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TruPS

TruPS Holders Have Standing to Commence An Involuntary Bankruptcy Case Against a Bank Holding Company

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As hundreds of bank holding companies across the country face the imminent expiry of the five-year interest deferral periods on their trust preferred securities ("TruPS"), a recent bankruptcy court decision could influence how they deal with the holders of the TruPS.

On Aug. 29, 2014, in *In re FMB Bancshares, Inc.*, the United States Bankruptcy Court for the Middle District of Georgia (the "Bankruptcy Court") ruled that the holder, Trapeza CDO XII, LTD (the "Trapeza"),[1] of all of the TruPS issued by a wholly-owned subsidiary of FMB Bancshares, Inc. ("FMB"), was entitled to file an involuntary Chapter 7 bankruptcy petition against FMB to force a sale of FMB's bank subsidiary, Farmers and Merchant Bank (the "Bank").[2] The ruling is significant because the Bankruptcy Court held as a matter of first impression that Trapeza has standing under the terms of the indenture and other documents governing the TruPS to file an involuntary bankruptcy petition, thereby confirming that holders of TruPS have a valuable tool to assert and protect their rights against distressed bank holding companies.[3]

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Background. Federally insured banks and their holding companies are required by the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System to maintain certain minimum levels of "Tier 1" capital. TruPS were at one point an attractive structure for bank holding companies to access Tier 1 capital because of their inherent tax and regulatory advantages. Specifically, a bank holding company does not issue TruPS directly. Instead, it forms a wholly-owned subsidiary trust that issues pre-

[1] Hunton & Williams LLP ("Hunton") represents Trapeza with respect to the FMB bankruptcy case.

[2] *See* Case No. 14-70716-jtl (Bankr. M.D. Ga. Aug. 29, 2014) [Doc. No. 30].

[3] This case, in fact, represents only the second involuntary bankruptcy proceeding initiated by TruPS holders against a bank holding company, and the first to utilize Chapter 7 of the Bankruptcy Code. TruPS holders first employed this strategy against a bank holding company in the Bankruptcy Court for the District of Minnesota, *In re American Bancorp.*, Case No. 14-31882-KAC (Bankr. D. Minn. 2014). In *American Bancorp.*, however, the holding company consented to the entry of the order for relief after the petition was filed. In addition, the petitioning creditors had already obtained a judgment against the holding company for the outstanding amount of the TruPS before commencing the involuntary. Hunton represents the petitioning TruPS holder creditors in *American Bancorp*.

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ferred shares – TruPS – to investors. The TruPS are backed by 30-year subordinated debentures issued by the holding company to the trust. The interest payments made by the holding company are tax deductible, but the capital in the trust constitutes ''Tier 1'' capital for regulatory purposes because of its extended maturity and the holding company's ability to unilaterally defer interest for up to five years.[4] The five-year deferral period was designed to allow a distressed bank holding company the breathing room to withstand any economic downturn.

Thus, as did many small to mid-sized community bank holding companies during the height of the economic boom, FMB entered into a trust preferred financing transaction in November 2006 to provide $12 million of capital to the Bank. Trapeza acquired all of the TruPS issued by FMB's subsidiary trust as part of that transaction. When the real estate market collapsed in 2008, the Bank experienced significant losses that threatened its, and by extension FMB's, survival. By early 2009, the Bank was no longer in a position to provide dividends to FMB, and FMB exercised its right in March 2009 to commence deferral of quarterly interest payments on the TruPS obligations.

In November 2009, FMB entered into a written agreement with the Federal Reserve Bank of Atlanta and the Banking Commissioner of the State of Georgia (the ''Written Agreement'') that included, among other things, a capital enhancement plan for the Bank and a prohibition against FMB making any payments on the TruPS without prior approval of the regulators.

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While the Bank's balance sheet and revenues slowly improved over the next few years, on March 30, 2014, the five-year interest deferral period expired. FMB, however, remained unable to make the required interest payments because of the proscriptions in the Written Agreement. Shortly thereafter, Trapeza exercised its right to accelerate the obligations and declared all amounts due and owing. The parties were unable to negotiate a resolution or consensual restructuring and, on June 9, 2014, Trapeza took the unprecedented step of filing an involuntary Chapter 7 bankruptcy petition against FMB to force a sale of the Bank.

FMB responded by filing a motion to dismiss the involuntary petition.[5] Specifically, FMB's motion to dismiss relied on three arguments:

(1) FMB argued that the petition failed to state a claim because Trapeza lacked standing under the terms of the indenture and related documents governing the TruPS to commence an involuntary bankruptcy case;

(2) FMB contended that the petition failed to state a claim because Trapeza's claim against FMB is contingent as to liability and, therefore, Trapeza does not meet the requirements to act as a petitioning creditor set forth in Section 303(b) of the Bankruptcy Code; and

(3) alternatively, FMB asserted that the Bankruptcy Court should abstain from exercising jurisdiction and dismiss the petition under Section 305 of the Bankruptcy Code because permitting the bankruptcy to proceed would result in unnecessary entanglement with the regulatory oversight already in place and would not be in the best interests of FMB and its creditors.

In addition to asking the Bankruptcy Court to dismiss the petition, FMB reserved the right to seek damages against Trapeza under Section 303(i) of the Bankruptcy Code, which gives a debtor that successfully dismisses an involuntary petition the right to recover attorneys' fees and, if bad faith is found, actual and punitive damages against the petitioning creditors.[6]

The Bankruptcy Court's Decision. The Bankruptcy Court rejected FMB's arguments and denied the motion to dismiss. In reaching its conclusion, the Bankruptcy Court carefully addressed each argument.

Trapeza Has Standing to File the Petition

Initially, the Bankruptcy Court addressed whether Trapeza has standing to file an involuntary y bankruptcy petition under the indenture and related documents governing the TruPS. Trapeza purchased the TruPS from the trust created by FMB, but did not have a direct contractual relationship with FMB. The indenture, however, provides that following an event of default, the holders of TruPS may commence a ''suit'' to enforce their rights against FMB directly. FMB argued that Trapeza's right to sue did not include the ''extreme remedy'' of an involuntary bankruptcy proceeding.[7] Instead, FMB contended that only the indenture trustee has the right to undertake an involuntary bankruptcy petition. The Bankruptcy Court rejected such a narrow reading of the indenture. Relying on other courts' interpretations of similar language in bond indentures, the court held that the term ''suit'' was broad enough to include the filing of an involuntary bankruptcy petition.[8]

Trapeza Is a Proper Petitioning Creditor Under Section 303(b) of the Bankruptcy Code

The Bankruptcy Court then addressed whether Trapeza is a proper petitioning creditor under Section 303(b) of the Bankruptcy Code, which provides that an involuntary bankruptcy case may only be commenced by one or more creditors that hold a ''claim'' against the putative debtor, provided that such claim is ''not contingent as to liability or the subject of a bona fide dispute as to liability or amount . . . ''[9] FMB argued that the existence of the Written Agreement, which prohibited

[4] Basel III grandfathered the treatment of TruPS as Tier 1 capital for holding companies with fewer than $15 billion when issued prior to May 19, 2010.

[5] *See FMB Bancshares, Inc.'s Motion to Dismiss the Involuntary Petition*, Case No. 14-70716-jtl (Bankr. M.D. Ga. Aug. 29, 2014) [Doc. No. 10].

[6] 11 U.S.C. § 303(i).

[7] *See FMB Bancshares, Inc.'s Motion to Dismiss the Involuntary Petition*, Case No. 14-70716-jtl (Bankr. M.D. Ga. Aug. 29, 2014) [Doc. No. 10], at 15-16.

[8] *See Memorandum Opinion*, Case No. 14-70716-jtl (Bankr. M.D. Ga. Aug. 29, 2014) [Doc. No. 30], at 9-10 (citing *In re Federated Group, Inc.*, 107 F.3d 730, 732 (9th Cir. 1997); *In re Envirodyne Indus., Inc.*, 174 B.R. 986, 996 (Bankr. N.D. Ill. 1994)).

[9] 11 U.S.C. § 303(b).

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FMB from making any payments on the TruPS obligations absent approval of the regulators, rendered Trapeza's claim contingent as to liability.[10] The Bankruptcy Court disagreed. While acknowledging that the limitations in the Written Agreement impacted FMB's ability to pay its TruPS obligations, the Bankruptcy Court noted that FMB's argument confused its ability to pay with its legal duty to pay.[11] In particular, the Bankruptcy Court held FMB's inability to pay did not impact its legal ***liability*** to Trapeza, and therefore the TruPS claim is not contingent as to liability.[12]

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Abstention Under Section 305(a) of the Bankruptcy Code Is Not Appropriate

Finally, the Bankruptcy Court addressed whether it should exercise its discretion under Section 305(a) of the Bankruptcy Code to abstain from hearing the case. Section 305(a) provides that a bankruptcy court may abstain and dismiss a bankruptcy case if ''the interests of creditors and the debtor would be better served by such dismissal.''[13] FMB argued that the Bankruptcy Court should abstain and dismiss the case because (i) permitting the case to proceed would interfere unnecessarily with the Bank's state and federal regulators, (ii) Trapeza does not have the best interests of FMB in mind when it filed the involuntary petition, and (iii) the bankruptcy case was premised upon a ''two-party'' dispute that should be resolved in a court of general jurisdiction.[14] The Bankruptcy Court rejected those arguments, finding first that there was no pending regulatory litigation related to either the Bank or FMB and that any purchaser of the Bank through the bankruptcy process would continue to be subject to the same regulatory structure and requirements.[15] Furthermore, the Bankruptcy Court recognized that abstention is an extraordinary measure to be used only in exceptional circumstances and that the Trapeza's decision to commence an involuntary bankruptcy proceeding to enforce its rights was properly within its business judgment.[16] Lastly, relying on the plain language of Section 303(b), the Bankruptcy Court noted that the Bankruptcy Code ''specifically contemplates'' that an involuntary case may involve a two-party dispute, and dismissal likely would result in protracted litigation in a court of general jurisdiction and force Trapeza to wait even longer for any recovery.[17] Accordingly, the Bankruptcy Court held that jurisdiction and the forum were proper and it would not exercise its right to abstain.

Conclusion. The Bankruptcy Court's decision in *FMB* should signal to any distressed bank holding company that holders of TruPS have another powerful tool available to enforce their rights. Given the risks and potential costs involved with an involuntary bankruptcy process, the ability for TruPS holders to take such aggressive action should encourage both sides to work cooperatively and realistically to restructure TruPS debt, facilitate a recapitalization or effectuate the sale of the subsidiary banks to maximize recovery. Most importantly, bank holding companies should be proactive – they should address recapitalization plans in advance of the expiration of the five-year interest deferral periods.

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[10] *See FMB Bancshares, Inc.'s Motion to Dismiss the Involuntary Petition*, Case No. 14-70716-jtl (Bankr. M.D. Ga. Aug. 29, 2014) [Doc. No. 10], at 16-19.

[11] *Memorandum Opinion*, Case No. 14-70716-jtl (Bankr. M.D. Ga. Aug. 29, 2014) [Doc. No. 30], at 13.

[12] *Id.* at 14 (holding that FMB's ''inability to satisfy its obligations to Trapeza does not affect its duty to do so or render those obligations 'contingent' '').

[13] 11 U.S.C § 305(a).

[14] *See FMB Bancshares, Inc.'s Motion to Dismiss the Involuntary Petition*, Case No. 14-70716-jtl (Bankr. M.D. Ga. Aug. 29, 2014) [Doc. No. 10], at 19-23.

[15] *See Memorandum Opinion*, Case No. 14-70716-jtl (Bankr. M.D. Ga. Aug. 29, 2014) [Doc. No. 30], at 16-18 (noting too that counsel for the FDIC appeared at the hearing on the motion to dismiss and took no position as to the appropriateness of the bankruptcy).

[16] *Id.* at 18-20.

[17] *Id.* at 19-20; *see* 11 U.S.C § 303(b)(2) (providing that a single creditor holding a claim greater than $15,325 that is not contingent as to liability or subject to a bona fide dispute may file an involuntary petition).