By Matthew R. Brooks

Community Bank Fights Involuntary Bankruptcy Filed by TruPS Owners

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The 2008 financial crisis and resulting Great Recession brought on a tidal wave of bank failures.[1] Yet despite recent positive economic indicators, a new tsunami may be building on the horizon for those community banks that navigated through the surge: the expiration of the five-year interest-deferral periods on their trust-preferred securities (TruPS). Industry data shows that more than 200 TruPS issuers were in default at the end of Q1 2015 and another 150 issuers could be deferring as much as $1.8 billion in obligations. While recent involuntary bankruptcy petitions filed by TruPS owners may be a harbinger of the gathering swell for those banks, the recent involuntary bankruptcy proceeding of *In re FMB Bancshares Inc.*[2] suggests that they may doomed to drown in the deluge.

TruPS allow bank-holding companies to pay tax-deductible dividends through the issuance of securities with equity-like features that qualify as Tier 1 capital, and that must be maintained by federally insured banks and their holding companies.[3] To achieve this favorable tax treatment, bank-holding companies enter into a two-tiered debt structure whereby they issue notes that are sold to a statutory trust subsidiary. The trust, a separate entity from the holding company, then issues TruPS to investors. The proceeds are used by the trust to purchase the junior subordinated notes issued by the bank-holding company. These notes issued by the bank-holding company typically have a 30-year term and a unique feature allowing the issuer to defer interest payments for 20 consecutive quarters. The terms of the TruPS mirror the terms of the notes. The bank-holding company is to make payments of principal and interest to the trust on the notes, and in turn, the trust uses those funds to pay dividends to the holders of TruPS.

FMB Bancshares Inc. issued TruPS in 2006 and elected to defer interest payments under the notes. At the end of the deferral period, FMB could not pay on the notes, and Trapeza CDO XII Ltd., the purported owner of the TruPS, filed an involuntary chapter 7 petition against FMB on June 9, 2014.[4] The involuntary petition came just one month after TruPS owners forced Minnesota-based American Bancorporation into chapter 7, who ultimately consented to an order for relief and sold its assets.[5] FMB received significant industry attention when it bucked the consensual sale trend and filed a motion to dismiss the involuntary petition. The ensuing legal battle highlights the complex issues that can arise when TruPS owners seek to enforce their repayment rights in the bankruptcy arena.

Trapeza's standing to file the involuntary petition was litigated on two separate occasions. First, in support of its motion to dismiss, FMB argued that Trapeza's limited rights under the indenture and trust agreement did not include the ability to bring an involuntary bankruptcy.[6] The indenture provided that "[a]ny registered holder of the [TruPS] shall have the right, upon the occurrence of an Event of Default … to institute a suit directly against [FMB] for enforcement of payment to such holder of the principal of and any premium and interest … on the [subordinated notes]…."[7] FMB argued that the trustee, which had broader enforcement rights than registered holders, was the only party "vested with the authority to initiate the 'extreme remedy' of an involuntary bankruptcy proceeding, as opposed to a lawsuit."[8]

The indenture and trust agreement did not define "suit," so the bankruptcy court first turned to *Black's Law Dictionary* for guidance, which defined "suit" as "[a]ny proceeding by a party or parities against another in a court of law."[9] Next, the court turned to cases interpreting similar indenture provisions, including *In re Federated Group Inc.*[10] and *In re Envirodyne Industries Inc.*,[11] which both held that the registered holder's right to bring a suit included the ability to file an involuntary petition.[12] The bankruptcy court concluded that "an involuntary bankruptcy petition may be properly construed as a 'suit ... for enforcement of payment," and denied FMB's motion to dismiss the involuntary petition.

1 Since 2009, nearly 500 banks have been taken over by the Federal Deposit Insurance Corp. FDIC Failed Bank List (updated May 19, 2015), *available at* www.fdic.gov/bank/individual/failed/banklist.html (unless otherwise indicated, all links in this article were last visited on June 1, 2015).
2 *In re FMB Bancshares Inc.*, Case No. 14-70716 (Bankr. M.D. Ga. Aug. 29, 2014) (memorandum opinion) ("FMB Bancshares Memorandum Opinion").
3 *See generally* George E. French, Andrea N. Plante, Eric W. Reither and Ryan D. Sheller, "Trust Preferred Securities and the Capital Strength of Banking Organizations," 7 *Supervisory Insights* 2, 3-16 (2010), *available at* www.fdic.gov/regulations/examinations/supervisory/insights/siwin10/SI_Wtr10.pdf.
4 FMB Bancshares Inc.'s Motion to Dismiss the Involuntary Chapter 7 Petition ("FMB Bancshare's Motion to Dismiss"), at ¶ 31-32 (Bankr. M.D. Ga. July 3, 2014).
5 *See* Case No. 14-31882, U.S. Bankruptcy Court for the District of Minnesota.
6 FMB Banchshare's Motion to Dismiss, at ¶ 33.
7 Junior Subordinated Indenture, Declaration of Jeff Parish [Docket No. 11], Ex. E.
8 FMB Bancshare's Motion to Dismiss, at ¶ 44.
9 FMB Bancshares Memorandum Opinion, at p. 9.
10 107 F.3d 730 (9th Cir. 1997).
11 174 B.R. 986 (Bankr. N.D. Ill. 1994).
12 *See* FMB Bancshares Memorandum Opinion, at p. 9-10.

For purposes of FMB's dismissal motion, the bankruptcy court and FMB accepted, as required, that Trapeza was the holder of the TruPS and therefore eligible to file the involuntary petition under § 303(b).

Determined to fend off a forced liquidation, FMB challenged Trapeza's standing to file the involuntary petition in its brief opposing the entry of an order for relief — this time focusing on whether Trapeza was the "registered holder" of the TruPS.[13] Under the indenture and trust agreement, standing to initiate a "suit" directly against FMB, as opposed to its subsidiary trust that issued the TruPS, was expressly reserved for the registered holder of the TruPS.[14] While the indenture did not define "registered holder," the trust agreement contained a similar provision conferring standing to initiate suit on the "holder" of the TruPS, defined as a "[p]erson in whose name the [TruPS] are registered in the Securities Register."[15] Documents obtained from the indenture trustee through discovery showed that Trapeza was not listed on the securities register. Instead, the TruPS were registered in the name of Cede & Co.[16] Since the TruPS were not registered in the name of Trapeza, FMB posited that Trapeza was not the holder of a claim on the involuntary petition date and did not qualify as a petitioning creditor under 11 U.S.C. § 303.[17]

FMB cited cases holding that alleged claimants similarly situated to Trapeza did not hold a claim against the debtor. In *In re Franklin Bank Corp.*,[18] the bankruptcy court held that beneficial owners of trust securities, but not the registered holders, were not creditors of the debtor.[19] On appeal, the district court agreed with the bankruptcy court, noting that the relevant language of the trust declaration "does little to advance [the collateral manager's] argument that the [beneficial owners] have standing because they are not a 'Holder' as defined in the Trust Declaration."[20] Outside of bankruptcy, FMB pointed to several cases where courts interpreted similar indenture provisions to find that beneficial owners, as opposed to the registered holders of TruPS, lacked standing to sue for nonpayment of principal or interest.[21]

Trapeza responded that FMB's standing argument was "grounded in form over substance" and ignored the "commercial reality and the intent of the parties to these transaction documents."[22] The parties' briefs described the ownership structure of the TruPS as follows: The TruPS were registered in the name of Cede, the nominee of the Depository Trust Co. (DTC); Bank of New York Trust Co. NA is shown in DTC's records as the depository participant; and Bank of New York Trust Co. NA held the TruPS as indenture trustee for the account of Trapeza pursuant to a CDO indenture.[23] Trapeza posited that requiring clearing and settlement agents such as Cede or DTC to file the involuntary petition would lead to "nonsensical results," as it would be "absurd to suggest that DTC — a party with absolutely no beneficial interest in the TruPS — would be filing involuntary petitions against issuers based on its status as a nominal, passive holder of TruPS."[24]

Trapeza further argued that the standing issue was moot because Trapeza had obtained litigation authorization from Cede sanctioning Trapeza to "commence, prosecute, or continue to prosecute litigation, an involuntary petition, arbitration or other dispute resolution against [FMB]."[25] FMB responded that such "post-petition gymnastics" did not provide Trapeza with *ex post* standing because "nothing in the Bankruptcy Code or the Bankruptcy Rules recognizes a post-petition authorization or ratification of an already-filed involuntary petition filed by an entity that was not a holder of a claim."[26] FMB distinguished the logic of nonbankruptcy decisions such as *Financial Restructurings Partners III Ltd. v. Riverside Banking Co.*[27] cited by Trapeza. In that case, the state court allowed civil litigation to proceed against a bank-holding company, even though the lawsuit was originally filed by a TruPS beneficial owner instead of the registered holder (also Cede) because, post-filing, Cede authorized the beneficial owner to proceed with the litigation and consented to being named as a party.[28]

FMB countered that Federal Rule 17(a)(3), allowing the joinder of the real party in interest to relate back to the initial complaint, was not incorporated under Bankruptcy Rule 1018 as a rule applicable to involuntary proceedings.[29] Thus, FMB posited, an involuntary petitioner must be the "holder of a claim" when it signs the involuntary petition; any attempt to "fix" a standing problem after the fact fails.[30] Before the bankruptcy court decided the issue, the case was dismissed on a motion by Trapeza, which cited a mutually agreeable resolution of the issues giving rise to the involuntary.[31]

Even without an opinion from the court, the case highlights several issues for TruPS owners and obligors to consider when evaluating their options in light of a looming default. First, the effectiveness of the post-bankruptcy litigation authorization remains unresolved. Although *Financial Restructurings* supports the effectiveness of such an authorization in nonbankruptcy enforcement proceedings, its logic may not apply in bankruptcy. Cede authorized Trapeza to continue to prosecute the involuntary petition, "which action(s) [Cede], as holder of the [TruPS,] is or may be entitled to take."[32] However, Cede did not assign to Trapeza its rights as the "holder" of the TruPS. Unlike the authorization in *Financial Restructurings*, Cede also did not consent to join the involuntary petition filed by Trapeza. If, as *Franklin Bank Corp.* held, the "real creditor" holding claims against the debtor-holding company is the indenture trustee, TruPS owners and their collateral managers

13 FMB Bancshares Inc.'s Brief in Opposition to the Entry of an Order for Relief ("FMB Bancshare's Opposition Brief"), Case No. 14-70716 (Bankr. M.D. Ga. Nov. 6, 2014).
14 *Id.* at p. 4-5.
15 *Id.* at p. 6.
16 *Id.* at p. 6-7.
17 *Id.* at p. 12.
18 Case No. Case No. 08-12924-CSS (Bankr. D. Del. July 13, 2013) (order, *vacated on other grounds*).
19 *Id.* at ¶ 35.
20 *In re Franklin Bank Corp.*, 526 B.R. 527, 535 (D. Del. July 21, 2014).
21 *See* FMB Bancshare's Opposition Brief, at p. 11 (citing *Caplan v. Unimax Holdings Corp.*, 188 A.D.2d 325, 326 (N.Y. Sup. Ct. 1992)); *Springwell Nav. Corp. v. Sanluis Corporación SA*, 46 A.D.3d 377 (N.Y. Sup. Ct. 2007) (citing *MacKay Shields v. Sea Containers*, 300 A.D.2d 165, 166 (N.Y. Sup. Ct. 2002)).
22 Trapeza CDO XII Ltd.'s Memorandum of Law in Support of Standing and for Immediate Entry of an Order for Relief ("Trapeza's Memorandum of Law"), at p. 11, Case No. 14-70716 (Bankr. M.D. Ga. Nov. 6, 2014).
23 *Id.* at p. 12.
24 *Id.* at p. 13.
25 *Id.* at p. 16.
26 FMB Bancshare's Opposition Brief, at p. 15-16.
27 2014 N.Y. Misc. LEXIS 36 (N.Y. Sup. Ct. Jan. 2, 2014).
28 *Id.* at *18.
29 FMB Bancshare's Opposition Brief, at p. 17.
30 *Id.* at p. 17-18.
31 *See* Trapeza CDO XII Ltd.'s Motion to Dismiss Case, Case No. 14-70716 (Bankr. M.D. Ga. Jan 22, 2015).
32 Trapeza's Memorandum of Law, at p. 16.

continued on page 58

from page 19

would not qualify under § 303(b) as the "holder of a claim" merely by having the indenture trustee or Cede authorize the suit on its behalf. Further, as FMB argued, the rules governing involuntary bankruptcy proceedings do not incorporate Federal Rule 17, which provides that an "action proceeds as if it had been originally commenced by the real party in interest" following ratification, joinder or substitution of the real party in interest. Consequently, post-petition measures taken to address any standing issues may not save a defective involuntary petition from dismissal.

As a practical matter, TruPS owners and collateral managers should take steps to resolve any standing issues prior to filing an involuntary bankruptcy, as a mulligan may not be available.[33] While it is unlikely that Cede would join as a petitioning creditor in an involuntary proceeding, the indenture or trust documents governing the TruPS may allow the collateral manager to become the "registered holder" of the TruPS, eliminating the need to seek authorization from Cede.

Second, given the scarcity of case law surrounding standing in the involuntary bankruptcy arena and the significant time and expense that were no doubt incurred by the parties in *FMB Bancshares* litigating the issue, TruPS owners may avoid the standing quagmire altogether by requesting that the indenture trustee lead any enforcement efforts. Presumably, indenture trustees have been wary to lead enforcement efforts given the risks that are associated with litigation. However, at least one trustee has recently agreed to lead the charge against defaulted banks. According to one commentator, BNY Mellon announced in May 2014 that it would lead a group of investors in passively managed trust-preferred CDOs to coordinate actions against defaulted banks, provided the investors indemnify BNY Mellon and shoulder litigation costs.[34] Whether such a move will result in a wave of involuntary bankruptcies against recalcitrant bank-holding companies remains to be seen, but such a move could very well eliminate the standing issue that may have provided FMB with leverage in its settlement negotiations.

Third, though not addressed in *FMB Bancshares*, bank-holding companies may, as a matter of right, convert an involuntary chapter 7 to a chapter 11 proceeding and attempt to reorganize their affairs, including the indebtedness owed to TruPS owners. However, conversion might not provide a magic bullet. It could moot any argument that petitioning creditors lacked standing to file the involuntary, and any hopes of effectively confirming a plan may be doomed by the priority claim afforded the FDIC under § 507(a)(9). Even so, the breathing spell afforded by a conversion will allow the bank-holding company to evaluate its options and determine the market value of its operating bank. TruPS owners would be wise to engage in negotiations with the bank regarding a reduced payoff or locating a strategic buyer for the bank assets, particularly when the liquidation alternative is likely to provide little or no recovery for TruPS investors. abi

33 *See* Fed. R. Bankr. P. 1003(a).

34 Chris Cummings, "TruPS Investors Add to Pressure on Deadbeat Banks," 14 *Asset Securitization Report* 14 (Aug. 2014), *available at* lexis.com (log-in required).