Fraud on the High Seas: A Case Study of International Tax Fraud, Bankruptcy, and Recovery

This case study examines the events and tax fraud of Overseas Shipholding Group (OSG) leading to Chapter 11 bankruptcy. Then, it examines OSG's subsequent recovery from bankruptcy. The CFO of OSG realized a deemed dividend from its overseas subsidiaries when 'joint and several' language was included in debt contracts. This made the deemed dividend taxable by Internal Revenue Code Section 956. This language was not reported by the CFO nor were the taxes paid. The fraud grew over several years until a chain of events caused OSG to file for Chapter 11 bankruptcy. This case presents a fraud that was committed by a single actor simply by failing to report debt contract language. Despite its simplicity, the fraud led to a cumulative tax liability of over $500 million. This case exhibits tax fraud resulting from inaccurately calculating taxable income, corporate culture and ethics, and lack of internal controls. It provides a valuable auditing example of nuances that multi-national operations can create.

Keywords: *tax fraud, financial reporting fraud, IRC Section 956, bankruptcy recovery, internal controls*

Introduction

Corporate tax fraud has been a compliance problem since governments passed the first corporate tax laws; corporate tax fraud continues to plague tax revenue agencies (e.g. the Internal Revenue Service of the United States) to the present day. Various factors may impact the rate of tax fraud including higher tax rates, poor economic conditions, poor corporate performance perceived tax fairness, tax knowledge, and moral obligation (Kassa, 2021). A driving force in the tax fraud depicted here is the poor financial performance of Overseas Shipholding Group (OSG) and the looming prospect of a huge tax bill, which led to OSG's Chapter 11 bankruptcy filing. This case study of OSG follows the company's pre-filing financial performance, tax fraud, bankruptcy filing, and post-filing financial performance.

Enron, Worldcom, Global Crossing and many other corporate failures are evidence of a strong relationship between fraud and bankruptcy. This connection is logical. Corporate executives at financially sound companies do not have the same incentive to commit fraud as corporate executives at firms that are not doing well financially (Richardson *et al.*, 2015). Still, the incentives for executives at firms that are not doing well must ultimately be personal and at-risk – salary, stock options, stock investment, bonuses. These incentives can drive executives to make decisions that, in the short term, appear sound, but may put the firm at risk. Such is the case with Overseas Shipholding Group and its CFO Myles Itkin.

This paper examines the course of Overseas Shipholding Group over several decades. This case exhibits several factors identified by DiGabriele *et al.* (2023) that need more research. Namely, this case exhibits tax fraud resulting from inaccurately calculating taxable income, corporate culture and ethics, and lack of internal controls. The following part of this paper examines the literature on the Fraud Triangle in general and as it relates to the story told here. The second part presents the literature on bankruptcy, including Chapter 11 and prospective recovery after filing for bankruptcy. The third part examines the facts about OSG as its tax fraud unfolded, resulting in OSG filing Chapter 11 bankruptcy. The fourth part follows OSG in the years from bankruptcy filing to present. The final part of this paper provides conclusions to be drawn from this case study.

This case study provides a valuable example for tax fraud for auditors. The fraud went undetected for many years and was the result of a single actor. This case study demonstrates the importance of knowing key tax laws that could potentially impact a company. It also demonstrates the importance of gathering direct evidence to verify there is not a violation. While the fraud would have been difficult to detect, several warning signs indicate a corporate environment existed where fraud could be likely.

Literature Review

Tax Fraud

The fraud triangle is composed of opportunity, rationalization, and incentive. The legal profession and U.S. and international auditing standards incorporate these three parts of the fraud triangle in their standards and literature. According to Black's Law Dictionary, fraud is 'knowing misrepresentation or knowing concealment of a material fact made to induce another to act to his or her detriment' (Black's Law Dictionary, 2019). A more refined definition of fraud that might apply closer to this study comes from the AICPA, defining fraud as an 'intentional act ... involving the use of deception that results in a misstatement in financial statements that are the subject of an audit.' (AICPA, 2021, p. 165). Furthermore, it is the primary responsibility of company management to prevent fraud and the auditor to obtain reasonable assurance that the financial statements do not contain material misstatements (AICPA, 2021). Deshmukh *et al.* (1998, p. 127) find "auditors must accept disproportionate false flag rates to maintain audit effectiveness in the presence of management fraud. Gao (2021) finds accountant CFOs are more likely to engage in corporate tax avoidance but less likely to engage in aggressive corporate tax avoidance. Tax fraud could be considered extreme and illegal tax avoidance. As we will see in this case study, the fraud committed at Overseas Shipholding Group used deception to conceal and misstate financial statements which was not detected by the auditors. At the time of the fraud the auditing firm was Ernst and Young. For the 2022 10-K the auditing firm was Grant Thornton.

Opportunity presents itself differently and depends on the circumstances. Individuals may identify a weakness in the corporate internal control system they can manipulate. Generally, this opportunity requires taking proactive steps to commit fraud. These steps may include falsifying journal entries, such as recording expenses as assets in the case of Worldcom (Clikeman, 2019) or recording nonexistent revenues as Miniscribe did (Schillit *et al.,* 2018). Worldcom's CEO Bernard Ebbers had corporate management record current use communication line rentals as assets even though there were no future benefits. This increased assets on the balance sheet and reduced expenses on the income statement to the tune of $11B. Miniscribe recorded revenues for items before they were shipped. To continue the level of fraud at Miniscribe, management resorted to shipping literal bricks to off-site warehouses and recorded revenue on the shipments of 'computer components.' Both Worldcom and Miniscribe frauds involved years of detailed duplicate records and involvement of numerous employees. Sometimes, however, the commission of fraud results from the lack of action and the involvement of only one person, as is the case with OSG. For OSG's CFO, Myles Itkin, the opportunity was easier because Itkin did not need to do anything to commit fraud and there was no effective oversight of his inactions. Audit quality acts as a deterrent to committing fraud by minimizing the opportunity present. Studies in Portugal and Nigeria found less earnings management in the presence of a strong audit (Lopes, 2018; Nwoye *et al.*, 2021).

Incentive may be referred to as need or desire, but incentive ultimately is monetary. For Itkin that incentive was his lucrative employment compensation with OSG, including, as noted below, a $1.5M bonus offer from the OSG Board to stay on past 'normal' retirement age. OSG's financial position was already precarious, as this story shows. That financial position was a negative reflection on corporate management and bankruptcy would almost certainly mean the loss of employment for upper management. Incentive is the perceived financial need to commit fraud (Gilson and Vetsuypens, 1993; Koh *et al.,* 2015). Nbcobo and Reddy (2024) find a link between performance pressure and compromised ethical leadership. The incentive to keep OSG afloat was significant. The incentive to commit fraud is higher for a firm that is not performing well financially or is not meeting market analysts' expectations. Miniscribe provides one example of a firm not meeting expectations and committing fraud to reach expectations, as falling short of analysts' expectations would mean a decline in the Miniscribe stock price (Schillit *et al.,* 2018). Miniscribe manufactured computer components when personal computers were new to the public. In that burgeoning industry expectations for companies like Miniscribe were rampant and investor demand was high. To maintain the company stock price required continued, rapid sales growth. Initially, that was not a problem as Miniscribe had a considerable production order backlog. When the company met the backlog orders but still needed to increase sales, management developed an intriguing (and illegal) approach by booking shipments of literal bricks as computer components and recording them as sales. Miniscribe sent these shipments to warehouses in Colorado and then to Singapore under 'bill and hold' accounting rules.[1] In the Miniscribe case, the incentive to commit fraud was indirect, with a sustained stock price supporting the work of corporate management. This incentive can be a direct benefit (e.g. reduced taxes) to the fraudster or indirect benefit (e.g. corporate performance reflected on the fraudster). For the case

[1] For more on the Miniscribe fraud, readers might refer to Wall Street Journal issues in the 1980s which presented the story as it unfolded.

examined here the incentive to the fraudster was indirect. As Cooper (1996, p. 8) states, "[M]anagers may be prepared to engage in evasion because they have been effectively motivated to further the shareholders' interests, or because they believe evasion will further their own interests," including possible management incentives provided by the Board of Directors. CFO Itkin did not benefit directly from the fraud but benefitted indirectly because the company continued in business, paying his salary and other compensation, including a bonus arrangement to encourage Itkin to stay past his normal retirement age.

Rationalization is the most difficult of the fraud components to decipher as rationalization is a result of the individual's thought-process and seldom divulged. What was the fraudster thinking when this fraud was committed numerous times over the years? Perhaps Itkin reasoned this omission was a victimless act, or the law was unreasonable, or OSG would soon be in better financial position and his lack of action would be unnecessary and unnoticed, or that his actions benefitted many, such as corporate employees. Like many individuals with similar opportunities, Itkin likely reasoned that the rewards outweighed the risks. As one fraudster noted, 'I could justify the financial deceptions because we firmly believed that we would eventually find legitimate ways to earn enough money to make everything all right. One... shrewd new business deal would set everything right.' (McNall and D'Antonio, 2003, pp. 119-120) 'Once we entered the realm of deception, it was just too easy to stay there.' (McNall and D'Antonio, 2003, p. 156) 'It wasn't as if we grabbed some guns and robbed a string of 7-Elevens. Our crimes may have been just as bad in the eyes of the law, but they were committed in a way that lacked any of the drama or danger that signals true evil. Though the scale was obviously enormous, our acts weren't much different from the little lies told when someone overstates his income on a mortgage application or lies about her debts on a credit card application. Those deceptions are criminal acts too...' (McNall and D'Antonio, 2003, p. 157) McNall may very well have been speaking on behalf of Itkin. The AICPA, on the other hand, takes rationalization a step further and recognizes that some 'individuals possess an attitude, character, or set of ethical values that allow them knowingly and intentionally to commit a dishonest act,' (AICPA, 2021, p. 174).

While much examination of fraud focuses on the actions of single individuals, Donegan and Ganon (2008) encourage the exploration of the corporate culture that led to and allowed individuals to commit fraud. Fraud at Crazy Eddie Electronics involved much of upper management and middle management, many of whom were family members. Fraud was a vital part of their corporate structure from the origins of the company.[2] In one (out of numerous) aspect of the fraud, the Antar family skimmed money off the books for several years, and did not record the revenue, when the company was privately held by their family. This money was banked in Panama. When the Antars decided to go public with the company they returned the money to the company in increasing amounts over several years and recorded it as revenue,

[2]To understand how to turn corporate fraud into a viable career, see Sam Antar's post-prison speaking tour in which he bills himself as 'former CPA and convicted felon.'

thus inflating revenues and projected revenue growth and sending the price of the newly publicly traded stock dramatically higher (Clikeman, 2019). The family made millions selling their stock at the now over-inflated prices. This has been referred to as the 'Panama Pump.' For more on the 'Panama Pump,' listen to Ben Affleck explain the system in 'The Accountant' (O'Connor, 2016).[3]

Itkin alone committed the fraud at OSG. Individuals are less likely to act fraudulently in a prohibitive corporate culture. Did the corporate culture at OSG support ethical behavior or allow fraud? For example, were appropriate internal controls (such as separation of duties) in place; did OSG have a code of ethics and if so, was that code regularly discussed with corporate management; was the corporate focus on short-term profits at the expense of long-term viability? These are a few of the questions one might ask to determine if an appropriate ethical culture existed at OSG.

Fraud often involves complex accounting transactions. Enron used hundreds of special purpose entities (SPEs) to hide its off-balance sheet financing (Clikeman, 2019; Schillit *et al.,* 2018). Upper management was involved in setting up these fraudulent entities and making the accounting transactions to support this multi-year operation. The process was complex, time-consuming, and involved numerous people inside the firm and outside the firm. On the other extreme the fraud committed at OSG was simple, required one person, and was an omission instead of a commission. Itkin made no overt acts to commit the fraud and there were few other individuals who directly knew of the fraud. Itkin simply did not report the existence of language in contracts that would trigger tax recognition.

Corporate Recovery after Bankruptcy

There are many academic publications that model bankruptcy or financial distress prediction (e.g. D. K. Barney *et al.,* 1999) but fewer research works examine post-bankruptcy corporate performance. This case study provides some insight into corporate performance after filing for Chapter 11 bankruptcy. Survival of the firm after Chapter 11 bankruptcy relies on numerous factors, including enhancements in financial restructuring, corporate management, and board of directors' oversight. The extent to which OSG made significant changes determined the ability of OSG to recover after filing Chapter 11 bankruptcy. This story follows OSG's recovery from before bankruptcy filing to the present.

Many firms filing Chapter 11 bankruptcy eventually fail.[4] To succeed after filing for bankruptcy a firm must make changes to its corporate structure and corporate method of operation. Much of that change must be with the board of directors and corporate management. 'More often than not, a business failure is associated with a less-than-ideal corporate governance structure within the

[3]You can also review the basics of this fraud and its outcome at *Called to Account*, pp. 141-148.
[4]'[T]he success ratio of Chapter 11 cases, although not easily quantifiable, is normally historically deemed to be low. Indeed, many Chapter 11 cases are not even filed with a belief that they can be reorganized. Instead, they are a strategic way to delay creditors to achieve negotiating leverage.' (Pugatch, 2008, p. 53)

organization. The failure to adopt an effective corporate governance model often leads to a sterile, inactive board of directors and may hasten a firm's demise.' (Elson *et al.,* 2002, p. 1917).

One important element for successful restructuring is a well-defined reorganization plan. '[W]ritten reorganization plans positively influence the outcomes of ... court-supervised reorganizations.' (Kuttner *et al.,* 2023, p. 24). Incorporating a strategic bankruptcy recovery plan can gain creditor support (Mayr and Lixl, 2019). This recovery plan provides for the effective use of limited resources and guides the elimination of underproductive resources. These resources include 'financial, physical, human, and organizational assets used by a firm to ... deliver products of services to its customers.' (J. B. Barney, 1995, p. 50) The primary resources OSG uses to deliver products is its fleet of ships. The efficient allocation of these ships is even more important following bankruptcy. Per Eggers (2020), these allocation decisions are more imperative during times of crisis, such as bankruptcy, as stakeholders are more reluctant to deal with the firm.

> *'In a bankruptcy restructuring firms must make hard decisions to survive. Many do not have the courage to make those decisions. In reorganization, a failed firm stands at a critical juncture at which it must take a course of action that will ensure its successful revival.' (Eggers, 2020, p. 1918)*

Per Laitinen (2011), these restructuring decisions will need to be dramatic for the firm to survive. Moderate or half-baked decisions will not lead to firm survival.

> *'[Firms] must ensure or increase the strategic focus ... especially to manage, coordinate, and reconfigure the resource allocation in the long term to guarantee sustainable reorganization and to be successful.' (Kuttner et al. 2023, p. 38)*

Debt restructuring is a critical step to successful bankruptcy recovery. This restructuring may be private, for which companies and their creditors need not follow legal bankruptcy proceedings, or ordered by a bankruptcy proceeding (Blazy *et al.,* 2014). Companies shifting from debt to equity funding have a higher bankruptcy recovery success rate (Jostarndt, 2007), although Laitinen (2009) found that while liquifying assets and restructuring debt/equity provides short-term success for bankruptcy recovery, long-term success depends more on strategic business restructuring.

While the direct causes of bankruptcy are generally hard to identify and for many companies are not known (Slatter, 1984), for Overseas Shipholding Group the primary cause of bankruptcy is the incurrence of a large and sudden tax bill that contributed to an already shaky financial position for the company. While there were many contributing factors to OSG's bankruptcy (e.g. economic conditions in the shipping industry) identification of this specific tax bill as the item that pushed OSG 'over the edge' can also aid OSG's bankruptcy recovery (Mayr and Lixl, 2019).

Mayr *et al.* (2017) identifies three factors that often lead to bankruptcy, especially in combination. Those factors are deficiencies or weaknesses in management, firm resources, and external forces, with a focus on strategic management failure as the predominant cause of bankruptcy (Mayr and Lixl, 2019). Therefore, change in upper management is key to bankruptcy recovery success (Gilson, 1989; Mayr and Lixl, 2019). Even for those firms that do not successfully navigate bankruptcy, there is a high turnover rate for upper management (Gilson and Vetsuypens, 1993; Koh *et al.,* 2015).

Other factors contribute to bankruptcy recovery success beyond relying more on equity funding, developing a strategic bankruptcy recovery plan, and changing upper management and the board of directors. Management should examine assets for the potential to down-size or right-size the company as operating the correct assets is vital to corporate recovery (Headd, 2003) as outlined in the resources-based view of bankruptcy recovery (J. Barney, 1991). In addition, changes in company location, name, identity, and technology can aid bankruptcy recovery (Mayr *et al.,* 2017).

One of the problems with filing bankruptcy is the public revelation. All stakeholders (e.g. employees, customers, suppliers) know of the firm's financial problems and potential impending demise. When a firm files for bankruptcy, stakeholders (e.g. customers) may decide to stop transacting with the firm. 'This may turn out to be a self-fulfilling prophecy that further worsens the firm's situation and its chances of reaching an agreement with its creditors.' (Epaulard and Zapha, 2022, p. 243). Customers may be wary of dealings with a firm in distress; investors and creditors will want more assurances; and resources to meet current needs may be lacking (Eggers, 2020). OSG was ultimately one of the 'successful' firms that recovered from Chapter 11 bankruptcy.

In summary the literature review suggests that the following items may increase the possibility of companies successfully navigating bankruptcy recovery. These items are:

1. Change in Board of Directors
2. Change in Management
3. Strategic Bankruptcy Plan
4. Financial Restructuring (Reduce Debt/Increase Equity)
5. Downsize/Right-size Assets
6. Changes in Name, Identify, Location, Technology, Product/Service Lines, Accounting Practices

OSG's Story

Overseas Shipholding Group (OSG), incorporated in Delaware U.S. in 1969 as a worldwide oil and petroleum transporter, maintains an international flag fleet and a U.S. flag fleet, with a brief foray into the cruise industry. OSG has numerous subsidiaries; OSG's two primary subsidiaries involved in this present scenario are OIN Marshall Islands Corporation and OSG Bulk Ships (OBS). OIN handled international shipping operations and OBS handled US shipping operations. Most of OSG earnings were dividends from its subsidiaries and earnings on investments. As of 31 December 2011, OSG's subsidiaries owned and operated a fleet of 111 ocean-going vessels. These ships had a deadweight tonnage (dwt) of 10.9 million and a capacity of 864,800 cubic meters (cbm), making OSG 'one of the largest independent bulk shipping companies in the world.' (OSG 10-K, 31 December 2011, p. 37). OSG was growing, with a plan to add 5 more vessels that year. Instead, OSG's 2012 bankruptcy filing, and subsequent reorganization resulted in a dramatic downsize to the company.

> *'On November 14, 2012 (the "Petition Date"), the Company and 180 of its subsidiaries (together with OSG, the "Debtors") filed voluntary petitions for reorganization under Chapter 11 of Title II of the U.S. Code (the "Bankruptcy Code") in the U.S. Bankruptcy Court for the District of Delaware (the "Bankruptcy Court"). ... On April 18, 2014, [OSG] Debtors... filed with the Bankruptcy Court a plan of reorganization ...The Bankruptcy Court confirmed the ... Plan by order entered on July 18, 2014... On August 5, 2014 ... the Plan became effective and OSG emerged from bankruptcy.' (OSG 2014 10-K, Note 2)*[5]

As of December 31, 2014, after exiting bankruptcy, OSG owned '81 vessels aggregating 7.5 million dwt ...' (OSG 2014 10-K Section 7 MD&A, p. 46.) While OSG downsized, the reduction in ships was not dramatic as OSG post-bankruptcy still held 73% of its ships and 69% of its dwt as it did pre-bankruptcy.

This case study examines the facts and actions leading up to this outcome. This case study is an examination of the underperformance of OSG coupled with financial statement/tax fraud ultimately leading to bankruptcy. The case also follows OSG after emerging from bankruptcy to examine how OSG was successful when so many other companies failed.

IRC Section 956

> *'Income earned by a foreign subsidiary of a U.S. domestic company is normally not taxed by the U.S. until that income is repatriated to the parent company. Internal Revenue Code Section 956, however, is an exception to that general rule. Under IRC Section 956, if a U.S. corporation used its foreign subsidiary's assets as collateral for a loan or otherwise had the foreign subsidiary guarantee the loan, the U.S. corporation received a 'deemed dividend.' This dividend was then subject to U.S. income tax laws to the extent of the loan or previously unrepatriated income, whichever was less. OSG subsidiaries, OIN in particular, carried significant levels of unrepatriated income.' (IRC Section 956)*

OSG Situation

OSG had cash flow and income problems and for years relied on loans to augment their cash flows. These loans were for several years in the millions of dollars, until OSG ultimately attempted to consolidate those loans. It was general

[5] Form 8-K filed with the SEC on 5 August 2014 provides more information about the OSG corporate restructuring.

practice for OSG to use further loans to address maturing long-term principal payments. Therefore, OSG had used several banks and credit agreements. OSG’s creditors were aware of OSG’s precarious financial condition and repeatedly pushed OSG for enhanced assurances that they would be repaid. One approach the creditors used was to request that OSG’s subsidiaries guarantee OSG’s debt. These credit arrangements would use the language ‘joint and several,’ meaning each of the entities would be liable for their own debt and for the debt of any other entity in the agreement. For this case, that would make OIN and OBS guarantors of OSG’s debt. This would mean that the lessor of OIN’s and OBS’s unrepatriated earnings or the collateral for the loan would be subject to taxation by OSG under the provisions of IRC Section 956, reduced by any earnings of the subsidiaries already taxed by OSG (SEC Administrative Ruling 3-17807, paragraph 10).

OSG’s management apparently understood the tax consequences of making OIN a guarantor of OSG’s debt. Myles R. Itkin served as OSG’s Executive Vice President, Chief Financial Officer, and Treasurer for 18 years, from June 1995 to April 2013. Itkin had immense responsibility within OSG and its subsidiaries, including OSG accounting, financial statement preparation and reporting, and taxes. Itkin was responsible for credit arrangements, financial reporting, and asset transfers. Itkin’s considerable authority extended beyond OSG to OSG’s subsidiaries, including OIN and OBS. This is an example where a lack of separation of duties created an opportunity for fraud. “In 1997, OSG negotiated a credit facility specifically to avoid including a ‘joint and several’ provision because it would make OIN, OSG’s foreign subsidiary, a guarantor of OSG’s loans under these credit facilities and trigger tax consequences under Section 956.” (SEC Administrative Ruling 3-17807, paragraph 11). Previous credit facilities did not include this language/guarantee.

In 1997, OSG’s Outside Attorney outlined the tax consequences of a ‘joint and several’ provision in any credit agreements. This communication from Outside Counsel to OSG’s current lending bank, OSG’s controller, and inside lawyer explicitly stated that the potential outcome from using the ‘joint and several’ language could be that OSG would be required to recognize U.S. Federal income taxes on previously undistributed untaxed earnings of its subsidiaries. OSG then negotiated a 1997 $600 million credit agreement without ‘joint and several’ language (SEC Administrative Ruling 3-17807, paragraph 14).

OSG’s financial position did not improve. In fact, OSG’s financial indicators declined, resulting in OSG’s need for more capital. Based on OSG’s financial declines and poor industry reports for the ocean shipping industry, lenders reduced OSG’s credit rating. This further fueled creditors’ calls for inclusion of ‘joint and several’ language in credit agreements. In a further effort to avoid inclusion of this language, Itkin turned to European banks as potential creditors. These banks also wanted the inclusion of ‘joint and several’ language in the credit agreements, as the U.S. had expected, but Itkin pushed back, citing tax implications of IRC Section 956. With little other recourse, Itkin relented. This 2000 agreement and all subsequent OSG credit agreements contained the ‘joint and several’ language. OSG did not record any tax impact in its financial statements and did not report this situation to its auditors or Board of Directors (SEC Administrative Ruling 3-17807, paragraphs 20-21).

On 9 February 2006 OSG management (Itkin) signed a credit agreement consolidating its debt into a $1.5B debt agreement. This agreement included the 'joint and several' provisions for OSG, OBS, and OIN. The creditors wanted to expand the language to include all OSG's subsidiaries, but Itkin resisted. This time he prevailed. This provision in the credit agreements continued each year to require OSG to recognize unrepatriated earnings of OIN and OSB as income to the extent of previously taxed income (PTI). By 2008 the loan guarantees had exceeded PTI and OSG should have started recognizing taxable income. Therefore, OSG's tax returns were faulty, and OSG's financial statements were misstated (SEC Administrative Ruling 3-17807, paragraphs 25-26).

OSG wanted to pay down some debt and therefore, in 2008, determined to repatriate about $500 million in cash from OIN to OSG. Outside Attorney, on Itkin's request, examined this transaction for possible tax implications. "The memo prepared by Outside Counsel dated March 14, 2008 advised that either a direct distribution which would be a direct dividend, or a loan, which would be a deemed dividend, of $500 million from OIN to OSG would not give rise to taxable income to OSG to the extent that the amount was covered by OSG's PTI." (SEC Administrative Ruling 3-17807, paragraph 28-29). The memo noted that this transfer would wipe out OIN's PTI, but Outside Attorney was not aware of the 'joint and several' provisions of the loan agreements since 2000. The Outside Attorney advised OSG that this transfer would create $53M of taxable income, which OSG recognized.[6] The Outside Attorney again cautioned OSG management, including Itkin, that using the 'joint and several' language in credit agreements would potentially trigger IRC Section 956 taxable income.

The combined credit agreement OSG came due on 8 February 2013. In April 2011, OSG was working on a $900M credit agreement to use to meet the upcoming February 2013 deadline.[7] Again, OSG's Outside Attorney advised OSG that using the 'joint and several' language in the new agreement had potential IRC Section 956 consequences. At that time Outside Attorney asked if previous debt agreements held that 'joint and several' language. This was apparently Outside Attorney's first indication that OSG debt agreements held that language (SEC Administrative Ruling 3-17807, paragraph 34).

> *After confirming that the language had been included in prior agreements, Itkin and others from OSG management requested that Outside Counsel analyze Section*

[6]OSG already had reason to expect the government to enforce such provisions. In 2010, the Department of Justice fined OSG $37M for dumping oil in the ocean. OIN paid the dividend for OSG. The IRS determined this payment constituted a deemed dividend, taxable for OSG.

[7]The ocean-transport industry experienced significant trouble after the 2008 financial crisis, resulting in numerous of OSG's competitors entering bankruptcy. To sustain operations, OSG applied for a loan guarantee from the Department of Transportation. Public disclosure that OSG was transporting oil from Iran resulted in OSG withdrawing their application for the loan. Thereafter Moody's 'reduced the rating on OSG's debt, citing the decline in shipping rates, OSG's problems with raising money in time to meet loan covenants, and excess tanker capacity.' (SEC Administrative Ruling 3-17807)

> *956 tax implications arising from the "joint and several" provision in the 2000 to 2006 credit agreements. After further examination, Outside Counsel reinforced that the IRS could interpret the "joint and several" liability provision under Section 956 (c) and (d). They also argued that the provisions were ambiguous and analyzed the issue from the standpoint of determining the original intent of the parties concerning that provision. In this regard, Outside Counsel advised OSG and Itkin that if the Company did not intend for OIN to be a guarantor of OSG's loans and thus trigger tax consequences, then OSG could argue under commercial law doctrines that the provision should be set aside and rendered unenforceable by the IRS in a court proceeding. In determining the intent of the parties, Outside Counsel repeatedly asked OSG for contemporaneous documents that would shed light on the original intent of the parties, including draft term sheets and communications surrounding the 2000 and 2006 credit facilities, but were told by management no such documents existed. Despite receiving at least two documents that discussed subsidiary guarantees in connection with the 2006 credit facilities (the December 2005 memo and the draft term sheet referencing "tax implications of guarantees from non-US subsidiaries")…, OSG management and Itkin did not disclose the documents to Outside Counsel. Itkin also did not disclose that he had signed promissory notes on behalf of all three entities in connection with the 2000 and 2006 credit facilities. Itkin and management of OSG also did not authorize Outside Counsel to reach out to individuals involved in earlier negotiations. (SEC Administrative Ruling 3-17807, paragraph 35-36)*

OSG's financial position became more desperate in 2012, with continuing financial troubles and an impending $1.49B loan payment. OSG needed renewed financing. Early in 2012 Itkin unsuccessfully tried to convince banks to increase OSG's credit limit. The potential tax implications of IRC Section 956 were a consideration for the banks, with a memo circulated among loan officers about the issue. Even though the banks discussed the issue, OSG did not yet tell its outside auditors or Board of Directors about the possible consequences of IRC Section 956 (SEC Administrative Ruling 3-17807, paragraph 40). In fact, in February and August 2012, Itkin provided OSG's outside auditors with management representation letters stating that the auditors had access to all relevant tax information, but the outside auditors did not know about the potential IRC Section 956 tax implications (SEC Administrative Ruling 3-17807, paragraph 42).

In OSG's 2011 10-K PriceWaterhouseCoopers LLP (PWC) issued an unqualified audit opinion on OSG's financial statements. PWC also determined that OSG maintained 'effective internal control over financial reporting.' (OSG 10-K, 31 December 2011, page 115). The SEC, however, found that 'OSG had inadequate internal accounting controls over its accounting for income taxes and had deficient controls over the impact of the credit agreements on its financial reporting process.' (SEC Administrative Ruling 3-17807, paragraph 2). PWC did not find cause for a going concern issue. Still, OSG would file for Chapter 11 bankruptcy within one year of that statement date. For OSG's 10-Ks, OSG and Itkin provided PWC letters affirming that OSG had provided PWC with all relevant materials, but PWC did not see the May 2011 document from OSG's outside counsel, which is a violation of Exchange Act Rule 13b2-2(a).

Even though OSG filed for Chapter 11 bankruptcy protection on November 14, 2012, in January 2012, Itkin, and other OSG management got agreements for two years' compensation if their employment ended (OSG 8-K, 01 January 2012); and then in June 2012 Itkin signed an agreement with OSG for $1.5 million to stay on past his retirement age. Five months later OSG and 180 of its subsidiaries would file for Chapter 11 bankruptcy protection.

OSG management and Itkin thereafter presented this information and the potential tax consequences of IRC Section 956 to OSG's Board of Directors on 20 September 2012, three months after Itkin signed a $1.5M deal with OSG to continue employment. The Board meeting included Board members, OSG management, and OSG's Outside Counsel. One Board member, G. Allen Andreas III, took especial umbrage with OSG's failure to present the potential Section 956 implications to the Board or PWC years earlier. Mr. Andreas pushed OSG management to discuss the Section 956 issue with PWC immediately. He demanded hiring an outside law firm to investigate the issue and its consequences. OSG took no immediate action. When OSG management continued to resist disclosure, Mr. Andreas resigned from the audit committee and the board of directors. On September 27, 2012, Andreas submitted his resignation letter, starting the events leading to OSG's bankruptcy filing. (OSG 8-K, 27 September 2012) Mr. Andreas' resignation caused little notice on the stock market with OSG's stock dropping overnight from $7.05 to $6.82 following his resignation announcement. This aligns with the findings of Kim and Li (2014) who find lower stock price changes based on firm-specific information in offshore firms. On 14 November 2012, John Ray became Chief Reorganization Officer (CRO) like he did previously at Enron and Nortel. (OSG 8-K, 15 November 2012)

Public notice of Andreas' resignation through the 8-K filing led to an avalanche of events. OSG hired an independent law firm to investigate. The IRS found that OSG had approximately $463 million in unpaid taxes due to IRC Section 956. OSG restated its financial statements from 2000 through the second quarter of 2012 and ultimately filed for Chapter 11 bankruptcy in November 2012. Because OSG did not comply with IRC Section 956, its cumulative tax liability was understated by the following dollars and percentages over 12 years. Table 1 presents these amounts.

Table 1. *OSG Cumulative Tax Liability Understatement by Year*

$123M in 2000 (10%)	$519M in 2006 (20%)
$159M in 2001 (12%)	$558M in 2007 (20%)
$146M in 2002 (10%)	$513M in 2008 (20%)
$169M in 2003 (14%)	$476M in 2009 (17%)
$173M in 2004 (12%)	$464M in 2010 (16%)
$187M in 2005 (11%)	$512M in 2011 (17%)

(SEC Administrative Ruling 3-17807, paragraph 54)

The SEC concluded that OSG 'violated Securities Act Sections 17(a) (2) and 17 (a) (3); Exchange Act Sections 13 (a), 13 (b) (2) (A), and 13 (b) (2) (B),' and certain Exchange Act rules (SEC Administrative Ruling 3-17807, paragraph

68). The SEC ordered OSG and Itkin to cease and desist from committing future violations and fined OSG $5 million. The SEC assessed Itkin a $75,000 civil penalty.

The SEC identified Itkin as the cause of OSG's negligence-based fraud for the following reasons:

(1) 'Itkin, in his role as CFO of OSB, had responsibility for the financial and accounting operations of the company, served on the board of directors for OIN and OBS, negotiated the credit agreements, signed promissory notes on behalf of all three entities, and directed the draw down of advances on behalf of OSG under the revolving credit facilities.
(2) In carrying out his responsibilities, Itkin knew the credit agreements triggered tax liabilities arising from the credit agreements.
(3) Itkin was negligent in allowing internal control deficiencies at the company, including processes to identify the tax consequences of intercompany transactions between OSG and its foreign subsidiary.
(4) Itkin signed management representation letters for the company's outside auditor confirming that the company had provided the auditor with all written tax advice, even though he was aware of the May 2011 memorandum from Outside Counsel, which the outside auditor did not have.' (SEC Administrative Ruling 3-17807, paragraph 73).

On 04 March 2013, James Edelson, OSG Senior Vice President, General Counsel and Secretary, filed a notice with the SEC that OSG would not file its 2012 10-K timely. The notice 'concluded that the Company's previously issued financial statements for at least the three years ended December 31, 2011 ... should no longer be relied upon' ... and the 'time frame for completing this review [of the previously issued financial statements] is not currently known.' (OSG 8-K, March 2013, page 4) OSG ultimately filed its 2012 10-K on 26 August 2013. The day following this 04 March 2013 announcement OSG's share price dropped from over $7 to $1.25. These Debtor-In-Possession statements provide a reconciliation of restated 2011 financial statements with the 2011 financial statements as presented in the 2011 10-K. (OSG 10-K 31 December 2012, Note 2, page 90) Per Note 14

'the Company determined that there were errors in its previously issued financial statements and specifically its tax provision for each of the twelve years in the twelve year period ended December 31, 2011. As a result of certain credit agreements under which OIN was a co-obliger with the Company on a joint and several basis ... it could not assert its intent to permanently reinvest OIN's earnings to the extent these earnings could be deemed repatriated as a result of OIN's joint and several liability under the Credit Facilities...' (OSG 10-K 2012, Note 14, page 127)

The adjustments to the financial statements were mainly to address U.S. federal income tax provisions, including an increase in 'Reserve for Uncertain Tax Provisions, of $318M and an increase in Deferred Income Taxes of $193M. The 2012 change in the income tax provision for 2011 was only $7M as OSG 'has several defenses available to mitigate its liability and intends to assert those defenses vigorously.' (OSG 2012 10-K, Note 2, page 90). Apparently, this strategy worked as OSG settled the final tax bill with the IRS for a little over half the original assessment.

> *'On February 11, 2013, the IRS filed its original claim with the Bankruptcy Court seeking $463,013[000] in taxes and interest. Subsequent to this original claim, the Company provided the IRS with additional information which resulted in the December 19, 2013 amended and reduced claim totaling $264,278[000] in taxes and interest for the periods 2004 through 2012. On January 21, 2014, the IRS amended the December 19, 2013 claim to adjust for a computational error in calculating the interest thereby reducing the claim to $255,760[000]. As of December 31, 2013, the claim submitted by the IRS has not been approved by the Bankruptcy Court and, therefore, the Company does not consider the IRS claim to have been effectively settled. This IRS claim has been reflected in income taxes payable on the consolidated balance sheet as of December 31, 2013.' (OSG 2013 10-K, Note 14)*

The 2012 10-K shows a restated 2011 'Reserve for Uncertain Tax Position' of $323M and a 2012 balance for this account of $17M. Current Income Taxes Payable went from $368 thousand in the restated 2011 balance sheet to $330M in the 2012 balance sheet, including a $326M current 'reserve for uncertain tax positions.'

OSG's 2014 10-K, filed with the SEC 15 March 2015, shows a significant reduction of Current Income Taxes Payable from $256M the previous year to $906,000 on 31 December 2014. On the Statement of Cash Flows, OSG recorded this reduction as part of its 'Bankruptcy and IRS Claim Payments' totaling $584M in the operating section of the indirect method Statement of Cash Flows. OSG's ultimate tax payment to the IRS was about 50% of the original assessment by the IRS.

There were changes to corporate management post-bankruptcy filing. OSG announced on 04 April 2013, that Myles Itkin left the firm 'as part of the Company's reduction in force in connection with its restructuring efforts.' (OSG 8-K, 04 April 2013) The CEO was replaced (as noted above) with a temporary CEO. The Board of Directors on 31 December 2013, was the same as it was for the 31 December 2008, filing except four members left the board. The remaining eight board members were replaced with new board members in 2014. (OSG 2014 10-K, Section 10) OSG adopted a Code of Ethics as part of their Corporate Policy on 08 August 2013. 'Overseas Shipholding Group, Inc... has a proud tradition of observing the highest standards of business conduct.' (2024) OSG also instituted an anonymous hotline to report Code violations. The Code has a section specific to financial employees, requiring employees to 'comply with applicable laws, rules, standards, and regulations of federal, state, and local governments...' (2024)

How did OSG survive Chapter 11 bankruptcy and remain a viable independent company when so many firms do not make that transition? Insight is available in a statement from OSG management's post-bankruptcy filing:

> *'As part of an overall strategy to position the Company to successfully emerge from Chapter 11 with a smaller, more-concentrated fleet without the need for costly systems, multiple offices and the associated expenses, we embarked on an organizational restructuring process over the past 24-months that notably involved (i) rejecting 25 executory contracts relating to above-market charter agreements (17 of the vessels were redelivered and 8 were renegotiated), (ii) exiting our full service International Crude Tankers Lightering business to focus only on ship-to-ship Lightering services, (iii) outsourcing the technical and commercial management of our International Flag conventional tanker fleet and (iv) deleveraging our balance sheet by using a combination of cash on hand and proceeds from two exit financing facilities and an equity offering to pay down $2,131,290[000] of our pre-petition debt obligations of $2,577,290[000] (gross of original issue discount). As of December 31, 2014, our total debt (including the Exit Financing Facilities) was $1,668,667[000]. We believe these actions have positioned us to compete more effectively in the markets in which we operate.' (OSG 2014 10-K MD&A, page 46)*

A reorganization plan, such as the one outlined above, is essential to the effective and efficient allocation of the firm's resources following bankruptcy (Kuijl and Adriaanse, 2006).

In other accounting activity, OSG took a loss on write-down of vessels of $279M in 2012 and $366M in 2013 after taking no such losses in 2011. OSG also took a goodwill loss of $16M in 2013 after recording no goodwill losses the previous two years. Apparently, the new management was doing some house cleaning. In addition, management slowed the acquisition of new vessels: $187M in 2011, $52M in 2012, and $36M in 2013. OSG Management also eliminated many vessels. During post-bankruptcy years, especially 2015, OSG vessels on the balance sheet went from a high of $2.8B in 2012 to $632M in 2017 with the biggest drop of $1.24B in 2015. (OSG 10-Ks)

OSG operated as debtors-in-possession from 14 November 2012 to 04 August 2014. On 05 August 2014 OSG exited bankruptcy. On 14 November 2012, OSG had $2.58 billion in debt and carried its highest debt balance of $3.7B on 31 December 2013. Through reorganization OSG reduced its debt to $2.1B by issuing stock and using the proceeds to pay off long-term debt. Ultimately OSG settled with the SEC without admitting wrongdoing in the SEC's investigation of underreporting taxes and financial statement misstatements for the period from 2000 to 2012.

Post-bankruptcy Recovery Steps

The previous literature review suggests that the following items may increase the possibility of companies successfully navigating bankruptcy recovery. How did OSG address these items?

1. Change in Board of Directors – OSG had a new Board of Directors post-bankruptcy that vowed to increase involvement and oversight of corporate governance. This new Board instituted a Code of Ethics, which OSG did not previously have.

2. Change in Management – The CEO and CFO were replaced shortly after the bankruptcy filing with temporary officers selected to lead OSG out of bankruptcy, which they did. 'Permanent' officers managed the firm after successful bankruptcy emergence.
3. Strategic Bankruptcy Plan – OSG had a strategic business plan that included reducing the size of the fleet, OSG's primary asset category.
4. Financial Restructuring (Reduce Debt/Increase Equity) - OSG used less debt for funding post-bankruptcy than just before bankruptcy. The debt/asset ratio several years post-bankruptcy resembled the debt/asset ratio several years before bankruptcy.
5. Downsize/Right-size Assets – OSG management stopped delivery of new ships and downsized OSG's fleet as part of the restructuring plan.
6. Changes in Name, Identify, Location, Technology, Product/Service Lines, Accounting Practices – OSG did not make any noticeable changes to any items in this category, except product/service lines. OSG eliminated at least one shipping line, in a move to specialize company operations. The company name, corporate headquarters, and identity stayed the same as pre-bankruptcy.

Overseas Shipholding Group made the changes the literature identifies as determinants, or at least, supportive of successful bankruptcy recovery. These changes were not easy but resulted in the desired outcome. The company survived bankruptcy and was acquired by Saltchuk Resources, Inc. on July 10, 2024 (OSG.com, 2025).

Conclusions

What can we conclude from this combined case study of tax/financial statement fraud and bankruptcy?

1. Fraud can be committed with simple actions or no actions at all. While this tax fraud resulted in a tax bill of over $500 million, it required no overt acts, no complicated second set of books, no cloak and dagger late-night operations, and no collusion. All this fraud required was silence for 12 years. In the words of another fraudster, '[o]nce we entered the realm of deception, it was just too easy to stay there.' (McNall, 2003, p. 156)
2. Tax fraud can impact financial statements. While the IRS got involved in this case, we examined this case from the financial reporting (SEC) perspective. For publicly traded companies, tax fraud means there is also financial reporting fraud – disclosure of unpaid tax liability on the balance sheet, expense on the income statement, and cash tax payment on the statement of cash flows .
3. Auditors must understand tax regulations specific to the company, industry, and scenario to avoid situations that could result in tax fraud and associated financial reporting fraud.

4. Auditors should be especially skeptical when sufficient efforts are not made by upper management to prevent fraud. These include having effective oversight of the board of directors, an effective internal audit function, a written code of ethics, and an internal mechanism to report fraud (AICPA 2021, 181).
5. Fraud can continue for years undetected. While honesty is the best policy, staying 'under the radar' helps conceal fraud. Concealing corporate fraud is easier in a firm that is performing well financially, yet there is less incentive to commit fraud in a financially sound firm. Quite the conundrum!
6. It is possible to recover from bankruptcy and fraud, with the proper measures. Those measures will generally be dramatic, perhaps draconian. OSG managed to survive these 13 plus years after declaring bankruptcy by taking solid steps to downsize and cut costs and change management. While these steps might draw sounds of exasperation from some stakeholders, bankruptcy and recovery from it are difficult processes to navigate.

Discussion Questions

1. How could the board of directors and/or auditors have discovered this fraud sooner?
2. As the audit was being conducted, what were some potential warning signs that fraud was being committed?
3. What internal controls were missing? What internal controls would have resulted in detecting the fraud?
4. What mechanisms would have allowed whistleblowers to express concerns?
5. Discuss the fraud triangle (opportunity, rationalization, and incentive). How could one or more of the sides have been diminished to prevent the fraud from occurring?
6. Surviving bankruptcy is rare; what financial and operational changes did OSG implement to survive bankruptcy?
7. Why was Itkin's penalty so light ($75,000 fine) when SEC cited several reasons to hold him accountable? Fraud laws have different outcomes in different courts and in different situations. Is there a pattern to civil and criminal penalties imposed on fraudsters or is much left to the whims of the courts? Should steeper penalties have been imposed?
8. What penalties for Itkin could have been enforced under The Sarbanes-Oxley Act of 2002?

Teaching Notes

- While this fraud may have been difficult for auditors to detect, there were several controls that appeared to have been missing. The company should have had a written code of ethics, annual training for all associates, a hotline for employees to report suspected fraud, and protection for whistleblowers from retaliation. Likewise, a robust internal audit function that reports directly to the board of directors is essential.

- There was a lack of separation of duties. The CFO had too much control over multiple functions within the company including treasury, tax, and financial reporting functions. This may have resulted in a lack of communication between these departments.
- Here are some non-exhaustive suggestions to break the fraud triangle:

    - Opportunity: Separation of duties, a whistleblower hotline, and other internal controls would remove the opportunity to commit fraud.
    - Rationalization: A written code of ethics and mandatory annual training would remove the opportunity of the CFO to rationalize the fraud.
    - Incentive: Harsher penalties for the CFO would have removed the incentive to commit fraud. Under the Sarbanes-Oxley Act of 2002, the CFO could have received steeper penalties because OSG's fraudulent financial statements were willfully certified. Contingencies on the bonus for the CFO would have removed financial pressure to commit fraud.

- Several different aspects of this case can be emphasized. We share the case from fraud to bankruptcy to recovery, but you can focus on one or multiple aspects of this case to fit the needs of your class. We focus the discussion on the fraud in this case. We share the bankruptcy and recovery to provide more details of the case.

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