# Delaware Banker

**Winter 2015**
**Vol. 11 No. 1**

# Who Pays When a Retailer Is Hacked?

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# View from the Chair

by
Rodger Levenson
Executive Vice President
WSFS Bank

Chairman
Delaware Bankers Association

***"The DBA pledges to be a constructive voice in the economic development of our State particularly as it relates to growing our financial services industry."***

As we begin 2015 I thought it may be appropriate to share some of the Delaware Bankers Association priorities for the year ahead. At a recent Board Meeting , we discussed both State and National legislative and Association operational priorities. Our discussions included the following:

**National Legislation** – Trying not to reinvent the proverbial wheel, we borrowed liberally from both the Independent Community Bankers Association and the American Bankers Association. In no particular order of importance, we will focus our collective energies in 2015 on the following issues:

- Having a level playing field.....we support equal treatment and regulatory control over nonbank competitors, including but not limited to credit unions, payday and platform lenders, and certain government sponsored lending entities. These groups should be subject to the same community reinvestment regulations and taxation as the banking industry.

- Reforming overly restrictive rules that limit the industry's ability to tailor products to serve its customers' needs....we support the review and rollback of unnecessary rules and regulations affecting such items as capital and liquidity, mortgage products and overdraft protection.

- Addressing the imbalance of cost and responsibility placed on the financial industry regarding cybersecurity and data breaches....we support a shared system of regulations that places more responsibility on businesses and nonbank entities involved in data breaches. Banks employ high standards of cybersecurity with enormous amounts of financial resources and time that is not shared by entities using their systems. We call for a higher standard of consumer protection and accountability.

**State Legislation** – The DBA pledges to be a constructive voice in the economic development of our State particularly as it relates to growing our financial services industry. We will strike a balance between protecting the rights of the consumer and promoting a robust business atmosphere within the State through which we may all benefit. We will continue to cooperate with the administration and legislative bodies, to address such ongoing issues as lending, housing, escheat, and protection of the citizenry, especially the elderly and infirm, to name a few.

**Operational Priorities** – We will work to increase our non-dues income through new industry specific educational forums. This increase will help us maintain and even lower our traditional dues schedule. We pledge to continue our support of financial literacy in the schools and the general media, because we feel an educated consumer is our best customer. We will endeavor to increase our level of activities aimed at promoting the participation of the emerging leaders in our industry.

I hope this gives you some insight into the plans we have put in place for the year ahead. Please remember your ideas are always welcome and encouraged.

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# President's Report

by
David G. Bakerian
President, CEO & Treasurer
Delaware Bankers Association

***"The Delaware banking industry has been very fortunate to be in the capable hands of theses professionals. "***

This May will mark my 30th year with the Delaware Chapter of the American Institute of Banking and 22nd with the Delaware Bankers Association. As many of you know, I plan on retiring this May. The Association has enlisted the assistance of a national search firm and they hope to have a replacement on board this Spring. I am confident that when I say goodbye in this column in May, I will be able to introduce you to my successor. Prior to that, I thought it would be nice to kick off 2015 by recognizing the experienced staff you, I, and the DBA Board have been working with all these years. These are the people that really drive the Association and serve the banking industry in Delaware.

Tom Collins, our EVP for Government Relations and newest staff member, is closing in on his second year of service at the DBA. Tom has over 33 years in banking experience as a General Counsel and legal specialist. He has done a terrific job of keeping our issues in front of the General Assembly and protecting our interests in Dover. Ironically, Tom was a member of our Government Relations Committee over 15 years ago and has come back to run it.

Greg Koseluk, VP for Marketing and Public Relations has been with the Association for 10 years. Greg handles all of our publications including the Delaware Banker Magazine and the DBA Weekly Digest. He also writes grant proposals soliciting funds for financial literacy projects and authors articles about Association events for the DBA and the local press. He designs advertising copy for all of our events and you may know him as the voice of the Great Investo on WDEL and WILM and other radio stations throughout the state.

Margaret Cregan is next in tenure with 13 years at the DBA. Margaret is the Director of Membership and Meetings. She coordinates events like the Washington Visit, the Trust Conference, the Annual Meeting, and the Legislative Reception, in addition to our training program venues. She also coordinates our membership database and our Associate Member solicitation process.

Next comes Renee Rau, Education Coordinator and Office Manager. Renee has been with the DBA's Financial Educational Alliance for 27 years. She is responsible for in-person and on-line education programming, and oversees all of our training relationships with the American Bankers Association and local colleges and universities. In addition, she coordinates educational budgeting and related office purchasing.

The tenure leader at the DBA is Shirley Glanden with 38 years of service. Shirley's title is Chief Administrative Officer, but that only scratches the surface of her value to the organization. She is the personnel director, the benefits coordinator, the medical liaison, audit chief, payroll administrator, and Secretary to the Board of Directors. Shirley is the Association archivist and has served literally hundreds of CEO Board members during her outstanding years of service.

The Delaware banking industry has been very fortunate to be in the capable hands of the above professionals. I think you would have a hard time finding a more experienced group of people in an Association setting. Here's to an exciting 2015!

Sincerely,

David

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# What's New at the DBA

## Regulatory Compliance School

A record number of compliance professionals attended the Delaware Bankers Association's **2014 Regulatory Compliance School**, November 18th, 19th, and 20th at the Christiana Hilton in Newark. The annual event was facilitated by **FIS Enterprise Governance, Risk & Compliance (EGRC) Solutions** and featured a comprehenisve review of the federal regulations affecting the financial services industry. Tuesday's sessions covered Lending Compliance and were taught by **Lorraine Williams** and **Elizabeth Rozsa**. On Wednesday **Alice Judd** and **Steve Manitzas** taught Deposit Operations Compliance. The school wrapped up on Thursday with a session on Credit Card Lending Compliance as instructed by **Bob Cardwell** and **Susi Robeson** (pictured above).

## BSA/AML for Financial Institutions

The **Delaware Bankers Association** held their **Bank Secrecy Act/Anti-Money Laundering for Financial Institutions** December 9th at the University & Whist Club in Wilmington. **Dr. Zoya Faynleyb,** CAMS, CRCM, Senior Manager AML/Sanctions, Governance, Risk & Compliance of **FIS Enterprise Governance, Risk & Compliance (EGRC) Solutions** conducted the half-day session. The session included just released information from the 2014 FFIEC BSA/AML Examination Manual. Other topics included: an overview of the Bank Secrecy Act; methods of money laundering; detection and reporting techniques; detecting suspicious activities; SAR filing; and best practices. The **BSA/AML for Trust Companies** will be held on March 25th. Visit www.debankers.com for full agenda and registration information.

## 2015 Teach Children to Save Day

Preparations are under way for **2015 Teach Children to Save**. This year's event, the 17th annual, will take place on Tuesday, April 21st, with additional classes taking place throughout the week. Teach Children to Save Day features volunteer bankers teaching lessons on the importance of thrift in public, private, and parochial schools throughout Delaware. On-line banker registration will begin March 3rd on the Delaware Bankers Association website (debankers.com). This year's Teach Children to Save Day lesson is taken from the new book ***The Great Investo and the Flourishing Flamingos***. The book, the fifth in the series, features a lesson on the importance of saving and magic of compound interest with the Money Wizard and his assistant Penny. After Penny correctly explains how compounding works Investo illustrates the concept by magically compounding flamingos. The problem is once he starts the lesson he can't stop and soon they are overrun with the pink birds. The book was written and illustrated by **Greg Koseluk** of the Delaware Bankers Association and was made possible by a grant from **Capital One**. Teach Children to Save Day is a part of a national program developed by the American Bankers Association's Education Foundation to teach children about the importance of saving. The Delaware Bankers Association coordinates the program in partnership with the University of Delaware's **Center for Economic Education and Entrepreneurship** (CEEE). The CEEE develops the lessons which meet Delaware's state economic education standards. In addition to lesson development, CEEE also prepares the lesson packets for each volunteer and classroom teacher. Each year over 300 banker volunteers teach over 10,000 students in 115 public, private, and parochial schools throughout the state.

## Delaware Banks Join Forces to Aid Disabled Vets

**Artisans' Bank**, **Discover Bank**, and **WSFS Bank** contributed a combined $9,000.00 towards the purchase of a van for the Disabled American Veterans, Department of Delaware. The donation from the banks was part of a matching government grant program. The van will be used to transport disabled Delaware veterans from their homes to VA facilities for treatment and services. "Delaware's banks are proud to help in this important effort to assist the veterans who have given so much to us all," said **David G. Bakerian**, president of the Delaware Bankers Association.

(l. to r.) David G. Bakerian, President, Delaware Bankers Association; Mark Wischmann, Commander, Disabled American Veterans, Dept. of Delaware; State Representative Earl G. Jaques, Jr; James J. Roszkowski, President, Discover Bank; Paul V. Lardizzone, Adjutant, Past Commander, Disabled American Veterans, Dept. of Delaware; Vernita L. Dorsey, Vice President Director of Community Strategy, WSFS Bank; Mark E. Huntley, President and CEO, Artisans' Bank; Rodger Levenson, Executive Vice President, WSFS Bank.

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Cover Story

# Who Pays When a Retailer Gets Hacked?

## A Look at Bank Claims Against Target Corporation Following Its Customer Data Security Breach.

by: Keith H. Ellis, Esq. and
Christine P. Schiltz, Esq.
Parkowski, Guerke and Swayze, P.A.

On December 2, 2014, United States District Court Judge Paul A. Magnuson issued a Memorandum and Order (the "Order") ruling that a consolidated class action lawsuit brought by several banks against Minneapolis-based Target Corporation ("Target") could proceed.[1] The significance of this ruling is in its recognition of a duty owed by a retailer accepting debit and credit card payments to the banks that issue those cards. This will be discussed more fully below. As the ruling is not a final ruling on the merits of the case, but a ruling on Defendant Target Corporation's Motion to Dismiss the Consolidated Amended Class Action Complaint (the "Motion to Dismiss") in the case, Target will have an opportunity to argue its case more fully as the case proceeds. However, the Plaintiff financial institutions have crossed an initial hurdle in bringing claims against Target. This review is not intended to be an exhaustive treatment of the legal issues presented by the Target class action case, but rather, a brief discussion of the groundwork laid for the case by Judge Magnuson in the Order, and a summary of the legal claims made against Target as well as potential claims which could be brought against other retailers for similar security breach issues.[2]

### Background

Target, which is identified by its large big box stores and its big red dot logo, is one of the nation's largest retailers. Millions of people flock to Target stores where they can find trendy clothing and housewares alongside everyday groceries, all at discounted prices. Target's motto "Expect More Pay Less" resonates with American consumers. Unfortunately, on December 19, 2013, consumers got more than they bargained for upon hearing that Target had issued a Press Release confirming that approximately forty million credit and debit card accounts were compromised between November 27 and December 15, 2013. At that time, Target indicated both that it had "identified and resolved the issue" and that it was "partnering with a leading

third-party forensics firm to conduct a thorough investigation of the incident."[3] It was later revealed that an additional seventy million accounts had been compromised. It was reported that the security breach occurred when hackers gained access to Target's network using login credentials stolen from a company that provided heating, ventilation, and air conditioning services for Target. The hackers then placed malware on Target's computer servers that read the data from customers' credit and debit cards at the moment those cards were swiped during the purchase transaction. By the time customers were loading their bags of holiday purchases into shopping carts, thanks to insidious malware, the information from their debit and credit cards was already in the hands of hackers who undoubtedly intended to use that information for their own financial gain.

While Target promptly notified the public and took action to mitigate losses, certain financial institutions believed these actions were not enough and filed a legal suit in the United States District Court. The Consolidated Class Action complaint in the financial institution cases (the "Complaint") argues that Target bears responsibility for the losses incurred by the financial institutions which issued those 110 million debit and credit cards to Target customers.[4] The Complaint alleges "[a]t the time of the breach, Target had specific notice of the potential attacks that could occur on its systems, and of the potential risks posed to the Company and to financial institutions such as Plaintiffs and the financial institutions class (the "FI Class") if it failed to adequately protect its systems." In the Complaint, Plaintiffs argue that Target ignored alerts from both the FireEye security system[5] and its own Symantec Endpoint Protection antivirus system, "which inaction allowed the entirely preventable data breach to continue." In addition, Plaintiffs allege that Target's computer system "was not properly segmented," allowing the hackers to move from less sensitive areas to the customer payments and personal data network.

### Negligence: Duty of Target to the Financial Institution Issuing the Card

What duty does Target or any retailer owe a financial institution which issues debit or credit cards to its customers? That is the question that is at the core of the lawsuit pending in Minnesota; Was Target negligent in failing to protect consumer data? For the financial institutions to succeed in their negligence claim against Target, four elements of a negligence claim under Minnesota law must be alleged: duty, breach, causation and injury. Target has not challenged Plaintiffs' allegations regarding the elements of causation and damages, presumably because it is clearly evident that a breach involving 110 million customers' personal financial information has resulted in economic loss to the financial institutions. Therefore, the key issue that remains in this litigation is whether a retailer, in this case Target, owes a duty of reasonable care to the financial institutions that issue the credit or debit cards accepted by that retailer. Under Minnesota law that duty may arise

*(continued on p. 12)*

(continued from p. 11)

either 1) "when a defendant's own conduct creates a foreseeable risk of injury to a foreseeable plaintiff," or 2) "when action by someone other than the defendant creates a foreseeable risk of harm to the plaintiff and the defendant and plaintiff stand in a special relationship."[6]

In the Complaint, the financial institutions argue that Target indeed owed them a duty of reasonable care "because they were a foreseeable and probable victim of any inadequate data security practices." The financial institutions also argue, in the alternative, that Target maintained a special relationship with them, because the Plaintiffs and the FI Class "entrusted Target with the personal and financial information of customers using credit and debit cards issued by Plaintiffs on the premise that Target would safeguard this information, and Target was in a position to protect against the harm suffered by the FI Class as a result of the data security breach."[7] In support of their position, Plaintiffs argue, among other things, that Target failed to implement adequate security protocols, "including protocols required by industry rules," sufficient to protect the data (access) and failed implement systems or security practices that could have prevented the loss of the data (exfiltration). Plaintiffs cite a *Bloomberg Businessweek* report, citing in turn an unnamed source who had consulted on Target's internal investigation, that indicates that the Target security team turned off a FireEye function that would have automatically deleted malware as it was detected. Plaintiffs further argue that a duty has been statutorily created under the Minnesota Plastic Card Security Act ("MPCSA"), which provides for reimbursement of costs and damages that result from certain security breaches.[8]

In contrast, Target contends it owes no such duty to the financial institution Plaintiffs who issue credit and debit cards to consumers across the country. In moving for dismissal of the Complaint, Target argues that they owe no duty to the card issuers because they have no contractual relationship with these institutions. Target notes that a retail merchant has a contractual relationship with the payment processor or merchant bank, which in turn has a contractual relationship with a payment card company such as Visa or MasterCard. The payment card company in turn has a contractual relationship with the issuing bank. "Thus," notes Target, "issuing banks and merchants have no direct dealings with one another in the payment system."[9] Target maintains that the negligence counts should turn on whether Plaintiffs have established that a "special relationship" exists between merchants and credit card issuers.[10] It argues that "[t]he Banks, however, are sophisticated parties that do not even have a direct relationship with Target, much less a special relationship that might suffice to create such a duty in either the negligence or negligent misrepresentation context."[11] In response to Plaintiffs invocation of the MPCSA, Target argues that the MPCSA requires reimbursement only "when the data breach involved the theft of certain types of sensitive payment card data that the merchant had been storing in violation of the statute."

The Court rejected Target's argument that the negligence claims had to be analyzed under the "special relationship" standard applicable "third-party-harm type of negligence."[13] Rather, the Court found that "[a]t this preliminary stage of the litigation, Plaintiffs have plausibly pled a general negligence case." The Court found that although the third-party hackers caused harm to the plaintiff financial institutions, "Target played a key role in allowing the harm to occur." In analyzing Plaintiffs' claim that Target owed them a duty of care under general negligence principals in the context of Target's motion to dismiss, the Court evaluated Plaintiffs' allegations "in the light most favorable to the Plaintiffs…"[13] The Court's key findings in this regard are as follows:

> "Plaintiffs have plausibly alleged that Target's actions and inactions – disabling certain security features and failing to heed the warning signs as the hackers' attack began – caused foreseeable harm to Plaintiffs. Plaintiffs have also plausibly alleged that Target's conduct both caused and exacerbated the harm they suffered. And Plaintiffs' allegation that Target was solely able and solely responsible to safeguard its and Plaintiffs' customers data is also plausible."

The Court went on to find that imposing a duty on Target would be consistent both with the public policy purpose of the MPCSA and its provisions regarding the availability of additional remedies for actions arising out of a failure to safeguard customers' information. The Court also noted that "it is clear that the institutional parties to credit- and debit-card transactions have already voluntarily assumed similar duties toward one another.[14]

While Delaware courts have not addressed the issue of duty owed to card issuers, we are of the view that the same result in regards to Target's duty to the card issuers might well have been reached under Delaware law.[15] Delaware case law recognizes essentially the same presumptions in favor of plaintiffs when ruling on a motion to dismiss as does Minnesota law.[16] The elements of a cause of action in negligence are also essentially the same.[17] In *Furek v. University of Delaware*,[18] the Delaware Supreme Court faced several of the issues presented in the Target FI case in the context of the duty owed by the university to a student injured during a fraternity hazing. The court found that no "special relationship" existed that would trigger a duty to control the conduct of a third person.[19] However, the Court found that a duty of care "'applies to any undertakings to render services to another which the defendant should recognize as necessary for the protection of the other person' and the harm to be protected against results from negligence in 'performance of the undertaking or from failure to exercise reasonable care to complete it or to protect the other when he discontinues it'"."[20] The Court notes Section 323 of the Restatement (Second) of Torts (1965) speaks to "the duty owed by one who assumes direct responsibility for the safety of another through the rendering of services in the area of protection."[21] While the "rendering of services" aspect of the *Furek* decision may be less clear in the merchant to card-issuer relationship, it is not unreasonable to assume that a merchant's sole control of the card-holder data and the processes that are used to capture it could be found to be an assumption of responsibility and a rendering of services in protection of that data within an undertaking for mutual commercial benefit. This, in turn, would support imposition of the duty of care necessary to support a

cause of action in negligence under Delaware law.[22]

### Other Counts: Negligent Misrepresentation by Omission; MPCSA Violation; Negligence Per Se

A successful claim for negligent-misrepresentation against Target under Minnesota law must allege duty, omission reliance and injury Plaintiffs allege that the representations made by Target as to the adequacy of their data security measures and systems and Target's knowing and deliberate failure to disclose material weaknesses in those systems and procedures resulted in injury to the Plaintiffs. Target counters that, as a matter of law, failure to comply with contract terms regarding compliance and failure to "ascertain the truth or falsity of one's present intention to act in the future" are not actionable. The Court, noted that "[a]s a general rule, one party to a transaction has no duty to disclose material facts to the other." However, as the Court's decision was being rendered on a Motion to Dismiss, the Court found that Plaintiffs' allegations that "Target knew facts about its ability to repel hackers" and that its public representation were misleading" were plausible. The Court found this allegation to be sufficient to state a claim both as to the elements of duty and omissions and found that injury had been adequately plead. However, the Court found that Plaintiffs had failed to submit facts supporting Plaintiffs' reliance on the alleged omissions.

Plaintiffs allege that Target violated the MPCSA by retaining certain payment information on its servers in violation of the statutory limit of 48 hours following the transaction and that the retention of that data was the proximate cause of Plaintiffs injuries. Plaintiffs further allege that violation of the MPCSA "constitute negligence per se." Target argues that the malware installed by the hackers "read the data from customers' credit and debit cards at the moment those cards were swiped in Target's stores." Thus, Target reasons that retention of the data in issue is irrelevant. In reviewing the Plaintiffs claim and Target's response to these allegations, the Court considered Plaintiffs contention that the hackers would have been unable to steal the cards' CVV without accessing the data that Target stored on its servers. In reviewing all of the information from both parties brought forth in the Motion to Dismiss, the Court ultimately ruled that the alleged violation of the MPCSA and the allegation that the hackers retrieved some of that data from Targets' servers were sufficient to state a claim, and the Court refused to grant Target's Motion to Dismiss. The litigation remains ongoing in the Minnesota United States District Court.

### Conclusion

In denying Target's Motion to Dismiss on all but the negligent-misrepresentation claim, the Court in Minnesota has opened the possibility for a precedent-setting finding regarding duty of merchants to safeguard customer information. A finding in the case that Target is financially responsible for losses incurred by financial institutions as a result of Target's negligence, would cause a substantial burden shift in the war on cybercrimes. The New York Times has estimated the cost of replacing stolen cards from the Target breach at $400

*continued on p. 14*

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(continued from p. 13)

million.[23] The finding that retailers owe a duty to card-issuers breaks new ground. Target will now need to make a case that it took all reasonable steps to protect the customer data and that it should not be held responsible for the actions of the hackers and the losses that their activities caused. Depending on the outcome of this case, Target and other retailers may need to embrace a new reality in the manner in which they protect their customers' financial data, one that opens up the possibility that retailers can and should be held financially responsible for a breach in their customer payment information. Financial institutions and retailers alike await the outcome of this litigation with retailers facing a possible new paradigm of a "Secure More Pay Less" approach to consumer retail transactions.

*KEITH H. ELLIS joined Parkowski, Guerke & Swayze in 2014 as a Partner, concentrating his practice in the areas of banking, trusts, consumer lending, internet-based lending, contracts, secondary market purchase and sale transactions, corporate governance, mergers and acquisitions, government relations, and real estate portfolio management. Mr. Ellis served as the Delaware State Bank Commissioner under two governors, the Honorable Mike Castle and the Honorable Thomas Carper (U.S. Senator, D-DE). During that period Mr. Ellis served as the Chairman of the Expenditures Committee of the Delaware Financial Advisory Committee, which advises the Executive and Legislative branches on matters relating to state budget and revenue matters. Mr. Ellis has served as minority counsel to the Banking Committee of the U.S. House of Representatives and as Chief Lobbyist and Legislative Counsel to the Conference of State Bank Supervisors. Mr. Ellis has also served as the general counsel and head of compliance of two financial institutions. Mr. Ellis graduated from the George Washington University in 1973, received his J.D. from The American University, Washington College of Law in 1976, and is admitted to practice in Delaware and the District of Columbia.*

*CHRISTINE P. SCHILTZ joined Parkowski, Guerke & Swayze in June 2003, concentrating in insurance and banking law, health care and government relations and regulatory matters. She has represented a variety of clients before the Delaware General Assembly and state administrative agencies. She is a member of the ABA's Business Law and Tort and Insurance Practices sections. She is also a member of the Delaware State Bar Association. Ms. Schiltz is a 1993 graduate of the University of Richmond, T.C. Williams School of Law and received her B.A. in history, cum laude, from Wake Forest University.*


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*Notes*

1- Memorandum and Order, MDL No. 14-2522, December 2, 2014 (the "Order"). References are made to the Order throughout the article. Additional citations have been omitted.
2- We note that the Court in *Banknorth v. BJ's Wholesale Club, Inc.*, 394 F. Supp. 2d 283 (D. Me. 2005), denied a motion to dismiss in a similar case, without significant discussion, leaving the issue of duty owed to the card-issuers for resolution in the decision on the merits.
3- Press Release dated December 19, 2013.
4- Consolidated Class Action Complaint, MDL No. 14-2522, August 1, 2014, (the "Complaint"). References are made to the Complaint throughout the article. Additional citations have been omitted.
5- FireEye, Incorporated, a security software company was retained by Target in February, 2013, to install malware detection software and monitor Target computers for intrusion attempts.
6- *Bjerke v. Johnson*, 742 N.W. 2d. 660, 665 (Minn. 2007).
7- It is of interest that Plaintiffs did not argue that they were intended third-party beneficiaries of consumer data protection provisions of agreements between the acquiring bank and the retailer.
8- Minn. Stat. Section 325E.64.
9- Defendant's Memorandum of Law in Support of Motion to Dismiss the Consolidated Class Action Complaint (the "Motion to Dismiss"), MDL No. 14-2522, September 2, 2014. References are made to the Motion to Dismiss throughout the article. Additional citations have been omitted.
10- The Motion to Dismiss makes the claim that application of the "special relationship" standard is required is based on the premise that the financial losses were caused by third-party criminal attacks.
11- Target notes in the Motion to Dismiss that the courts in Minnesota have been reluctant to extend special relationship duties beyond limited categories "in which that other person is deprived of normal opportunities of self-protection;"
12- In doing so, the Court acknowledges that the "separate and distinct" special relationship doctrine has been found to apply "in a very few, limited situations that are not applicable here." Order, Slip Op. at p.5; Citing *RKL Landholding, LLC v. James*, No. A12-1739, 2013 WL 2149979, at *2 (Minn. Ct. App. May 20, 2013).
13- The Court applied a five factor test used in determining whether a defendant owed a duty of care in a general negligence case.
14- In this regard, the Court implies a third-party beneficiary aspect to the series of contracts in the transaction chain.
15- In *Slaughter v. Aon Consulting, Inc.*, 2012 WL 1415772 (Del. Super. 2012), dismissal was granted because plaintiff card-holders could not show that they had suffered "an actual, not hypothetical, injury" as a result of the breach. This decision followed a line of decisions dismissing consumer cases in other jurisdictions on similar grounds. Plaintiff financial institutions do not face difficulty in proving injury.
16- See e.g. *Ramunno v. Cawley*, 705 A2d 1029 (Del. 1998): "…we remain heedful of our duty to draw all reasonable inferences in favor of the non-movant…" at 1034; See also *Kesting v. River Road Swimming Club*, 2014 WL 7149740 (Del. Super. 2014).
17- See e.g. *Revell v. Simmons*, 2014 WL 6667493 (Del. Super. 2014): "…plaintiff must prove the presence and breach of a duty owed by the defendant, which is the proximate and legal cause of the plaintiff's injury." See also *Morris v. Theta Vest, Inc.*, 2009 WL 693253 (Del. Super. 2009).
18- 594 A2d 506 (Del. 1991).
19- The Court notes that the doctrine of *in loco parentis* has been rejected by other courts as a basis for a finding of a "special relationship", at 517-518.
20- Id. at 520, citing Section 323 of the Restatement (Second) of Torts (1965). The Court cites *Jardel Co., Inc. v. Hughes*, 523 A2d 518, 524 (1987) for the proposition that if a party "takes charge and control of [a] situation, he is regarded as entering into a relationship which is attenuated with responsibility."
21- Id. at 520.
22- It does not appear that the economic loss doctrine, prohibiting certain claims in tort where there exist adequate overlapping claims in contract, would bar a card-issuer negligence claim, as there is a lack of contractual privity between the merchants and the card-issuers, but their respective duties are collectively rooted in contract; See *Commonwealth Construction Co. v. Endecon, Inc.*, 2009 WL 609426 (Del. Super. 2009); See also discussion in *Liability of Retailer and its Affiliate Bank to Credit Card Issuer for Costs Arising out of Breach of Retailer's Computer Security*, Weston, 51 A.L.R. 6th 311 (2010).
24- The New York Times, *Bank's Lawsuits Against Target for Losses Related to Hacking Can Continue*, Dec.4,2014.


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# The FHLBank in Our Backyard

by Lynda Messick
President & CEO
Community Bank Delaware

As Delaware bankers, we typically think of our Federal Home Loan Bank, FHLBank Pittsburgh, as a reliable liquidity source. And no wonder: with $18.8 billion in advances outstanding to eight Delaware banks at September 30, 2014, it's clear that many of us count on FHLBank Pittsburgh when borrowing makes sense for our strategic business goals. But for those who think of FHLBank as a liquidity provider only, I have news.

FHLBank offers many products, services and opportunities to its members and to the communities of Delaware. As president and CEO of Community Bank Delaware, the chair-elect of the Delaware Bankers Association and a member of FHLBank Pittsburgh's board of directors, I've seen first-hand the impact FHLBank Pittsburgh has right here in Delaware – not only in helping its member banks grow and thrive, but also in making Delaware's underserved communities better places to live and work. All Delaware bankers, whether members of FHLBank or not, should be glad to know that the First State has a partner in Pittsburgh.

### Strategic Business Partner

From the largest banks in the nation to community banks like mine, Delaware bankers understand the importance of strategic planning. Today, large banks here in Delaware are turning to FHLBank Pittsburgh to meet the requirements of the Liquidity Coverage Ratio rules set by the Basel Committee, which promote short-term resilience in a bank's liquidity risk profile. They are finding advances to be an attractively priced solution to the Committee's requirement to have sufficient High-Quality Liquid Assets (HQLA) to survive a significant stress scenario lasting for 30 days.

On the regional and local levels, FHLBank credit products help Delaware bankers with asset/liability management and liquidity management, and provide a secondary mortgage market alternative – all of which help meet strategic business goals.

Ron Samuels, senior vice president and treasurer at WSFS Bank, is a regular borrower who understands how the partnership benefits both WSFS and the community. "Having ready access to funding is strategically important to our business," he said. "We use advances to manage our

liquidity, and other FHLBank products and services to support our operations and strategic mission as a community bank. With the various terms and rates offered by FHLBank, we are able to borrow advances that fit with our specific balance sheet strategies and asset/liability risk parameters. As we have continued to grow our lending in the communities we serve, FHLBank advances have helped support that growth.” Ron continued, “FHLBank has helped us support homeownership, business expansion and job creation through our use of their targeted programs such as the Community Lending Program, Affordable Housing Program and Banking On Business. We think of FHLBank as our partner: together we keep credit flowing, and that makes a difference in the communities we serve.”

Representative Carney and Senator Coons tour the PopDot Printshop with Paul Calistro of Bright Spot

Advances are not the only FHLBank product that Delaware bankers use for balance sheet management. Letters of credit (LCs) are on the rise. In fact, at September 30, 2014, Delaware bankers had $9.3 billion in FHLBank Pittsburgh LCs, many of which secure state and municipal (public unit) deposits. Public institution depositors appreciate the security backed by the LCs’ high credit rating and the fact that investments made in local financial institutions are routinely reinvested back into the community. FHLBank’s members like LCs because they offer an affordable way to increase liquidity. With a highly rated and comparable form of collateral, they are able to use their securities collateral for other important business purposes.

FHLBank also offers the Mortgage Partnership Finance® (MPF®) Program, which started in 1997 and today includes more than 1,000 participating financial institutions that have delivered over $100 billion in mortgage commitments nationwide. As bankers, we know that mortgages can be complicated assets to hold given their long terms and the borrowers’ ability to prepay without penalty. The MPF Program serves as a secondary market outlet for Delaware bankers. It combines the member’s credit expertise with FHLBank’s funding and hedging expertise to provide an effective alternative for funding mortgages.

### Community Development Resource

One of the most rewarding aspects of membership in the FHLBank is its array of community investment products. As a board member, I’ve had the opportunity to attend a number of ribbon cuttings, grand openings and special events that support how FHLBank, working through its member financial institutions, helps to make Delaware communities better.

This year, the Affordable Housing Program (AHP) celebrates 25 years of making housing affordable for individuals and families, many of whom have special needs. Since 1990, FHLBank Pittsburgh has provided over $197 million in AHP dollars, which leverages to almost $2.8 billion in investment. And bear in mind, these are private dollar grants. Often AHP dollars are the first dollars in to a project, encouraging other funders to commit additional dollars.

Here in Delaware, AHP has provided over $14 million in grants to subsidize 1,528 units of housing in 72 projects. While all of the projects are important and worthwhile, one that stands out is Milford Housing Development Corporation’s self-help homeownership program. Groups of four to seven qualified families work together to build their own homes under the leadership of a construction supervisor. When all are completed and inspected, the families can move in. Working with their trusted partner, County Bank, Milford Housing has secured three AHP grants for these self-help projects. David Moore, president and CEO of Milford Housing, can attest to the joy of move-in day and the importance of AHP in making it happen. “The flexibility built into AHP provides the burst of equity that low- and very low-income families sometimes need to make the numbers work,” he said. “Especially in rural areas, AHP is a necessary resource for making the dream of homeownership a reality for many of our families.”

Another community investment program of note is Banking On Business (BOB). This is a product FHLBank Pittsburgh launched back in 2000 to help create or retain jobs by making certain small business loans bankable for member financial institutions. As we all know, even with a solid business plan, new businesses don’t always have enough equity or cash flow to obtain a loan. With BOB, FHLBank commits up-front money to a local lender so the loan can meet the lender’s underwriting standards.

In the 14 years since launching BOB, FHLBank has provided more than $47 million in funding to assist small businesses in its three-state area of Delaware, Pennsylvania and West Virginia, working with local lenders to create or save more than 6,700 jobs. Here in Delaware, FHLBank has funded 16 BOB loans. The most recent of these was in the West Side Grows Blueprint Community in Wilmington where WSFS Bank used BOB to fund an inspired new enterprise, Popdot, LLC. (Blueprint Communities® is an FHLBank initiative that helps older communities to build capacity by training local leaders and offering access to special funding opportunities. There are currently seven Blueprint Communities in Delaware.)

*(continued on p. 18)*

## Community Development

(continued from p. 17)

Popdot came about when Bright Spot, created by West End Neighborhood House, was looking for a way to provide actual jobs, not just training, for former foster youth who have aged out of the system. Paul Calistro, who runs Bright Spot, approached Sir Speedy printing to create the subsidiary company, Popdot, which provides commercial and consumer signage and printing services. Today, 75 percent of all Popdot employees are former foster kids who are gaining business experience, learning new skills and heading into their futures with added confidence – and a paycheck.

### Foundation of Strength

These products and community development activities stem from FHLBank's mission statement, which is simple but powerful: to assure the flow of credit to members to support housing finance and community lending, and to provide related services that enhance members' businesses and vitalize their communities. FHLBank's ability to achieve this mission, year in and year out since 1932, relies upon strengths that derive from a unique cooperative structure and a business model that works.

Congress created the FHLBank System with a unique cooperative structure that currently includes the 12 individual FHLBanks, each with its own management and board of directors; their fiscal agent, the Office of Finance; and more than 7,500 members that are both owners and customers. Crucial to the structure is joint and several liability for the debt issued by the Office of Finance and the System's status as a government-sponsored enterprise. Its unique structure allows the System to enjoy the highest credit rating and preferred standing in the capital markets. Because they can tap into the most effective investors globally, FHLBanks are able to deliver cost-effective funding locally.

The FHLBank business model is another key component of the System's strength. Credit extended to members is secured by residential mortgages and other types of high-quality collateral. In more than eight decades, no FHLBank in the System has ever incurred a credit loss on an advance. This remarkable record is attributable in part to the collateral requirements built into the business model, and also to a strong regime of conservative underwriting and credit monitoring at the individual FHLBanks.

There's no question that the unique structure of the FHLBank System, combined with the fully collateralized business model, results in an organization that is both strong and stable. And because the individual FHLBanks are co-ops, in which owners and customers are one and the same, conservative management is a given. As a director, I can attest to a constant focus on proper governance and risk management balanced against concentrated attention to providing member value every day.

### Delaware's FHLBank Team

As Delaware bankers, we understand how profoundly banking and community are interwoven, and FHLBank Pittsburgh is an important partner in supporting both. As the numbers attest – $28 billion in credit and another half-billion committed through community investment programs – the financial impact makes a difference.

But numbers don't build businesses or communities: people do. That's why I'm happy to introduce the others joining me in the Delaware contingent of the FHLBank team: Dave Buches, Anas Ben Addi, Russ Huxtable, John Darr and FHLBank's newest director, Glenn Brooks.

Dave Buches is the Community Investment manager at FHLBank where he has worked for the past 14 years helping to make communities stronger throughout the three-state footprint, especially here in Delaware where he resides. I'm proud to add that during his tenure at FHLBank, Dave served three terms in Iraq and Kuwait before retiring from the United States Air Force late in 2013 as Chief Master Sergeant.

Two Delawareans serve on FHLBank's Affordable Housing Advisory Council (AHAC), which serves both management and the board of directors. Anas Ben Addi is the director of the Delaware State Housing Authority and a member of the Governor's cabinet. At DSHA, Anas directs the housing finance, planning and community


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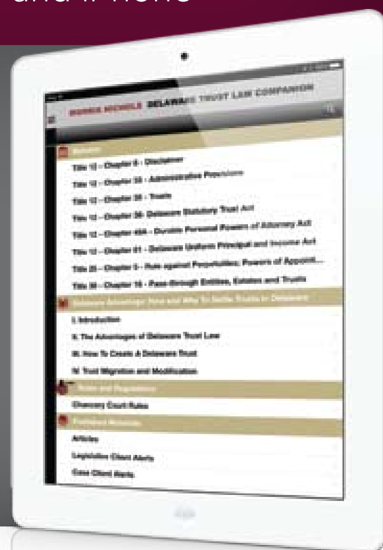

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development for the state, as well as the public housing authority for Kent and Sussex counties. Russ Huxtable is the vice president and chief operating officer for Milford Housing Development Corporation, leading all development-related activities for the agency, including single-family fee simple and multifamily developments.

John Darr, vice chairman of FHLBank's board, is on the board of directors of the West Rehoboth Land Trust, which is focused on creating affordable housing and revitalizing the historic neighborhood of West Rehoboth for both residents and lower-income workers. For 15 years he served as CEO and managing director of the FHLBanks' Office of Finance where he was responsible for issuing debt in the global capital markets on behalf of the 12 FHLBanks. John also serves on the board of Meals on Wheels in Lewes/Rehoboth.
Finally, I am pleased to introduce Glenn Brooks, who began his term on FHLBank's board of directors on January 1. Glenn is the chief operating officer and senior vice president of Leon N. Weiner & Associates Inc., a Wilmington-based home building, development and property management firm. He is responsible for the Weiner organization's development activities and is a member of the firm's board of directors. Glenn served on FHLBank's AHAC between 2004 and 2012, including terms as vice chair and chair.

Delaware bankers can be proud of the team that represents the First State at FHLBank, and we should be pleased about our partnerships and the impact we're making on our businesses and communities. So even though the logo says it's FHLBank Pittsburgh, you can see why I call it the FHLBank in our backyard.

*"Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.*

*"Blueprint Communities" is a registered trademark of the Federal Home Loan Bank of Pittsburgh.*

*Lynda A. Messick is President and CEO of Community Bank Delaware in Lewes. She serves on the boards of FHLBank Pittsburgh and Atlantic Community Bankers Bank, and is the chair-elect of the Nanticoke Memorial Hospital and the Delaware Bankers Association.*


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# The Art of Business Valuations

by Jonathan A. Patterson, CPA
Belfint, Lyons & Shuman, CPAs

***"A great business at a fair price is superior to a fair business at a great price"***

***- Charlie Munger***

Charlie Munger's intriguing quote is one that begs two questions: what type of business and what is it worth? Businesses can be considered great for a variety of reasons. They may have superior products or services, an exceptional salesforce, or attractive real estate holdings. All of these things may be attractive to potential buyers, but how do they know what these things are worth and how do they know they are getting a fair price when purchasing a business interest? Many of us deal with this challenge in our daily lives. Whether we are shopping for a flat screen television, buying a new car, or buying stock, determining something's value and making sure we are getting a good deal can be a daunting task to say the least. While it may be impractical to pay someone to help us determine the value of small personal items, when large sums of money are at stake, a prudent buyer should employ a seasoned valuation professional to perform a detailed business valuation to assist them in making their decision. Not only will the buyer develop greater comfort over the purchase price, the valuation report may help them secure the necessary financing for the purchase.

Most people hear "Business Valuation" and think they can calculate value by using three times EBITDA, five times sales, or some other arbitrary metric. Employing these bar napkin approaches is often as useful as throwing darts at a dartboard. Approaching a business valuation in this way can lead to a grossly over or understated value. A proper business valuation not only considers multiples of past performance, but also incorporates a great deal of non-financial data into calculating value, making the process much more of an art form than a science.

**Valuations can be used to assist with these scenarios, to name a few:**

- Mergers and acquisitions
- Sales and divestitures
- Loan applications
- Personal financial statements
- Martial dissolution
- Buy/sell agreements
- Fairness opinions
- Shareholder transactions
- Raising capital
- Employee Stock Ownership Plans (ESOPs)
- Litigation support
- Expert testimony
- Estate planning and tax
- Gift taxes
- Allocation of purchase prices
- GAAP valuations for financial statements
- Bankruptcy cases
- S corporation elections for the built-in gain potential

When performing a business valuation of a closely held entity, IRS Revenue Ruling 59-60 is among the most important and often cited revenue rulings and provides valuators with the most authoritative guidance. This ruling gives professional business valuators guidelines that must be followed and methods that must always be considered. Key methods cited in this 1959 ruling still hold true today. The ruling instructs valuators to consider all of the following methods each time they are performing a valuation engagement: comparable price, asset or income method. Each method takes a different approach in calculating value and each is appropriate under different circumstances.

Prior to considering any of the methods outlined the most critical and often most overlooked item when performing a business valuation is identifying the purpose. Valuations are classified as either tax (estate tax, gift tax, ESOPs, etc.) or a nontax valuations (purchase, sale, buy/sell agreements, etc.). Matching the purpose of the valuation to the methods selected is critical and highlighted best by Pratt, Reilly, and Schweihs in Valuing a Business – 4th edition, McGraw-Hill:

> "No single valuation method is universally applicable to all appraisal purposes. The context in which the appraisal is to be used is a critical factor. Many business appraisals fail to reach a number representing the appropriate definition of value because the appraiser failed to match the valuation methods to the purpose for which it was being performed. The result of a particular appraisal can also be inappropriate if the client attempts to use the valuation conclusion for some purpose other than the intended one."

After identifying the purpose of the valuation classifying it as a tax or nontax valuation, the valuator will need to know the terms under which the valuation is to be performed. Valuations are defined by two different sets of parameters: the standard of value and the premise of value.

There are three different standards of value as defined below:

1. Fair Market Value which is defined by IRS Revenue Ruling 59-60 to be "The price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."
2. Fair Value as defined by the Financial Accounting Standards Board: "Fair value is the price that would be received for an asset or paid to transfer a liability in a transaction between marketplace participants at the measurement date"
3. Strategic or Investment Value is defined as a unique value to an individual based on their specific requirements and expectations, or on a strategic basis, such as eliminating competition in the marketplace or vertical integration.

After the standard of value is selected, the premise of value must be determined. The premise of value falls into four main categories as listed below; they may also be broken down into various subsets as well:

1. Book Value – the difference of the total assets and total liabilities on a balance sheet
2. Going Concern Value – the value of a business that is expected to continue operating into the future
3. Liquidation Value – the value of the business if terminated and the assets sold off, either in an orderly or forced manner
4. Replacement Value – the cost of similar new property that is nearest to the property being valued (value to replace)

After understanding the reason for the valuation, the standard of value, and the premise of value, it is now appropriate to gain an understanding of the entity that is being valued. Understanding the business plays a pivotal role in a valuation and can on occasion cause nonfinancial facts to become as relevant as or even more relevant than financial facts. For example, what does the sales force look like in a small family business? Is the owner the only sales person? If the business gets purchased, who is left to sell their products or services? What does employee turnover of key personnel look like? Is there a concern because upper management seems to be changing every six months? Answers to these questions can

*continued on p. 22*

## Business Valuations

(continued from p. 21)

cause doubt about an entity and its ability to survive a purchase or question the ability of the business model to generate future revenue from existing assets if there are inherent issues that the financial statements themselves would not address.

Don't misunderstand – financial information is important, VERY important! Yet financial information isn't quite as useful unless it can be compared or benchmarked to industry data. Closely held businesses are not like publicly traded stocks. Luckily there are service providers who offer comparable data such as the Risk Management Association (RMA), which provides comparable industry data based on the North American Industry Classification System (NAICS), and the Standard Industrial Classification (SIC) codes. These data sources, like many others, give valuable comparable balance sheets, income statements, and financial ratios that can be used to benchmark a company's financial information with peers above or below them.

Another major issue valuators face with financial information is the accounting method, Generally Accepted Accounting Principles (GAAP), used for preparation because it relies heavily on historical cost. As a CPA, there are two words that get spoken more than any other: tax and GAAP. Yet GAAP is not very helpful when it comes time for a business valuation. In fact, it can make the job of valuing a business harder and perhaps more costly. Why, you might ask? Let's consider a building that was purchased in 1965. The GAAP financial statement says the building is worth very little, yet in reality the owner could probably sell the building at a much higher price. Value needs to be today's value, not yesterday's and yesterday's value is what GAAP presents to its readers. What does this mean for a valuation? Valuators need to convert historical information to fair market value. The costly part comes into play because any assets need to be converted to fair market value (potentially) based on the approach taken by your business valuator. Imagine you own a lot of commercial real estate. Now imagine the price you are paying to get each property valued? GAAP could have just potentially increased your cost a few thousand dollars!

If all of the steps above have been considered, i.e., the reason for the valuation, the standard of value, the premise of value, a thorough understanding of the company and its financial position, it is now time to address the valuation methods to be applied. As stated previously, each valuation under IRS revenue ruling 59-60 needs to consider an asset method, comparable price method, and income method but within each category are a gamut of options to consider. Let's take a look at each method, circumstances under which it would be used, and the various approaches under each.

The Asset Method is considered by many to be the "base line" or bottom to a value of a business. The asset method seeks the economic worth of the tangible and intangible, recorded and unrecorded assets, less the outstanding liabilities of a company. The asset method is valuable for developing a base line value for a business but is often rejected by a valuation analyst since it does not take into account the ongoing business operations. This method is often used, however, in the situation of a holding company. The two most commonly used approaches for the asset method are the book value method and adjusted net asset method. The adjusted net asset method adjusts all assets and liabilities (including deferred taxes and built-in gains tax) to their fair market value in determining the value whereas the book value method simply uses the equity of a company as the value.

The Income Method is defined in the International Glossary of Business Valuation Terms as "a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount." The means of coming up with a benefit stream to turn into a value can take multiple shapes. Some common methods are:

- Capitalization of earnings method
- Discounted cash flow method
- Gordon Growth Model

These methods try to accomplish the same goal of using projected income or cash flow and discounting that back to the present value. This method is widely accepted and most easily utilized. The disadvantage is the amount of subjectivity used in selecting a discount rate and a growth rate used to determine the value of the income or cash flow.

The Comparable Price Method or Market Approach utilizes comparable guideline companies for already completed and


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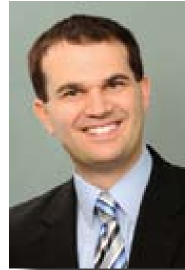
known transactions and applying multiples from those transactions to the company being valued. This approach is difficult to utilize due to the limitation of the availability of reliable data. However, if reliable data (both timely and comparable) is available, this method is appropriate in most situations since it relies on actual market data. Once data is selected, parameters must be selected on the data to be able to compare to the valued company to arrive at a price. Some common examples of parameters used are as follows:

- Revenues
- Gross profit
- EBITDA
- EBIT
- Debt-free net income
- Debt-free cash flow
- Cash flows
- Pretax income

After calculating values under each method, many additional adjustments for discounts need to take place. Control and lack of marketability discounts are the two most commonly used other discounts below may also be appropriate given the circumstances:

- Key person discount
- Investment company discount
- Information access and reliability discount
- Lack of diversification discount
- Restrictive agreements discount
- Small company risk discount
- Specific company risk discount
- Built-in gains tax discount

Valuations are an art form that is developed from experience and education. If knowing the approaches, learning the skills, and developing your own art form isn't enough, valuations are like tax law where there are a constant flow of new court cases modifying current approaches and offering completely new ones. For these reasons, it is important to have a valuator who is knowledgeable and well-versed in this art form and it is your client's best chance at having a valuation report hold up, whether in court or with the IRS.



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# Income Tax Basis Considerations in Estate Planning

## Now More Important Than Ever

by Jay W. Allen
Senior Wealth Strategist
UBS Financial Services

Recent increases in income tax rates along with favorable modifications to estate tax exemptions and rates have changed the traditional approach to planning for estate and income taxes. For decades there has been a wide gap between the estate tax rate, which at times exceeded 50%, and the relatively low income and capital gain tax rates. As a result, typical estate planning for taxpayers concerned about estate tax exposure focused on making lifetime gifts of assets expected to appreciate, often with little or no thought to the longer term income tax consequences of the transfer. The goal of removing future appreciation from the taxpayer's taxable estate to avoid estate taxes often trumped any income tax advantage to holding assets until death. Recent changes in the tax environment are prompting taxpayers to rethink this traditional approach. Gone are the days when taxpayers could reflexively transfer assets downstream, ignoring income tax considerations. Although gifting assets is still beneficial in many circumstances, today's environment requires careful analysis of a number of different factors to determine whether the estate tax benefit of giving away a particular asset outweighs the potential income tax benefit of retaining the asset until death.

The planning environment began to change with two major developments in 2013. The first was the enactment of the American Taxpayer Relief Act of 2012 (the "Act") in early 2013. In addition to permanently setting estate tax exemptions at $5,000,000 subject to annual inflation adjustments, the Act permanently set the estate tax rate at 40%. Although the rate is still higher than many taxpayers would prefer, the estate planning landscape today is much more favorable than that of the past several decades. With the increase in estate tax exemptions, far fewer taxpayers are now impacted by the estate tax.

The second development was a significant increase in federal income tax rates over the past three years. Top

ordinary income tax rates increased to 39.6%, while top long term capital gain rates and qualified dividend rates both increased to 20%. Adding to this burden is the 3.8% Medicare tax that took effect in 2013 which applies to certain types of net investment income above specified income thresholds Taxpayers in states imposing a state level income tax may have also experienced an increase in state income tax rates in recent years. As a result of these increases, many taxpayers are now very focused on income tax planning and are paying much more attention to the income tax implications of estate planning.

## The Importance of Income Tax Basis

The tax basis of an asset is used to determine the taxable gain or loss upon sale. The starting point for basis is generally the original cost of the asset, subject to a number of adjustments. Particularly relevant to estate planning are the rules governing adjustments to income tax basis at death. Often referred to as basis "step-up," these rules adjust basis to fair market value at the date of death (or in certain circumstances six months after the date of death). In the case of appreciated property eligible for adjustment, the basis step-up can be very favorable for heirs or beneficiaries because adjusting basis to fair market value eliminates income tax on any 'built in' gains associated with the inherited property. The heir/beneficiary can then immediately sell the property and pay no capital gain tax. Alternatively, if the beneficiary retains the inherited property for a period of time, she would only pay capital gain tax on appreciation that occurred in her hands.

Note that the above discussion applies only to property held at death. Unfortunately the step-up rules do not apply to assets given away during life. Instead, lifetime gifts are subject to "carry-over" basis, meaning the donee takes the donor's basis in the appreciated property. Thus, the donee will be taxed on all appreciation when she ultimately sells or disposes of the asset.

## Lifetime Giving

As a general rule, giving away assets during life eliminates the opportunity for a step-up in basis. In periods where the estate tax rate has been high relative to income tax rates, the loss of the step-up in income tax basis has been less of a concern because the estate tax savings often outweighed the income tax benefit afforded by the step-up in basis. For example, in 2001 the highest estate tax rate was 55%, which declined slightly over the next decade but was slated to return to 55% in 2011. During this period the maximum long term capital gain tax rate was as low as 15%. Transferring assets during life in hopes of avoiding a 55% estate tax often justified foregoing the basis step-up for assets held at death. Because this is less likely to be the case in the current environment, estate planning has become more complex in that it now requires analysis of future income tax consequences in almost every situation.

Taxpayers with estates safely below today's estate tax exemption should consider focusing their estate planning efforts on positioning appreciated assets for a step-up in basis. There is little estate tax incentive under current law for these taxpayers to make lifetime gifts unless there is a risk that future appreciation will be significant enough to exceed available estate tax exemptions. Taxpayers with non-tax reasons for making gifts should consider making gifts with cash or higher basis assets, if possible, to position lower basis assets for a potential step-up in basis upon death.

Lifetime gifting continues to be a powerful estate planning strategy for those with taxable estates, but the current environment requires taxpayers to perhaps be more thoughtful than in times past. Taxpayers should consider the tax basis of assets along with the potential for future appreciation before making a gift. If a low basis asset has little appreciation potential it may be more beneficial to retain the asset until death for a potential step-up in basis. A number of factors play into this decision including:

- What is the age and life expectancy of the taxpayer?
- Does the donor's state impose a state level estate tax that could be avoided by making a lifetime gift?
- Will the donee immediately sell the asset or hold it longer term?
- If a future sale by the donee is likely, what is the donee's federal and state income tax rate? Will he or she be subject to the Medicare tax on net investment income?

In some instances it will be an easier decision than in others. For example, making a lifetime gift of a low basis asset that is expected to explode in value may be a relatively easy analysis. Similarly, income tax basis may not be a tremendous concern for gifts of "legacy" type assets intended to stay in the family long term. In contrast, it would be a much tougher call for an 80 year old taxpayer contemplating a gift of low basis assets with moderate appreciation potential.

## Rethinking Basic Estate Planning Documents

Many married couples have estate plans designed to utilize the estate tax exemption of the first to die spouse by funding a trust upon his or her death with an amount equal to his or her unused estate tax exemption. Often referred to as a "Bypass Trust" or "Credit Shelter Trust," the assets of these trusts (including future appreciation) escape estate tax inclusion upon death of the surviving spouse. This approach may continue to makes sense for many married couples, especially those who have estate tax exposure under current tax law. However, married couples with estates well below current exemption levels might actually benefit from having the assets of the Bypass Trust included in the surviving spouse's estate since the assets would then be eligible for a step-up in basis. Depending on the nature of the assets, the time between the death of the first to die and surviving spouse, and the rate of appreciation, it might be preferable to forgo funding of the Bypass/Credit Shelter Trust to position the assets for another basis step-up upon surviving spouse's death.

Because it is not always easy to predict whether a taxpayer may have estate tax exposure in the future, flexibility is extremely helpful. Many estate planning attorneys are exploring ways to deal with the unknowns such as including provisions in irrevocable trusts to cause estate tax inclusion should that turn out to be beneficial in the future. This can be particularly beneficial in the context of the Bypass/Credit Shelter Trust by allowing the trust to be included in the surviving spouse's estate if doing so would not result in estate tax liability.

*(continued on p. 26)*

*(continued from p. 25)*

**Example:**

**Taxpayer owns real estate with a current value of $5,000,000 and a basis of $5,000,000 which she expects to appreciate substantially over the next decade. She is contemplating utilizing her lifetime exemption to make a gift of this property to a trust for the benefit of her children. Assume that at the end of 10 years Taxpayer dies and the property is worth $7,000,000.**

- **Assuming the $2,000,000 of appreciation would be subject to a 40% estate tax absent the gift, making the gift would save approximately $800,000 in estate taxes ($2,000,000 x 40%).**

- **However, before proceeding, Taxpayer must consider the income tax consequences if the trust sells the property. If the trust sells the property upon Taxpayer's death at the end of year 10, the long term capital gain tax would be approximately $400,000 ($2,000,000 gain x 20%). Under these assumptions the gift likely makes sense since anticipated the estate tax savings are larger than any income tax liability upon future sale.**

**Changing the facts slightly, now assume that the current value is $5,000,000, but the taxpayer's basis is only $2,500,000 (rather than $5,000,000).**

- **The gift still potentially removes $2,000,000 of appreciation from the estate saving approximately $800,000 in estate taxes.**

- **However, if the trust sells the property upon Taxpayer's death at the end of year 10, the long term capital gain tax would be approximately $900,000 (($7,000,000 - $2,500,000)x 20%)) Under these assumptions the benefit retaining the property to achieve a step-up in basis might outweigh the benefit of removing future appreciation from the estate.**

**In situations where the income tax savings of the step-up justify retaining the asset to position it for a step-up in basis, life insurance could be used to create liquidity and replace assets lost to the increased estate tax liability. Another strategy to consider if retaining the assets is to use the retained asset as collateral for a loan, followed by a gift of the loan proceeds to descendants or a trust for their benefit. If held until death, the loan would be a deduction for estate tax purposes, which would reduce the estate tax liability, and any appreciation on the gifted funds would be outside of the estate and not subject to estate tax. Obviously the expected rate of appreciation on the gifted assets would need to exceed the interest rate on the loan.**

### Rethinking Prior Estate Planning

Clients who have in the past implemented estate planning strategies seeking to reduce or suppress valuations with the goal of reducing estate taxes should revisit the planning in light of current rates and exemptions. Some may find they no longer have estate tax exposure due to today's higher estate tax exemptions, and may actually benefit from a higher valuation if this can establish a higher income tax basis at death without creating estate tax liability. In these cases it may make sense to work with an estate planning attorney to unwind the previously implemented strategy, while being mindful of any non-tax considerations relating to the prior planning such as asset/creditor protection.

Similarly, clients with estates safely below today's estate tax exemption level may find benefit in having assets previously transferred out of their estates via gifts or other techniques included in their estate if inclusion can establish a higher basis without triggering an estate tax liability. This type of reverse estate planning requires careful analysis by tax and legal advisors but may be beneficial in certain situations.

Today's tax environment requires a careful balance and coordination of income tax and estate tax issues. Planning for clients with estates well below federal and state exemption levels will likely focus on maximizing opportunities for a step-up of income tax basis, while planning for clients with taxable estates will require much more analysis and consideration of many of the factors previously discussed. A team of professionals including both tax and legal advisors is critical to navigating these complex considerations.

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Notes:

*1- Note that certain types of property are not eligible for basis step-up. For example, traditional IRAs, 401ks, property the decedent received by gift that passes back the original donor or original donor's spouse generally do not qualify.*

*2- In the case of depreciated property, note that basis adjustment rules may result in a step-down in income tax basis, eliminating an heir/beneficiary's ability to take advantage of a capital loss. In certain situations it may be beneficial to sell loss property prior to death to take advantage of the capital loss income tax benefit.*

*3- In the case of gifts of depreciated property, basis will equal fair market value if the property is ultimately sold below the donor's basis.*

*4- The Economic Growth and Tax Relief Reconciliation Act of 2001 actually provided for one year repeal of the estate tax in 2010, followed by a return to the 2001 rate of 55% in 2011*

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# DBA Calendar of Events

For more information on these and other programs visit ***www.debankers.com***, or phone the DBA at 302-678-8600, or email: debankers@debankers.com

## March 2015

**March 4th - 6th – 2015 DBA Executive Officer Visit to Washington, DC.** This highly acclaimed event for top-level bank executives provides an extraordinary opportunity to meet with the key federal regulators as well as

with our industry's representatives at the American Bankers Association in Washington, DC. In addition, we also meet with the entire Delaware Congressional Delegation. This year, DBA participants will be staying at The Willard InterContinental Hotel located at 1401 Pennsylvania Avenue, NW, Washington, DC.

**March 25th - Bank Secrecy Act Compliance & Anti-Money Laundering Seminar for Trust Companies, University & Whist Club, Wilmington**

Attention trust companies! Receive the federally required BSA/AML training with a focus on your organization's unique needs. Presented by the DBA and FIS Enterprise Governance, Risk & Compliance (EGRC) Solutions.

**2015 BSA/AML for Trust Companies**

## April 2015

**April 21st & 22nd - 2015 Teach Children to Save Day.**

Join other Delaware volunteer bankers as they visit public, private, and parochial schools, throughout the state as part of Delaware's 17th annual Teach Children to Save Day. Banker volunteer registration starts March 2nd at www.debankers.com. This year's Teach Children to Save Day lesson is taken from the new book ***The Great Investo and the Flourishing Flamingos.*** The book teaches the importance of saving and the magic of compound interest.

## May 2015

**May 14th – The 120th DBA Annual Meeting and Dinner.** Hotel du Pont, Wilmington. Join Delaware's top bankers at this annual event at the historic Hotel du Pont with dinner in the elegant Gold Ballroom. Sponsorship opportunities available.

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## Web and CD Seminars

For more information, or to register, please visit the Web Seminar link at www.debankers.com. The DBA has introduced an improved web seminar catalog featuring an easy to view, searchable listing. There is no log-in required to view the catalog. The checkout function has also been improved and includes itemized receipts.

### February - March 2015

**February 10 - Achieving Unclaimed Property Compliance**

**February 11 - 8 Keys to Teller Excellence**

**February 13 - Lending Schedules**

**February 17 - Understanding the New Integrated Disclosures Rules - General Rules**

**February 19 - 7 Habits for Success at Supervising**

**February 19 - Online Fraud & Cybercrime**

**February 23 - Personal Financial Statement Analysis**

**February 24 - Basic Bankruptcy for Bankers**

**February 25 - Introduction to Personal & Business Tax Returns**

**February 26 - ALERT! New W-8BENE & W-9**

**February 27 - Demystifying the New Liquidity Requirements for Community Banks**

**March 2 - Analyzing Business Financial Statements**

**March 3 - Understanding the New Integrated Disclosure Rules - The New Loan Estimate**

**March 4 - New 2015 Employment Compliance Obligations for Financial Institutions**

**March 5 - ACH Risk Management**

**March 6 - Call Report Revisions & Update, Part 2**

**March 16 - Analyzing Business Cash Flow**

**March 18 - ACH Compliance**

**March 19 - Bank Director Training**

**March 20 - Best Practices in Retaining, Attracting & Pricing Deposits**

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# Lending Law Update

by
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Young Conaway Stargatt & Taylor, LLP

***"In any loan restructuring or modification, the parties should proceed with the advice of sophisticated tax counsel to ensure that tax consequences and planning opportunities are considered."***

## Modifying Loans for Distressed Debtors: Debt Relief or Tax Trap?

Easily accessible credit and relaxed institutional standards gave rise to the most significant financial collapse since the Great Depression. From 2005 through 2008, investors lost nearly a decade of investment growth. As a result, creditors and debtors continue to restructure or modify under-collateralized loans and, in some cases, unintended tax consequences occur. In any loan restructuring or modification, the parties should proceed with the advice of sophisticated tax counsel to ensure that tax consequences and planning opportunities are considered.

Generally speaking, a debtor will recognize cancellation of indebtedness income ("COD Income") when a creditor forgives a debtor's loan. In many situations, the parties can easily determine and identify COD Income. For example, if a creditor gratuitously forgives $100,000 of debtor's loan by reducing the principal amount from $500,000 to $400,000, the debtor will have $100,000 of COD Income. COD Income, however, can result from more innocuous situations including, "substantial modifications" of an existing loan.

Under the Internal Revenue Code of 1986, as amended (the "Code"), a "modification" is any alteration of a legal right or obligation of the holder or the issuer of the loan, including the addition or deletion of a right or obligation. If a modification is "substantial", then under Code, the original loan is deemed exchanged for the new loan. The Treasury Regulations contain complex rules and safe harbors concerning when a modification is "substantial". Examples of modifications that may be "substantial" depending on their nature, include: (i) changes in the interest rate; (ii) maturity extensions; (iii) changes in the obligor; (iv) addition or material enhancement of a guarantee; (v) a change in collateral; and (vi) changes in the nature of the loan (recourse vs. non-recourse).

A debtor will realize COD Income after a substantial modification if the issue price of the new modified loan, as determined under the original discount rules, exceeds the issue price of the old loan. In many cases, notwithstanding a substantial modification and deemed exchange, COD Income can be avoided if the new loan is not publicly traded, has the same face amount as the old loan and provides for an interest rate equal or greater than the applicable federal rate. If a debtor does realize income in the substantial modification, however, the debtor will be required to recognize the gain in the year in which the substantial modification occurred. Notably, in some cases debtors may desire to intentionally trigger COD Income in a particular year to offset losses.

In cancellation of debt situations, the IRS requires that certain creditors (such as banks) issue a Form 1099-C. Creditors should tread carefully and seek appropriate legal advice when issuing Form 1099-C. With some exceptions, the IRS may impose civil monetary penalties for a creditor's failure to file Form 1099-C by the due date and for failure to furnish the required information to the debtor. In addition, some lower courts, following the minority view, have held the filing of Form 1099–C with the IRS constitutes prima facie evidence of an intent to discharge a loan, at which point the burden shifts to the creditor to proffer evidence that the Form 1099-C was filed by mistake or pursuant to an implied discharge triggering event. If a creditor is operating in a jurisdiction following the minority view, it should be careful with the filing of Form 1099-C because such filing may have the unintended consequence of prohibiting further collection of the debt.

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