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Selected Bankruptcy Issues Arising in Bank Holding Company Cases

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Matthew W. Levin

Virtually all financial institutions experienced stress during the Great Recession and, as a result, numerous banks failed. Typically, banks are owned by a bank holding company and when the bank fails or is seized by the FDIC, that holding company may file for bankruptcy. After the subsidiary bank is seized, the bank holding company is generally left with minimal assets to reorganize and most of these cases end up liquidating, either in Chapter 11 or Chapter 7. There are some unique issues which arise when a bank holding company files for bankruptcy and this article touches on a few of those issues; specifically, capital maintenance commitments, Director and Officer claims, and the allocation of tax refunds.

Capital Maintenance Commitments

In a typical bank holding company structure, the holding company serves as a source of strength to the subsidiary bank. When the subsidiary bank is troubled, it generally looks to the holding company to raise capital to support the bank through the holding company's access to traditional capital markets. Often, the bank's regulators will push the holding company to raise capital to support the bank and may even seek consent orders or agreements to enforce this directive. When bankruptcy arises, the FDIC may argue that the holding company was party to a Capital Maintenance Agreement which required the holding company to support the bank and, if such is the case, such an agreement can generate enormous claims against the holding company while diluting other unsecured creditors. In certain circumstances those agreements can give rise to priority claims against the holding company's assets, thereby placing the FDIC ahead of all other unsecured creditors. As one might imagine, this is a hot button litigation issue for the non-FDIC creditors.

To establish the existence of a Capital Maintenance Agreement under section 507(a)(9) of the Bankruptcy Code,[1] the FDIC must show that a debtor holding company clearly and irrevocably committed to provide capital support to the debtor's subsidiary bank in a signed writing with the applicable regulatory agency.[2] The FDIC may argue that the clear, irrevocable signed writing that constitutes the capital maintenance commitment is derived through a combination of some or all of several acts including, but not limited to, an agreement between the holding company and its regulators and a capital directive issued to the holding company by the regulator to maintain capital in the bank.

The Statutory Scheme

A "prompt corrective action" directive ("PCA") is a type of directive which enables and encourages regulatory agencies such as the FDIC to act more quickly and aggressively to address an insured bank's financial problems. When a regulatory agency issues a PCA and deems a bank "undercapitalized," the bank must submit a "capital restoration plan" for approval to the regulatory agency within 45 days. Before a capital restoration plan will be approved by a regulatory agency, the holding company must, among other things, submit a guaranty that the bank will comply with the plan until it has been "adequately capitalized."[3] This is the typical but not the exclusive means by which regulators attempt to obtain a capital maintenance commitment from a bank holding company.

In addition to acting as a source of strength arising from capital restoration plans, Federal Reserve regulations require bank holding companies to "serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner."[4] A bank holding company's failure to meet these obligations will generally be considered "an unsafe and unsound banking practice."[5] However, this regulation does not impose an obligation on a holding company to

[1] 11 U.S.C. § 507(a)(9).

[2] *See Wolkowitz v. Fed. Deposit Ins. Corp. (In re Imperial Credit Indus.), 527 F.3d 959, 964 (9th Cir. 2008).*

[3] 12 U.S.C. § 1831o(e)(2)(C); 12 C.F.R. §325.104.

[4] 12 C.F.R. § 225.4(a)(1).

[5] Policy Statement on the Responsibility of Bank Holding Companies to Act as a Source of Strength to Their Subsidiary Bank, 52 Fed. Reg. 15707 (April 30, 1987).

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A Letter From the President

Anthony V. Sasso, CIRA
Deloitte CRG

Greetings to all friends of the AIRA! I hope you enjoyed a great summer. The leaves are all turning in my home state of NJ; kids are in school, the soccer season is almost over, and shorter days and brisk fall temperatures are upon us. With 2014 around the corner, we hope your continuing education calendars for the upcoming year will include joining us at **AIRA's 30th Annual Bankruptcy and Restructuring Conference,** for which planning is well underway.

We are looking forward to celebrating the 30th anniversary of this marquee event in "Rocky Mountain High" style. The conference will take place **June 4-7, 2014**, at the Westin Denver Downtown. This year's Planning Committee co-chairs include **Chris LeWand**, a senior managing director in the Denver office of FTI Consulting & FTI Capital Advisors; **Michael Pankow**, a Shareholder, located in the Denver office of Brownstein Hyatt Farber Schreck, LLP; and **Peter Schulman**, a Partner in the Corporate Finance & Forensics Services Group of RubinBrown LLP. While the agenda is not yet finalized, you can count on a great educational and social experience, with high profile keynote speakers, coverage of the latest important happenings in our profession, and opportunities to take in the natural beauty of the great state of Colorado. Denver is home to world-class museums including the Denver Art Museum and Museum of Nature and Science; Elitch Gardens, a downtown amusement park; and one of the nation's most popular zoos. Options for day trips include hiking in the beautiful Rocky Mountains, river rafting on the Cache La Poudre or through Clear Creek Canyon, golfing on one of Denver's many world-class golf courses, or spending an afternoon shopping on Larimer Square or at the many boutiques in Cherry Creek North. You can also see why the Denver area is being called the "Napa Valley of Beer" at Coors Brewery, the world's largest single site brewery, or on one of the city's microbrewery tours. Please reserve June 4-7 and make plans now to join us for an exceptional program in the Mile High City.

In addition to our annual conference, I would like to add one last reminder about **AIRA's 12th Annual Advanced Restructuring & POR Conference in New York**. This year's POR Conference takes place on November 18th at the Union League Club, 38 East 37th Street, New York. As I mentioned in my last letter, you are encouraged to join us for a thought-provoking and informative day discussing important events impacting our profession over the past year. Earn up to 8 CPE / 7 CLE credits, and also enjoy the post conference cocktail reception where we will pay tribute to **Hon. Robert E. Gerber, Judge, U.S. Bankruptcy Court, SDNY,** for his many years of distinguished service to the bench.

That's it for now. I hope to see you at an AIRA event soon!

Tony Sasso

To contribute to the newly established

AIRA Grant Newton Educational Endowment Fund

contact Elysia Harland, eharland@aira.org

A Note From the Executive Director

I am writing this note from Atlanta where I have just attended the 2013 National Conference of Bankruptcy Judges. While I enjoy this conference for many reasons including its technical sessions, the most enjoyable aspect of the conference is the opportunity to see so many members of AIRA, including those with CIRA and CDBV credentials and those who have been in at least one of the courses I have taught. It is highly gratifying to spend time with the many outstanding professionals that are involved in the CIRA and CDBV program. Also memorable was the opening reception on Wednesday night hosted again by AIRA, the ballroom packed with over 1,000 people forging new connections and catching up with longtime associates. I want to personally express my appreciation to the firms that sponsored this year's reception: **CBIZ MHM, LLC; Deloitte.; FTI Consulting, Inc.; Huron Consulting Group; McGladrey LLP; Mesirow Financial Consulting, LLC; Protiviti Inc.;** and **PricewaterhouseCoopers LLP.**

--Grant Newton, CIRA

Bankruptcy Retakes: What Constitutes a Tax Return for Discharge Purposes?

Prof. Jack F. Williams, PhD, JD, CIRA, CDBV
AIRA Resident Scholar
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Notwithstanding the debtor's discharge under the Bankruptcy Code, certain debts are excepted from discharge as a matter of public policy pursuant to section 523(a). These exceptions to discharge are strictly construed because they are inconsistent with the rehabilitative nature and fresh start policy embodied in bankruptcy policy. An *exception* to discharge should be contrasted with an *objection* to discharge. If successful in an objection to discharge proceeding, the creditor's claim along with every other claim survives the bankruptcy case; that is, an individual debtor will not receive a discharge at all. It is significantly different with an exception to discharge proceeding under section 523(a). If successful in asserting section 523(a), the creditor's claim will not be discharged and will survive the bankruptcy case; that is, a section 523(a) claim may be enforced and ultimately satisfied even after the bankruptcy case. Thus, although the debtor receives a general discharge, the section 523(a) claims live on.

Section 523 of the Bankruptcy Code generally specifies which debts of an *individual debtor* are not discharged in a bankruptcy case under section 727 of chapter 7, section 1141 of chapter 11, or section 1328(a) and (b) of chapter 13 (the "super-discharge" and the "hardship" discharge). Included among these debts are certain taxes which are identified as nondischargeable.[1] One category of nondischargeable tax claims is set forth in Bankruptcy Code section 523(a)(1)(B)(ii) and is often referred to as the two-year rule. It is this rule that is the subject of this article.

[1] In *In re Olsen*, 123 B.R. 312 (Bankr. N.D. Ill. 1991), the bankruptcy court held that a nondischargeable tax claim survives bankruptcy regardless of whether such claim was filed or allowed in the bankruptcy case.

Initially, some procedural background is in order. An action to except a debt from discharge under section 523 is an adversary proceeding under Part VII of the Bankruptcy Rules. It is commenced by the service of a summons and complaint in accordance with Bankr. R. 4. The Federal Rules of Civil Procedure ("FRCivP") generally apply to adversary proceedings through Part VII of the Bankruptcy Rules, although several Bankruptcy Rules have non-FRCivP provisions.

The burden of proof to assert that the debt is nondischargeable under section 523(a) falls squarely on the shoulders of the creditor asserting the exception and not necessarily the plaintiff for reasons soon to become apparent. Unlike many grounds for an exception to discharge that must be brought by the applicable bar date in a bankruptcy case, tax claims that may survive the discharge can be asserted against the individual debtor *in personam* well after the bar date has run or even past the closing of the bankruptcy case. Thus, it may be beneficial for the debtor to commence an adversary proceeding against the relevant taxing authority for a determination of whether the tax claim is dischargeable while the bankruptcy case is pending. If that be the case, the taxing authority still has the burden to prove that the tax claim is nondischargeable. Although there is some authority to allow re-opening of a bankruptcy case that has been closed under section 350, this is simply too thin a reed to rest such an important determination. Thus, a bankruptcy practitioner should carefully consider the tactical and strategic advantageous to the commencement of an adversary proceeding where the taxing authority has failed to do so.

Now back to the subject matter at hand. Imagine your client has filed no return or has filed a return late. What is the proper course of action? Obviously, tax compliance is always a good thing. Very bad things can happen to your client if they fail, and continue to fail, to file returns. Very, very bad things. A debtor that fails to file a return will find that any taxes, interest, and penalties associated with that return year are nondischargeable. Of course, there are also certain criminal and civil penalties that may also apply to a taxpayer that willfully fails to file a return.

Generally, in representing debtors with tax problems, a bankruptcy tax professional is interested in determining how the debtor got in the mess in the first place and whether there is a game plan in place to fix the present problem and avoid future problems from recurring. Here, some of the best in our field have taught me

that patience is worth its weight in gold. We know that not all problems can be fixed by bankruptcy. We should also remind ourselves that not all bankruptcies need to be filed today. If you can (and you often can), let income taxes age before you file a bankruptcy petition.

As mentioned, any tax liabilities relating to a tax return that was not filed are nondischargeable.[2] There have been several cases that have struggled with what constitutes a "return" for these purposes. BAPCPA has now defined a return by reference to applicable nonbankruptcy law. Thus, for federal income tax purposes, a return includes a §6020(a) return where a taxpayer signs it, a written stipulation to a judgment, and a final order by a court of competent jurisdiction. If a return is filed but filed late, then the return must age two years from the filing date, that is, from the delivery date and not the mailing date.

Occasionally, the question arises whether a SFR or Substitute for Return prepared by the IRS under §6020(b) constitutes a return for bankruptcy purposes. The general rule is that an SFR under §6020(b), any return where the *jurat* has been altered or the return is unsigned, or any return filed in the wrong place do not constitute a return for these purposes. But again, a little more context may be helpful. Our tax system is a voluntary assessment process. A taxpayer files a return and self-assesses the tax. Overwhelmingly, the IRS agrees with the self-assessment and life goes on. However, there are times where the IRS disagrees and the tax dispute process begins.

Here is the problem behind the problem. If the taxpayer doesn't file a return, there is no self-assessment, and the IRS may not be aware of the taxpayer, the income, the tax, or any assessment. The IRS may not be able to collect the tax. Thus, Congress provided the IRS the authority to prepare and file the SFR, usually drawing from third-party sources, including 1099s and W-2s. SFRs typically overstate income and taxes because they usually do not include otherwise appropriate filing status, exemptions, credits, deductions, etc. Here, again, my teachers were insistent that things often do not appear as they seem. In advising clients, we usually consult an Account Transcript. Just because the Account Transcript states that there has been an SFR assessment does not mean that the taxes related to that tax year are nondischargeable. If an actual return was filed and accepted before the SFR assessment was made, then the taxes related to that tax year should be dischargeable.

One of the more pressing issues is whether a taxpayer may file a return after the IRS has prepared an SFR and meet the return requirements for purposes of dischargeability under the non-filer or two-year rule. Four circuits have concluded no, but it appears that only the Sixth Circuit has embraced a per se rule.[3] The Fourth, Ninth, and Tenth Circuits have embraced a rule that presumptively concludes the taxpayer can never purge a prior SFR, the ultimate conclusion appears to rest on a determination of whether the debtor made an honest and reasonable attempt to satisfy the law and whether the return actually filed constitutes a return for income tax purpose.[4]

In a recent bankruptcy court case, new life was breathed into post-assessment returns filed by a debtor purging a prior SFR for discharge purposes. In *In re Martin*,[5] the bankruptcy court held that a return filed by a debtor after the IRS had filed a SFR may constitute a return for purposes of the two-year rule. The court embraced a plain meaning approach to section 523(a)(1)(b). An approach that would not allow a later filed return to trigger the two-year rule for late filed returns would be nonsensical, even if the return was filed after an SFR had been prepared and filed by the IRS.

Martin and cases like it are presenting some hope for late filers who are confronting an SFR. Whether a client can seek a robust discharge of tax liabilities associated with a year in which a return was not filed will require a late-filed return and appropriate aging under the two year rule. If before the late-filed return is filed the IRS prepares and files an SFR, then the world becomes increasingly complicated for our client. One circuit has concluded that a taxpayer can never purge an SFR taint. Other circuits have eschewed the per se rule, embracing an ad hoc approach. A more recent line of cases employs a plain meaning approach, weighing in on the side of a robust discharge. Time – or the Supreme Court – will ultimately tell how indulgent the Bankruptcy Code is with late filers.

***Professor Jack F. Williams, PhD, JD, CIRA, CDBV**, is Senior Managing Director with Mesirow Financial Consulting, LLC, and Professor of Law at Georgia State University College of Law/Middle East Institute in Atlanta, Georgia, where he teaches and conducts research in a number of areas, including Bankruptcy, Business and Commercial Law, Finance and Capital Markets, Tax, and Archaeology (Ancient Exchanges, Markets, and Commerce).*

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[2] *See, e.g., In re Bergstrom*, 949 F.2nd 341 (10th Cir. 1991), where the United States Court of Appeals for the Tenth Circuit held that the term "filed return" was not broad enough to include a substitute return prepared by the IRS, absent the debtor's signature thereon; *In re Pruitt*, 107 B.R. 764 (Bankr. D. Wyo. 1989), where the bankruptcy court held that substitute tax returns filed by the Internal Revenue Service when the debtor failed to file such returns for several years did not preclude application of the Bankruptcy Code rendering tax debts nondischargeable for any tax debt with respect to which a return was required and not filed; *In re Brookman*, 114 B.R. 769 (Bankr. M.D. Fla. 1990), where the bankruptcy court held that the debt for unpaid income taxes was nondischargeable because the debtor failed to rebut prima facie evidence that the tax return for the applicable tax year was not filed; *In re Crawford*, 115 B.R. 381 (Bankr. N.D. Ga. 1990), where the bankruptcy court held that a tax obligation for which the debtor did not file a tax return is non-dischargeable even though the Internal Revenue Service filed the return on the debtor's behalf.

[3] *See, e.g., In re Hindenlang,* 164 F.3d 1029 (6th Cir. 1999).

[4] *In re Moroney,* 352 F.3d 902 (4th Cir. 2003); *In re Nunez*, 232 B.R. 778 (BAP 9th Cir. 1999); *In re Savage*, 218 B.R. 126 (BAP 10th Cir. 1998).

[5] 2012-2 USTC Para. 50,674 (Bankr. D. Colo. 2012).

Ensuring Municipal Debtors Meet the Good Faith Prepetition Negotiation Requirement

Robert Cairns

Municipal bankruptcy, while still rare, has increased in the last decade as a result of failed labor contracts, declining urban population, and the recent economic downturn. A municipality is not eligible for relief under the Bankruptcy Code unless it has negotiated in good faith with its creditors and has failed to obtain, with respect to a plan of adjustment of its debts, the agreement of creditors. Section 109(c)(5) of the Bankruptcy Code provides a municipal debtor four different ways to negotiate, or attempt to negotiate, with its creditors before filing for bankruptcy.

How a municipality conducts a good faith negotiation is less than clear. Compared to corporate and personal bankruptcies, there are few municipal bankruptcies and even fewer cases that address the issue of good faith prepetition negotiation. This article will examine the good faith negotiation requirement, including the essential elements of the plan of adjustment, the negotiations themselves, and what actions do and do not constitute good faith negotiations.

The original municipal bankruptcy law, passed in 1934, required the municipality to create a plan that had the support of a majority of its creditors before filing for bankruptcy. Public Law 94 260, passed in 1976, gave municipalities the option of filing for bankruptcy without the consent of creditors if the municipality had first negotiated in good faith. The requirement to negotiate in good faith was meant as a creditor protection measure to address the fear among municipal bond holders that by completely removing the original prepetition negotiation requirement there would be a surge in municipal bankruptcies. 2 *Collier on Bankruptcy*, P 109.34(3)(e).

The Bankruptcy Code gives little guidance on what a good faith negotiation is. Section 109(c)(5) reads in relevant part, "[A municipality may be a debtor only if the municipality] has negotiated in good faith with creditors and has failed to obtain the agreement of creditors...". Nowhere in the Code is "good faith" defined. The courts were left with little guidance from Congress on how to interpret the meaning of good faith.

It is fitting that the first issue addressed here is what a chapter 9 plan looks like and what kinds of issues are open for negotiation. The prepetition negotiations generally must be about the plan and the treatment of creditors under such a plan. The Ninth Circuit Court of Appeals gently points out that in order for a debtor to negotiate a plan in good faith with its creditors, such a plan must actually exist. *In re City of Vallejo*, 408 B.R 280, 297 (B.A.P. 9th Cir. 2009). The plan does not need to be a complete plan, but it must at a minimum outline the classes of creditors and their treatment. Negotiations may be informal, and may be over a mere outline of the plan, so long as the classes of creditors and their treatment is discussed. *Id.* at 297.

A complete plan of adjustment is not required to show good faith negotiation; the possible terms of a plan will suffice. In a case involving the bankruptcy of a public corporation created to facilitate gambling on horse races, the petitioner engaged in negotiations with both creditors and major stakeholders. While these discussions were primarily focused on restructuring the public corporation and avoiding bankruptcy, a possible plan of adjustment was often mentioned. These meetings went on for over 6 months and involved banks, unions, and other creditors. *New York City Off-Track Betting Corp.*, 427 B.R. 256, 275 (S.D.N.Y. 2010). The court characterized the negotiations over the plan of adjustment as "informal," but held that the negotiations were sufficient to satisfy the requirement to negotiate in good faith. Id. at 275. While the plan was not a complete plan, the court found that "There simply is no requirement . . . for a debtor to have solved the riddles of its business woes prior to filing for bankruptcy protection." The essential element of a plan of adjustment—the classes of creditors and their treatment under the proposed plan—was present in the plan and the issue negotiated in good faith. *Id.* at 274-275.

Municipal bankruptcy is controlled by both state and federal law. 11 U.S.C. § 109(c)(2) requires a municipality to first acquire the approval of the state before it can file for bankruptcy. The state can authorize, deny, or require the municipality to meet certain conditions before a municipality can file for bankruptcy. Furthermore, the changes to a municipal government contained in a chapter 9 proposed plan may require voter or legislative approval under applicable state or local law. In recognition of the role the state and voters play in municipal bankruptcy, courts have allowed proposed plans to be contingent on support from the voters or the state government.

The reorganization plan of a municipality may be dependent upon future legislative action by the state government. The petitioner need not present a completed plan of adjustment at the time of filing. In the case of *New York Off-Track Betting Corp.* the debtor was a public corporation whose plan of adjustment required the New York State Legislature to approve a new bond issue and modify the statutory scheme under which the public corporation operated. The court held that a plan that was contingent upon the approval of the state legislature was still a valid plan for the purposes of section 109(c)(5). *Id.* at 281; *see also In re Valley Health System*, 383 B.R. 156, 164 (C.D. Cal. 2008) (court found no bad faith when some elements of debtor's prepetition plan of adjustment would have required voter approval).

Municipal bankruptcy is rarely something that appears overnight; there are often months or even years of warning before a municipality turns to bankruptcy relief. In an attempt to prevent bankruptcy, many municipalities negotiate with creditors, labor unions, and other stakeholders before filing a bankruptcy petition. These negotiations, however, may not constitute good faith negotiations for the purpose of section 109(c)(5) unless the negotiations outline the classes of creditors and their treatment under a chapter 9 plan.

Extensive prepetition negotiations aimed at lowering expenses in order to avoid bankruptcy, but without a plan of adjustment, are not negotiations for the purpose of section 109(c)(5). In *City of*

Continues on p. 18

QUARTERLY REPORT OF BUSINESS BANKRUPTCY FILINGS FOR PERIOD ENDING SEPTEMBER 30, 2013

BankruptcyData.com, a division of New Generation Research, Inc. and leading provider of information on companies in bankruptcy, is pleased to provide you with our Quarterly Report of Business Bankruptcy Filings for period ending September 30, 2013.

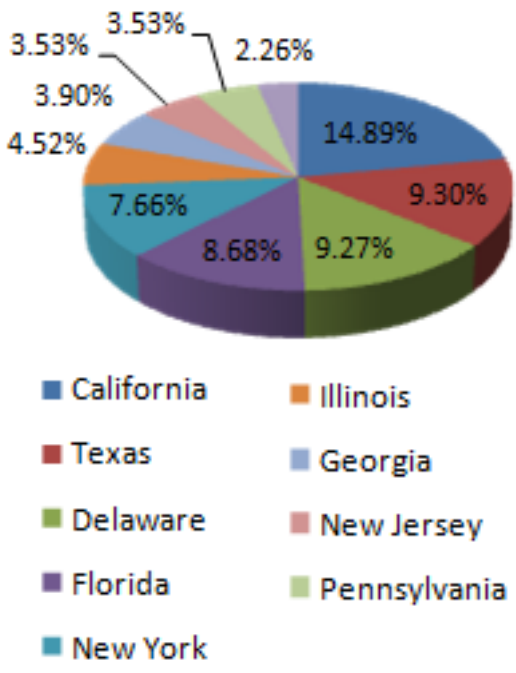
Each quarter we produce a Business Bankruptcy Overview Report to provide insight into the most recent activity in the business bankruptcy sector.

Q3 2013 BUSINESS BANKRUPTCY SUMMARY

The number of businesses filing for bankruptcy in the third quarter 2013 jumped 32% compared to the previous quarter with 47 states and territories seeing an increase in business bankruptcy activity. Additionally, these Q3 2013 numbers are up 26% compared to the same quarter in 2012. Despite these quarter-to-quarter increases, the number of business bankruptcy filings YTD through September 30, 2013 is still down 9% compared to the same period in 2012. The year-to-year decline in bankruptcy volume, which started in 2009, has been attributed to sustained low interest rates, tighter lending standards and belt-tightening by business owners.

BUSINESS BANKRUPTCIES BY STATE

Q3 2013



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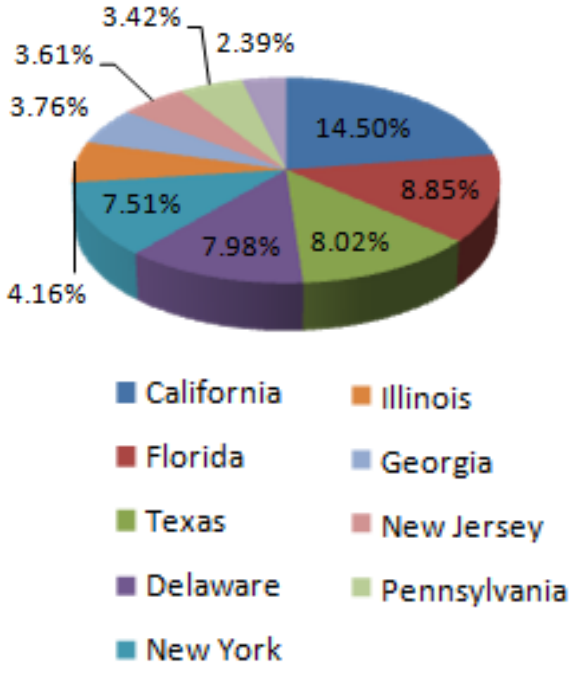

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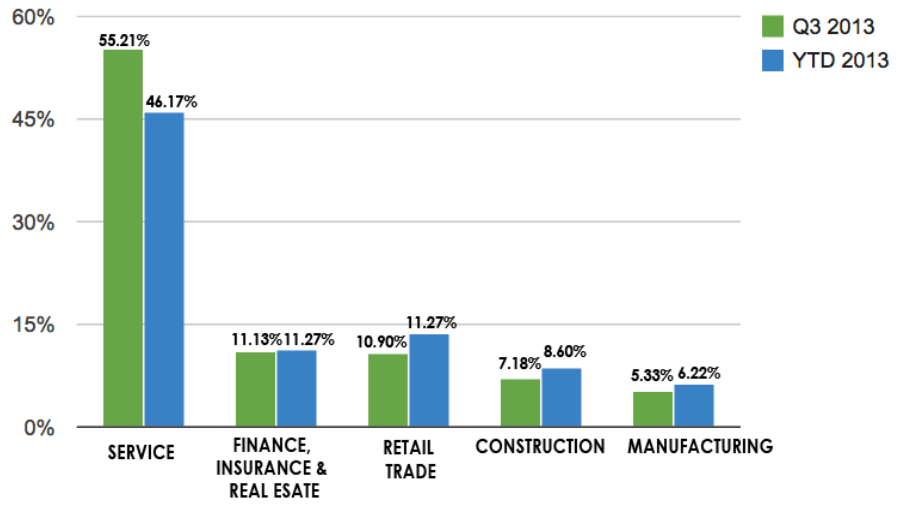
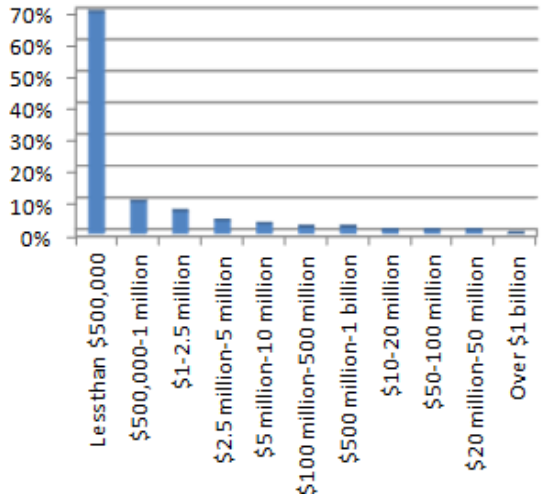
BUSINESS BANKRUPTCIES BY INDUSTRY



BUSINESS BANKRUPTCIES BY SALES VOLUME

Q3 2013



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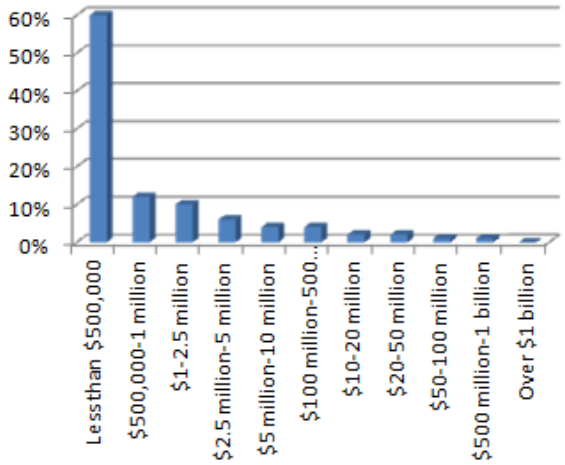
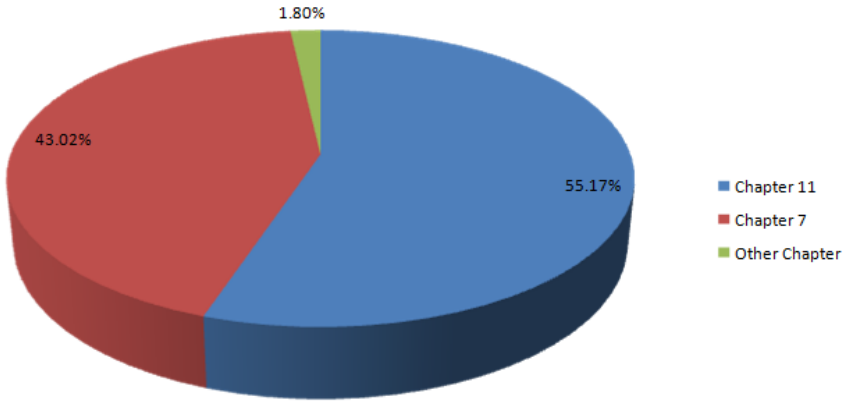


BUSINESS BANKRUPTCY FILINGS CHAPTER 11s VS CHAPTER 7s



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Dionne Warwick Chapter 7 Highlights Hazards of The Music Industry

Forrest Lewis, CPA

Legendary singer Dionne Warwick's continuing financial troubles provide a window into the turbulent world of the music recording industry. Warwick filed a petition in Chapter 7 on March 21, 2013. *In re Warwick*, Bankr. D. N.J., No. 13-15875 (MS).

Warwick's Career

Born Marie Dionne Warwick in 1940 in East Orange, New Jersey, Ms. Warwick grew up in a family of RCA recording artists that performed in a renowned gospel group and made frequent appearances throughout the New York metropolitan area.[1] Her first televised performances were in the mid-to-late 1950s with the family group on local television stations. After earning a Master's Degree in music, she was discovered by composer Burt Bacharach while she was performing as a backup singer with the highly successful group, the Drifters. Working in collaboration with Bacharach and his partner Hal David, she recorded her first successful single, *"Don't Make Me Over,"* in 1962. Other smash hits turned out by these three artists in the 1960s were: *"Do You Know the Way to San Jose," "Walk on By," "Alfie," "Wishin' and Hopin' "* and *"Anyone Who Had a Heart."*

Though they were contractually bound to provide music for Warwick, Bacharach and David had a falling out in 1972 which led to their default on their obligations to Warwick and Warner Records. Warwick sued the two writers, reaching an out of court settlement for $5 million and the rights to all her recordings produced by them. In the 1970s and 1980s Warwick enjoyed modest success working with various producers and artists including Barry Manilow, Johnny Mathis, Luther Vandross and Barry Gibb of the Bee Gees. Probably her most memorable song from this period is *"I'll Never Love This Way Again."* Warwick ranks among the 40 biggest hit makers of the entire rock era (1955–2012), based on the Billboard Hot 100 Pop Singles Charts. She is second only to Aretha Franklin as the most-charted female vocalist of all time with 56 of Dionne's singles making the Billboard Hot 100 between 1962 and 1998.[2] Her total world-wide sales are estimated to exceed 100 million copies.[3] All of which begs the question, how could she end up so broke?

Music Recording Industry Finances

Financial arrangements in the recording business are very complex. Indeed, there are a lot of fingers in the pot. The big picture is that songwriters and publishers make most of their money from recordings but historically most singers made the bulk of their revenue from touring, i.e. live performances. The initial copyright laws were created solely to protect the songwriters, music publishers and record labels with statutory copyright royalties known as "mechanical royalties," publishing rights and performing rights fees. The singers and band members received none of those royalties from recordings made, having to rely solely on royalties from the record company agreed to when they signed with that label. Those royalties generally ranged from 10% to 25% of the records, tapes or compact discs sold. Unproven performers were usually at the lower end of that range—10% to 15%. An established artist was paid an "advance" against those royalties, but there were so many production and overhead costs that could be charged against the royalties under the typical contract that often nothing was payable under the percentage phase of the contract. The performer usually received nothing beyond the advance, if they were lucky enough to receive one.[4] Studio musicians and backup singers are usually paid on a fee for service basis and get no royalties whatever. In addition, the performing artists are exposed to a certain amount of credit risk of financial default by the record company.

Singer Martha Reeves of the Vandellas lamented that under the long standing royalty system she never received a penny for all the times their hits such as *"Dancing in the Streets"* and *"Heat Wave"* have played on AM or FM radio.[5] Even successful artists like Warwick often compound their financial problems by selling their future royalties to third parties in order to get a quick infusion of cash. The upshot is that while Warwick may have made a lot of money touring, her royalty income is probably a lot less than you would think.

The situation for the performing artist has improved a little with legislation in 1998 which requires payment to the artist for internet and satellite distribution of music, known as the Digital Millennium Copyright Act. However, the music industry as a whole is in a period of great transition with the highly profitable sales of tangible recordings—records and CDs being replaced by less profitable internet and satellite distribution. The Act provided that 45% of a new type of royalties required to be paid under the formula in the Act by internet and satellite music sites must go to the recording artist. So far, the amounts paid have turned out to be quite small based on the all the complaints posted on the internet by artists. In fairness, those artists should recognize that much of the web-delivered music is free, that's why sites like YouTube and Pandora are so popular. Those sites are making the royalty payments mandated by the Act out of the associated advertising income they are generating. (The future of the recording industry is quite uncertain as modern technology has drastically reduced recording costs and the internet has greatly reduced distribution costs, which are thought to open up many new channels for recording and distribution. It will be interesting to see where it goes.)

Warwick's Financial History

Warwick's current representatives have attributed most of her financial problems to negligent financial management by a business manager who has since been fired.[6] According to the Ch.

[1] She is a cousin of the late Whitney Houston per an item in the London Telegraph, 3/20/13.

[2] http://en.wikipedia.org/wiki/Dionne_Warwick

[3] London Telegraph, 3/20/13.

[4] Rockonomics: The Economics of Popular Music, by Marie Connolly and Alan Krueger of Princeton University, ch. 1 & 2.

[5] http://thegrio.com/2013/06/25/martha-reeves-artists-seek-just-compensation-from-radio-pandora/#

[6] Huffington Post.com. Posted: 03/26/2013; updated: 07/22/2013.

7 petition, Warwick's total assets are $25,500 consisting primarily of furniture and clothing and her debts are $10.7 million. Of the $10.7 million in debts listed, $6,955,000 is owed to the Internal Revenue Service and $3,246,000 to the California Franchise Tax Board. She lists monthly income as: $14,000 Screen Actors Guild pension, $2,200 in Social Security, $1,000 as royalties and $5,000 as an employee of Star Girl Productions, Inc., which has an address in Los Angeles. Total monthly income is shown as $20,950 and monthly expenses as $20,940, leaving a net $10 cash monthly income.

Star Girl and KMBA Productions

The petition lists as an executory contract an employment contract with Star Girl Productions, Inc. with a Los Angeles address. The petition shows "business income" in 2012 of $78,000 from a "KMBA Productions" but nothing from Star Girl. For 2011, it shows $122,370 from Star Girl Productions, Inc. but nothing from KMBA. No stock or other ownership interest is listed for Star Girl or KMBA in Warwick's petition and no further public information about them is available. It is interesting that the IRS filed assessments against Star Girl and KMBA as her "alter ego"—meaning those entities may hold assets which are actually controlled by her or due to her.[7] It may be that Warwick was assigning her royalties and her personal appearance fees to Star Girl for some time. A purported "personal appearance rider for Dionne Warwick" appearing on the internet says that "all payments to artist shall be made out to Star Girl Productions, Inc." (FSO Dionne Warwick)…and giving a corporate federal tax identification number.[8]

Apparently there was a bit of a "race to the courthouse" involved. While the IRS had already filed the lien notices about March 11, 2013 in three states—New Jersey, Florida and California, the notices contained a typographical error as to the 1998 liability listing it as $151,517 instead of the correct amount of $1,515,217. On the same day that Warwick's Ch. 7 petition was filed, March 21, 2013, the IRS was busy filing a correction to the 1998 lien notices. As part of an IRS motion before the bankruptcy court to lift the automatic stay and let the IRS proceed to collect on their assessments, the IRS had to argue that its filing of the correction a few hours after the petition was filed is effective.[9] No ruling by the court had been made as of the writing of this article.

The Tax Assessments

The assessments, which are presumably for individual income taxes, cover the periods 1991- 1995, 1997-1999 and 2007. The California assessments are for roughly the same period and are described as "franchise tax-business." Apparently an offer in compromise of some amount was made by Warwick's representatives but it was turned down by IRS.[10] Warwick's attorney Daniel Stolz said in an interview that the federal tax balance resulted from IRS crediting past payments made against interest and penalties and not against tax principal. That is a common IRS collections practice. He also pointed out that the tax amounts were well beyond the three year limit and therefore dischargeable in bankruptcy.[11]

Commentary

Like professional athletes, performing artists sometimes fail financially through poor investments, poor financial management and/or extravagant living. Recording artists are subject to a credit risk for collection of royalties due to default by record companies which professional athletes rarely face. Almost uniformly, any professional athlete holding a guaranteed contract has no collection risk. Historically the financial cards were stacked against the performing artist in the recording industry. With the rapid changes in technology, the future of the music industry itself is very cloudy at this time.

Thanks to Prof. Eric Honour, Young Park, Grant Newton and Dennis Bean for their assistance with this article.

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7 IRS motion to lift the automatic stay, filed May 23, 2013, document 6

8 http://www.docstoc.com/docs/19710321/DIONNE-WARWICK-PERSONAL-APPEARANCE-RIDER

9 IRS motion to lift the automatic stay, filed May 23, 2013, document 6

10 London Telegraph, 3-20-13

11 Huffington Post.com Posted: 03/26/2013| Updated: 07/22/2013

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8:45 - 9:00 am	**Introduction and Opening Remarks**
9:00 - 10:15 am	**"2013 - A Year in Review from the Persepctives of Judges and Attorneys"** The presentation will cover the leading decisions and case law issued over the past year from the 2nd and 3rd Circuits.
10:15 - 10:30 am	**Break**
10:30 - 11:30am	**"Indenture Trustees / Bond Holders"**—An examination of how Indenture Trustees / Bond Holders impact plan development and confirmation.
11:30 - 12:45 pm	**Lunch Program: "Is Too Big to Fail Over?" presented by Prof. David A. Skeel Jr., Caryl Louise Boies Visiting Professor of Law, NYU School of Law, and S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania School of Law**
12:45 - 1:45 pm	**"Cram Down"**—Cramdown issues will be discussed by the panel with particular focus on recent case law developments and analysis of hypothetical cramdown scenarios.
1:45 - 2:45 pm	**"Plan Support Agreements"** —This session will focus on the Inn Keepers and Indianapolis Downs cases along with PSAs in general and their function in today's restructuring environment.
2:45 - 3:00 pm	**Break**
3:00 - 4:00 pm	**"The New AIRA Standards for Distressed Business Valuation: What Valuation Analysts Need to Know"**— AIRA's new valuation standards: To whom and to what types of work they apply; relationship of AIRA's standards to other business valuation standards; how the new standards may affect the way valuations are performed in bankruptcy contexts; how recent court opinions, including Daubert challenges, may be impacted; and why the standards offer a model for best practices that should be followed even if they are not directly binding.
4:00 - 5:00 pm	**"Independent Directors"**—A trend has developed toward independent directors who serve the best interests of the company as a whole, not merely the creditors individually. This type of board ultimately plays a critical part in maximizing stakeholder value. The panelists will discuss how to put such boards in place and the issues related to their recruitment.
5:00 - 7:00 pm	**2013 AIRA Judicial Service Award & Reception recognizing The Honorable Mark E. Gerber Judge, U.S. Bankruptcy Court, Southern District of New York**

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Bankruptcy *continued from p. 1*

guarantee or otherwise assure the solvency or capital levels of a subsidiary bank.

Written Agreements

Written agreements between regulators and holding companies often provide that the holding company "shall take appropriate steps" to fully use the holding company's financial and managerial resources as a "source of strength" to the subsidiary bank. These written agreements usually require the holding company to submit a written capital plan to the regulators to ensure that the holding company and the bank, on a consolidated basis, maintain sufficient capital. In most cases nothing in these written agreements provides that, under the capital plan submitted, the holding company is *required* to maintain the capital of the bank. Moreover, and importantly, usually nothing in these written agreements imposes upon the holding company any obligation to guarantee or otherwise assure the solvency or capital level of the bank.

Capital Directives and Plans

In a troubled bank situation, regulators often require banks to agree to capital directives which require the bank to achieve and maintain capital equal to certain thresholds. Banks then develop capital plans that detail how the holding company and the bank will achieve and maintain the directed capital levels. The capital plans could include, among other things (1) retaining investment bankers, (2) embarking upon a capital raise, (3) engaging in recapitalization and restructuring opportunities, (4) utilizing branch sales, and (5) entering into a bank merger or sale. Importantly, nothing in these capital directives or related plans imposes upon the holding company any obligation to guarantee or otherwise assure the solvency or capital level of the bank. Indeed, the holding company is almost never a party to these capital directives and plans.

Legal Authority

In some limited cases holding companies have been found to have entered into binding, unambiguous capital commitments. For example, in *Resolution Trust Corp. v. FirstCorp, Inc. (In re FirstCorp)*,[6] the holding company entered into an agreement that provided "the regulatory net worth of [the bank] shall be maintained at the greater of (1) three percent of total liabilities …, or (2) a level consistent with that required by [specific regulation] … and where necessary, to infuse sufficient additional equity capital … to effect compliance with such requirement."[7] In *Franklin Sav. Corp. v. Office of Thrift Supervision*,[8] the holding company agreement stated that the holding company "will cause the net worth of [the bank] to be maintained at a level consistent with that required of institutions insured twenty years or longer by [specific regulation] …, infusing sufficient additional equity capital to affect [sic] compliance with such requirement whenever necessary."[9] In *Office of Thrift Supervision v. Overland Park Fin. Corp. (In re Overland Park Fin. Corp.)*,[10] the holding company stipulated that "it will cause the net worth of [the bank] to be maintained at a level consistent with [specific regulation], and where necessary, that it will infuse sufficient additional equity capital to effect compliance with such requirement."[11] Finally, in *Wolkowitz v. Fed. Deposit Ins. Corp. (In re Imperial Credit Indus.)*,[12] the holding company committed itself to "absolutely, unconditionally and irrevocably guarantee[] the performance of [subsidiary] under the terms of the Capital Plan and … pay the sum demanded to [subsidiary] or as directed by the [FDIC] in immediately available funds."[13]

Conversely and more commonly, as noted above, the language from alleged capital maintenance commitments only require the bank to maintain certain total risk-based capital ratios and require the holding company and the bank to submit a plan to achieve these ends. Indeed, the alleged capital maintenance commitments often fail to impose on the holding company any obligation to guarantee or otherwise assure the solvency or capital level of the bank, nor do they require the holding company to "infuse" capital into the bank. In the absence of such precise language, a regulatory agency's bankruptcy claim against the holding company should fail.

For example, in two recent cases a capital maintenance commitment was found not to exist. In the first case, *In re Colonial BancGroup, Inc.*,[14] the bankruptcy court examined whether a capital maintenance commitment within the meaning of section 365(o) of the Bankruptcy Code had been made. In the course of deciding the issue the bankruptcy court analyzed (i) an agreement between the debtor bank holding company and the Federal Reserve Bank of Atlanta, (ii) a memorandum of understanding between the debtor and the Alabama Banking Department and the Federal Reserve Bank of Atlanta, and (iii) a cease and desist order against the debtor.[15] After reviewing these documents, the court found that "the Debtor [holding company] and the Federal Reserve did not intend to create a commitment in the Debtor to maintain the capital of Colonial Bank within the meaning of 11 U.S.C. § 365(o)" inasmuch as the language of such documents did not expressly provide for a capital maintenance commitment.[16]

Similarly, in the second case, the United States District Court for the Northern District of Ohio found that a bank holding company did not provide a capital maintenance commitment within the meaning of section 365(o) of the Bankruptcy Code. In *Fed. Deposit Ins. Co. v. AmFin Fin. Corp. (In re AmTrust Fin. Corp.)*,[17] the FDIC as receiver for a failed bank argued that the holding company had made a commitment to maintain the capital of the bank by virtue of, among other things, two cease and desist orders, a capital management policy and a three-year strategic business plan. Notably, based on the testimony at trial, language of the capital management policy and the three year strategic business plan, the court held that "[t]he [capital management policy] and the three-year strategic business plan were not, and did not contain, a commitment by [AmFin] to maintain the capital of the

6 973 F.2d 243 (4th Cir. 1992).
7 *Id.* at 244.
8 303 B.R. 488 (D. Kan. 2004).
9 *Id.* at 491.
10 236 F.3d 1246 (10th Cir. 2001).
11 *Id.* at 1249.
12 527 F.3d 959 (9th Cir. 2008)
13 *Id.* at 965.
14 436 B.R. 713 (Bankr. M.D. Ala. 2010).
15 *Id.* at 730.
16 *Id.* at 733.
17 Case No. 1:10-CV-1298, 2011 WL 2200387 (N.D. Ohio June 6, 2011).

Bank. Rather, they contained a plan, projection, or description of a preferred course of action."[18]

Accordingly, alleged capital maintenance commitments should be examined closely to determine whether they merely state aspirational goals and desired courses of action; or rather, a firm, unambiguous commitment to raise capital. Further, although written agreements by the holding company may require the holding company to serve as a "source of strength" for the Bank, the *Colonial* court concluded that "the source-of-strength doctrine [found in 12 C.F.R. § 225.4] does not require a bank holding company to make capital contributions to its subsidiaries."[19] Likewise, the AmFin district court held: "[t]here is no legal requirement, under the general banking regulations, that a holding company commit to maintain the capital of a bank; that it guarantee the performance of the bank; or, that it infuse its own capital into a failing bank, whether or not the holding company or the bank may be facing a potential bankruptcy."[20]

Directors and Officers Claims

During the Great Recession, many banks failed due in part to risky investments in subprime mortgages and related mortgage backed securities. Those risky investments raised serious questions as to whether the relevant directors and officers of the bank exercised due care with respect to the management of the bank; but they also raised questions as to whether the directors and officers of the holding company exercised due care in the management of the holding company itself. In many cases, claims against the directors and officers of the holding company for alleged breaches of fiduciary duties ("D&O claims") may be the most promising source of recovery for the creditors of the bankruptcy estate.

Standing Issue

While D&O claims can take many forms and are intensely fact-specific, a recurring threshold issue has arisen in these cases, namely whether the claims against the directors and officers belong to the holding company or whether they belong to the subsidiary bank. If the latter is true, then the FDIC as receiver for the failed bank is the only party that has standing to pursue the claims. The legal issue turns on whether the claims in question are derivative claims that relate to damages that occurred at the bank level, or direct claims that relate to damages that occurred at the holding company level.

When these claims are brought against former directors and officers, the director and officer defendants will generally argue that the plaintiff (usually the bank holding company creditors' committee or a bankruptcy or plan trustee) does not have standing to bring the claims in question. More specifically, they will argue that if the holding company's alleged damages amount to diminution in value of the holding company's interest in the subsidiary bank (due to their alleged failure to exercise due care in protecting and preserving the holding company's interest in the bank subsidiary), then the holding company's claim against its own directors and officers for such breach is merely a derivative claim, as to which the holding company has no standing to pursue.

Legal Authority in General

In general, corporate law provides that, depending on the circumstances, a claim by a shareholder against officers or directors of a corporation in which the shareholder owns stock can qualify as a direct claim or a derivative claim. Under many states' laws, a shareholder can maintain a direct claim against a third party who harmed the corporation in which she holds stock (including an officer or director of that corporation) if she also was harmed in an unique or independent way.[21] The claim in question becomes a derivative claim where every shareholder was injured in the same way (i.e., where the complained of actions or omissions resulted in damage to the corporation that affects all of the shareholders as a group). Because corporate law, as described above, accommodates the possibility that a claim by a shareholder against officers or directors of a corporation in which the shareholder holds stock can constitute a direct claim, even if the challenged conduct harmed the corporation as well, a principled basis for distinguishing claims that belong to the shareholder (direct claims) from claims that belong to the corporation (derivative claims) had to be adopted.

To resolve these conflicts the "distinct and separate injury" test emerged from various cases that addressed this issue. To determine whether a claim is direct or derivative, courts analyze whether the shareholder plaintiff has suffered an injury separate and distinct from that suffered by other shareholders. If the injury alleged in connection with a claim is diminution in value of the shareholder's stock resulting from harm suffered by the corporation, then all shareholders are harmed in the same manner, and the claim is typically classified as a derivative claim.[22]

Bank Holding Company Cases

Plaintiffs in bank holding company cases generally assert that there is no principled basis for transporting the "distinct and separate injury" test into a totally different context to deprive a corporation (that happens to be a bank holding company) of claims against its own officers for breach of their fiduciary duties owed directly to the holding company.[23] Almost invariably a holding company's principal asset is its interest in its subsidiary (or subsidiaries). Thus, application of the "distinct and separate injury" test, and its diminution in value component (which were adopted to distinguish derivative claims from direct claims of shareholders against officers of a corporation in non-bank holding company cases), to breach of fiduciary duty claims by a holding company against its own officers for failing to protect and preserve the value of the holding company's interest in its subsidiary, will render holding company officers and directors essentially unaccountable for breaching their fiduciary duties.

Further, officers of a parent corporation have no fiduciary

[18] *Id.* at *11. On appeal, the Sixth Circuit Court of Appeals recently affirmed the decision of the district court in AmFin. *See Fed. Deposit Ins. Co. v. AmFin Fin. Corp. (In re AmTrust Fin. Corp.)*, 694 F.3d 741 (6th Cir. 2012).

[19] *Colonial*, 436 B.R 730 n.15.

[20] *AmFin*, 2011 WL 2200387, at *7.

[21] *See, e.g., Pagán v. Calderón*, 448 F.3d 16, 28 (1st Cir. 2006) (noting that "[a] shareholder, for example, may be able to bring an action if he sustains an injury that is peculiar to him alone, and [that] does not fall alike upon other stockholders" (internal quotation marks omitted)).

[22] *See, e.g., Tooley v. Donaldson. Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004)

[23] *See Gen. Rubber Co. v. Benedict*, 215 N.Y. 18, 21-25, 109 N.E. 96 (1915) (Cardozo, J.).

duties to a wholly-owned subsidiary.[24] Because no correlative direct claims against the defendants for breaching their fiduciary duties to the holding company are held by any other party, the plaintiff will submit that its claims against the defendants cannot be derivative claims. Characterizing them as derivative would mean that there will be no redress against the defendants for breaching their fiduciary duties to the holding company. It seems counter-intuitive that the direct/derivative dichotomy adopted by the courts to protect a corporation's interest in claims against its fiduciaries for breach of duty is intended to produce such a result.

Relevant case law suggests that an executive officer of a holding company has a fiduciary duty to the holding company to exercise due care in protecting and preserving the holding company's interest in its subsidiary.[25] Accordingly, where the plaintiff's claims against the defendants are claims for breach of their fiduciary duties owed to the holding company and the damages suffered by the holding company as a result of the breaches, the plaintiff should be able to maintain such claims. Nonetheless some courts take the view that standing is affected by whether the directors and officers in question were also directors and officers of the failed bank.[26] Needless to say this is an area of the law that will continue to be hotly contested.

Tax Sharing Agreements

Tax refunds due from the federal and state governments, based on the often huge losses incurred by the consolidated bank group leading up to the filing, are another potential source of recovery for creditors of bankrupt bank holding companies. The IRS currently allows a parent corporation to file a consolidated federal income tax return on behalf of itself and all of its subsidiaries. As a result, the bank holding company generally files a single consolidated tax return for the consolidated subsidiary group—the bank holding company, the subsidiary bank and any other subsidiaries ("the Group"). The holding company acts as an agent for the Group and, in doing so, remits any taxes due, and receives refunds on behalf of the Group.

Federal law is silent regarding how any tax liabilities or tax refunds should be shared among the members of the Group. Rather, federal law allows the Group members to determine that allocation amongst themselves. In fact, often the Group members will execute a tax sharing or tax allocation agreement (the "Agreement") which specifies how the tax liabilities and tax refunds will be shared among Group members; but when one member of the group files for bankruptcy, that filing can upset the proverbial "apple cart." In bank holding company cases, the FDIC will generally assert claims to any tax refunds on behalf of the seized bank subsidiary. In such cases, the terms of the governing Agreement, if any, is crucial to the allocation paradigm.

Although these Agreements are generally unique, most follow a typical pattern: the Group agrees to file federal and state income tax returns on a consolidated basis and to allocate the tax obligations and savings arising therefrom. The holding company also agrees to remit all income tax payments on behalf of the Group, including the bank. In addition the Agreement requires the bank to pay the holding company an amount equal to the total amount of tax liability related to the separate taxable income of the bank. Similarly, the Agreement requires the holding company to remit tax refunds to the bank within a reasonable period following receipt of such refunds from the government.

Neither the Internal Revenue Code nor the Internal Revenue regulations address an individual Group member's entitlement to a tax refund due to the Group. Although 26 C.F.R. § 1.1502-77(a) provides that the common parent (e.g. the holding company) is the agent for each subsidiary in the Group, this agency relationship is only created for the convenience and protection of the IRS and it has no bearing on to which member or individual Group member's ownership of tax refund.[27] As a result, when members of a Group enter into an Agreement, that Agreement will govern the ownership tax refunds and the Group member's rights with respect to them.[28]

Before addressing the Group member's rights under an Agreement, it is useful to address the allocation methodology in the absence of such an Agreement. When courts address this situation, they must determine whether the parties intended a debtor-creditor relationship (where the other members of the Group have claims against the parent corporation-agent for their share of the tax refund at issue), or whether the parties intended a trust type relationship (where the parent-agent holds the Group's members' shares of the tax refund in trust, and thus the tax refund never becomes part of the parent's bankruptcy estate). In *Western Dealer Management, Inc. v. England (In re Bob Richards Chrysler-Plymouth Corp., Inc.)*,[29] the seminal case on this issue, the court held that in the absence of a written Agreement, tax refunds are held in trust for the other members of the Group. The *Bob Richards* decision expressly recognizes that its holding does not apply when an

[24] *See, e.g., MC Asset Recovery, LLC v. The Southern Co.*, No. 1:06-CV-0417-BBM, 2006 WL 5112612, at *7 (N.D. Ga. Dec. 11, 2006); *Aviall, Inc. v. Ryder Sys., Inc.*, 913 F. Supp. 826, 832 (S.D.N.Y. 1996), *aff'd*, 110 F.3d 892 (2d Cir. 1997); *Household Reins. Co., Ltd. v. Travelers Ins. Co.*, No. 91 C 1308, 1992 WL 22220, at *3 (N.D. Ill. Jan. 31, 1992) (same); *In re Hydrogen, L.L.C.*, 431 B.R. 337, 347 (Bankr. S.D.N.Y. 2010); *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988)

[25] *See Lubin v. Skow*, 382 F. App'x 866, 873 (11th Cir. 2010) (recognizing that defendants, in their capacities as holding company officers, had oversight responsibilities to the holding company with respect to its bank subsidiary); *Case Fin., Inc. v. Alden*, No. 1184-VCP, 2009 WL 2581873, at *7 (Del. Ch. Aug. 21, 2009) (holding that a holding company's breach of fiduciary duty claims against its former CEO, who was also CEO of its subsidiary, were direct claims, even though the alleged misconduct, including misappropriation of corporate opportunities, occurred at the subsidiary level). *See also Gen. Rubber Co.*, 215 N.Y. 18, 21-25; *Ochs v. Simon (In re First Cent. Fin. Corp.)*, 269 B.R. 502 (Bankr. E.D.N.Y. 2001).

[26] *See, e.g., Official Comm. of Unsecured Creditors v. FDIC (In re BankUnited Fin. Corp.)*, 442 B.R. 49 (Bankr. S.D. Fla. 2010) (holding a claim on behalf of a bankrupt holding company against its own officers to be derivative where the officers were also officers of the failed bank and the alleged injury occurred at both the holding company level and the bank level), *rev'd in part*, No. 11-20305-CIV, slip op. (S.D. Fla. Sept. 28, 2011); *Vieira v. Anderson*, No. 2:11-CV-0055-DCN, 2011 WL 3794234, at *5 (D.S.C. Aug. 25, 2011) (holding that a claim on behalf of a bankrupt holding company against its officers and directors for loss of its interest in its failed bank subsidiary was derivative where defendants were also officers and directors of the bank).

[27] *See Jump v. Manchester Life & Cas. Mgmt. Corp.*, 579 F.2d 449, 452 (8th Cir. 1978) ("[T]his agency relationship is for the convenience and protection of IRS only and does not extend further."); *Superintendent of Ins. v. First Cent. Fin. Corp. (In re First Cent. Fin. Corp.)*, 269 B.R. 481, 489 (Bankr. E.D.N.Y. 2001), aff'd, 377 F.3d 209 (2d Cir. 2004).

[28] *See First Cent. Fin. Corp.*, 269 B.R. at 490; *Franklin Sav. Corp. v. Franklin Sav. Ass'n (In re Franklin Sav. Corp.)*, 159 B.R. 9, 29 (Bankr. D. Kan. 1993), aff'd, 182 B.R. 859 (D. Kan. 1995).

[29] 473 F.2d 262, 264 (9th Cir. 1973).

Agreement exists and that, in such a case, the terms of the Agreement will determine the rights of the parties to any tax refund.[30]

When there is an Agreement, a court must review its terms to determine if the parties intended to create a debtor-creditor or trust relationship. The cases on this subject are mixed and the precise language of the Agreement is paramount.[31] For instance where an Agreement repeatedly uses the words "pay," "payment," "remit," and "credit," courts have repeatedly found that the use of these and similar terms in an Agreement evidences a debtor-creditor relationship.[32] Moreover, where a tax sharing agreement contains no provisions requiring the holding company to escrow the tax refunds or restricting its use of such funds, "courts have repeatedly found that the lack of [these] provisions … further evidences a debtor-creditor relationship."[33] In another case, the Agreement also contained additional provisions that provided the holding company was obligated to pay the bank an amount equal to the refund it would receive if it would have filed on a separate entity basis regardless of whether a refund was received. The court found that that provision further strengthened the conclusion that a debtor-creditor relationship was intended.[34]

In contrast, the FDIC has had some successes in arguing that the Agreement in question did not create a debtor-creditor relationship. For example in *Lubin v. Fed. Deposit Ins. Corp.*,[35] the Agreement in question expressly provided that holding company would act as agent for the bank with regard to tax refunds received by the holding company. As a result the court found that refund was not property of the holding company.[36]

More recently, in *In re BankUnited Fin. Corp.*,[37] the Eleventh Circuit ruled on an Agreement and held, in essence, that the tax refunds at issue belonged to the bank subsidiary and that they were not property of the holding company, notwithstanding an Agreement that appeared to create a debtor-creditor relationship. In *BankUnited*, the Agreement provided that the holding company would file the consolidated tax returns for itself and its subsidiaries, but it contained an atypical provision: the bank rather than the holding company was the party responsible for remitting all taxes and distributing all refunds to members of the Group. Further, the Agreement did not contain provisions that specified the holding company's obligation to remit to the bank any tax refunds it received.

The Eleventh Circuit held that the Agreement was "ambiguous" but nonetheless determined that the parties intended that the holding company would "forward the tax refunds to the bank on receipt," rather than "retain the tax refunds as a company asset and . . . be indebted to the bank in the amount of the refunds."[38] In short the Eleventh Circuit found that the parties clearly intended to create a trust-type relationship with regard to the tax refund (despite the fact that they found the agreement to be ambiguous). Interestingly, in contrast to the prior decisions that focused on the existence (or lack) of express language creating a trust relationship as a reason for finding a debtor-creditor relationship, the Eleventh Circuit focused on the existence (or lack) of language creating a debtor-creditor relationship as a reason for finding that trust-type relationship was intended. At this time, it is difficult to say if *BankUnited* is just an outlier or the new normal.

Conclusion

Given the limited assets available in many bank holding company cases, there will likely be continued conflict between bank holding companies and (1) the regulatory agencies regarding capital maintenance agreements, (2) their directors and officers regarding breach of fiduciary claims, and (3) the FDIC regarding tax refunds. The law on these issues will continue to develop over time. Stay tuned.

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30 *Bob Richards*, 473 F.3d at 264 *See also Capital Bancshares, Inc. v. Fed. Deposit Ins. Corp.*, 957 F.2d 203, 207 (5th Cir. 1992)

31 *See Siegel v. Fed. Deposit Ins. Corp. (In re IndyMac Bancorp, Inc.)*, No. 2:09-ap-01698, 2012 WL 1037481 (Bankr. C.D. Cal. March 29, 2012); *Zucker v. Fed. Deposit Ins. Corp. (In re NetBank, Inc.)*, 459 B.R. 801 (Bankr. M.D. Fla. 2010); *Team Fin., Inc. v. Fed. Deposit Ins. Corp. (In re Team Fin., Inc.)*, Adv. No. 09-5084, 2010 WL 1730681 (Bankr. D. Kan. Apr. 27, 2010).

32 *See, e.g., IndyMac*, 2012 WL 1037481 at *13.

33 *Id.* at *15

34 *NetBank*, 459 B.R. at 814.

35 No. 1:10-CV-00874-RWS, 2011 WL 825751 (N.D. Ga. March 2, 2011).

36 *Id.*

37 No. 12-11392, 2013 WL 4106387 (11th Cir. Aug. 15, 2013), *1, *2, *4 & n.2.

38 *Id.* at *5.

Bankruptcy Taxes

Forrest Lewis, CPA
Section Editor

COURT RULES TAX REFUND STAYS WITH BANKRUPTCY ESTATE OF CONSOLIDATED GROUP PARENT, NOT FDIC

Despite the fact that a $195 million federal tax refund resulted from a failed bank subsidiary's losses, the bank's parent was entitled to keep the refund according to a federal district court in Ohio. The primary issue is whether a consolidated group parent holds a tax refund as a trustee or as a debtor of the loss subsidiary. (LinkFederal Deposit Insurance Corporation v. AmFin Financial Corporation, N.D. Ohio, No. 1:11CV2574, 3/26/13).

AmTrust Financial Corporation, AmFin's predecessor, was the parent of a group which included a bank and several affiliates. For federal tax purposes the group filed a consolidated federal income tax return. AmFin and five subsidiaries filed for Chapter 11 bankruptcy protection in November 2009. AmTrust Bank, one of the subsidiaries, was closed weeks later, and the FDIC stepped in as receiver. The FDIC claimed the refund was the property of AmTrust Bank, saying the tax-sharing agreements that governed seven AmTrust Bank-related debtors and firms created a trust, but the court disagreed, holding the refund is the property of the holding company's bankruptcy estate, not the bank.

The tax and legal overview of inter-corporate arrangements on tax liabilities and assets is a confusing one. First, the consolidated return regulations say that the group return must be filed by the parent and that the parent is generally the "agent" for the group (1.1502-77). Then, there is a distinction between allocations of corporate earnings and profits, purely for tax purposes, under Internal Revenue Code Section 1552. That allocation does not create assets or liabilities that have legal effect. Many corporate groups do create inter-corporate tax sharing agreements which can create valid assets and liabilities (see article in this column in AIRA Journal Vol. 22, number 3, Aug.-Sept., 2008). While there is no blanket rule in the Internal Revenue Code requiring tax sharing agreements, they are typically required by regulators for banks, insurance companies, etc.

The AmFin group had a pretty common version of a tax sharing agreement which started with the separate tax liability of a profitable member or tax "asset" from losses of a subsidiary. The agreement provided that profitable group members could use the deductions of loss members to reduce group consolidated tax but in such a case, the loss member is to be "reimbursed." When the parent AmFin received a $195 million tax refund for consolidated group losses, the FDIC sought turn-over of the refund for its administration of the AmTrust Bank liquidation. Though the FDIC made several arguments that AmFin received the refund in a fiduciary capacity, the Court cited cases involving four different bank holding company groups which held that such a tax sharing agreement created debtor/creditor relationship. Therefore, all the FDIC had as administrator of the AmTrust Bank liquidation was an unsecured claim in the parent AmFin Chapter 11 case.

Commentary

The facts in the ruling actually have a fairly limited scope. In this case the refund would either stay with the bankruptcy estate of the parent or go to the FDIC. If the parent had not been in bankruptcy, the FDIC would have succeeded in collecting from the parent under the tax sharing agreement. From a broader perspective, the decision the Court reached is consistent with the majority line of cases on this point. It also continues the unusual notion that if there had been no formal tax sharing agreement, the parent indeed would have received the refund as a fiduciary for

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Am Trust Bank and the FDIC would have recovered the refund. Thus, under the current state of the judicially created law, where there is a tax sharing agreement, it will generally be respected as creating intercompany assets and liabilities, but where there is no agreement courts may find the parent receives the refund as a trustee for the subsidiaries which incurred the tax losses.

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

IRS SIMPLIFIES PROCEDURES FOR LATE S-CORP RELATED ELECTIONS

In order to be a "pass-through" corporation whose tax is paid by the shareholders, not the corporation, an election is required under SubChapter S of the Internal Revenue Code, thus the term "S corp election." The election is required to be filed with the Internal Revenue Service on Form 2553 within two months and 15 days of the beginning of the tax year. Because there were so many administrative problems with failures to timely file the S election and disputes about whether the Internal Revenue Service had lost filed elections, in 1997 IRS began to create automatic procedures to allow late elections. Recently, IRS updated the guidance on obtaining a late S election in Revenue Procedure 2013-30, generally effective August 3, 2013. This guidance is another step in the IRS move to more "automatic" elections and to reduce the number of election requests which actually require IRS consideration and a detailed ruling response. If a late election qualifies under this guidance, no user fee is required.

This latest guidance supersedes all previous guidance on the late S election and sweeps into it late or missed elections for a number of other S corp-related elections. In order to understand the following list, bear in mind that only the following are eligible shareholders for an S corporation: individuals, certain decedent's estates, certain trusts and certain exempt organizations. (A C (regular) corporation cannot own an S corp, but an S corp can own a C corp.) These are the other late S-related elections covered by the new guidance:

- Qualified Subchapter S Trust (QSST) elections—a QSST is one of the types of trusts which may own S corporation stock and is used primarily for estate planning purposes.
- Electing Small Business Trust (ESBT) elections—an ESBT is another type of trust which may own S corporation stock but the beneficiaries of the trust must be basically the same list of eligible S corp shareholders above.
- Qualified Subchapter S Subsidiary (QSub) elections—when a C corp which owns a subsidiary is converted to an S, an election is available to treat the former subsidiary as liquidated taxfree into the new S corp and operates thereafter as a disregarded entity for tax purposes only.
- Late corporate classification elections—the most common example involves a Limited Liability Company which is normally treated as a partnership or disregarded entity but can elect to be treated as a corporation. One asset protection strategy involves forming a LLC and then electing status as an S corporation. It is thought that any creditor of the shareholder who comes into possession of the LLC "stock" will have more limited distribution rights than they would have in a true corporation.

Qualifying for Relief

The new guidance is quite difficult to follow as it has somewhat different steps for each type of relief listed above and different due dates or windows in which the request for relief must be filed. In fact, the Rev. Proc. contains a flow chart for each type of relief needed. This article will not go into all those variations, but these are general conditions for relief applicable to all:

1. The entity intended to be classified as an S corporation, intended the trust to be an ESBT, intended the trust to be a QSST, or intended to treat a subsidiary corporation as a QSub;
2. The entity requests relief under this revenue procedure within 3 years and 75 days after the intended election date (except that in the case of corporations which simply failed to file the S election but always filed an annual return as an S corporation, the relief period can be longer);The failure to qualify as an S corporation, ESBT, QSST, or QSub as of the intended date was solely because the Election Under Subchapter S was not timely filed by the Due Date of the Election Under Subchapter S; and
3. In the case of a request for relief for a late S corporation or QSub election, the entity has reasonable cause for its failure to make the timely Election under Subchapter S and has acted diligently to correct the mistake upon its discovery. Apparently, reliance on a tax professional to file the election, even though it was ultimately missed, is reasonable cause.

Filing the Request for Relief

While the filing procedure to request relief is different for each type of relief needed, these are general common elements:

1. The entity must file the missing form, e.g. Form 2553, with IRS.
2. A series of representations must be made that the intent was to be treated as an S corp, etc. from the original date, the entity qualifies under this Rev. Proc., that there was reasonable cause for the failure to file, etc. Generally the shareholders must have included all taxable income of the S corp in their returns annually or agree to amend and do so.
3. A statement under penalty of perjury that the representations made are true and complete.

Conclusion

If for some reason an election is missed but the facts do not qualify under this guidance, a taxpayer can still apply for a private letter ruling for relief. The best advice for anyone filing an original election is still to keep a copy of what is filed and file by certified mail to avoid need for relief under this procedure.

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

***Taxes** continued from previous page*

IRS EXTENDS "SUCCESS FEE" TREATMENT TO MILESTONE PAYMENTS

To settle a previously contentious area of the tax law, in 2011 the IRS issued Revenue Procedure 2011-29 in which they said they would allow a deduction for 70% of certain "success based fees" in a business acquisition without requiring a great deal of detailed substantiation. The remaining 30% of the success fees paid must be capitalized. Now the IRS is extending the same treatment to "milestone payments" per a directive sent by IRS to its field auditors. (LB&I-04-0413-002)

To qualify a success fee payment under Rev. Proc. 2011-29 for the 70% deduction, a payor must:

1. pay or incur a success-based fee for services performed in the process of investigating or otherwise pursuing a transaction described in §1.263(a)-5(e)(3) (certain taxable acquisitions or nontaxable reorganizations);
2. treat 70 percent of the amount of the success-based fee as deductible;
3. capitalize the remaining 30 percent, and
4. attach a statement to its original federal income tax return for the taxable year the success-based fee is paid or incurred, stating that the taxpayer is electing the safe harbor, identifying the transaction, and stating the success-based fee amounts that are deducted and capitalized.

Apparently during IRS audits conducted after the issuance of the Rev. Proc., IRS Agents were still arguing about whether "milestone payments" were covered by the Rev. Proc. when they encountered them. According to the directive, "in an effort to balance current resources and workload priorities", IRS Agents were directed not to challenge deductions for milestone payments to investment bankers which meet all the following tests:

The taxpayer must

1. have qualified for and timely elected the Rev. Proc. 2011-29 safe harbor for the covered transaction;
2. not have deducted more than 70% of any eligible milestone payment incurred in connection with the respective success-based fee on its original tax return for the year in which the taxpayer's liability for the eligible milestone payment accrued; and
3. not be contesting its liability for the eligible milestone payment.

Conclusion

While the directive says it is "….not an official pronouncement of law, and cannot be used, cited, or relied on as such….", certainly if an IRS Agent challenges a deduction for a milestone payment, this directive should be brought to the Agent's attention.
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***Debtors** continued from p. 5*

Vallejo, the City had been engaging in negotiations with its employee unions and its single largest creditor for over 6 months when it filed for bankruptcy. *City of Vallejo*, 408 B.R 280, 295. The 9th Circuit held, however, that prepetition negotiations with creditors that did not involve the treatment of creditors under a proposed plan were not the negotiations required by 109(c)(5)(B). The Court pointed out that in order to negotiate the terms of a plan such a plan must, at least conceptually, exist, or else there is nothing to negotiate over. *Id.* at 297.

The municipality must also be willing to negotiate over the substantive terms of the plan. A municipality that presents a plan to creditors as "take it or leave it" has not negotiated in good faith and risks having its petition dismissed by the bankruptcy court. In *Ellicott School Building Authority*, the municipality held several public and private prepetition meetings with bondholders. During these meetings, "bondholders were advised that the 'economic provisions' of the proposed plan were not negotiable." *In Re Ellicott School Building Authority*, 150 B.R. 261, 266 (Bankr.D.Col. 1992). The municipality also declined to address concerns about the plan that had been expressed by a major bondholder. The court noted that the debtor had desired to effect a plan and that the plan was of the kind required by § 109(c)(4); however, the court held that the plan was not proposed in good faith pursuant to § 109(c)(5). *Id.* at 265; *see also, In Re Sullivan County Regional Refuse Disposal District*, 165 B.R. 60, 77 (Bankr.D.N.H. 1994) (court held that the "halfhearted" attempt by the debtor to create a plan mere weeks before filing for bankruptcy when the debtor had been in financial trouble for years was not a good faith negotiation.)

In summary, the fundamental factors that a bankruptcy court generally considers in assessing whether the debtor has negotiated in good faith under section 109(c) purposes are:

1. A proposed plan of adjustment exists that at a minimum outlines the classes of creditors and their treatment under the proposed plan;
2. The plan does not need to be a complete plan as long as factor one is met;
3. A plan may be contingent on approval by voters or the state;
4. A municipality must be willing to actually negotiate with creditors; a "take it or leave it" approach is not a good faith negotiation.

Few things can be worse for a municipality that has sought refuge in the bankruptcy court than to be thrown out of the courthouse, subject to the mercy of its creditors. If the municipality thought negotiating with creditors was hard before bankruptcy, the situation after a failed petition would be, to say the least, awkward and unpleasant. It is far better to ensure prepetition negotiations meet the requirements of section 109(c)(5) than to have to negotiate after a failed filing. A municipality facing unforgiving insolvency should negotiate with creditors and confront the range of workouts, including likely terms and conditions of a plan of adjustment, and not allow bankruptcy to remain the elephant in the room.

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