Chula Vista v. Gutierrez*, 207 Cal. App. 4th 681, 685 (Cal. App. 4th Dist. 2012) (citations omitted); *Waag v. Hamm*, 10 F. Supp. 2d 1191, 1193 (D. Colo. 1998); *Sec. Pac. Nat'l Bank v. Geernaert*, 199 Cal. App. 3d 1425, 1431-1432 (Cal. App. 5th Dist. 1988).

16 *KeyBank Nat'l Ass'n v. Michael*, 737 N.E.2d 834, 850 (Ind. Ct. App. 2000).

17 *See* Cal Rules of Court, Rule 3.1179.

18 *See Shannon v. Superior Court*, 217 Cal. App. 3d 986, 998 (Cal. App. 5th Dist. 1990).

19 *See Clear Creek Power & Development Co. v. Cutler*, 79 Colo. 355 (Colo. 1926).

20 *See* William Hoffman, *Troubled Assets: Commercial Real Estate in Receivership*, Commercial Lending Review (Nov-Dec. 2010).

21 *See Hendricks v. Emerson*, 199 Ga. App. 208, 209 (1991).

22 *See Georgia Rehabilitation Center, Inc. v. Newnan Hosp.*, 284 Ga. 68 (Ga. 2008) ("A 'receiver' is an officer of the court which appoints him, and his duty upon his appointment is to take possession of the assets of the insolvent debtor for the court and to preserve those assets so that upon distribution of the assets to the creditors they will be fully available to pay the claims of the creditors."); *Clark v. Clark*, 58 U.S. 315 (1885).

may be protected by judicial immunity for breaches of fiduciary duty arising from omissions or actions during the course of the receivership.[23] Although a receiver may be replaced, the court that appointed the receiver will be the same court that reviews any concerns regarding the ability or conduct of the appointed receiver.[24] Given that a receiver may receive limited liability and a potentially favorable disposition by the appointing court, the interests of stakeholders are best served by initially seeking the appointment of a knowledgeable and experienced receiver who will cost the receivership as little as possible within a framework in which the conduct of the receiver may be absolved without recourse. So long as the lender does not assert inappropriate control over the receiver or take other actions that may lead to liability, parties may not generally seek recourse for the selection of the receiver or from a lender for damages caused by the receiver.[25]

An ideal receiver will have experience managing properties or entities similar to the entity or property in receivership, understand the nuances of receivership law, and have the proper skill set to function as a court-appointed fiduciary administering the receivership for the benefit of all creditors of the receivership estate. While an inexperienced receiver may offer a lower hourly rate than an experienced receiver or even a "free receivership" in exchange for future commissions or other business arrangements,[26] such arrangements may be illegal or inappropriate in some states.[27] A novice receiver may: 1) not have the ability to personally perform all functions required of some receivers such as liquidating, preserving, and pursuing assets or pursing litigation matters; 2) not adequately understand court procedures, legal implications, or tax consequences of particular acts; or 3) experience a learning curve at the expense of the creditors. Ultimately, an inefficient receiver with a lower hourly rate may result in higher costs than a more qualified and efficient receiver with a higher hourly rate. Accordingly, the actual total cost of a receivership is comprised of: 1) the cumulative fees charged by a receiver; 2) the impact of inefficient conduct and lost opportunities to preserve and recover assets; and 3) any losses caused by mistakes generated by the receiver.

Avoiding Inefficient Conduct and Lost Opportunities— Inefficient conduct and lost opportunities to preserve or recover property can significantly increase the total cost of a receivership, particularly when time is of the essence. The failure of a receiver to timely and efficiently perform tasks not only harms the receivership estate, but may also subject the receiver to potential liability for mismanagement and other claims.[28] An experienced receiver will have a better understanding of how to prioritize tasks and focus on the issues that require immediate attention. For example, a receiver with relevant experience will know to, among other tasks, immediately: 1) secure the assets and records of the receivership to prevent the loss or destruction of vital documents and assets; 2) obtain control of the mail to manage deliveries, communications, and mailed payments; 3) identify estate property; 4) recover funds such as security deposits or funds wired out of the company in the days prior to the receivership; 5) coordinate and exchange information with the party seeking the appointment of a receiver; 6) ensure that all assets of the estate are insured; 7) create a database of investors/creditors; 8) communicate with parties-in-interest in the case; and 9) obtain an understanding of the big picture and resolve tasks specific to the property in receivership. Without a prompt response to such tasks, the value of the property in receivership can be harmed and potentially eliminated.

Avoiding Unnecessary Mistakes—An inexperienced receiver can also generate costly mistakes such as failing to properly preserve and protect property of the estate, recover all potential assets for the benefit of the estate, and maintain necessary licenses.[29] Some mistakes may stem from a failure to understand the business or assets in receivership, but other mistakes may stem from taking actions without prior court approval, commingling funds from different entities in receivership, improperly disregarding the separate and distinctive nature of different entities that have not been consolidated, and paying personal or inappropriate expenses out of the receivership estate. Such mistakes could expose the receiver to liability for improper use of funds[30] or subject certain stakeholders to a potentially reduced distribution.[31] Furthermore, an unprepared receiver may pay certain claims at the expense of claims of higher priority and, after incurring litigation costs and delaying the administration of the estate, have to disgorge windfall payments paid to creditors of lower priority and then properly redistribute the proceeds of the estate.[32]

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23 *See In re Yellow Cab Co-op. Ass'n*, 185 B.R. 844, 852-53 (Bankr. D.Colo. 1995).

24 *See* O.C.G.A. § 9-8-8 ("The receiver is an officer and servant of the court appointing him, is responsible to no other tribunal than the court, and must in all things obey its direction.").

25 *See Wolfe v. Illinois Fed. Sav. & Loan Ass'n*, 158 Ill. App. 3d 321, 323 (Ill. App. Ct. 5th Dist. 1987) (finding that a mortgage holder who commenced a foreclosure action and then obtained the appointment of a receiver was not liable for damage to the property when the receiver subsequently allowed insurance coverage to lapse and the property was damaged).

26 Bill Hoffman, *'Low or No Charge' Receiverships: A Very Costly Mistake?,* California Real Estate Journal (March 29, 2010).

27 Kirk S. Rense, *Illegal Agreements Between Receivers and Foreclosing Lenders*, Receivership News, page 3 (Fall 2009).

28 *See* Complaint, *Michael Alonso et al. v. Leslie J. Weiss et al.*, case number 1:12-cv-07373 (N.D. Ill. 2012) (alleging that the receiver and the attorneys for the receiver intentionally breached their fiduciary duties, committed malpractice, were reckless and grossly negligent and intentionally, recklessly or with gross negligence, disregarded their fiduciary duties of care and the best interests of parties in interest).

29 *See* William Hoffman, *Troubled Assets: Commercial Real Estate in Receivership*, Commercial Lending Review (Nov-Dec. 2010).

30 *See United States v. Bradley*, 2009 U.S. Dist. LEXIS 36465 at *6 (S.D. Ga. Apr. 29, 2009) (indicating the substitute receiver shall recover all fees accrued due to the misfeasance of the prior receiver).

31 *See In re Charter First Mortg., Inc.*, 56 B.R. 838, 849 (Bankr. D. Or. 1985) ("If the creditor has allowed his proceeds to be commingled in the debtor's deposit accounts, the creditor may receive only that amount determined under the formula").

32 *See In re Receivership Estate of Indian Motorcycle Mfg., Inc.*, 2006 U.S. Dist. LEXIS 52182, at *28-29 (D. Colo. 2006) (finding that, to ensure that compromised priority claims against the receivership estate are paid, both law and equity weigh in favor of recovering windfall paid to claimants who received 100% payment ahead of claims of greater priority).

An inexperienced receiver may also negatively impact the value of property in receivership by failing to: 1) properly market and sell property in receivership;[33] 2) adhere to fiduciary duties;[34] 3) properly deal with taxing authorities and tax liabilities; 4) conform to the applicable standard of care;[35] or 5) properly identify insurable property interests.[36] An experienced professional is better able to avoid such mistakes among other minefields and, as a result, prevent the receivership from incurring the losses that may result from such mistakes.

3. Prudently Crafting the Order Appointing a Receiver

After selecting the most cost-effective neutral receiver with a sufficient amount of relevant knowledge and experience, the content of the order appointing the receiver may be the most critical component of a successful receivership. The powers, duties, and scope of the authority of the receiver are defined in the order appointing the receiver.[37] Prudent parties will participate in the drafting of the order appointing the receiver to ensure that the order addresses the concerns of the parties and reduces the need to return to the court to obtain a clarifying order.

The order appointing a receiver empowers a receiver to perform tasks necessary to accomplish the objectives of a receivership and provides an overlying structure for the receivership. One of the most important issues in planning a receivership is determining whether the entire entity or just certain assets owned by an entity will be placed in receivership. In recent years, lenders have more frequently sought to place only the assets of an entity in receivership in order to avoid potential legacy problems associated with the entity. When an entity is placed in receivership, the receiver may potentially have to deal with outstanding income, payroll, and sales tax issues, litigation with third-parties, and other issues that can be avoided if only the assets or property are placed in the receivership. Placing an entire entity in receivership when the only value is in certain assets owned by the entity can result in increased administrative costs and reduced distributions as the receiver is burdened with the issues related to the entity without a corresponding benefit to creditors. In certain circumstances parties-in-interest may consider a receivership related to the individuals who own an entity in order to assist in recoveries related to the entity or assets owned by the entity. If the tax returns and tax payments of the individual are not current; however, incorporating an individual in a receivership may result in devastating tax consequences to the receivership estate that would not otherwise be applicable if only the assets of the entity were included in the receivership. Accordingly, parties-in-interest should carefully consider the structure of the receivership in order to define the property subject to the receivership in the most beneficial manner possible.

In addition to defining the property subject to the receivership, the order should also address the funding of the costs and expenses incurred during the course of a receivership. "'Courts generally are vested with large discretion in determining who shall pay the cost and expenses of receiverships. The court may assess the costs of a receivership against the fund or property in receivership or against the applicant for the receivership, or it may apportion the costs among the parties, depending upon circumstances.'"[38] In instances where funds available in the receivership are insufficient to pay the expenses of the receivership, the party that sought the appointment of a receiver may be required to provide the means for payment.[39] In addition to providing that the party which sought the appointment of a receiver shall be liable for any outstanding administrative expenses of the receivership, the order appointing the receiver should also address the liability of any successor-in-interest to the party appointing the receiver and condition any transfer of any secured interest of the party seeking the appointment of the receiver upon either: 1) the termination of the receivership with payment of all administrative expenses; or 2) the party acquiring the secured interest being responsible for the expenses of the receivership.

33 *See Ohio Director of Transp. v. Eastlake Land Dev. Co.*, 177 Ohio App. 3d 379 (Ohio Ct. App., Cuyahoga County 2008) (reversing approval of sale by receiver of real property free and clear of liens where receiver did not: 1) present evidence of marketing or sale efforts; 2) provide notice or obtain approval of lien holder; or 3) indicate whether the property would be sold free and clear of the liens of the senior lienholder).

34 *See FTC v. Certified Merch. Servs.*, 126 Fed. Appx. 651 (5th Cir. Tex. 2005) (requiring the receiver to disgorge portion of compensation due to breaches of fiduciary duty by the receiver involving misrepresentation, self-dealing, and causing the company to pay certain fees and expenses incurred by the receiver without first reporting such fees to the court).

35 *See F.T.C. v. Think Achievement Corp.*, 2007 WL 3286802, at *7 (N.D. Ind. 2007) (finding that an inexperienced receiver who failed to procure insurance on an asset that was damaged was entitled to have jury determine whether the receiver was liable for damages for failing to confirm his conduct to the applicable standard of care and recognize that the receivership had an insurable interest in the property that was damaged).

36 *Id.*

37 *See* O.C.G.A. § 14-2-1432; *see also Federal Home Loan Mortg. Corp. v. Tsinos*, 854 F. Supp. 113, 115 (E.D.N.Y. 1994) ("The court that appoints the receiver determines the scope of that receiver's authority").

38 *Handlan v. Handlan*, 360 Mo. 1150, 1169 (Mo. 1950) (*quoting* 45 Am. Jur. 224, Sec. 290.); *See also, Kawfield Oil Co. v. Illinois Refining Co.,* 169 Okla. 75 (Okla. 1934) (indicating that the court has discretion to order payments to be: a) made from funds available to the estate; or b) divided between parties on equitable principles).

39 *See, e.g., First Nat'l Bank v. Dual*, 392 P.2d 463, 465 (Alaska 1964) ("Although the general rule is that a receiver's compensation and expenses are payable from the funds in his hands, and are not taxable against the party at whose instance the receiver was appointed, an exception arises when there is no fund out of which the expenses can be paid and such circumstances exist that it would be inequitable not to hold the party responsible who invoked the processes of the court to have the receiver appointed.") (*citations omitted*); *Stanton v. Pratt*, 18 Cal. 2d 599, 603 (Cal. 1941) (if funds available to the estate are insufficient, the receiver may look to the party or parties who obtained his appointment and "any or all of the parties for whose benefit the receivership was created." (*citations omitted*); *Brill v. Southerland*, 14 A.2d 408 (Del. 1940) ("Where there is no fund out of which expenses can be paid, or the fund is insufficient, the usual rule is that the party at whose instance the receiver was appointed should be required to provide the means of payment") (*citations omitted*).

In addition to designing the framework for the receivership, an order appointing a receiver can incorporate protections for both the receiver and the receivership estate by clearly defining the duties and responsibilities of a receiver, requiring the receiver to file with the court periodic status reports and other updates regarding activity in the receivership, and including provisions that explicitly limit the liability of a receiver.[40] The order appointing the receiver can also set forth the basis for calculating the compensation of the receiver and require monthly fee applications and estimates of fees so that all parties are aware of the costs associated with pursing actions at the time that the work is being done rather than only at the end of the case. The order may also require a receiver to post bond in an amount as determined by the court,[41] which could be important in instances where a receiver may not otherwise have sufficient funds to satisfy a judgment resulting from the misconduct of the receiver. Other protections to limit potential loss of value during the course of a receivership may be available based on the specific circumstances of a particular receivership, such as addressing environmental or regulatory concerns.

PROCEDURES DURING THE COURSE OF A RECEIVERSHIP

Certain procedures, some of which may be established in the order appointing the receiver, during the course of a receivership can assist in limiting liability and loss of value in a receivership. Two helpful procedures are: 1) maintaining and building a record of the activity in the receivership; and 2) requiring the receiver to provide adequate updates to keep the supervising court fully informed until the conclusion of the receivership. A clear record of the conduct during the receivership will be useful in the future should any conduct later be questioned. In the GG Receiverships, the absence of a clear record caused confusion regarding the termination of the receiverships and led to additional expenses as the GG Receiver attempted to avoid liability related to the finding of contempt. To establish a clear record for a reviewing court, a receivership can maintain procedures pursuant to which conferences and hearings are recorded or transcribed and written orders are issued to document significant events, such as the disposition of property in receivership, a bankruptcy filing for any entities in receivership, and the termination of the receivership.

Just as any employee is wise to update their manager, it is in the best interests of the receiver, and the receivership estate, for the court to have sufficient and current knowledge regarding the conduct of the receiver and the status of the receivership. A receiver can further supplement the record and avoid surprises by filing regular reports, including all required reports,[42] and having such reports approved by the court. Since receiverships do not generally have routine hearings, regular reports are an important medium to provide adequate disclosure of: 1) the progress of the receivership without having to incur the expense of updating each interested party individually; and 2) proposed future conduct. Effective communication between creditors and the receiver is critical in any successful receivership. To enable ongoing access to receivership activities and to avoid surprises at the end of the case, in addition to filing reports a receiver can also post reports, fee applications and other docket activity on the website of the receiver. Websites maintained by a receiver are especially helpful in the many state court systems that do not have electronic access to dockets like the Pacer system in federal courts.

While prior court approval is not required for every detail in a receivership, a receiver is ultimately responsible to the court and has a duty to keep the court informed and seek the guidance in instances where the appointment order is unclear.[43] A receiver has a strong interest in remaining within the scope of the authority granted by the court since a receiver assumes the risk of liability for any act taken without court authority.[44] Accordingly, an experienced receiver will keep the court fully informed and obtain explicit court approval in instances where authority is unclear or where proposed future conduct may be questioned.[45]

For example, a receiver filing a bankruptcy petition for an entity in receivership without express authority may encounter disputes regarding the authority of the receiver and dismissal of the bankruptcy case resulting in additional expenses for the receivership estate.[46] If the appointment order empowers the receiver to initiate a bankruptcy case for the entity in receivership, the receiver may rely on such authority without obtaining additional approval.[47] Even with such authority, however, the receiver may incur liability, as happened with the GG Receiver.

Avoiding a Receivership Nightmare *continues on p. 14*

40 *See Liberte Capital Group, LLC v. Capwill*, 462 F.3d 543, 551 (6th Cir. Ohio 2006) ("receivership court may issue a blanket injunction, staying litigation against the named receiver and the entities under his control unless leave of that court is first obtained.").

41 *See* O.C.G.A. § 14-2-1432(b); Minn. R. Gen. Pract. 137.03 (2011) (requiring a receiver to post a bond); *see also Belk's Dep't Store, Miami, Inc. v. Scherman*, 117 So.2d 845 (Fla. 3d DCA 1960) (indicating that a receiver should be required to post a bond).

42 *See* Mass. R. Civ. P. 66(b).

43 *See Haw. Ventures, LLC v. Otaka, Inc.*, 114 Haw. 438, 468 (Haw. 2007) (*citations omitted).*

44 *See Interlake Co. v. Von Hake*, 697 P.2d 238, 240 (Utah 1985) (stating that a receiver "has only very limited powers and should apply to the court for advice and directions [since a receiver assumes the risk of liability for]…acts without court authority").

45 *See Fauci v. Mulready*, 337 Mass. 532, 538, 150 N.E.2d 286, 290 (1958) ("Where his judgment is likely to be questioned by creditors, prudence will dictate recourse to the court for a decree authorizing the particular action which will afford protection against later claim that the action was disadvantageous to the estate or beyond his authority.").

46 *In re American Marine Holdings, LLC*, et al. Case No. 12-11354-EPK, Doc 72 (Mot. to Dismiss) (S.D. Fla. Feb. 2, 2012); *but see In re Statepark Building Group, Ltd., et. al,* Case No. 04-33916-hdh-11 (finding that a state court appointed receiver had authority to initiate a bankruptcy proceeding without an express grant of such authority in the order appointing the receiver).

47 *See* Honorable H. DeWayne Hale, et al., Dueling Proceedings Between Bankruptcy and Receiverships, The University of Texas' 29th Annual Jay L. Westbrook Bankruptcy Conference (Nov. 19, 2010) (citations omitted); *see also In re Statepark Building Group, Ltd., et. al*, Case No. 04-33916-hdh-11 (holding that a receiver had authority to commence a bankruptcy proceeding even without an express grant of such authority); *Central* Mortgage *& Trust Inc. v. State of Texas (In re Central Mortgage & Trust Inc.)*, 50 B.R. 1010, 1020 (S.D. Tex. 1985) (finding that "a corporation may not be precluded by state law from availing itself of federal bankruptcy law.").

A receiver can avoid potential liability and loss of value to the estate by keeping the court fully informed and obtaining written authorization to proceed with a bankruptcy filing. Under such circumstances, the receiver should also advise the court of the impact of the automatic stay on the receivership assets and document a clear plan of action regarding the termination of the receivership.

PROCEDURES UPON INTERSECTION OF A RECEIVERSHIP AND BANKRUPTCY CASE (SECTION 543)

The filing of a bankruptcy case for an entity in receivership converts the receiver of such entity into a custodian in possession of property of the estate in the bankruptcy case subject to administration at the direction of the bankruptcy court.[48] Once a receiver has knowledge of a bankruptcy case involving property in the receivership, the receiver is required to comply with the rules and procedures set forth in Section 543 of the Bankruptcy Code. In pertinent part, Section 543 provides that, upon learning of a bankruptcy case, a receiver: 1) may not make disbursements or administer the property of the debtor other than to the extent necessary to preserve such property; and 2) shall file an accounting and deliver property of the estate in the possession of the receiver to the trustee or debtor-in-possession. In the event that the interests of creditors or, if debtor is not insolvent, of equity security holders would be better served by permitting the receiver to remain in possession of certain property, the bankruptcy court may excuse compliance with Section 543 of the Bankruptcy Code and *may* allow a custodian, such as a receiver, "to continue in possession, custody, or control of such property."[49]

To attempt to avoid conflicting instructions in the receivership and the bankruptcy case, the receiver should confirm that the bankruptcy proceeding was properly initiated and keep all supervising courts up to date and as informed as possible under the circumstances until the termination of the duties of the receiver. Many receivers add specific language in their receiver order to detail procedures to follow in the event of the filing of a subsequent bankruptcy case. Upon notification of the filing of a subsequent bankruptcy case, a receiver is required to comply with Section 543 of the Bankruptcy Code and should be prepared to step aside if the bankruptcy court so orders. Furthermore, the receiver should consider whether to:

1. seek the dismissal of the bankruptcy case;[50]
2. seek to be excused from the turnover provisions set forth in Section 543 of the Bankruptcy Code pursuant to Section 543(d) of the Bankruptcy Code or by seeking abstention,[51] requesting that the bankruptcy court voluntarily refrain from continuing the bankruptcy case;
3. turnover property subject to the bankruptcy case and assist in the bankruptcy case if employment of the receiver in the bankruptcy case is approved by the bankruptcy court; or
4. turnover property subject to the bankruptcy case and pursue other opportunities unrelated to the property.

After the assets of the receivership estate are either fully administered or transferred to a bankruptcy trustee, the receiver should officially resign as receiver and obtain from the court that appointed the receiver the entry of a written order of discharge and termination of the receivership.

CONCLUSION

Although not an exhaustive overview of receiverships or all potential issues that may be encountered in a receivership, this article advances several recommendations to assist parties in avoiding a potential nightmare receivership for creditors, the receiver, and any lenders that may be involved in the case. The rules and regulations governing receiverships are complex, especially in instances where a receivership intersects a bankruptcy case. Since parties unfamiliar with receiverships are more likely to encounter a nightmare scenario like the GG Receiver, the importance of obtaining an experienced, neutral fiduciary who implements proper procedures and is able to properly communicate with all key constituents in the case cannot be understated. In contrast to the results that may be obtained by an inexperienced party, an experienced receiver will be cognizant of potential minefields throughout the course of the receivership and will more readily and cost-effectively be able to navigate around them for the benefit of creditors of the receivership. ■

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48 *See Pimper v. State ex rel. Simpson*, 274 Ga. 624, 626 (Ga. 2001).

49 11 U.S.C. § 543(d).

50 Section 305(a)(1) of the Bankruptcy Code provides that a bankruptcy court may dismiss any bankruptcy case at any time if "the interests of creditors and the debtor would be better served by such dismissal."

51 *See In re Weldon F. Stump & Co.,* 373 B.R. 823, 828 (Bankr. N.D. Ohio 2007) (exercising permissive abstention under § 305 where a state-court receivership action had already commenced).

United States v. Bank Of America: U.S. Sues Bank of America for Mortgage Fraud Against Fannie Mae and Freddie Mac

Professor Baxter Dunaway
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Preet Bharara, U.S. Attorney for the Southern District of New York, Steve A. Linick, Inspector General of the Federal Housing Finance Agency ("FHFA"), and Christy L. Romero, Special Inspector General for the Troubled Asset Relief Program ("SIGTARP"), announced that the United States has filed a civil mortgage fraud lawsuit against Bank of America Corporation ("BANK OF AMERICA") and its predecessors Countrywide Financial Corporation and Countrywide Home Loans, Inc. (collectively, "COUNTRYWIDE"). The Government's Complaint seeks damages and civil penalties under the False Claims Act and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") for engaging in a scheme to defraud the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). Specifically, the Complaint alleges that from at least 2007 through 2009, COUNTRYWIDE, and later BANK OF AMERICA after acquiring COUNTRYWIDE in 2008, implemented a new loan origination process called the "Hustle," which was intentionally designed to process loans at high speed and without quality checkpoints, and which generated thousands of fraudulent and otherwise defective residential mortgage loans sold to Fannie Mae and Freddie Mac that later defaulted, causing over $1 billion in losses and countless foreclosures.[1,2]

This is the first civil fraud suit brought by the Department of Justice concerning mortgage loans sold to Fannie Mae or Freddie Mac.

According to Bharara, for the sixth time in less than 18 months the Manhatten U.S. Attorney's office has been compelled to sue a major U.S. bank for reckless mortgage practices in the lead-up to the financial crisis. "The fraudulent conduct alleged in today's complaint was spectacularly brazen in scope," stated Bharara. "As alleged, through a program aptly named 'the Hustle,' Countrywide and Bank of America made disastrously bad loans and stuck taxpayers with the bill . . . [and] systematically removed every check in favor of its own balance." Bharara indicated this included casting aside underwriters, eliminating quality controls, incentivizing unqualified personnel to cut corners, and concealing the resulting defects. The "toxic" loans were then sold to the government sponsored enterprises as "good" loans.

FHFA Inspector General Steve A. Linick said, "Countrywide and Bank of America allegedly engaged in fraudulent behavior that contributed to the financial crisis, which ultimately falls on the shoulders of taxpayers. This type of conduct is reprehensible and we are proud to work with our law enforcement partners to hold all parties accountable."

SIGTARP Special Inspector General Christy Romero stated that the complaint alleges Bank of America made serious and significant misrepresentations before and during the time taxpayers invested $45 billion in TARP funds in the bank.

The following allegations are based on the Complaint filed in Manhattan Federal court:

COUNTRYWIDE, on its own and as part of BANK OF AMERICA, was for many years the largest provider of residential mortgage loans to the Government-Sponsored Enterprises, Fannie Mae and Freddie Mac (collectively, the "GSEs"). Fannie Mae and Freddie Mac rely on lender representations and warranties that the loans they are delivering for sale comply in all respects with the standards outlined in the Fannie Mae and Freddie Mac selling guides and lender sales contracts, which set forth underwriting, documentation, quality control, and self-reporting requirements. Because Fannie Mae and Freddie Mac do not do pre-purchase loan reviews, lender representations that they are underwriting and delivering investment-quality mortgages according to selling guides and contractual requirements are central to the GSE's purchase decisions.

Lender representations attest to the credit quality of their loans at the time of sale, the borrower's ability to repay the loan, and the accuracy of the loan data provided. Among the most basic requirements of an investment-quality mortgage are that: (i) all required loan data is true, correct, and complete; and (ii) no fraud or material misrepresentation has been committed by any party to the loan. A lender must also represent and warrant that its quality control department implements various post-closing measures intended to detect problems with loan quality and fraud. Whenever a lender identifies a material breach of a selling warranty, it must self-report the loan to the GSE.

COUNTRYWIDE initiated the Hustle (or "HSSL," for "High-Speed Swim Lane") in 2007 through its Full Spectrum Lending Division, just as loan default rates were increasing throughout the country and the GSEs were tightening their loan purchasing requirements to reduce risk. According to internal COUNTRYWIDE documents, the goals of the Hustle were high speed and high volume, where "loans move forward, never backward" in the origination process. To accomplish these goals, the Hustle removed necessary quality control "toll gates" that could slow down the origination process. For example, the Hustle eliminated underwriters from loan production, even for many high-risk loans such as stated income loans. Instead, the Hustle relied almost exclusively on unqualified and inexperienced clerks, called loan processors. Although loan processors had not been previously considered competent or knowledgeable enough to be permitted even to answer borrower questions, they were now required to perform critical underwriting duties. If a loan processor entered data from a loan file into an automated underwriting system and

U.S. v. Bank of America *continues on p. 16*

1 *U.S. v. Bank of America/Countrywide, et al. Complaint,* United States District Court Southern District of New York (Oct 24, 2012).

2 October 24, 2012, Press Release by Commercial Litigation Branch of the U.S. Dept. of Justice Civil Division, Washington D.C..

U.S. v. Bank of America continued from p. 15

received a rating that the loan had an acceptable risk of default (or "Accept" rating), no underwriter would ever see the loan. The Hustle also did away with compliance specialists, whose job it was to ensure that any loans that were approved with conditions had the conditions satisfied before closing. Although loan processors were at the time entrusted with much more responsibility, they were given much less guidance. For example, mandatory checklists for performing important underwriting tasks (such as evaluating an appraisal or assessing the reasonableness of stated income) were eliminated. Loan processors were also financially incentivized to put volume ahead of quality, as Full Spectrum Lending changed its compensation plan to provide bonuses based solely on loan volume. Reductions to compensation for poor loan quality were discontinued.

Full Spectrum Lending's senior management was repeatedly warned that eliminating toll gates for quality control and fraud prevention, and expanding the authority of loan processors and compensating them based on volume without regard to quality, would yield disastrous results. For example, in January 2008, a pre-funding quality review showed an overall defect rate of 57%, and a defect rate of nearly 70% for stated income loans. Full Spectrum Lending senior management, however, made no changes to the Hustle, and instead restricted dissemination of the pre-funding review.

As the warnings about the Hustle went unheeded, COUNTRYWIDE and later BANK OF AMERICA knowingly originated loans with escalating levels of fraud and other serious defects and sold them to the GSEs. For example, with loan processors encouraged to put volume before quality, and no underwriters checking loan files that were accepted through automated underwriting systems, there was widespread falsification of underwriting data. Loan processors also had no incentive to ensure that conditions on loans were satisfied, resulting in a spike of closed loans with outstanding conditions or without critical documentation. By February 2008, post-closing quality reviews showed defect rates of approximately 37%, far above the industry standard defect rate of 4 to 5%.

Instead of notifying Fannie Mae and Freddie Mac that they had been purchasing large volumes of fraudulent and otherwise defective loans that did not meet GSE guidelines, COUNTRYWIDE concealed the defect rates and continued the Hustle. In addition, Full Spectrum Lending initiated a one-time bonus to its quality control personnel to "rebut" the defect rates found by corporate quality control. For example, an "unreasonable stated income" finding could be reversed if corporate quality control could not prove that the stated income was actually false. After this "rebuttal" process, the final defect rate was revised down to 13%. COUNTRYWIDE concealed this bonus plan from the GSEs as well.

In July 2008, BANK OF AMERICA acquired COUNTRYWIDE via a merger. After the merger, the Hustle continued unabated through 2009. At no time did BANK OF AMERICA take any steps to disclose the Hustle to Fannie Mae or Freddie Mac. Throughout the Hustle, COUNTRYWIDE and BANK OF AMERICA sold thousands of Hustle loans to the GSEs that they knew did not meet their representations and warranties of quality. And after the loans defaulted, BANK OF AMERICA has resisted buying many of them back, despite the presence of fraud, misrepresentation, and other obvious violations of GSE requirements.

In September 2008, as a result of massive losses from, among other things, the payment of guarantees to investors on loans that defaulted, Fannie Mae and Freddie Mac were placed in conservatorship under the FHFA pursuant to the Housing and Economic Recovery Act of 2008. Simultaneously with the creation of the conservatorships, the United States Treasury exercised its authority under this Act to purchase Fannie Mae and Freddie Mac stock. As of December 31, 2011, the Treasury had provided $183 billion in funding to Fannie Mae and Freddie Mac through stock purchases.

Bank of America received $15 billion in federal funds through the U.S. Department of the Treasury's Troubled Asset Relief Program (TARP) on October 28, 2008; an additional $10 billion on January 9, 2009; and $20 billion on January 16, 2009. Bank of America repaid taxpayers' combined $45 billion TARP investment in full on December 9, 2009.

* * *

The Complaint seeks civil penalties under FIRREA, as well as treble damages and penalties under the False Claims Act, for over $1 billion in losses suffered by Fannie Mae and Freddie Mac for defaulted loans fraudulently sold by COUNTRYWIDE and BANK OF AMERICA.

The case is being handled by the Office's Civil Frauds Unit. Mr. Bharara established the Civil Frauds Unit in March 2010 to bring renewed focus and additional resources to combating financial fraud, including mortgage fraud.

To date, the Office's Civil Frauds Unit has brought five other civil fraud lawsuits against major lenders under the False Claims Act alleging reckless residential mortgage lending in connection with loans insured by the Federal Housing Administration. Three of the five cases have settled. On February 15, 2012, the Government settled its civil fraud lawsuit against CitiMortgage, Inc. for $158.3 million. On February 24, 2012, the Government settled its civil fraud suit against Flagstar Bank, F.S.B. for $132.8 million. On May 10, 2012, the Government settled its civil fraud suit against Deutsche Bank and Mortgage for $202.3 million. The Government has also filed lawsuits against Wells Fargo, N.A., as well as against Allied Home Mortgage Corp. and two of its officers. Those cases remain pending. In each settlement, the defendants have admitted and accepted responsibility for certain conduct alleged in the Government's Complaint. The Office's Civil Frauds Unit is handling these cases as part of its continuing investigation of reckless lending practices. ■

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Bankruptcy Taxes

Forrest Lewis, CPA

SOLYNDRA PLAN OF REORGANIZATION PRESENTS NOVEL TAX PLANNING ISSUES

On October 22, 2012 Judge Mary Walrath of the U. S. Bankruptcy Court for the District of Delaware confirmed the Solyndra Chapter 11 Plan of Reorganization which contains an unusual bifurcation, with the majority of the companies' assets being liquidated and distributed to creditors but its Holding Company emerging with little but a substantial endowment of tax net operating loss and credit carryforwards. Despite the objections of the Internal Revenue Service and other interested parties, Judge Walrath confirmed management's proposed Plan of Reorganization. The descriptions of the events of the case and the Plan of Reorganization below have been highly simplified in the interest of conciseness.

History of Prepetition Events[1]

Solyndra, Inc. was formed in 2005 and from 2005 through 2007, the company focused on research and development efforts to refine its proprietary thin-film technology used to create electrical energy from solar power. In July 2008, the company began its first commercial shipments from its initial production facility, referred to as "Fab 1". To fund the initial research and development phase and production facility acquisition, the company raised approximately $709 million in private capital through eight issuances of preferred stock and a line of credit from a commercial bank. In March 2009, Solyndra Inc. received a conditional commitment from the U.S. Department of Energy ("DOE") for a $535 million guarantee of a loan from the U.S. Federal Financing Bank. In December, 2009, that loan was funded as well as additional private funds were raised.

By early 2011, a variety of factors, including a dramatic decline in the prices of competing silicon-based photovoltaic products, and a worldwide oversupply of photovoltaic panels, required the company to secure incremental financing, restructure its then outstanding debt, consolidate its operations and take other cost cutting measures. The company approached both existing and new potential investors but the lenders required as a condition to providing new capital that the new financing have priority in the event of liquidation over the company's existing debt, including the DOE Loan. Specifically, in February 2011, the company's investors and creditors agreed to a global out-of-court restructuring. Madrone Partners, LP and Argonaut Ventures I, LP (who are thought to have been majority shareholders) agreed to loan Solyndra $75 million which was made senior to the DOE loan (the "February 2011 Restructuring").[2] Apparently, Madrone is owned at least partly by the family of the late Sam Walton,[3] and Argonaut by the family foundation of Oklahoma financier George Kaiser.[4] Madrone and Argonaut received warrants for new stock to take control of the company. All preferred stock was converted to common equity.

Filing of Petition

Business conditions continued to deteriorate for the debtors who owed more than $783 million in senior secured debt and had insufficient cashflows to continue operations. As a result, on August 31, 2011, the Debtors suspended their manufacturing operations and terminated the vast majority of their workforce totaling over 1,000 employees as the Debtors filed their petitions in chapter 11.

Significant Events Since the Petition Date

On September 9, 2011, with no prior warning agents from the Federal Bureau of Investigation, working in cooperation with the Office of the Inspector General of the DOE, raided the Debtors' facilities shutting down operations for the day and seizing computers, documents and electronic files. About that same time, the officers of the company received letters from the Congressional Committee on Energy and Commerce inviting the officers to appear before the Committee in connection with an investigation of the circumstances of the DOE Loan.[5] Here the reader should note that George Kaiser was a major donor to the 2008 election of President Obama.[6] The officers appeared but on the advice of counsel invoked the privilege against self-incrimination under the Fifth Amendment. Despite extensive efforts, no buyer on a "turnkey" basis was found for the business and piecemeal sales resulted in realizing little over $100 million for the estate.[7] (The estate has retained a law firm and a property tax consulting firm on a 25% contingent fee basis to contest certain property tax assessments).

Implementation of the Confirmed Plan

Following are the main points of the confirmed plan of reorganization.[8] In the Plan, Madrone and Argonaut who had exercised their warrants and taken control are referred to as the "Plan Sponsors." The Plan calls for the Plan Sponsors to contribute about $16 million to the estate as follows:

The Plan Sponsors will put in $11.5 million to pay case administrative expenses and fund recovery on the "February, 2011 Restructuring Loan" of $75 million, some of which will come back to them as holders of that loan. They are expected to recover 55% to 100% on that loan.

The Plan Sponsors will put in $3.5 million to settle a WARN Act lawsuit on behalf of the employees who did not receive the statutorily required notifications of a possible layoff.

The Plan Sponsors will put in an amount to provide a 3% recovery by Holdings Unsecured Claimants which is estimated to be about $800,000.

***Bankruptcy Taxes** continues on p. 18*

1 The history of the events of the case is taken from the Disclosure Statement, Docket number 1060, pp. 11-21.
2 Disclosure Statement, p.12.
3 MorrisAnderson.com, article on Oct. 26, 2012.
4 IRS Objection, docket # 1129, p. 4.
5 Disclosure Statement p. 14.
6 Washington Post.com, Sept. 2, 2011.
7 Disclosure Statement, pp. 19-21.
8 Disclosure Statement, pp. 34-35.

Bankruptcy Taxes continued from p. 17

Reorganized Holdings will emerge from bankruptcy, albeit with no operating businesses but carrying forward about $900 million in net operating losses and tax credits.

The DOE loans will recover the residual assets from the Liquidating Trust, which is estimated to fall between 3% and 19% of the claim amounts.

Other General unsecured creditors totaling about $340 million are expected to recover 3% or less[9]

The original equity holders will receive nothing for their equity.

Emergence of Reorganized Holdings

Usually debtor corporations in essentially liquidation scenarios like this one are dissolved; however according to the Plan, Reorganized Holdings will continue to exist as a separate corporation and emerge from bankruptcy with estimated net operating loss carryforwards for U.S. federal income tax purposes of between $875 million and $975 million. While the net operating losses could be reduced under Internal Revenue Code Section 382 as explained later, if it is assumed there are no reductions and the entirety are applied against income without limitation, and if it is further assumed that the highest current federal corporate income tax rate of 35% applies, then the tax savings could range between $306 million and $341 million. There are also general business credit carryforwards approximating $11 million in the aggregate.[10]

IRS Objection

On October 10, 2012, the Internal Revenue Service filed a 441-page objection (including attachments) to confirmation of the Plan, primarily because of the net operating loss carryforward. The IRS Objection was based solely on Bankruptcy Code arguments and claimed the Plan should not be confirmed because it did not qualify under Section 1129 of the Bankruptcy Code ("BC Section 1129"):

Under Section 1129(d) a Plan of Reorganization cannot be confirmed if "tax avoidance is a primary purpose" of the Plan.

The Internal Revenue Service did an excellent job of proving from discovered internal Solyndra, Madrone and Argonaut documents and emails [collectively "the internal documents"] that preserving the net operating losses was recognized fairly early on as Solyndra spun downward as a way of salvaging some of their lost investment. The IRS demonstrated that much time and effort was expended by Madrone and Argonaut to carefully plan and execute an arrangement where the NOLs and tax credits would be preserved in the emerging Reorganized Holdings.

The IRS cited several other cases in which the Bankruptcy Court refused to confirm plans where tax avoidance was a primary purpose.

The IRS argued that in exchange for injecting approximately $16 million as described above, Madrone and Argonaut stood to recover many times that amount through the NOLs and credits.

9 Disclosure Statement, p. 6-8.
10 Disclosure Statement, p. 36.

The IRS concluded "the principal purpose of this Plan *is* tax avoidance." [11]

Responses to the IRS Objection[12]

Both Argonaut and the Unsecured Creditors Committee filed responses to the IRS Objection. They pointed out there were only two reported cases where a Plan was not confirmed because of objections that it was tax motivated and sought to distinguish those cases from Solyndra. Both responses highlighted the importance of the fresh money that Plan Sponsors were putting in, particularly to settle the WARN employee lawsuit. They pointed out that Madrone and Argonaut could simply sit back as senior creditors, get their recovery and walk away from an almost administratively insolvent case; however they were not proposing to do that. Argonaut denied the IRS charges about being completely focused on using the NOLs and pointed out that it had never valued the total NOLs at anywhere near the $350 million stated by IRS. At most, Argonaut said the discounted present value of the total NOL was estimated to be around $80 million, which did not include any risk of IRS audit or being able to efficiently use the losses. However, the Creditors Committee simply embraced the use of the NOLs and said, "Why not? It's just another estate asset that can be realized for the benefit of all the creditors." The Creditors Committee concluded that even if the Plan is confirmed, the IRS will still have their chance to audit Reorganized Holdings and attack the NOLs. In the end, the Judge ruled against the IRS and confirmed the Plan.[13]

Latest Events in the Case

The IRS filed an appeal of the Plan confirmation in Delaware Federal District Court on November 1, 2012, but in the process also asked for a stay in the effectiveness of the confirmation, which was denied on November 5.[14]

Tax Issues

The main feature of the Plan from a tax point of view—the emergence of Reorganized Holdings with no assets except the NOLs and tax credits—is a very unusual fact pattern. It is common for corporations to emerge from Chapter 11 with some operating assets and some usable NOLs, and it is common for corporations to emerge with some operating assets and no NOL carryforwards because of the operation of Internal Revenue Code Sections 382 and/or Section 108 (explained below); however for a shell corporation to emerge with no assets and a large amount of NOLs is very rare, perhaps unprecedented. These are the most salient issues in using the NOLs and tax credits:

The NOLs cannot simply be transferred to a profitable corporation (which Kaiser or the Waltons may own or acquire) and realized that way, as explained below. The losses can only be realized by injecting a profitable business into Reorganized Holdings, because of the anti-loss trafficking rules (including IRC Sec. 382) on change in control and the Separate Return Limitation Year (SRLY) rules of the consolidated return regulations. However, it may be very difficult to inject a business into Reorganized

11 IRS Objection, pp. 20-29.
12 Responses to IRS Objection, Docket # 1143 and 1149.
13 Order confirming Plan, Docket # 1173.
14 *BNA Daily Tax Reports*, Nov. 8, 2012.

Holdings that can generate almost $1 billion in taxable income in the next 15-20 years.

There may be as much as $950 million in discharged debts in this case.[15] Generally the discharged debt must be applied to reduce any net operating loss carryforward in the first tax year after the Effective Date of the Plan under IRC Sec. 108(b)(1). However, The Plan Sponsors anticipated no reduction in the NOLs as a result of the large cancellation of debt because they planned to elect to reduce depreciable assets under Sec. 108(b)(5) which would preserve the NOLs for future use.[16]

The following is a simplified version of the extremely complex IRC Sec. 382, which provides that if a loss corporation undergoes a change in control during a three year period, any net operating loss carryforwards may only be used on an amortization basis generally determined by multiplying the value of the corporation at the date of change times the IRS rate of interest. When Sec. 382 applies, usually it severely reduces the effectiveness of a loss carryforward. The analyses found in the internal documents by IRS indicate there were several changes of ownership in the period ending August 15, 2008, and $205 million of NOLs would be subject to the Section 382 amortization method but that it was projected none of those NOLs would expire because of the 15 year limit.[17]

A change in control is generally defined as an increase of 50 percentage points in the ownership of the stock during a three year period. Although there are some conflicting reports on the ownership interest of Madrone and Argonaut, the internal documents IRS obtained seem to show that for the last several years Madrone and Argonaut owned over 50% of the stock, thus there was no recent change in control.[18]

In this case, the consequence of the Section 382 change in control test would be even more critical because Section 382(c) contains a general requirement that the corporation must continue its historic business for at least two years or *no* NOL carryover will be allowed. Since Reorganized Holdings is emerging with no active business, any NOL carryover would be totally eliminated. [Although the issue is beyond the scope of this article, it is interesting to note that under one of the favorable exceptions for bankruptcy cases, IRC Section 382(l)(5), the continuity of business requirement does not apply—but then the Plan Sponsors might not meet the holding period requirements for their debt and certain reductions would be made to the amount of the NOLs.][19]

Several commentators have observed that Reorganized Holdings may be vulnerable to an IRS attack under IRC Section 269 which provides that if "any person or persons acquire....directly or indirectly, control of a corporation….and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance." Historically, IRS has not been very successful with Section 269 cases.

Another issue that has been raised by some observers is whether the old equity was worthless and the new stock issued under the warrants in February 2011 constituted new equity and a change in control.

Commentary

This case presents several interesting aspects. I have already commented on the unique situation of the emergence of Reorganized Holdings with neither assets nor business but with a large amount of losses and credits. It is interesting that the IRS argued against confirmation exclusively on BC 1129 grounds, not bothering to raise the 382 change in control issue, Sec. 269 acquisition of corporate control with a principal purpose of tax avoidance, lack of economic substance, etc. It is difficult to evaluate Judge Walrath's decision. The IRS makes a valid point that the Plan Sponsors after the bankruptcy petition were only focused on the tax benefits, and those benefits were potentially several times larger than the $16 million the Plan Sponsors were willing to contribute. It is understandable that Judge Walrath's primary interest might be in obtaining the largest recovery possible for the unsecured creditors, especially the employees WARN litigation; however, the $16 million may ultimately be funded by the American taxpayer via the net operating losses.

Thanks to Grant Newton for his assistance with this article.

ABA OFFERS SOLUTION TO SEPARATE TAXABLE ESTATE PROBLEM IN INDIVIDUAL CH. 11 CASES

For whatever reason, the tax rules for Chapter 11 individual cases have historically contained several novel tax principles—the most notable being the treatment of the bankruptcy estate as a taxable entity separate from the tax return of the individual debtor, albeit at the same individual tax rates and following many of the same individual rules. In Chapters 7 and 11 corporate and partnership cases and Chapter 13 individual cases, there is no separate taxable estate. Also, in Chapter 11 individual cases, administrative expenses of the estate are treated as a quasi-net operating loss with many more limitations. To date these rules have proved unworkable.

Pre-2005 Rules

Before 2005 the tax rules pulled the unincorporated business operations and any net operating loss carryovers of the individual debtor into the bankruptcy estate but left post-petition wages on the tax return of the individual. That situation was difficult because the individual wanted to earn wages or salaries to make a fresh start but the loss of the tax benefits of his business operations or net operating losses usually left him in a surprise tax liability situation, making future recovery more difficult. Also, there was a tax trap in which sales of assets, forced or otherwise, during the portion of the year before the petition was filed were also not

15 Disclosure Statement, pp. 5-8.

16 IRS Objection, Exhibit 51, p.3.

17 IRS Objection, internal NOL analysis, Exhibit 16, p.2.

18 One recent article based on Solyndra's SEC filings indicated that Argonaut and Madrone had only 46.75% of the stock (Kogan, *BNA Daily Tax Reports*, 11/09/2012: "NOLs: Solyndra: Now It's IRS's Turn"). The various Sec. 382 internal analyses reproduced in the IRS Objection, e.g. Exhibits 50 and 51, show Madrone and Argonaut comfortably in excess of 50%, in addition, various internal emails betray strong confidence on their part that they were not subject to 382).

19 IRS Regulation §1.382-9(m)(1).

protected by his net operating loss carryovers, resulting in tax, often without cash left to pay the tax. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) changed the law to include wage and salary income plus self-employment earnings of an individual debtor in the taxable estate. However, this has led to many difficult tax accounting situations on which the Internal Revenue Service still hesitates to provide guidance seven years later.

The BAPCPA Version

BAPCPA added section 1115 to the Bankruptcy Code, providing that estate property now includes all postpetition earnings from services. However, the corresponding provision in the Internal Revenue Code, Section 1398, was not changed. Its current application is that all income of the estate is taxed but the "living allowance" granted the individual debtor is deductible by the estate. Thus, the "living allowance" becomes taxable to the individual. Unfortunately, the longstanding federal employment tax withholding rules do not contemplate the reporting and allocation of wage income and withholding remittances to the government agencies between a debtor and his bankruptcy estate. The IRS issued Notice 2006-83 which does provide helpful guidance on some points but mainly acts to protect the existing employment tax rules and W-2 form reporting from change due to this individual bankruptcy estate reporting problem. The Notice permits any reasonable method of allocation of taxable income between the estate and debtor but requires that the withholding tax allocation use the same method. An optional form for reporting the allocation by the estate to the debtor is contained in the Notice. (The Notice does clarify that wages in a Ch. 7 case are not property of the bankruptcy estate and not subject to this dual reporting regime).

Problems under BAPCPA

The communication issues inherent in the dual reporting of wages of debtors are the current system's main downfall. In the typical case, a net paycheck is turned over to the trustee weekly and the withholding remains in limbo until the end of the year when tax returns are prepared. As we have all experienced at one time or another, it is difficult to adjust weekly withholding to the actual year-end tax liability and this matching problem is exacerbated by allocation between debtor and estate. Many times debtors still owe tax in excess of the withholding, so they must apply for an additional living allowance. Little guidance is provided on how the debtor's tax return is prepared, is the "living allowance" listed under wages, miscellaneous income or business income (Schedule C). One practitioner reported an experience with a fairly common issue: excess FICA withholding from two employers, which is a credit on the tax return but how should it be allocated between debtor and estate? Another unfortunate situation under the current rules is that of self-employed individuals. The IRS Notice referenced above concludes that the income, and therefore part of the income tax, belongs to the estate but the entire self-employment tax is the individual's responsibility. So many complaints have been made that the American Bar Association studied the problem and proposed a solution.

The ABA Solution

In a letter to the Chairpersons of the Congressional tax writing committees dated August 23, 2012, the ABA Section on Taxation recommended a fairly simple legislative fix—delete the reference to "Chapter 11" from Internal Revenue Code Section 1398. According to the letter, this will eliminate the bankruptcy estate as a separate taxable entity such that a Ch. 11 individual case will be taxed similarly to a Ch. 13 case; i.e., the debtor will just continue to file a normal 1040.

Commentary

One small drawback of the ABA proposal is that there seems to be potential for a small increase in unfiled tax returns and unpaid taxes. Many individuals cannot cope with the stringent budgeting and expense control needed to successfully complete a Ch. 13 plan, resulting in many dismissals of Ch. 13 cases. This undoubtedly leads to failure in some cases to file tax returns and contributes to the piling up of tax debts. At least under the current BC Sec. 1115 regime, trustees are assuring that tax returns are filed and payments are made for the estate portion of the income. Purely from a tax standpoint, perhaps the ABA suggestion is a good solution because it will simplify the process and allow earnest petitioners to have the benefit of tax losses to reduce their tax bills while they are trying to make a fresh start.

Thanks to Dennis Bean for his insights and to Grant Newton for his assistance with this article.

RECENT IRS RULINGS AND COURT CASES

IRS Discusses Importance of Notice in Ch. 13 Tax Discharge Cases

BAPCPA 2005 clarified that a creditor must be given notice of any debts which the debtor proposes be discharged. A recent Internal Revenue Service Technical Advice Memorandum says this includes any prepetition federal tax liabilities. The usual "old and cold" tests for discharge of taxes still apply, e.g. generally the returns must have been filed at least three years before the petition date. Technically, delinquent federal income tax liabilities are supposed to be either listed or scheduled in the bankruptcy petition. The Technical Memorandum focuses on the instance where the federal taxes were not disclosed in the bankruptcy petition but the taxpayer gives notice to IRS after filing the petition but before the claims bar date. Under the 2005 rule, no discharge can be made where IRS is first notified after the bar date. But how much time must IRS have before the bar date for notification to be effective? The Technical Advice Memorandum states that there is no clear legal authority on this. It does mention the requirement under Bankruptcy Rule 4007 that a creditor must be given at least 30 days to request a determination of discharge of a liability, but says even that period of time may not provide adequate notice to IRS. The Technical Advice concludes that the timeliness of a notification to IRS made after the petition date of a federal tax liability which the debtor is seeking to discharge must be decided on a case by case basis. (PMTA 2012-19)

IRS Attorneys Say Overpayment Should Be Credited Against Potential Assessments if Taxpayer Requests

A taxpayer, presumably a corporation, had an overpayment on its 2010 tax return but simultaneously the Internal Revenue Service was auditing the taxpayer's returns for four years prior to 2010. The taxpayer was still wrangling about those years in the

IRS Appeals Division, so they were not yet resolved or assessed. In 2011, taxpayer filed its 2010 tax return and requested the overpayment be applied as an "advance payment" on Years 2 and 3 of the four year period. No doubt they requested that to cease the running of interest on any deficiency. The IRS Service Center refused to honor the request and actually sent the money back to the taxpayer. The taxpayer then sent the money back to the IRS and requested the opinion of IRS Chief Counsel's Office. The IRS Attorneys ruled in favor of the taxpayer and recommended the Service Center accede to the taxpayer's request. (CCA 201236026)

IRS Amends Defined Benefit Pension Regs to Help American Airlines, Others in Bankruptcy

The Internal Revenue Service finalized a regulation permitting employers in bankruptcy to eliminate a lump sum defined pension benefit under fairly narrow circumstances. Both American Airlines and their pilots union had lobbied for this change to prevent termination, presumably for default, of the plan. These are conditions under which the lump sum distribution option may be eliminated:

The plan's enrolled actuary has certified that, for the plan year for which the amendment is being sought, the plan's adjusted funding target attainment percentage is less than 100 percent.

The plan is not permitted to make any "prohibited payment"—generally a payment that is in excess of the monthly amounts payable under a single life annuity—because the plan sponsor is a debtor in a bankruptcy case.

The bankruptcy court handling the case has issued an order stating that the adoption of the amendment is necessary to avoid a distress termination or an involuntary termination of the plan prior to completion of the bankruptcy case.

PBGC has issued a determination that the amendment is necessary to avoid a distress or involuntary termination of the plan prior to completion of the bankruptcy case and that the plan assets are insufficient to cover all PBGC-guaranteed benefits. (Treasury Decision 9601)

Another Chapter in the Continuing Saga of What Constitutes a Tax Return for Discharge Purposes under BAPCPA

Peter Martin failed to file timely tax returns for 2000 and 2001. In 2004 the IRS prepared substitute returns for those years and assessed the tax. Mr. Martin felt the SFRs overstated his tax liability and in 2005 filed late 2000 and 2001 returns showing a lower tax liability. The IRS adjusted his tax liability down to the amounts shown in the 2005 returns Mr. Martin filed but that tax was never paid. In 2010 he filed a petition in Ch. 7 and sought discharge of the 2000 and 2001 remaining liabilities. The Colorado bankruptcy court following recent precedent there ruled:

Debtor relies on a literal reading of §523(a)(1)(B)(i). Debtor argues that whether a "return" was filed should depend on an objective analysis of the document filed, not a subjective test of the taxpayer's motivation for filing the return. Finally, he asserts that the United States' position - that a return filed after a tax debt is assessed is not a "return" - is not logical. Debtor contends that the BAPCPA amendment to §523(a) does not change the analysis in this case. The United States contends that a return filed after assessment does not "satisf[y] the requirements of applicable nonbankruptcy law," as required by the BAPCPA amendment, because the purpose of the filing - to generate a self-assessment of tax - has been made moot by the prior IRS tax assessment. The taxpayer, by post-assessment filing, "cannot alter the fact that the tax debt was not self-assessed [and is, therefore,] a tax debt 'for which no return was filed.'" …. The United States notes that this was also the majority view of cases that considered this issue prior to BAPCPA….

Some courts have interpreted "applicable filing requirements" in the BAPCPA Amendment to encompass the time for filing a tax return. Under this reading any late-filed return, other than one prepared pursuant to section 6020(a) of the Tax Code, or a similar provision in a State or local law, does not meet the BAPCPA definition of a "return," and all taxes relating to late-filed returns are non-dischargeable under §523(a)(1)(B)(i).…. This interpretation says too much, however, essentially rendering §523(a)(1)(B)(ii) superfluous. Section 523(a)(1)(B)(ii) provides that taxes for which a return was filed "after such return was last due" and less than 2 years prior to the date of bankruptcy are not discharged. This section refers specifically to late-filed tax returns, and is the only place in §523(a) where late filing is specifically referenced. To read "return" in §523(a)(1)(B)(i) as meaning "timely-filed return" would make the discharge exception of §523(a)(1)(B)(ii) entirely coincidental with that of §523(a)(1)(B)(i), except in the case of tax returns prepared under section 6020(a) of the Tax Code more than 2 years prior to bankruptcy….A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant …"

The court ruled in favor of the debtor, discharging the 2000 and 2001 tax liabilities. (*Martin v. US, Bankruptcy Court*, D. Colorado, 2012-2 U.S.T.C. ¶50,674, (Nov. 14, 2012))

Thanks to Grant Newton and Dennis Bean for their assistance with this article. ■

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Bankruptcy Cases

Professor Baxter Dunaway

SIXTH CIRCUIT

The litigation spawned by *Stern v. Marshall,* ––– U.S. ––––, 131 S.Ct. 2594, 180 L.Ed.2d 475 (2011) on the scope of the judicial authority of the Bankruptcy Court continues. In *Waldman v. Stone*, --- F.3d ----, 2012 WL 5275241 (6th Cir.(Ky.) Oct 26, 2012) (NO. 10-6497),

Chapter 11 debtor Stone brought adversary proceeding against his principal creditor Waldman, among others, asserting fraud and other claims. Creditor filed counterclaim, seeking to collect unpaid debt. Following bench trial, the United States Bankruptcy Court for the Western District of Kentucky, 421 B.R. 401, entered judgment for debtor, discharging debts owed by debtor to creditor and awarding debtor more than $3,000,000 in compensatory and punitive damages. Creditor appealed. The District Court, 2010 WL 4873565, affirmed. Creditor appealed.

Waldman challenged on three grounds the bankruptcy court's power to enter its judgment in this case. First, Waldman argued that Stone's state-law fraud claims are beyond the jurisdiction of any federal court. Second, Waldman argued that the judgment here was beyond the statutory authority of the bankruptcy court in particular. And third, Waldman argued that the judgment was beyond the bankruptcy court's power as limited by Article III of the Constitution.

Applying *Stern v. Marshall,* the Sixth Circuit Court of Appeals, Kethledge, Circuit Judge, held that:

> (1) debtor's claims fell within "related to" jurisdiction under bankruptcy jurisdiction statute, despite their state-law basis. A claim is "related to" a bankruptcy case, under bankruptcy jurisdiction statute, if outcome of claim could conceivably have any effect on estate being administered in bankruptcy. 28 U.S.C.A. § 1334(b). 2012 WL 5275241 (6th Cir.(Ky.) *3.
>
> (2) creditor forfeited objection that bankruptcy court acted beyond its statutory authority to enter final judgment;
>
> (3) affirmative claims were "related to" claims as to which bankruptcy court could submit proposed findings of fact and conclusions of law; and(4) debtor's testimony supported judgment on his disallowance claims.

The adjudication of so-called private rights

[*Wildman,*]*5 [8][9] "The adjudication of so-called private rights—historically described as "the liability of one individual to another under the law as defined"—is part of the judicial Power reserved to Article III courts under the Constitution. *Stern,* 131 S.Ct. at 2612. Bankruptcy courts therefore cannot enter final judgments as to claims involving liability between individuals, unless the claim falls within the so-called "public rights" exception to Article III. *Id.* at 2610. A public-rights claim is one that "derives from a federal regulatory scheme, or in which resolution of the claim by an expert governmental agency is essential to a limited regulatory objective within the agency's authority." *Id.* at 2613. Whether Stone's claims involve "public rights" is the issue here. In *Stern,* the Court reviewed the line of cases applying the public-rights doctrine to bankruptcy proceedings. 131 S.Ct. at 2609–14. That line begins with *Northern Pipeline*, which held that "the restructuring of debtor-creditor relations"—*i.e.,* the bankruptcy court's power to rule on a debtor's objections to a creditor's proof of claim against the estate—"must be distinguished from the adjudication of state-created private rights," such as, in that case, a debtor's state-law action for contract damages against a non-creditor. 458 U.S. at 71, 102 S.Ct. 2858 (plurality opinion). "The former may well be a 'public right,' " the Court said, "but the latter obviously is not." *Id.*

[*Wildman,*]*6 [10] "Next came *Granfinanciera, S.A. v. Nordberg,* which held that the public-rights doctrine does not allow a bankruptcy court to decide a fraudulent-conveyance claim filed by a bankrupt estate's trustee against a non-creditor. 492 U.S. 33, 55, 109 S.Ct. 2782, 106 L.Ed.2d 26 (1989). By means of such a claim, the estate seeks to recover property that the debtor transferred in anticipation of bankruptcy. Fraudulent-conveyance claims, *Granfinanciera* said, "constitute no part of the proceedings in bankruptcy." *Id.* at 56, 109 S.Ct. 2782. They are "quintessentially suits at common law that more nearly resemble state-law contract claims ... to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res." *Id.* Thus, only an Article III court can enter final judgment on such a claim. (*Granfinanciera* actually involved the limits of the bankruptcy court's equity jurisdiction for Seventh Amendment purposes, not the limits of the bankruptcy court's authority for purposes of Article III. But the Supreme Court stated that the analysis for each is the same. *See id.* at 53–54, 109 S.Ct. 2782.)"

[*Wildman,*]*6 [10] "In contrast, the Supreme Court has twice authorized the bankruptcy courts to decide statutory preference actions brought by trustees against creditors who filed a proof of claim in the bankruptcy. *See Katchen v. Landy,* 382 U.S. 323, 86 S.Ct. 467, 15 L.Ed.2d 391 (1966); *Langenkamp v. Culp,* 498 U.S. 42, 111 S.Ct. 330, 112 L.Ed.2d 343 (1990) (per curiam). When a debtor transfers property to a creditor shortly before filing for bankruptcy, the effect is to increase the creditor's share of the estate. Thus, under the bankruptcy statute, if a debtor transfers property to a creditor within a certain period (90 days for most creditors, 1 year for "insiders") before the date of the bankruptcy petition, the trustee of the estate can void the transfer. *See* 11 U.S.C. § 547. *Katchen* held that the bankruptcy court can decide a preference action against a creditor of the estate—even an action that seeks return of property to the estate, rather than only disallowance of the preferred creditor's proof of claim—because the determination whether the creditor received a voidable preference is "part and parcel" of the claims—allowance process. 382 U.S. at 330, 86 S.Ct. 467; *see also Langenkamp,* 498 U.S. at 44, 111 S.Ct. 330."

[*Wildman,*]*7 [11] *"Stern* thus provides a summary of the law in this area: When a debtor pleads an action under federal bankruptcy law and seeks disallowance of a creditor's proof of claim against the estate—as in *Katchen*—the bankruptcy court's authority is at its constitutional maximum. 131 S.Ct. at 2617–18. But when a debtor pleads an action arising only under state-law, as in *Northern Pipeline*; or when the debtor pleads an action that would augment the bankrupt estate, but not "necessarily be resolved in the claims allowance process[,]" 131 S.Ct. at 2618; then the bankruptcy court is constitutionally prohibited from entering final judgment. *Id.* at 2614."

[*Wildman,*] "Affirmed in part, vacated in part, and remanded."

See also, *In re Global Technovations Inc.,* 694 F.3d 705, 56 Bankr. Ct. Dec. 266 (6th Cir.(Mich.) Sep 13, 2012) (NO. 11-1582):

OPINION 694 F.3d 705, 709 (6th Cir.(Mich.) Sep 13, 2012).

"*BOGGS*, Circuit Judge.Global Technovations Incorporated ("GTI") went bankrupt after it purchased Onkyo America Incorporated ("OAI"), a subsidiary of Onkyo Corporation ("Onkyo"). GTI had purchased OAI for $13 million in cash and $12 million in three-year promissory notes. Onkyo attempted to recover the remainder of the purchase price from GTI's bankruptcy estate by filing a proof of claim for $12 million. GTI responded by suing Onkyo under the theory that the OAI purchase was a fraudulent, voidable transaction. The bankruptcy court agreed. The court found that OAI was worth $6.9 million at the time of the transaction, not $25 million. As a result,*710 the court voided GTI's obligation to pay the remainder of the purchase price. It also ordered Onkyo to repay GTI $6.1 million—the difference between the $13 million GTI had paid and the $6.9 million the bankruptcy court determined that OAI was worth.The United States District Court for the Eastern District of Michigan affirmed the bankruptcy court's decision. After wrestling with a debate about the extent of the bankruptcy court's jurisdiction to order relief, we also affirm."

See, *Global Technovations Incorporated* 694 F.3d 705, 722-723 (6th Cir. (Mich.) Sep 13, 2012):

[Global Technovations Incorporated], [23] *"Stern* cited with approval the Court's prior precedent holding that a bankruptcy court may award affirmative relief to a debtor after its creditor's proof of claim has been resolved and where "nothing remains for adjudication." *723 131 S.Ct. at 2616 (citing *Katchen,* 382 U.S. at 334, 86 S.Ct. 467). In this case, once the bankruptcy court determined that the sale of OAI had been a fraudulent transfer and Onkyo was a good-faith transferee, awarding GTI relief was a simple matter of subtraction. The bankruptcy court credited Onkyo the $6.9 million it determined OAI was worth at the time of the transfer, and then ordered Onkyo to pay back the remainder—$6.1 million—of the $13 million it had received from GTI. We hold that the court had jurisdiction under *Stern* to enter this judgment."

FIRST CIRCUIT

Can a conviction be upheld for bankruptcy fraud of a debtor who failed to disclose in the petition that the debtor used other persons' identities to obtain credit cards?

First Circuit upholds conviction for bankruptcy fraud of a debtor who failed to disclose in the petition that the debtor used other persons' identities to obtain credit cards. *U.S. v. Marston*, 694 F.3d 131 (1st Cir.(N.H.) Sep 20, 2012) (NO. 11-2100).

A false oath conviction under 18 U.S.C. § 152(2) requires the government to prove (1) the existence of a bankruptcy proceeding; (2) that the defendant made a false statement in that proceeding under penalty of perjury; (3) that the false statement concerned a material fact; and (4) that the defendant made the false statement knowingly and fraudulently. *United States v. Cutter,* 313 F.3d 1, 4 n. 4 (1st Cir.2002). See also *Metheany v. United States,* 390 F.2d 559, 561 (9th Cir.), *cert. denied,* 393 U.S. 824, 89 S.Ct. 81, 21 L.Ed.2d 94 (1968) (same elements restated under five headings).

The defendant debtor Marston was charged with five counts of bankruptcy fraud, 18 U.S.C. § 152, each count alleging that she had made a false statement in her application or schedule. The two counts ultimately submitted to the jury alleged as follows:

Count One: that Marston had used the names Kristy Kromer and Susan Blake but knowingly and fraudulently failed to disclose this as required in the petition.—Court Four: that Marston knowingly and fraudulently failed and refused to disclose debts to Bank of America, BMW Bank of North America, and American Express.

The government's theory as to the first count was that Marston had used the names of her two friends, Blake and Kromer, in credit card applications without their approval in order to secure cards with which Marston then made unauthorized purchases in their names; as to the fourth count, its theory was that the credit card issuers had claims against Marston for purchases made with those accounts. The jury convicted on both counts and Marston was ultimately sentenced to concurrent terms of 37 months imprisonment and three years supervised release for each count, as well as a statutory $100 special assessment imposed separately for each count.

The Court of Appeals, held that:(1) proof that defendant had used the names of her acquaintances in securing credit cards, but failed to disclose those names on her bankruptcy petition as other names she used, was sufficient to support false oath bankruptcy fraud claim, and (2) proof that defendant omitted debts incurred by her fraudulent use of another's name to obtain credit cards on bankruptcy schedule was insufficient to support false oath bankruptcy fraud conviction. ■

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