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CONTENTS

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The editorial staff of the *Michigan Business Law Journal* welcomes suggested topics of general interest to the Section members, which may be the subject of future articles. Proposed topics may be submitted through the Publications Director, D. Richard McDonald, The Michigan Business Law Journal, 39577 Woodward Ave., Ste. 300, Bloomfield Hills, Michigan 48304, (248) 203-0859, drmcdonald@dykema.com, or through Daniel D. Kopka, Senior Publications Attorney, the Institute of Continuing Legal Education, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432, dan@icle.org.

Each issue of the Michigan Business Law Journal has a different primary theme focused on articles related to one of the standing committees of the Business Law Section, although we welcome articles concerning any business law related topic for any issue. The primary theme of upcoming issues of the Michigan Business Law Journal and the related deadlines for submitting articles are as follows:

Issue	Primary Theme/Committee	Article Deadline
Fall 2013	Financial Institutions Committee	July 31, 2013
Spring 2014	Regulations of Securities Committee	November 30, 2013
Summer 2014	In-House Counsel Committee	March 31, 2014
Fall 2014	Corporate Laws Committee	July 31, 2014

ADVERTISING

All advertising is on a pre-paid basis and is subject to editorial approval. The rates for camera-ready digital files are $400 for full-page, $200 for half-page, and $100 for quarter page. Requested positions are dependent upon space availability and cannot be guaranteed. All communications relating to advertising should be directed to Publications Director, D. Richard McDonald, the *Michigan Business Law Journal*, 39577 Woodward Ave., Ste. 300, Bloomfield Hills, MI 48304, (248)203-0859.

MISSION STATEMENT

The mission of the Business Law Section is to foster the highest quality of professionalism and practice in business law and enhance the legislative and regulatory environment for conducting business in Michigan.

To fulfill this mission, the Section shall: (1) expand the resources of business lawyers by providing educational, networking, and mentoring opportunities; (2) review and promote improvements to Michigan's business legislation and regulations; and (3) provide a forum to facilitate service and commitment and to promote ethical conduct and collegiality within the practice.

The *Michigan Business Law Journal* (ISSN 0899-9651), is published three times per year by the Business Law Section, State Bar of Michigan, 306 Townsend St., Lansing, Michigan.

Volume XXII, Issue 1, and subsequent issues of the *Journal* are also available online by accessing http://www.michbar.org/business/bizlawjournal.cfm

Postmaster: Send address changes to Membership Services Department, State Bar of Michigan, 306 Townsend Street, Lansing, Michigan 48933-2012.

From the Desk of the Chairperson

By Marguerite M. Donahue

Debtor-creditor issues are the focus of this excellent issue of the *Michigan Business Law Journal*. The Michigan legislature recently adopted significant amendments to the Michigan Uniform Commercial Code that will be effective July 1, 2013. Joseph McGill explains important amendments to the Code that set forth new requirements for the proper way to identify individual debtors in UCC financing statements. These amendments provide needed simplicity and predictability for both filers and searchers.

Brian Phillips and Scott Eisenberg discuss the psychology, motivation, and methods of bank fraud perpetrators in several case studies, and the three elements that fraud experts agree are present in most cases of bank fraud. Messrs. Phillips and Eisenberg also highlight five techniques to reduce bank fraud that will be useful to you and your lender clients.

The other articles in this issue address bankruptcy law issues. Judy Calton and Daniel Linna discuss the uncertainty created by the United States Supreme Court's *Stern v Marshall* decision, in which the court decided a bankruptcy court lacked authority to finally determine certain core proceeding counterclaims against the estate. Ms. Calton and Mr. Linna provide valuable tips to practitioners in how to draft pleadings, shape proceedings, and interact with opposing counsel in light of the *Stern* decision. Lisa Mullen and Heather McGivern explain what bankruptcy counsel to consumer debtors need to know about Revised Federal Bankruptcy Rule 3001 and new Federal Bankruptcy Rule 3002.1. In their article discussing *In re TOUSA*, Paul Hage and Richard Kruger warn that upstream guarantees given by a subsidiary to support a parent entity's obligations may not be enforceable, especially when given within two years before a bankruptcy filing. This article explores reasonably equivalent value through indirect benefits as a defense to upstream guarantee challenges in Michigan and the Sixth Circuit. Daniel Morley and Megan VerMerris suggest the law and theories under which a building contractor who violates the Michigan Building Trust Fund Act may be unable to discharge in bankruptcy the amounts owing to its unpaid laborers, subcontractors, and materialmen.

In addition to enjoying these informative articles, please mark your calendars for the Section's 25th Annual Business Law Institute to be held on Friday, June 7 at the JW Marriott Hotel in Grand Rapids. To celebrate the 25th anniversary of the Institute, a panel comprised of preeminent Michigan business lawyers will reflect on significant developments that have shaped the landscape of business law practice and provide expert advice and perspective on what is next for Michigan businesses.

The Institute will also feature a multi-segment case study on advising successful entrepreneurial clients. The case study will include the following topics:

- *Handling Shareholder Disputes*. With increased success often comes an increase in disputes among shareholders. Prepare to handle shareholder disputes if and when they arise. Explore issues such as minority shareholder oppression, inspection rights and available remedies.
- *Intellectual Property Issues*. For many clients, intellectual property is among the company's most important assets. Gain a better understanding of who actually owns IP and how IP assets are valued.
- *Implications of the JOBS Act*. Raising capital is an important issue for the growing business. The JOBS Act affects private offering exemptions, crowdfunding and IPOs. Obtain an overview of this important legislation and understand how it will affect your clients who need to raise capital.
- *Negotiating the Venture Capital Term Sheet*. Representing a growing business may entail negotiating a venture capital term sheet. Review the terms contained in venture capital term sheets in the current marketplace, including voting rights, dividends, and indemnification.

As in years past, the popular business legislation and caselaw updates will also be presented at this year's Institute. As always, the Institute will offer the opportunity to spend time with seminar faculty, Section council members, fellow registrants, and friends at the reception and annual Section dinner following the program. I look forward to seeing you there!

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Corporation, Securities, and Commercial Licensing Bureau

The Bureau of Commercial Services (BCS) is being renamed as the Corporations, Securities and Commercial Licensing Bureau effective February 1, 2013. In September 2012, Governor Rick Snyder issued Executive Order 2012-13 transferring the Securities Division from the Office of Financial and Insurance Regulation to the Department of Licensing and Regulatory Affairs (LARA).[1] This change, effective on November 5, 2012, afforded LARA the administrative ability to assign the Securities Division to another agency within the department.

The Securities Division administers the Michigan Uniform Securities Act and the Living Care Disclosure Act, regulating securities offerings, broker-dealers, securities agents, investment advisers, investment adviser representatives, and living care facilities. The Division is committed to educating and protecting Michigan investors and consumers while promoting capital formation.

LARA assigned the Securities Division to the BCS to foster efficiencies in both the Securities Division and the other areas of BCS and to capitalize on the common regulation and licensing responsibilities located in BCS. BCS is committed to ensuring that the Securities Division maintains efficient, effective, and fair regulation of individuals and entities in the securities industry. To integrate the Securities Division into the Bureau, BCS is being reorganized.

Two administrative law specialists have been added to the Bureau's administrative area and will primarily work on securities related issues. The Securities Division will be reorganized and the Licensing & Production Section will be renamed Securities Division with Diane Bissell as the Securities Division director. The Investigation and Examination Sections will become part of the Bureau's Enforcement Division and Audit Section, respectively. Barrington Carr is the Enforcement Division director and Timothy Teague is the audit manager.

The Securities Division is currently located in Constitution Hall in downtown Lansing. The Department of Technology, Management and Budget (DTMB) will be requiring the Securities Division to vacate Constitution Hall to begin the re-stacking process of state-owned buildings. In conjunction with the Bureau's reorganization and vacating Constitution Hall, the Securities Division will move to 2501 Woodlake Circle, Okemos, and the Bureau's Enforcement Division and Audit/Examination Division will move from 2501 Woodlake Circle to auxiliary space. All indications are that the physical location changes should occur in late winter or early spring 2013.

The Bureau will be revising forms, certificates, and web page to reflect the new Bureau name. Current forms will, however, continue to be accepted. A new form will be developed for securities complaints and posted on the website as soon as it is available. Updated contact information for the Bureau and the various Divisions and Sections will be posted on the website as the changes occur.

The repealed "Uniform Securities Act," 1964 PA 265, MCL 451.501-.818, continues to apply in several instances. All effective registrations, administrative orders related to registrations, statements of policy, interpretative opinions, declaratory rulings, no action determinations, and conditions imposed on registrations under the prior act remain in effect for the same time period as if 2008 PA 551 had not been enacted. In addition, section 31 of the Administrative Procedures Act, MCL 24.231, provides that when a law authorizing or directing an agency to promulgate rules is repealed and substantially the same rule-making power or duty is vested in agency by a new provision of law, the existing rules continue in effect until amended or rescinded. Rule making authority in section 605 of the Uniform Securities Act (2002), MCL 451.2605, provides substantially the same rule making power as under the predecessor act. Review of the existing rules, transition orders, and rules previously drafted under 2008 PA 551 is being conducted and options are being considered regarding adoption of rules to carry out duties under Uniform Securities Act (2002).

Professional Service Corporations and Amendments to Business Corporation Act

Senate Bill 1320, Public Act 569 of 2012 effective December 31, 2012, repeals the Professional Service Corporation Act and amends the Business Corporation Act (BCA) to add chapter 2A, which permits the formation of a professional service corporation under the BCA. A definition added to section 109 defines "services in a learned profession" as "services provided to the public by a dentist, an osteopathic physician, a physician, a surgeon, a doctor of divinity or other clergy, or an attorney-at-law." Sections 201(3) and 281(1) clarify that a corporation providing professional services that are not services in a learned profession may elect to organize as a professional corporation and be subject to requirements applicable to professional corporations or may incorporate as a corporation that is not required to comply with Chapter 2A. Provisions in Chapter 2A generally include the same provisions as were in the Professional Service Corporation Act, albeit with some revisions.

A professional corporation must include names and addresses of shareholders on its annual report and certify that each shareholder is a licensed person in one or more of the professional services provided by the professional corporation and that the corporation meets the requirements of Chapter 2A. "Licensed person" is defined in section 282, MCL 450.1282, as "an individual who is duly licensed or otherwise legally authorized to practice a professional service by a court, department, board, commission, or agency of this state or another jurisdiction. The term in-

cludes an entity if all of its owners are licensed persons."

2012 PA 569 also includes amendments to the BCA eliminating the requirement that names of all participants in shareholder meeting be divulged to all participants if a shareholder participates by remote communication, allows shareholder agreement for assessable shares, allows a matter to be submitted to a vote of shareholders even if the board of directors initially approved the matter and no longer recommends the matter or the board recommended against shareholder approval, and includes conversion in the definition of business combination in Chapter 7A.

Fraud-on-the-Market Doctrine

On December 13, 2012, Oregon became the first state to adopt the "fraud-on-the-market" doctrine as a way for a plaintiff to demonstrate reliance on a material misrepresentation or omission. *Oregon v Marsh & McLennan Cos Inc*.[2] The "fraud-on-the-market" doctrine refers to a rebuttable presumption establishing reliance as an element in securities fraud cases accepted by the United States Supreme Court in *Basic Inc v Levinson*, 485 US 224 (1988). The basis of the doctrine is that the price of a security traded on the open market is based on publicly available information and that material misrepresentations therefore artificially distort a security's price.

The state of Oregon asserted claims against Marsh & McLennan companies, Inc. and Marsh, Inc. (collectively "Marsh") alleging that false and misleading statements by Marsh caused the state to lose approximately $10 million on investments in Marsh stock. The state alleged that they purchased more than $15 million of common stock in MMC in the open market on the New York Stock Exchange in 2003 and 2004. The state argued that the price of the shares was artificially inflated because of misrepresentations made by Marsh. Marsh asserted that the state's claims must fail because the state failed to establish direct reliance by state actors on action by Marsh and asserted that the state could not establish reliance on a presumption of reliance based on the "fraud-on-the-market" doctrine. The Oregon Supreme Court held that "ORS 59.137 requires a stock purchaser to establish reliance, but that a stock purchaser who purchases stock on an efficient, open market may establish reliance by means of the 'fraud-on-the-market' presumption."

North American Securities Administrators Association (NASSA) filed briefs *in Oregon v Marsh & McLennan Cos Inc* arguing that 1) antifraud claims under Blue Sky statutes prohibiting misrepresentations and omission do not require reliance, or, alternatively, 2) reliance can be presumed under the fraud-on-the-market theory.[3] NASAA expressed concern that the Oregon Court of Appeals decision in the case would weaken investor protection laws and concern with the adverse consequences for investors and regulators that would flow from the Oregon Court of Appeals decision.

The Oregon Supreme Court reversed the Court of Appeals and remanded the case to the Court of Appeals for further proceedings.

NOTES

1. http://www.michigan.gov/documents/snyder/EO_2012-13_397215_7.pdf.
2. http://www.publications.ojd.state.or.us/docs/S059386.pdf.
3. http://www.nasaa.org/wp-content/uploads/2011/08/1-Amicus_OR.pdf and http://www.nasaa.org/wp-content/uploads/2011/08/Brief_OR_Letter.pdf.

G. Ann Baker is Deputy Director of the Corporations, Securities and Commercial Licensing Bureau, Department of Licensing and Regulatory Affairs. Ms. Baker routinely works with the department, legislature, and State Bar of Michigan's Business Law Section to review legislation. She is a past chair of the Business Law Section and is the 2008 recipient of the Stephen H. Schulman Outstanding Business Lawyer Award.

By Paul L.B. McKenney

The Year End Tax Act Passed, Now What? Some Practical, Proactive Observations

As you are all aware, year-end tax legislation, the American Taxpayer Relief Act of 2012[1] (the "2012 Act"), is now law. For the first time in over a decade, we now can plan with the luxury of "permanent" tax rates and structures, or at least as permanent as that may describe tax legislation. While a discussion of the intricacies of this 159-page bill is well beyond the space allocated to this column, this short summary offers you information for the benefit of your high income individual and business owner clients as well as practical proactive steps.

The 2012 Act generally reaffirms the Bush tax cuts with certain significant exceptions for higher income taxpayers. As you will note, the triggers for these rules are different income thresholds and non-uniform measuring definitions, such as taxable income versus modified adjusted gross income. Thus, the specifics for each must be addressed. First, those with taxable income above the "applicable threshold" ($450,000 for joint filers and $400,000 for single filers in 2013) will be in a 39.6 percent marginal bracket rather than 35 percent.[2] The lower rates are unchanged. Second, the top rate for individual capital gains and qualifying dividends will rise from 15 percent to 20 percent for taxpayers with taxable incomes exceeding $450,000 for joint filers and $400,000 for single filers.[3] Third, under the 2010 Patient Protection and Affordable Care Act (PPACA), two new health care funding surtaxes took effect on January 1, 2013. These are in addition to income tax increases. An additional 3.8 percent Medicare surtax applies to "net investment income" over the threshold amount (i.e. $250,000 modified adjusted taxable income, or AGI, for married filing joint and $200,000 modified AGI for single individuals, trusts, and estates).[4] Net investment income is defined to include gross income from interest, dividends, annuities, royalties, rents, and investment gains. Also in addition to the past surtaxes on wages and self-employment income totaling 2.9 percent, an additional .9 percent surtax applies to such compensation-based income in 2013.[5] The same thresholds apply as with the net investment income surtax.

A fourth major change is that the so-called Pease limit on itemized deductions is reinstated effective in 2013. It was temporarily suspended under the Bush tax acts. Individual taxpayers with income over the "applicable amount" (i.e., $300,000 AGI for joint returns and $250,000 AGI for individuals) lose 3 percent of their deductions over the applicable amount.[6] In any event they can retain at least 20 percent of otherwise allowable deductions. There are myriad other details in the 2012 Act.

Thus, the highest effective federal income tax rate is 39.6 percent income tax plus 3.8 percent surtax, or 43.4 percent, and then up to 80 percent of otherwise valid deductions are lost, which in turn raises the true federal effective tax rate.

Owners of S Corporations and LLCs

The operational results of S corporations and many LLCs are ultimately reported on individual Form 1040s. The higher rates and surtaxes on upper incomes obviously impact thousands of Michigan taxpayers, particularly select professionals and those who own successful enterprises. There are also a number of business provisions in the 2012 Act, including numerous "extenders" of expiring tax breaks. One of particular interest that has been continued is the so-called bonus depreciation that allows, in addition to regular depreciation deductions, an additional first year deduction equal to 50 percent of the adjusted basis of qualified property.[7] Thus, in the year an asset is placed into service the depreciation deduction would be equal to sum of a) the 50 percent bonus depreciation, plus, b) depreciation claimed under traditional depreciation regimes and elections on the other 50 percent. Taxpayers can elect out of bonus depreciation. The practical impact of several years of various bonus depreciation regimes since 9/11 is that assets were very quickly written off for tax purposes, and taxable income was artificially suppressed in the short-term. The rationale behind bonus depreciation was to use the tax system to artificially spawn businesses acquiring new equipment and other assets and resultant, hoped-for job creation. The detriment to business owners is that several years later while the asset still has quite viable economic life, there is no, or virtually no, depreciation deduction. In plain English, it kicked the tax can down the road. Taxable income is then artificially raised. There are now some resultant perverse tax scenarios for your capital-intensive business owner clients.

Additionally the 2012 Act raises other issues for higher income individuals.

1) Continuation of a preferential rate for "qualified dividend income." While the rate increased from 15 percent to 20 percent, it is far less than the 39.6 percent marginal bracket for ordinary income.[8] This encourages investing in dividend paying stock as well as closely held C corporations paying out dividends.

2) While the calendar year 2012 has passed, the return preparation process is barely starting. The 2012 business returns present unique filing season decisions. A well-advised business owner must evaluate and make informed decisions on numerous expensing and depreciation

elections of when to claim deductions, capitalizing versus deducting certain expenses, electing out of bonus depreciation, etc. These raise the question of when, including factoring in the time value of money, is the most advantageous year to claim a deduction. For example, the owner of an S corporation or LLC purchased a million dollars of equipment that would, with bonus depreciation, result in a $700,000 2012 deduction. Should it all be claimed that year? Instead, should they elect out of bonus depreciation and be eligible for a $200,000 depreciation deduction that year but more in later years against otherwise higher income? Would your answer vary if the extra $500,000 bonus depreciation the first year was again low marginal brackets and/or zero? The wise answer depends on what the deductions are worth considering all of the other income, deduction, and credit items on a given return. The answers will not be "one-size-fits all." In addition to bonus depreciation, one must include alternative minimum tax computations, depreciation systems, and slower declining balance or straight-line methods in lieu of accelerated methods, expensing certain intangibles, etc.

Early in 2013, high-income taxpayers and taxpayers with flow-through business items need to have serious sit-downs with their tax preparers and tax teams and decide what elections, regardless of what was done in past "normal years," should be made given the new higher income tax landscape. This includes the increasing tax rates, which in theory make deductions more valuable, and is countered by the Pease limitations on deductions. The answer will vary among clients. Experience teaches that there is simply no substitute for running the numbers.

Estate Planning Considerations

We now know that the credit equivalent to a $5 million indexed for inflation (actually $5,250,000 in 2013) combined life-time gift and estate tax exemption is permanent.[9] The same number applies for GST purposes. The rate for gifts and taxable estates over the exemption equivalents was increased from 35 percent to 40 percent. Also because of inflation indexing, the gift tax annual exclusion per donee increased from $13,000 to $14,000.

Is there any rush for clients to do anything now? The answer for many is "yes" for two separate reasons. First, for the first time in 12 years we know the permanent (at least as permanent as anything is in tax) exemption amounts and rates and can do long-term planning with more certainty of the tax regime. Unlike income tax planning, estate planning and lifetime transfers have a far longer horizon. There is, under traditional planning, benefit to removing an asset from a taxpayer's name now so that future appreciation goes to the children/trust for grandchildren. The $5 million plus inflation gift tax exemption per donor creates opportunities for many higher net worth taxpayers to do something meaningful.

A second reason to act is to use, while still available, valuation discounts to value transferred interests for gift tax purposes. As discussed in the Fall 2012 issue of this column, most sophisticated taxpayers do not simply make a gift by transferring cash, securities, or real estate. Instead, for valuation discount purposes, they use interests in limited liability companies or other closely held business interests coupled with grantor-retained annuity trusts ("GRATs") or intentionally defective trusts (IDITs). There is some concern in the estate planning community because the corner stone of all large gifting is valuation discounts for minority interests and non-publically traded closely held business interests. If, for example, combined lack of control and lack of marketability discounts of 30 percent apply, is not the effective rate against underlying assets only (70 percent post-discount x 40 percent bracket) 28 percent? Congress just raised the rate from 35 percent to 40 percent, yet many will actually pay only 28 percent. The newly inaugurated administration and many in Congress would like to prospectively repeal those valuation discounts for gift and estate tax purposes.

There is obvious benefit to taxpayers making transfers now rather than after the next tax bill. From the government's perspective, valuation discounts represent large tax expenditures and impact less than 1 percent of the voters. In plain English, they are low-hanging fruit in Washington when seeking deficit reduction.

Conclusions

For the first time in many years there is some "permanence" in income tax as well as transfer tax regimes. There are also some transitional issues particularly on the 2012 income tax and elections on return perspectives. Now is an opportune time for you to educate clients and then sit down and ask them simple questions: Given the new regime, what proactive steps should you be taking in your own best interests and your family's best interests?

NOTES

1. 112 Pub L No 240, 126 Stat 2313.
2. IRC 1(a)(2).
3. IRC 1(h)(1)(D).
4. IRC 1411(a)(1).
5. IRC 1401(b)(2) and 3101(b)(2).
6. IRC 68(b)(1).
7. IRC 168(k).
8. IRC 1(h)(11).
9. IRC 2010(c).

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By Michael S. Khoury and Andrew T. Hayner

Michigan's Internet Privacy Protection Act

The tempest in the teapot for 2012 was generated when applicants at educational institutions and those searching for employment were compelled to turn over their user names and passwords for social media and other accounts. According to an April 2012 report by the Council of State Governments, "State Leaders Work to Protect the Privacy of Employees' and Students' Social Media Accounts,"[1] the issue became significant in Michigan when a teacher's aide was fired for refusing to provide login credentials to her social media account.

This issue generated substantial media coverage and discussions in the legal and human resources communities, and many commentators were suggesting that compelling potential students or employees to disclose their information could very well result in significant liability. Advice given to employers was often that the hassle and potential liability associated with this practice could offset any potential value.

Late in the 2012 legislative session, Michigan became the sixth state in the United States to enact legislation addressing the privacy of individual accounts and prohibiting employers and educational institutions from taking actions related to these accounts. The act, known as the Internet Privacy Protection Act (the "Act"), was signed into law by Governor Snyder on December 28, 2012.[2] The legislation took effect immediately, and is the current law in Michigan.

Scope of Michigan Legislation

This Act was drafted to address practices of employers and educational institutions. Employers include all private and public employers and their representatives.[3] Educational institutions include almost every conceivable private or public educational establishment, including academies, schools, districts, professional training and testing services, or their agents. The term educational institution "shall be construed broadly to include public and private institutions of higher education to the greatest extent consistent with constitutional limits."[4]

The legislation focuses on internet accounts of individuals that are protected with access credentials such as user name and password. The types of social media and internet accounts covered under the legislation include Facebook, Twitter, Instagram, and Tumblr, as well as personal e-mail accounts of the prospective student or employee.

Prohibited Practices

This Act is broken down into two sections. Employers are prohibited from requesting that an employee or applicant grant access to their personal internet account or disclose information that allows access to the account by the employer. It also prohibits the employer from discharging, disciplining, or failing to hire or otherwise penalizing an employee or applicant for failing or refusing to grant access to their account.[5]

Educational institutions are similarly prohibited from requesting a student or prospective student to grant access to their accounts and may not expel, discipline, fail to admit, or penalize the student for refusing to provide this information.

Among the interesting features of the Act is a safe harbor clarification that an employer or educational institution does not have a duty to search or monitor the activity of a personal internet account[6] and is not liable to request any information.[7] The Act provides for criminal penalties and gives an individual who is the subject of a violation the private right of action against the offending party. In both cases, the maximum exposure is a fine or damage award of $1,000, but employers and educational institutions should be wary of the provision that allows a claimant to obtain reasonable attorney fees and court costs, which will likely exceed the damages.[8]

Exceptions

There are important exceptions to the Act that are helpful and practical. Section 5 makes clear that an employer is not prohibited from gaining access to devices or accounts provided or maintained by the employer or taking action if the employee compromises or transfers the employer's proprietary or confidential information or financial data to his or her personal internet account.[9]

Similarly, the employer is not prohibited from conducting an investigation about activity on an employee's personal account for the purposes of ensuring compliance with applicable laws and regulations. The Act makes clear that the employer may restrict access to websites from employer-supplied devices without violating the Act.

Educational institutions have similar exceptions for devices or accounts maintained by the institution or from reviewing publicly available information about the student or applicant.[10]

Important Items to Note

There are some interesting aspects to the Act that individuals and employers should consider. Many educational institutions provide students (and even alumni who never heard of e-mail) with e-mail accounts for which the educational institution maintains the service. From the standpoint of the student, access to the account by the institution for any reason appears to be an exception to the Act. This is consistent with the "no expectation of privacy" rule that employees have within their employment relationship. What the Act does not address is whether the educational institution has the right to access an internet account used by an alumni.

It is also important to note that employers are given special protection to conduct the necessary internal investigations to protect the organi-

zation, and, in this regard, the Michigan Legislature has at least thought through this aspect of the issue.

Whether this entire topic continues to become an important issue or will disappear into the ether will be seen in time, but employers and educational institutions should be aware of and conform their internal and external policies to the legislation.

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NOTES

1. http://knowledgecenter.csg.org/drupal/content/state-leaders-work-protect-privacy-employees-and-students-social-media-accounts#3.
2. Public Act 478, Public Acts of 2012 (HB 5523).
3. Section 2(c) of the Act.
4. Section 2(b) of the Act.
5. Section 3 of the Act.
6. Section 7(1) of the Act.
7. Section 7(2) of the Act.
8. Section 8 of the Act.
9. Section 5(1) of the Act.
10. Section 6 of the Act.

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What Business Lawyers Need to Know About Bankruptcy Court Authority After Stern v Marshall

By Judy B. Calton and Daniel W. Linna, Jr.*

Introduction

On June 23, 2011, the United States Supreme Court decided *Stern v Marshall*,[1] holding unconstitutional a certain congressional delegation of authority to bankruptcy courts and sending shockwaves throughout the bankruptcy world as to the extent of bankruptcy courts' authority.[2] Courts have split over the scope of *Stern*'s impact.[3] Although significant issues on bankruptcy court authority remain unsettled and will take years to resolve fully, lawyers need to practice in the bankruptcy court before the issues are settled. This article contains an analysis of *Stern's* impact and recommendations for steps to take until post-*Stern* law is settled.

Bankruptcy Court Jurisdiction: The Statutory Scheme

The Constitution gives Congress the power to establish uniform laws on bankruptcy.[4] Congress's statutory bankruptcy scheme vests bankruptcy jurisdiction in the district courts, which are Article III courts,[5] and allows the district courts to refer certain matters to the bankruptcy courts, which are Article I courts.[6] The district courts are given original and exclusive jurisdiction over all cases under title 11 of the U.S. Code.[7] The district courts have original, but not exclusive, jurisdiction over proceedings that arise under title 11 of the U.S. Code, arise in bankruptcy cases, or are related to bankruptcy cases.[8]

Congress authorizes the district courts to refer bankruptcy cases and bankruptcy proceedings within their original jurisdiction to the bankruptcy courts.[9] Virtually every district court has a standing order or local rule referring to the bankruptcy court all bankruptcy cases and bankruptcy proceedings over which the district court has original jurisdiction.[10]

Under the statutory scheme, the bankruptcy courts can hear and finally determine bankruptcy cases and "core proceedings," subject to appellate review under 28 USC 158.[11] There is a nonexclusive statutory list of "core proceedings" integral to the administration of a bankruptcy case.[12] Among the statutory core proceedings are "counterclaims by the estate against persons filing claims against the estate."[13] If a proceeding is related to the bankruptcy case, but not core, the bankruptcy judge must submit proposed findings of fact and conclusions of law to the district court. The district judge then reviews the proposed findings and conclusions of law and any timely objections and enters the final order or judgment.[14] If the parties consent in noncore proceedings, however, the bankruptcy judge can hear, determine, and enter final orders and judgments.[15] There is no provision for the district court to review proposed findings of fact and conclusions of law in core proceedings.

The district court has jurisdiction over appeals from bankruptcy court orders.[16] Where bankruptcy appellate panels are established and authorized, the bankruptcy appellate panel, consisting of three bankruptcy judges, also has jurisdiction over appeals from bankruptcy court orders.[17] Appeals may be taken from district courts and bankruptcy appellate panels to the United States Court of Appeals.

As discussed below, the *Stern* opinion upset this statutory scheme of bankruptcy court jurisdiction, holding some of it unconstitutional.

The *Stern* Case

Procedural History

The Stern dispute began in 1995 and reached the United States Supreme Court ("the Court") twice. Chief Justice Roberts aptly compared the *Stern* litigation to the seemingly never-ending fictional case of *Jarndyce v Jarndyce* in Charles Dickens' *Bleak House*.[18] The Stern in the case is Howard K. Stern, Executor of the estate of Vickie Lynn Marshall, better known as former Playmate of the Year, dancer, and model, Anna Nicole Smith ("Smith"). Smith married J. Howard

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Marshall II ("J. Howard"), believed to have been one of the richest men in Texas, when she was 26 and he was 89. He died in August 1995, roughly a year after the wedding, leaving Smith nothing in his will or trust.[19] The Marshall in the case is Elaine T. Marshall, Executrix of Pierce Marshall ("Pierce"), son of J. Howard.[20]

Smith contended in Texas Probate Court that J. Howard's son, Pierce, had tortiously interfered with her expectations to receive property from J. Howard on his death. The Texas Probate Court determined that J. Howard's estate plan was valid despite Smith's contentions.

In January 1996, Smith filed a voluntary Chapter 11 bankruptcy case in the Central District of California (the "Smith Bankruptcy Case"). Pierce filed a proof of claim for defamation and commenced an adversary proceeding in the Smith Bankruptcy Case seeking non-discharge of his defamation claim. Smith filed a counterclaim to Pierce's proof of claim, based on her tortious interference claim. Smith won her tortious interference counterclaim on the merits after a trial in the bankruptcy court. The bankruptcy court, finding that Smith's counterclaim was a core proceeding, entered a final judgment for Smith against Pierce.

Pierce sought review of the bankruptcy court's judgment, asserting, among other arguments, that the bankruptcy court lacked subject matter jurisdiction. The district court treated the bankruptcy court's final order as proposed findings of fact and conclusions of law, and adopted them as modified.[21] The United States Court of Appeals for the Ninth Circuit held that the bankruptcy court lacked subject matter jurisdiction because the Texas Probate Court had exclusive jurisdiction under Texas law over probate matters under what is known as the "probate exception" to bankruptcy court jurisdiction. The Supreme Court granted certiorari and reversed, holding that the probate exception did not apply and state legislation cannot deprive a federal court of jurisdiction. The Court remanded the case to the Ninth Circuit to address whether Smith's counterclaim was a core proceeding and the applicability of claim and issue preclusion.[22]

On remand, the Ninth Circuit held that Smith's counterclaim was a non-core proceeding for which the bankruptcy court could issue proposed finding of facts and conclusion of law. The court treated the district court's decision as a review of proposed findings of fact and conclusions of law, and held that the Texas Probate Court's finding in favor of Pierce was entitled to preclusive effect.[23]

The Stern *Holding*

On its second grant of certiorari, the Court affirmed, on alternative grounds. Chief Justice Roberts, writing for a 5-4 majority, found that Smith's counterclaim against Pierce was a core proceeding within the meaning of 28 USC 157(b)(2)(C).[24] The Court held, however, that the broad grant of authority in 28 USC 157(b)(2)(C) to the bankruptcy court to determine finally counterclaims by the estate against claimants is an unconstitutional delegation of authority to the bankruptcy court.[25] Because Pierce's counterclaim against Smith was a tort claim at common law, its final determination must be by an Article III court. The Court held that "[t]he Bankruptcy Court below lacked the constitutional authority to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor's proof of claim."[26]

The Court found that Pierce's filing of a proof of claim did not result in him consenting to the bankruptcy court's final determination of Smith's counterclaim. Pierce's consent was to final determination of his proof of claim.[27] The Court held that "the notion of 'consent' does not apply in bankruptcy proceedings as it might in other contexts."[28]

The Court rejected the theory that the bankruptcy court could enter a final judgment on Smith's counterclaim as an "adjunct" of the district court. The Court reasoned that the bankruptcy court was exercising the essential attributes of judicial power, as opposed to serving as the functional equivalent of an administrative officer of the district court."[29]

The Court stated that its decision was a "narrow" one, which would not "meaningfully change[] the division of labor" between the district court and bankruptcy court, or "change all that much."[30]

Questions Not Answered By *Stern*

The Court's ruling in *Stern* raised many questions it left unanswered, which bankruptcy courts and practitioners will have to deal with until they are settled by higher courts, including the following:

The Court's ruling in *Stern* raised many questions it left unanswered, which bankruptcy courts and practitioners will have to deal with until they are settled by higher courts[.]

The delegation of authority to the bankruptcy court to determine counterclaims not related to a proof of claim is unconstitutional. Are other delegations of authority over core proceedings to the bankruptcy court also unconstitutional?

Although the only delegation to the bankruptcy court of final determination of core proceeding held unconstitutional in *Stern* was counterclaims against claimants not related to their proofs of claim, it is questionable to what extent Congress may withdraw from Article III courts "any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty."[31] Most of the attention to date on this question has focused on the delegation to the bankruptcy court of authority to enter final judgments in "proceedings to determine, avoid, or recover fraudulent conveyances."[32] Bankruptcy trustees are authorized to use state law to avoid fraudulent transfers.[33] Post-*Stern*, there has been a split as to whether that delegation is constitutional.[34] The courts holding that the bankruptcy court has such authority are described as having a "narrow" interpretation of *Stern*, and those holding the bankruptcy court is without such authority are described as having a "broad" interpretation.[35]

By statute, the authority of the bankruptcy court to issue proposed findings of fact and conclusions of law for *de novo* review by the district court is limited to noncore proceedings.

The first circuit court of appeals to address the fraudulent-transfer authority issue was the Sixth Circuit.[36] The Sixth Circuit interpreted *Stern* narrowly, holding that where the transferee had filed a proof of claim, the bankruptcy court had constitutional authority to adjudicate whether there was a fraudulent transfer because the determination was necessary to rule on the proof of claim.[37] The Sixth Circuit also held that the bankruptcy court had authority to determine the transferee's state law affirmative defenses.[38]

In another case, the Sixth Circuit subsequently held that the bankruptcy court has authority to disallow a secured claim against the estate even though no proof of claim was filed. The bankruptcy court, however, could not determine the debtor's fraud causes of action against the creditor to recover damages based in part on the same conduct that justified disallowance of the claim.[39] The case was remanded for the bankruptcy court to recast its judgment on the debtor's affirmative claims as proposed findings of fact and conclusions of law.[40]

Is the* Stern *holding jurisdictional?

Stern held that the bankruptcy court lacked "constitutional authority" to enter a final judgment. There is a split as to whether this lack of constitutional authority is a lack of subject matter jurisdiction.[41] Without subject matter jurisdiction, a bankruptcy court cannot even enter proposed findings of fact and conclusions of law.

Is there a gap where the bankruptcy court has neither the constitutional authority to make a final determination nor to issue proposed findings of fact or conclusions of law?

By statute, the authority of the bankruptcy court to issue proposed findings of fact and conclusions of law for *de novo* review by the district court is limited to noncore proceedings.[42] In core proceedings, the bankruptcy court is to enter final orders subject to appellate review by the district court.[43] The *Stern* Court created a new category of proceedings—core by statute but not within the bankruptcy court's authority. There is no statutory provision that authorizes the bankruptcy court to issue proposed findings of fact and conclusions of law in core proceedings. "If the bankruptcy court lacks constitutional power to issue a final judgment [in the gap] does it have statutory or other authority to submit proposed findings of fact or conclusions of law?"[44] Without an answer to this question, and when the parties do not expressly consent to final determination by the bankruptcy court, it has become common for the district court to withdraw the reference from the bankruptcy court before trial in core proceedings for which the bankruptcy court has questionable constitutional authority.[45]

What is the future of Bankruptcy Appellate Panels?

Bankruptcy appellate panels consist of three bankruptcy judges appointed to review appeals from the bankruptcy court.[46] Where a bankruptcy appellate panel is authorized, appeals from the bankruptcy court are directed to the bankruptcy appellate panel by default, unless a party elects to have the appeal heard by the district court.[47] The bankruptcy appellate panel is not an Article III court.

Given the questionable constitutional authority or jurisdiction of Article I judges, it is expected that more parties will elect to have

appeals heard by district courts, to avoid the risk of the bankruptcy appellate panel being determined to lack authority or jurisdiction.

What constitutes consent to have the bankruptcy court determine a core proceeding not within its authority?

By statute, parties may consent to the bankruptcy court's entry of final judgments in non-core proceedings.[48] Consent in non-core proceedings is determined by the pleadings. The Federal Rules of Bankruptcy Procedures require an allegation in a complaint that the proceeding is core or non-core, and that the allegation be admitted or denied in the answer. If the allegation is denied, the respondent must state whether it consents to entry of final orders and judgments by the bankruptcy court.[49]

There are no similar rules requiring an express statement in core proceedings of consent or nonconsent to entry of final orders by bankruptcy courts because, before *Stern*, it was accepted that bankruptcy courts could enter final orders in core proceedings.

Stern is not particularly helpful regarding what conduct may be deemed consent to the bankruptcy court's final determination of core but unconstitutional proceedings. As discussed above, Pierce consented to bankruptcy court determination of his proof of claim against Smith by expressly so telling the bankruptcy court.[50] Pierce's express consent forfeited any right later to contest bankruptcy court authority.[51] In contrast, Smith's counterclaim against Pierce was commenced on June 14, 1996,[52] and Pierce objected to the bankruptcy court's exercise of jurisdiction over the counterclaim in July 1996.[53] While Pierce's objection was held to preserve his lack of consent, it is unclear what behavior, if any, other than express written consent or oral consent on the record in open court, would be deemed to waive objections to the bankruptcy court finally determining a core action.[54]

The Rulemaking Response to *Stern*

On August 15, 2012, the Judicial Conference of the United States' Advisory Committee submitted proposed rules in response to *Stern*, as well as addressing other issues, for public comment through February 15, 2013. The proposed amendments would become effective on December 1, 2014 if they are approved, with or without revision, by the relevant advisory committee, the Committee on Rules of Practice and Procedure, the Judicial Conference, and the Supreme Court, and if Congress does not act to defer, modify, or reject them.[55]

The proposed amendments remove the terms core and non-core from current Bankruptcy Rules 7008 (general rules of pleading), 7012 (responding to a pleading), 9027 (procedure after removal) and 7033 (review of proposed findings of fact and conclusions of law in non-core proceedings).[56] Also, Bankruptcy Rule 7016 (pretrial proceedings) would direct bankruptcy courts to decide the proper jurisdictional treatment of a pleading in a pretrial conference. The proposed rules focus on consent instead of core and non-core.[57]

Bankruptcy judges have reacted to *Stern* by establishing their own procedures, such as requiring the parties early in the litigation to expressly state in writing whether they consent to the bankruptcy court entering final orders.[58] Some bankruptcy courts are also adopting local rules requiring parties in core proceedings to state whether they consent to the bankruptcy court entering final orders.[59]

Bankruptcy judges have reacted to *Stern* by establishing their own procedures, such as requiring the parties early in the litigation to expressly state in writing whether they consent to the bankruptcy court entering final orders.

District courts around the country have also amended their standing orders of reference of bankruptcy cases and proceedings to the bankruptcy court to mirror the one adopted by the Southern District of New York on January 31, 2012. That order provides for submission of proposed findings of fact and conclusions of law in core proceedings and allows purported final bankruptcy court orders to be treated as proposed findings of fact and conclusions of law if the proceeding turns out to have been outside the bankruptcy court's constitutional authority. Southern District of New York Miscellaneous Order 12 Misc 00032 Standing Order of Reference provides a preference for the bankruptcy court to handle proceedings over which they do not have authority up until trial and a fail-safe retroactive treatment of purported final orders as proposed findings:

> If a bankruptcy judge or district judge determines that entry of a final order or judgment by a bankruptcy judge would not be consistent with Article III of the United States Constitution in a particular proceeding referred under this order and determined to be a core matter, the bankruptcy judge shall, unless otherwise ordered by the district court, hear the proceeding and submit proposed findings of fact

and conclusions of law to the district court. The district court may treat any order of the bankruptcy court as proposed findings of fact and conclusions of law in the event the district court concludes that the bankruptcy judge could not have entered a final order or judgment consistent with Article III of the United States Constitution.

This rule discourages motions to withdraw the reference in non-jury proceedings.[60]

Tips For Practitioners

Practitioners should evaluate at the beginning of the proceeding whether the client prefers final determination by the bankruptcy court or the district court.

If the bankruptcy court is the preferred forum:

1. Shape the proceeding as much as possible to concern federal claims and claims arising under Title 11, as opposed to common law state claims.
2. Expressly state in the earliest possible pleadings and filings and in open court that the client consents to entry of final orders by the bankruptcy court.
3. If the adverse party will not consent, pressing for the adversary to state its position would not be helpful. If the adverse party does not object, it is possible that its later conduct could be deemed consent.[61]

If the district court is the preferred forum:

1. Evaluate closely whether the client should file a proof of claim, due to the risk that filing the claim could be interpreted as consent to bankruptcy court authority to enter final orders in litigation related to the claim.[62]
2. Object to entry of final orders by the bankruptcy court in the earliest pleadings and filings, and orally in open court at the earliest opportunity.
3. Review local rules on filing motions for withdrawal of reference. While there is no deadline in the Bankruptcy Rules for filing a motion for withdrawal of the reference,[63] the local rules in some courts set deadlines that the motion must be filed concurrently with the pleading providing the basis for withdrawal.[64]

Until there is final resolution of the questions raised by *Stern*, practitioners have to take steps at the beginning of the proceeding to address the constitutional authority of the bankruptcy court to determine the proceeding or risk re-litigating the proceeding.

NOTES

1. *Stern v Marshall*, ___ US ___, 131 S Ct 2594, 180 L ED2d 475 (2011)(hereinafter "*Stern*").

2. The impact of *Stern* is compared to an earthquake in Christopher S. Lockman, *Makalidung's Post, How Stern v. Marshall is Shaking Bankruptcy Court Jurisdiction to its Core*, 50 Duq L Rev 125, 126 (2012); and in Jolene Tanner, *Stern v. Marshall: The Earthquake That Hit The Bankruptcy Courts and the Aftershock That Followed*, 45 Loyola L Rev 587.

3. An October 5, 2012 panel of bankruptcy judges said that the storm caused by *Stern* has calmed with over a year's experience. Stephanie Gleason, *Stern Clouds Lift, Bankruptcy Judges Say*, http://blogs.wsj.com/bankruptcy (10/5/2012).

4. US Const Act 1, Section 8, Clause 4.

5. Judges appointed under US Const Art III, Section 1 have life tenure. Federal district courts are Article III courts.

6. Bankruptcy judges are appointed under US Const Art I, Section 8, for 14 year terms, not life terms. 28 USC 152(a)(1). Bankruptcy courts are Article I courts.

7. 28 USC 1334(a).

8. 28 USC 1334(b).

9. 28 USC 157(a). A bankruptcy case is the main bankruptcy case. A proceeding is a separate lawsuit within the bankruptcy case. *See Menk v Lapaglia (In re Menk)*, 241 BR 896 (9th Cir BAP 1999).

10. *See e.g.* ED Mich LR 83.50(a) (referring bankruptcy matters to bankruptcy judges).

11. 28 USC 157(b)(1).

12. 28 USC 157(b)(2). Core proceedings include allowance of claims, exemptions, avoidance of preferences, and determination of discharge of a particular debt or dischargeability. 28 USC 157(b)(2)(B), (F), (I), (J).

13. 28 USC 157(b)(2)(C).

14. 28 USC 157(c)(1).

15. 28 USC 157(c)(2).

16. 28 USC 158(a).

17. 28 USC 158(b), (c).

18. 131 S Ct at 2600.

19. *Marshall v Marshall (In re Marshall)*, 275 BR 5, 8-25 (CD Ca 2002), *rev'd, sub nom Marshall v Marshall*, 392 F3d 1118 (9th Cir 2004), *rev'd*, 547 US 293 (2006).

20. Both Smith and Pierce died during the pendency of the case.

21. *In re Marshall*, 275 BR at 56-58.

22. *Marshall v Marshall*, 547 US 293, 315 (2006).

23. *Marshall v Stern (In re Marshall)(*, 600 F3d 1037 (9th Cir 2010), *affirmed on alternative grounds*, ___ US ___, 131 S Ct 2594, 180 L Ed 2d 475 (2011).

24. 131 S Ct at 2604.

25. Kenneth N. Klee, *Stern v Marshall: A Brave New World, Annual Walter Shapero Bankruptcy Symposium* May 24, 2012.

26. 131 US at 2620.

27. *Id.* at 2606-2607. The ruling that Pierce consented to final determination of his proof of claim was not based on the filing of the claim itself serving as consent.

Pierce had advised the bankruptcy court that "[a]ll parties are in agreement that the amount of the contingent Proof of Claim filed by [Pierce] shall be determined by the adversary proceedings" in the bankruptcy court. *Id.* at 2607.

28. *Id.* at 2615 n 8.

29. 131 S Ct at 2618-2619.

30. *Id.* at 2620.

31. 131 S Ct at 2609 (quoting *Den ex dem Murray v Hoboken Land & Improvement Co*, 59 US 272, 284 (1856)).

32. 28 USC 157(b)(2)(H).

33. 11 USC 544(b). Use of state law also borrows the state law statute of limitations for fraud of six years, MCL 600.5813, whereas avoidance of a fraudulent transfer by a trustee under 11 U.S.C. 544(a) is subject to a two year statute of limitations.

34. *Compare Burtch v Seaport Capital, LLC (In re Direct Response Media, Inc)*, 466 BR 626 (Bankr D Del 2012) (bankruptcy court has authority) and *Goldstein v Eby-Brown, Inc (In re Universal Mktg)* 459 BR 573 (Bankr ED Pa 2011) (same) *with Paloian v American Express Co (In re Canopy Fin, Inc)*, 464 BR 770 (ND IL 2012) (bankruptcy court does not have authority) and *Adelphia Recovery Trust v FLP Group, Inc*, No 11 Civ 6847, 2012 US Dist LEXIS 10804 (SDNY Jan 30, 2012) (same).

35. *See, e g*, Danielle Spinelli & Craig Goldblatt, *Bellingham: No Reasonable Argument For "Narrow" Reading of Stern*, ABI Journal (14 April 2012).

36. *Onkyo Europe Elecs GMBH v Global Technovations, Inc (In re Global Technovations)* 694 F3d 705 (6th Cir 2012).

37. *Id.* at *722.

38. *Id.*

39. *Waldman v Stone*, 698 F3d 910, 921 (6th Cir 2012).

40. *Id.* at 923.

41. *Compare Ortiz v Aurora Health Care, Inc*, 665 F3d 906, 914-915 (7th Cir 2011) (because bankruptcy court did not have constitutional authority to enter final judgment on debtor's claims under state law, appellate court lacked a statutory basis for appellate jurisdiction) *with Heller Ehrman LLP v Arnold & Porter, LLP (In re Heller Ehrman LLP)*, 464 BR 348, 355 (ND Cal 2011) (*Stern* did not implicate the bankruptcy court's jurisdiction because the bankruptcy court can enter proposed findings and conclusions).

42. 28 USC 157(c).

43. 28 USC 157(b)(1).

44. *Kirschner v Agoglia (In re Refco Inc)*, 461 BR 181, 185 (Bankr SDNY 2011).

45. *See, e.g.*, *Development Specialists, Inc v Akin Gump Strauss Hauer & Feld LLP*, 462 BR 457 (SDNY 2011) (withdrawing reference for action to avoid fraudulent transfers and other claims against defendants who did not file proofs of claim).

46. 28 USC 158(b).

47. 28 USC 158(c).

48. 28 USC 157(c)(2).

49. Fed R Bankr P 7012(b).

50. 131 S Ct at 2607. See text and notes 27-28 above.

51. *Id.* at 2608. The Court expressed disapproval of "'sandbagging' the court – remaining silent about his objections and belatedly raising the error only if the case does not conclude in his favor." *Id.* (quoting *Puckett v United States*, 556 US 129, 134 (2009)).

52. *In re Marshall*, 275 BR 5, 9 (2002).

53. 131 S Ct at 2607.

54. Failing to respond to a complaint was held not to constitute consent to the bankruptcy court entering final orders or a waiver of the right to have an Article III court decide a claim for a money judgment in *Moyer v Koloseik (In re Sutton)*, 470 BR 462, 474-475 (WD Mich 2012).

55. *Memorandum to the Bench, Bar and Public* dated August 15, 2012 from Honorable Mark R. Kravitz, Chair, Committee on Rules of Practice and Procedure of the Judicial Conference of the United States.

56. The proposed amendment to Rule 7033 would clarify that the bankruptcy court may issue proposed findings and conclusions where it lacks authority to enter final judgments.

57. Douglas N. Candeub, *New Rules Amendments Would Excuse Mention of Core or Noncore*, ABI Journal, Vol. XXXI, No. 9, October 2012.

58. *See e.g.,* United States Bankruptcy Court Eastern District of Michigan Local Form Report of Rule 26(f) Conference ¶3(g) (requiring parties to state whether or not they consent to the Bankruptcy Court entering final judgment in the proceeding).

59. *See, e.g.*, Bankr SDNY Local Rules 7008-1, 7012-1, 9027-1 and 9027-2.

60. Candeub, *New Rules Amendments Would Excise Mention of Core or Noncore*, ABI Journal, Vol. XXXI, No. 9 (October 2012).

61. The court in *Bachrach Clothing, Inc v Bachrach (In re Bachrach Clothing, Inc)*, 480 BR 820 (Bankr ND IL 2012) found that admitting an action was core and consenting to determination by the bankruptcy court was consent to bankruptcy court authority even if the core designation was unconstitutional. The court also found consent could be implied. But see text and notes 27-28, 48-52 above.

62. *See* Judy B. Calton, Rozanne M. Giunta & Adam D. Bruski, *Proof of Claim: Whether to File and If So, How to File*, 30 Mich BL J 10, 13 (Spring 2010).

63. Fed R Bankr P 5011.

64. For example, ED Mich LBR 9015-1(a) provides that a party shall be deemed to have consented to the bankruptcy court conducting a jury trial unless a motion to withdraw the reference is filed concurrently with making a jury demand. The other party has until the later of 14 days after service of the jury demand or the deadline to file an answer or other responsive pleading to file a motion to withdraw the reference or it will be deemed to have consented to the bankruptcy court conducting the jury trial.

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Revised Federal Bankruptcy Rule 3001 and New Federal Bankruptcy Rule 3002.1 – What They Mean and What You Need to Know

By Lisa K. Mullen and Heather D. McGivern*

Introduction

There are several reasons why a consumer debtor chooses to file a Chapter 13 bankruptcy case. One common reason is to attempt to cure a default on a mortgage that is secured by the debtor's principal residence. During the pendency of a Chapter 13 bankruptcy case, a debtor is able to cure a default on a mortgage that secures his or her principal residence while maintaining ongoing payments with the mortgage lender. If the debtor successfully completes all payments required under the Chapter 13 plan of reorganization, he or she should exit bankruptcy current on the mortgage obligation. Unfortunately, this has not always been the case. Historically, some debtors have exited bankruptcy only to discover that their mortgage obligation is not current and that they are facing foreclosure on the very obligation they sought to cure in their bankruptcy case.[1] This typically stems from post-petition changes in the monthly payment amount on the mortgage obligation that were not revealed to the Chapter 13 trustee or filed with the bankruptcy court. Such payment changes usually occur because of a change in the interest rate on the obligation, a change in the amount held in escrow by the lender, the lender adding forced placed insurance on a non-escrowed loan, or post-petition advances for property taxes.

To address these issues, the Judicial Conference, Congress, and the United States Supreme Court drafted and adopted Federal Rule of Bankruptcy Procedure 3002.1 ("Rule 3002.1"), revised Federal Rule of Bankruptcy Procedure 3001 ("Rule 3001"), and created new official bankruptcy forms required for claims secured by the debtor' s principal residence. These important changes to the Bankruptcy Rules and forms became effective December 1, 2011. This article discusses these important changes to the Bankruptcy Rules and forms and provides practice tips for complying with Rule 3002.1 and the amendments to Rule 3001.

The "New" Federal Rule and Amendments to the Federal Rules

Federal Rule of Bankruptcy Procedure 3001

Rule 3001 identifies what a proof of claim is, who may file it, and what is required to be attached to the proof of claim. If the claim is based on a writing, the writing must be attached to the proof of claim, or, if the writing is lost, a statement of the circumstances of the loss or destruction must be filed with the claim.[2] The only exception to the writing requirement is where the proof of claim is based on an open-end or revolving consumer credit agreement.[3] In that instance, the writing is not required to be attached but instead must be provided to a party in interest within thirty days of a written request sent to the creditor.[4] Generally, however, where the debtor is an individual, the document and information requirements have been expanded with the passage of revised Rule 3001.

The intent of the expanded requirements appears to be to standardize the types of required documentation believed necessary for a review of the claim. The amount of disclosure required by the claim holder increases in a waterfall fashion based on the type of claim being filed. For example, claims such as credit card claims that include interest, fees, charges, or expenses, in addition to the principal amount, must include an itemized statement attached to the proof of claim detailing the amounts owed. On its face, this subsection of Rule 3001, as revised, will apply to most if not all claims being filed in bankruptcy cases, as most obligations include some type of charge in addition to the principal amount. There is no official form required to be attached to the proof of claim to detail this information.

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If the claim is secured by a security interest in property, other than the debtor's principal residence, the claim must include a breakdown detailing the amount necessary to cure the default as of the date of the filing of the petition.[5] To date, the Judicial Conference has not created nor approved an official form for the claim holder to provide these required disclosures.

If the claim is secured by the debtor's principal residence, Rule 3001 requires the mortgage holder to file an itemized breakdown of any amounts due and owing on the obligation securing the mortgage at the time of the filing of the bankruptcy case. The holder is required to disclose the information using Official Form-B 10 Attachment A ("Attachment A").[6] Further, if the holder maintains an escrow account for payment of future real property taxes or insurance, an escrow account statement showing the account balance and any amount owed as of the petition date must also be attached to the claim.[7]

A common "theme" of the rules amendments that took effect on December 1, 2011, was the inclusion of a sanctions provision. Sanctions provisions were included not only in the amendments to Rule 3001, but also in new Rule 3002.1. Subdivision (D) of Rule 3001 sets forth the sanctions that the court may impose when the creditor fails to provide the required information under subsection (c). If the holder of the claim fails to provide an itemized statement of other charges (subdivision A) or fails to provide a statement regarding the amount needed to cure (subdivision B) or fails to utilize Attachment A (subdivision C), a party may seek sanctions against the claim holder for noncompliance under subdivision (D).

If a party seeks sanctions against a claim holder pursuant to Federal Rule 3001(c)(2)(D), the court has an either/or choice in determining whether sanctions are appropriate. The standard the court will apply is whether the failure was "substantially justified or is harmless."[8] Rule 3001 gives the court great discretion in applying the standard and imposing sanctions. The court may allow the information to be supplied (and any amendment to the proof of claim), or the court may preclude the claim holder from presenting the omitted information.[9] Rule 3001 also leaves the door open for the court to impose a sanction that goes beyond the failure to allow the evidence or amendment to the proof of claim.

Practice Tips:

- For claims that include interest, fees, expenses, or other pre-petition charges in addition to the principal amount, it is ***mandatory*** that an itemized statement of these charges be filed with the proof of claim. There is no official form for this required itemized statement.
- For claims that assert a security interest in the debtor's property, it is ***mandatory*** that a statement be filed with the proof of claim stating the amount necessary to cure any default as of the petition date. There is no official form for this required statement.
- For claims that assert a security interest in the debtor's principal residence, it is ***mandatory*** that Official Form B 10-Attachment A be filed as an attachment to the proof of claim. Further, for escrowed loans, it is ***mandatory*** that an escrow account statement prepared *as of the petition date* be attached to the proof of claim. Attachment A may be used for all claims secured by real property, even if the real property is not the debtor's principal residence, however the filing of Attachment A is not mandatory for non residential properties.
- In addition to the new mortgage proof of claim disclosures, all other required documents must be attached to the mortgage proof of claim including the endorsed note, the recorded mortgage, and all recorded assignments. Documents attached to proofs of claim must redact all personal indentifying information including loan numbers, social security numbers, etc.
- When filing Attachment A with the proof of claim, include the property address and the post-petition mortgage payment amount. Although Official Form-B 10 Attachment A does not have any sections designated for this important information, it is necessary for the Chapter 13 trustee to properly administer the claim. Additionally, if there is an escrow account and the escrow analysis prepared as of the date of filing results in a payment change,

A common "theme" of the rules amendments that took effect on December 1, 2011, was the inclusion of a sanctions provision.

make certain that the new payment amount, as well as the effective date of the payment change, are included on Official Form-B 10 Attachment A.

- Although there is a designated section on Attachment A for the escrow advance in the arrearage breakdown section, it should not be used for escrowed loans as it will lead to overcollection of the escrow account. This problem with Attachment A will require careful hand calculation of both the arrearage and total debt calculation of the claim when carrying over the information to the proof of claim form. The figures that appear on Attachment A are frequently different than what will appear on the proof of claim form as the total due on the obligation.

The motivation behind Rule 3002.1 was to provide the debtor with the necessary information to determine the exact amount needed to cure any prepetition arrearages.

Federal Rule of Bankruptcy Procedure 3002.1

In General

Rule 3002.1 applies to claims that are secured by a security interest in the debtor's principal residence and are provided for in the debtor's plan pursuant to 11 USC 1322(b)(5).[10] Rule 3002.1 requires the holder of a claim, with a security interest in the debtor's principal residence, to file notices regarding changes in the monthly payment amount on the obligation, provide a process for disclosing fees, expenses, and charges that accrue post-petition, and provide a process for determining whether a debtor's mortgage obligation is current after completion of all payments required under the Chapter 13 plan of reorganization. The rule applies regardless of whether the Chapter 13 plan provides for the debtor to make payments directly to the claim holder or via the chapter 13 trustee.[11]

The motivation behind Rule 3002.1 was to provide the debtor with the necessary information to determine the exact amount needed to cure any prepetition arrearages.[12] The rule was also intended to provide a process to inform the debtor of any changes in the debtor's post petition mortgage payments whether due to escrow account adjustments, changing interest rates, or the assessment of any fees, expenses or other charges.[13] To accomplish these goals, new official forms were approved to facilitate the transmittal of the information required in Rule 3002.1.

Notices of Payment Changes—Rule 3002.1(b)

Pursuant to Rule 3002.1, the holder of a claim secured by the debtor's principal residence is required to "file and serve on the debtor, debtor's counsel, and the Trustee a notice of any change in the mortgage payment amount, including any change that results from an interest rate or escrow account adjustment, no later than 21 days before a payment in the new amount is due."[14] To provide the required notice, the creditor must use new Official Form B10- Supplement 1 ("Supplement 1").[15]

Supplement 1

Supplement 1 is titled "Notice of Mortgage Payment Change" and implements Rule 3002.1(b). There are four (4) parts to the form:

- Escrow Account Payment Adjustment;
- Mortgage Payment Adjustment.
- Other Payment Change;
- Signature box.

The form requires the holder of the claim to indicate the basis for the new payment amount and the date the new payment amount will take effect. Part 1 of the form requires the holder to attach a copy of the escrow account statement in a form consistent with applicable nonbankruptcy law if there will be a change in the debtor's escrow account payment.[16]

In the event of a change in the debtor's principal and interest payment due to an adjustment to the interest rate, Part 2 of the form requires the holder to attach a copy of the rate change notice and state a basis for the change.[17] Part 3 is a "catch-all" provision for any other payment changes including repayment plan or loan modification agreements.[18]

Part 4 of the form requires filers of the form to indicate whether they are (1) the creditor or (2) the creditor's authorized agent.[19] The form does not provide an option to state that the filer of the form is the attorney for the creditor, which is the typical relationship between the party filing the form and the creditor. Not checking either box and stating that the filer is the attorney has not yet resulted in a challenge to a filed Notice of Payment Change; however, the issue is not settled. Counsel filing a Notice of Payment Change should review the form as well as their retention agreement to determine the best way to complete that portion of the form.

The signature of the filer on the form also certifies the accuracy of the information contained in the proof of claim and acts as a certification that the standards under FR Bankr P 9011(b) have been met.[20] It is important to note that the Notice of Payment Change must be filed as a *supplement to the proof of claim* and must be served on the debtor, debtor's counsel, and the trustee.[21] Since the notice must be filed as a supplement to the proof of claim, it is important that the claim holder file a claim early in the case so that the claim holder can relate the notice back to the original claim when the notice is filed. After filing the Notice of Payment Change, the notice will appear either on the PACER docket, the Claim's Register, or both, depending on the jurisdiction in which you are filing the notice.

It should be noted that Federal Rule 3002.1 does not provide a process for objecting to payment change notices. In some jurisdictions, local bankruptcy rules have filled that gap providing a process for debtors and trustees to object to payment change notices filed under Rule 3002.1(b).[22] Local Bankruptcy Rule 3001-2 (EDM), as revised, provides a process and deadline to object to any payment change notice filed under Federal Rule 3002.1(b) or Local Rule 3001-2 (EDM). An objection to the notice of payment change must be filed no later than 21 days after service of the notice. Although the Federal Rule does not specifically state when the payment change is to become effective, Local Rule 3001-2 (EDM) provides that the proposed payment change will become effective 21 days after service of the notice, unless the court orders otherwise. In the Western District of Michigan, the current Local Bankruptcy Rules do not have any specific provisions dealing with mortgage payment change notices.

Notice of Fees, Expenses and Charges—Rule 3002.1(c)

Rule 3002.1(c) requires the claim holder to file and serve an itemized notice of any post-petition fees, expenses, or other charges (i.e., inspection fees, late charges, attorney fees, etc.) that were incurred in connection with the claim after the case was filed and that the claim holder asserts are recoverable from the debtor or against the debtor's principal residence. The claim holder must serve the notice within 180 days after the date on which the fees, expenses, or other charges were incurred ("the 180 day notice").[23] A new Official Form-B 10 Supplement 2 ("Supplement 2") was approved to be used to recover such fees, expenses, and charges incurred post-petition.[24]

Supplement 2

Supplement 2 is titled "Notice of Post-Petition Mortgage Fees, Expenses and Charges" and implements Rule 3002.1(c). The form is required to be filed as a supplement to the proof of claim and must be served on the debtor, debtor's counsel, and the trustee.[25] The language in the rule referencing "supplement to the proof of claim" is not specifically defined. However, it has been construed to mean that the document should be filed as a stand-alone document and linked to the original proof of claim.

The form requires the claim holder to indicate whether the current notice supplements a prior notice for post-petition fees, expenses, or charges and state the date of the prior notice.[26] The form further requires the holder to itemize any fee, expense, cost, or charge included in the notice and puts the filer on notice that the debtor or trustee may challenge whether the fees, expenses, and charges listed are required to be paid.[27]

Practice Tips:

- Claims secured by a security interest in the debtor's principal residence should be filed early in the case since Supplement 2 must be filed "*as a supplement to your proof of claim.*"(emphasis added) The filing of the original proof of claim will ensure that the claim holder may recover post-petition fees, expenses, and charges in connection with the claim.
- Supplement 2 should be filed as a stand-alone document—not attached to the original proof of claim form.
- Post-petition and pre-confirmation attorney fees may be recovered by filing Supplement 2. Post-petition and pre-confirmation attorney fees may not be included in the original proof of claim form. This is a change from the standard practice prior to the rule changes.
- Make sure the notice is filed timely, i.e., within 180 days of the date upon which the fees, expenses, or charges were incurred. If the notice is not filed timely, the claim holder runs

It should be noted that Federal Rule 3002.1 does not provide a process for objecting to payment change notices.

the risk that the fees will be disallowed if challenged pursuant to Rule 3002.1(e).

- Debtor's counsel should review Supplement 2 to determine if the fees, expenses, and charges are reasonable, permitted under the underlying mortgage, and are timely filed.

Determination of Fees, Expenses, or Charges—Rule 3002.1(e)

After the creditor files Supplement 2 (the 180-day notice of fees, expenses, or other charges), the debtor or trustee may file a motion contesting the validity of the fees, expenses, or charges. The motion, not an objection, must be filed *within one year after service of the notice*.[28] Practically speaking, motions taking issue with the fees requested should be filed as soon as is practicable after the notice is filed since the trustee may commence disbursements on the fees, expenses, or charges requested in the notice with the disbursement following the filing of the notice. On the filing of the motion by the debtor or trustee, the court will schedule a hearing to determine whether the payment of the fees, expenses, or other charges are required pursuant to the underlying agreement and applicable nonbankruptcy law to cure the default on the claim or maintain payments in accordance with 11 USC 1322(b)(5).[29]

Compliance with the new and revised rules is essential as non-compliance may lead to the imposition of sanctions.

Notice of Final Cure Payment—Rule 3002.1(f)

Another component of Rule 3002.1 deals with the duties of the chapter 13 trustee at the end of the debtor's case. Rule 3002.1(f) requires the trustee to serve a notice "within 30 days after the debtor completes all payments under the plan" on the holder of a claim secured by the debtor's principal residence. The notice must include (1) a statement that the debtor has paid in full the amount required to cure any default on the claim and (2) inform the creditor of its obligation to file a response.[30] The rule also allows the debtor to file the notice if the trustee does not timely file and serve the notice and the debtor believes that the final cure payment has been made and all plan payments have been completed.[31]

To comply with this requirement, the chapter 13 trustee will review the case to determine if the debtor has met all obligations to complete the plan, including the remittance of all plan payments and tax refunds and an amount necessary to pay the claims as required by the confirmed plan to make the debtor eligible for a discharge. If the chapter 13 trustee's review demonstrates that the debtor has met these requirements, the notice will be filed with the court and served on all parties to the case.[32]

Response to Notice of Final Cure Payment—Rule 3002.1(g)

Within 21 days after the chapter 13 trustee files the Notice of Final Cure Payment, the claim holder is required to file and serve on the debtor, debtor's counsel, and the trustee a statement indicating whether it agrees or disagrees that the debtor has paid in full the amount required to cure the default on the claim and whether the debtor is otherwise current on all payments consistent with 11 USC 1322(b)(5).[33] If the creditor disagrees that the debtor is current, the creditor must file an itemized statement detailing the amount required to cure the default or the post-petition amounts, if any, that the holder contends remain unpaid as of the date of the statement.[34] Failure to file a response agreeing or disagreeing with the trustee's Notice of Final Cure Payment may subject the claim holder to sanctions as set forth in Rule 3002.1(i) as the filing of the response is mandatory.[35]

In the Eastern District of Michigan, if a claim holder files a response disagreeing with the chapter 13 trustee's Notice of Final Cure Payment, the court automatically schedules a hearing. The claim holder must appear and defend their "disagree" response at the hearing.[36]

One of the major issues claim holders have with the requirements of Rule 3002.1(g) is that the rule requires a response be filed to the Notice of Final Cure Payment even if the property was surrendered or the automatic stay was lifted at any point after confirmation of the debtor's chapter 13 plan. Compliance with the requirements of Rule 3002.1 proves difficult when the mortgage or note has been assigned, or the servicing of the mortgage or note is transferred, as the notice filed by the chapter 13 trustee may never reach the current servicer or note holder. Sometimes the lien on the property has been foreclosed on, the mortgage extinguished, and the property sold months or years before plan completion. Rule 3002.1 makes no exceptions for these situations. Some courts are attempting to remedy these issues by creating exceptions to the

response requirements.[37] However, absent a rule amendment, the issue will remain.

Practice Tips:

- After receipt of the chapter 13 trustee's notice of final cure payment, debtor's counsel should review the case 21 days after service of the notice to determine if the claim holder has filed a response. If a response is filed indicating that the debtor is not current, debtor's counsel should determine where the discrepancy lies. This determination includes analyzing whether the claim holder is claiming a default based on missed payments by the debtor after completion of the payments by the chapter 13 trustee to the creditor, or payments made during the case. If the claim holder contends that payments were missed during the case, debtor's counsel should determine whether the payment changes filed with the court are consistent with the chapter 13 trustee disbursements. If the debtor disagrees with the claim holder's notice, debtor's counsel should contact the claim holder to discuss the discrepancy in payments and/or file a motion for determination within 21 days after service of the claim holder's statement.
- Creditors with claims secured by the debtor's principal residence should be aware that Rule 3002.1(g) requires a statement to be filed in response to the trustee's notice even when the claim holder agrees the account is current. Failure to file the response may subject the claim holder to sanctions.[38]

Determination of Final Cure and Payment—Rule 3002.1(h)

After the claim holder files the required response to the trustee's Notice of Final Cure Payment, the debtor or the chapter 13 trustee may file a motion challenging the information in the response within 21 days after service of the claim holder's response.[39] After notice and hearing, the court will make a determination regarding whether the debtor has cured the default and has paid the required post petition amounts.[40]

Failure to Notify—Rule 3002.1(i)

Rule 3002.1(i) contains a sanctions provision identical to the new provisions of Rule 3001(c)(2)(D). Rule 3002.1(i) provides that if the claim holder fails to provide any information required by subdivision (b) (notice of payment change), subdivision (c) (notice of fees, expenses, and charges), or subdivision (g) (response to notice of final cure payment), the court may impose sanctions, including the preclusion of information and/or expenses or attorney fees caused by the failure to comply.[41] The "substantially justified or is harmless" standard also applies when the court is determining whether to sanction a party for failing to comply with the requirements of Rule 3002.1.[42] Like the sanctions provision in Rule 3001, the court has sole discretion to determine what the appropriate remedy is for violating Rule 3002.1. Given the fact that the sanctions provision is present in both revised Rule 3001 and Rule 3002.1, there appears to be a message being sent that there may be detrimental consequences in the event of noncompliance with these rules.

Conclusion

The amendments to Rule 3001 and new Rule 3002.1 made considerable changes to current practices and procedures regarding claim requirements, the dissemination of information on mortgage claims, and end of case issues. Compliance with the new and revised rules is essential as non-compliance may lead to the imposition of sanctions. The changes to the Federal Rules of Bankruptcy Procedure and the Official Bankruptcy Forms were implemented to aid in the payment of mortgage claims in chapter 13 cases and are intended to provide more certainty in the debtor's financial condition at the completion of the debtor's case. With the passage of time, it will become apparent whether these changes are sufficient to accomplish the intended goals.

NOTES

1. *See http://www.uscourts.gov/RulesandPolicies/Federal/RulesofPractice&Procedure/Overview.aspx,*- Report of the Judicial Conference Committee on Rules of Practice and Procedure, September, 2010 at p. 13.

2. *See* Bankruptcy Rule 3001(c).

3. *See* Bankruptcy Rule 3001(c)(3), effective December 1, 2012.

4. *See* Bankruptcy Rule 3001(c)(3)(B), effective December 1, 2012.

5. *See* Bankruptcy Rule 3001(c)(2)(B).

6. *See http://www.uscourts.gov/Forms&Fees/BankruptcyForms/B10A.*

7. *See* Bankruptcy Rule 3001(c)(2)(C).

8. *See* Bankruptcy Rule 3001(c)(2)(D)(i).

9. *See* Committee Note to Bankruptcy Rule 3001.

10. *See* Bankruptcy Rule 3002.1(a).

11. *See* Committee Notes to Bankruptcy Rule 3002.1.

12. *See http://www.uscourts.gov/RulesandPolicies/FederalRulesofPractice&Procedure/Overview.aspx,*- Report of the Judicial Conference Committee on Rules of Practice and Procedure, September, 2010 at p. 15.

13. *Id.*

14. *See* Bankruptcy Rule 3002.1(b).

15. *See http://www.uscourts.gov/Forms&Fees/BankruptcyForms/B10S1.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.; See also* Committee Notes to Bankruptcy Rule 3002.1, *supra.*

21. *Id.*

22. *See* LBR 3001-2(b) (EDM).

23. *See* Bankruptcy Rule 3002.1(c).

24. *See http://www.uscourts.gov/Forms&Fees/BankruptcyForms/B10S2.*

25. *Id.; See also* Bankruptcy Rule 3002.1(c), *supra.*

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *See* Bankruptcy Rule 3002.1(f).

31. *Id.*

32. *See also* LBR 2015-5 (EDM).

33. *See* Bankruptcy Rule 3002.1(g).

34. *Id.*

35. *See* Bankruptcy Rule 3002.1(i).

36. *See* LBR 2015-5 (EDM).

37. *See* www.mieb.uscourts.gov; "Notice Regarding New Chapter 13 Model Plan", October 25, 2012.

38. *See* Bankruptcy Rule 3002.1(I), *supra.*

39. *See* Bankruptcy Rule 3002.1(h).

40. *Id.*

41. *See* Bankruptcy Rule 3002.1(i), *supra. See also* Committee Notes to Bankruptcy Rule 3002.1, *supra.*

42. *See* Bankruptcy Rule 3002.1(i)(1).

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Builders Trust Fund Act Debts: Building a Case for Conversion as a Basis for Nondischargeability

By Daniel M. Morley and Megan M. VerMerris*

Introduction

The United States Bankruptcy Code, at 11 USC 523(a)(4), provides that debts incurred from fraud or defalcation by the debtor in a fiduciary capacity are excepted from discharge in bankruptcy.[1] A debt is nondischargeable as the result of defalcation when a preponderance of the evidence establishes (1) a pre-existing fiduciary relationship, (2) a breach of that relationship, and (3) a resulting loss.[2] It has long been recognized that debts incurred by a debtor in violation of the Michigan Building Contract Fund Act, commonly referred to as the Michigan Builders Trust Fund Act ("MBTFA"), are nondischargeable in bankruptcy under 11 USC 523(a)(4).[3]

Due to the availability of treble damages in cases of conversion, nondischargabilty under a conversion theory coupled with a claim of "willful and malicious injury" under 11 USC 523(a)(6) may be an additional, valuable remedy for victims of a debtor's violation of the MBTFA. This article discusses the MBTFA and violations incurred under its provisions, whether such violations constitute conversion, and why it may be advantageous to a creditor to assert that such violations are nondischargeable as conversion under 11 USC 523(a)(6).

Background

The MBTFA

Under the MBTFA, a building contractor is prohibited from retaining or using construction payments from a particular project until all laborers, subcontractors, and materialmen who worked on the project have been paid.[4] It is a remedial state statute that is designed to prevent fraud in the construction industry.[5] Section 1 of the MBTFA provides that a building contract amount paid by any person to a contractor, or by such person or contractor to a subcontractor, is a "trust fund" for the benefit of the person who makes the payment, contractors, laborers, subcontractors, and materialmen.[6] The trust is established when the owner makes payment to the general contractor. Those funds are then held in trust by the general contractor for payment to subcontractors, laborers, and materialmen who provided labor or material for the project.[7]

The MBTFA provides that the contractor must first use money from the "trust" to pay subcontractors, laborers, and materialmen who have provided labor or services on the specific construction project.[8] Any other allocation of funds before the subcontractors, laborers, and materialmen have been paid is deemed a violation of the Act and evidence of intent to defraud.[9]

On its face, the MBTFA is a criminal statute.[10] A violation of the act is a felony that can be punished by up to three years imprisonment and a fine up to $5,000.[11] The act is silent as to whether it provides a civil remedy. For the first 35 years of the MBTFA's existence, no civil remedy was recognized.[12] In 1966, however, the Michigan Supreme Court held that the MBTFA also provides a civil remedy for its intended beneficiaries.[13]

To establish a civil cause of action under the MBTFA, a plaintiff must establish that (1) the defendant is a contractor or subcontractor that is engaged in the building construction industry; (2) a person paid the contractor or subcontractor for labor or materials that were provided on a construction project; and (3) the defendant retained or used those funds, or any part of those funds, for any purpose other than to first pay laborers, subcontractors, and materialmen, who were engaged by the defendant to provide labor or material for that specific project.[14]

The MBTFA and Nondischargeability Under 11 USC 523(a)(4)

The MBTFA can be particularly useful to a creditor when a contractor who has received money from an owner, thus establishing a trust relationship, seeks to discharge any remaining debt that it owes to a subcontractor, laborer, or materialman.[15] As noted

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previously, under 11 USC 523(a)(4), debts incurred from fraud or defalcation while one acts in a fiduciary capacity are excepted from discharge in bankruptcy.[16] Courts have regularly held that a debt that is owed to subcontractors, laborers, and materialmen under the MBTFA is nondischargeable under 11 USC 523(a)(4).[17]

A debt is nondischargeable as the result of defalcation when a preponderance of the evidence establishes a pre-existing fiduciary relationship, a breach of that relationship, and a resulting loss.[18] The plaintiff carries the initial burden to prove the existence of a trust relationship.[19] To satisfy this initial burden of proof, the plaintiff must establish the existence of a fiduciary duty. In the context of the MBTFA, the plaintiff must show that the defendant received funds and that those funds were impressed with a trust, by virtue of the MBTFA, for the plaintiff's benefit.[20]

From purely a legal standpoint, a violation of the MBTFA can be equated to that of an act of defalcation while acting in a fiduciary capacity as applied to section 523(a)(4).

The fiduciary relationship established by the MBTFA arises at the time any monies are paid to the contractor or subcontractor whether or not there are any identifiable beneficiaries of the trust relationship at that time, and it continues until all the trust beneficiaries have been paid.[21] The Sixth Circuit in *In re Patel* determined that a contractor owed a subcontractor a fiduciary duty under section 523(a)(4) by virtue of the language and application of the MBTFA, and that "defalcation in the MBTFA context occurs when evidence supports 'the objective fact that monies paid into the building contract fund were used for purposes other than to pay laborers, subcontractors or materialmen first…so long as the use was not the result of mere negligence or a mistake of fact.'"[22]

The effect of this statute is to impose a trust relationship, with the contractor serving as the trustee, of the funds paid by any person in connection with a building contract.[23] From purely a legal standpoint, a violation of the MBTFA can be equated to that of an act of defalcation while acting in a fiduciary capacity as applied to section 523(a)(4).[24] Thus, under the Sixth Circuit's holding in *In re Patel*, not only is a contractor-corporation liable under the MBTFA, but an individual is also liable for misconduct under the MBTFA if that person is a corporate officer who "participated" in the defalcation, such as by being the contractor's day-to-day administrator.[25]

Non-Dischargeability for Willful and Malicious Injury

In General

11 USC 523(a)(6) provides that individual debtors may not be discharged from debts "for willful and malicious injury by the debtor to another entity or to the property of another entity."[26] To meet the requirements of 11 USC 523(a)(6), the injury must be both willful and malicious. The first component, that the injury be willful, requires "a deliberate or intentional *injury*, not merely…a deliberate or intentional *act* that leads to injury."[27] In other words, "unless 'the actor desires to cause the consequences of his act, or…believes that the consequences are substantially certain to result from it,' he has not committed a 'willful and malicious' injury as defined under § 523(a)(6)."[28] The second component of section 523(a)(6), that the injury be malicious, "means in conscious disregard of one's duties or without just cause or excuse."[29]

Though not limited to specific transgressions, it has been generally recognized that debts that arise out of specific types of misconduct may satisfy the willful and malicious injury standard, including: intentional infliction of emotional distress, malicious prosecution, conversion, assault, false arrest, intentional libel, and deliberately vandalizing the creditor's premises.[30] However, not every act of conversion necessarily meets the willful and malicious injury standard.[31] For example, a negligent or reckless conversion would not satisfy the wilful and malicious injury requirement, and thus it would not be nondischargeable under section 523(a)(6).[32]

The Tort of Conversion

The tort of conversion is defined as "any distinct act of domain wrongfully exerted over another's personal property in denial of or inconsistent with the rights therein."[33] Conversion is an intentional tort in that the defendant's action must be willful, but one can commit the tort unwittingly if unaware of the plaintiff's outstanding property interest.[34] Statutory conversion consists of "[a]nother person's stealing or embezzling property or converting property to the other person's use."[35]

Money is considered personal property. Therefore, if one wrongfully exerts domain over another individual's money, the act of conversion is committed. Under Michigan

law, to support an action for conversion of money, the defendant must have an obligation to return the specific money entrusted to his care.[36] Further,

> It is clear that when the dispute is over moneys owed, conversion is only applicable in cases involving money that is the property of one party but held by another party (e.g., bank accounts, trusts, etc.) which is then wrongfully taken. *See Trail Clinic, PC v. Bloch,* 114 Mich. App. 700, 319 N.W.2d 638 (1982) (allowing a conversion claim when one party appropriated checks payable to another party); *Rennie v. Pentagon Refining Co.,* 280 Mich. 1, 273 N.W. 325 (1937) (conversion found where one party appropriated funds from another party's brokerage account).[37]

To prove a case of conversion, however, it need not be shown that the defendant has an obligation to return the entire sum of money held by the defendant in trust or otherwise. Michigan courts have held that a plaintiff may maintain an action for conversion where the defendant cashes a check as the plaintiff's agent, or bailor, and retains an amount to which he was not entitled.[38] For example, in *Citizens Ins Co v Delcamp Truck Ctr, Inc*, Citizens Insurance issued a check to both Delcamp Truck Center and to Cook Sanitation in the amount of $33,846.08, after Cook Sanitation's garbage truck was involved in an accident and Delcamp performed repair work on the truck.[39] However, Citizens did not list Bell Equipment Company on the check, the company that had performed the majority of the repair work on the garbage truck.[40] Delcamp, who had only performed around $5,000 worth of repairs, cashed the entire check and gave Cook Sanitation a credit balance.[41] Despite being contacted multiple times by Citizens about the overpayment, Delcamp never returned the overpayment to Citizens.[42]

The Michigan Court of Appeals affirmed the trial court's finding that an action for conversion lies where an individual cashes a check and retains the full amount of the check when that individual was entitled to only a portion of the full amount.[43] Thus, even if an individual is entitled to a portion of the funds, an action for conversion is proper when that individual improperly converts the remaining funds. This is significant in the construction of an argument that defalcation under the MBTFA may constitute conversion. It stands for the principle that an undivided interest in intangible funds can be the subject of a conversion, and it is necessary for a court to accept that principle in order to find that trust funds under the MBTFA, which, in legal terms, are the property of the contractor, can be converted.

Treble Damages, Attorney Fees, and Costs

MCL 600.2919a was amended in 2005 to provide that a person damaged as a result of another person's stealing or embezzling property or converting property to the other person's own use may recover three times the amount of actual damages sustained, plus costs and reasonable attorney fees. Before this amendment, the statute only allowed the victim of a theft or embezzlement to bring a civil action against the "fence" or person who bought, received, or concealed the stolen property. The statute's provisions did not, however, specifically mention that an action could be brought against the person who committed the original theft.[44] The amendment in 2005 clarified that the victim of a conversion could bring a civil action against both the original perpetrator and the "fence" for treble damages.

Though Michigan courts have not expressly held that a violation of the MBTFA results in conversion and resultant treble damages, at least one Michigan case has suggested that such a result is a reasonable conclusion.[45] In *Structural Eng'g Solutions, LLC v Vision Dev Props & Rentals, LLC,* the plaintiff alleged that the defendant violated the MBTFA, and, as a result, the defendant should owe the plaintiff treble damages for violation of MCL 600.2919a. The court found that a violation of the MBTFA had not been proven, and so it did not address the nexus between the MBTFA and a statutory conversion claim.[46] However, the court did observe that "[a]bsent a violation of the MBTFA, plaintiff is not entitled to treble damages."[47] Thus, it appears that the court would have considered the connection between the MBTFA and statutory conversion if a violation of the MBTFA had occurred.

Finally, the U.S. Bankruptcy Court for the Eastern District of Michigan has found that treble damages in a conversion action are nondischargeable under section 523(a)(6). Following trial in *In re Hamama,*[48] the bankruptcy judge found a defendant-employer liable for conversion under Michigan law where he wrongfully withdrew money from

Though Michigan courts have not expressly held that a violation of the MBTFA results in conversion and resultant treble damages, at least one Michigan case has suggested that such a result is a reasonable conclusion.

his employee's bank account.[49] Moreover, the judge allowed recovery of treble damages for this conversion based on MCL 600.2919a.[50] And, further the court found that the treble damages were nondischargeable under section 523(a)(6):

> The Court previously found that the liability of Hamama to Masters for the wage claim and conversion is nondischargeable under § 523(a)(6). Generally, all liabilities resulting from the willful and malicious act are non-dischargeable. *Coen v Zick,* 458 F.2d 326, 329 (9th Cir. 1972) ("The statutory exception which measures non-dischargeability is 'for liabilities…for willful or malicious injuries to the person or property of another...[now contained in § 523(a)(6)].' The exception is measured by the nature of the act, i.e., whether it was one which caused willful and malicious injuries. All liabilities resulting therefrom are non-dischargeable."); *Stokes v Ferris,* 150 B.R 388, 393 (W.D. Tex 1992) (under § 523(a)(6), all debts, including statutory damages, which flow from the debtor's willful and malicious conduct are nondischargeable). Accordingly, the double damages awarded on the wage claim and the treble damages awarded on the conversion claim are nondischargeable.[51]

A violation of the MBTFA arguably meets the definition of a willful and malicious injury under section 523(a)(6).

The MBTFA and Nondischargeability as Conversion

The statutory framework of the MBTFA suggests the basis for a claim of conversion of money. The MBTFA imposes an obligation on a contractor to recognize a beneficial interest in building-contract funds on the part of suppliers of material and labor. Thus, the failure to respect that beneficial interest is a violation of the MBTFA. Logically, conversion occurs when a building contractor retains or uses construction payments from a particular project before all laborers, subcontractors, and materialmen who worked on the project have been paid. By failing to pay the intended beneficiaries, a contractor wrongfully exerts dominion over another's personal property.

Similar to the cases in which a defendant is liable for conversion, even if the defendant was entitled to a portion of the money that he or she converted, a contractor under the MBTFA may be entitled to a portion of the funds held in trust. However, retaining the contractor's own portion of the funds before paying what is owed to subcontractors, laborers, and materialmen who worked on the project results in a conversion. If such a conversion occurs, the beneficiaries would be entitled, under MCL 600.2919a, to treble damages of the amount actually sustained, plus costs and reasonable attorney fees.

If the contractor declares bankruptcy, an affected subcontractor, laborer, or supplier of materials who does not agree that the debt should be discharged is required to file a complaint to seek a determination that the debt owed by the debtor is not dischargeable. In addition to a claim that the debt results from a "defalcation by a trustee," which renders the debt nondischargeable under section 523(a)(4) (and possibly a claim that the debt results from fraud which is nondischargeable under section 523(a)(2)), a creditor with an MBTFA claim should consider seeking a determination that the debt is nondischargeable under section 523(a)(6) as conversion. Debts that arise out of conversion are generally held to satisfy the requirements of section 523(a)(6), i.e. the willful-and-malicious-injury standard, and a contractor's violation of the MBTFA is arguably also an act of conversion. However, as discussed above, not every act of conversion is necessarily nondischargeable as a willful and malicious injury, and, therefore, an analysis of the act of conversion under the MBTFA must be performed to determine if the willful and malicious injury standard can be met.

A violation of the MBTFA arguably meets the definition of a willful and malicious injury under section 523(a)(6). Proving whether an injury is "willful" is a bit of a challenge. For a debt to be nondischargeable under section 523(a)(6), the defendant must have deliberately or intentionally caused the injury, not simply deliberately acted, which act then resulted in injury. The argument in favor of an MBTFA violation being a willful injury is that when one holds a specific, identifiable amount of money and chooses to pay either himself or his or her own personal debts over those who are entitled to be paid from those funds, that individual possesses knowledge that the consequences of this action will be to deprive another who is entitled to payment. A contractor who violates the MBTFA would likely argue that no injury was intended because he or she simply paid certain debts before paying the remaining debts and had no way to know that there would not be suf-

ficient funds. Restated, the contractor may have acted deliberately, but he or she did not act to intentionally injure suppliers, laborers, or materialmen. Whether or not a violation of the MBTFA will be considered a "willful" injury may very well depend on the facts of each case, the severity of the injury, and the contractor's knowledge at the time of the misappropriation.

A violation of the MBTFA may also, in many circumstances, meet the requirement of being "malicious." If a contractor has violated the MBTFA, it is because the contractor acted in conscious disregard of his or her statutory duties, or at least because he or she has acted without just cause or excuse. Any other allocation of the funds held in trust before the subcontractors, laborers, and materialmen have been paid is a violation of the MBTFA and evidence of intent to defraud. Thus, in many cases the proofs should demonstrate that the injury was "malicious."

If the bankruptcy court accepts that the MBTFA violation was a conversion, and the willful and malicious injury standard is met, the affected subcontractors, laborers, and materialmen would be entitled to treble damages. More importantly, the treble damages associated with the conversion would also be nondischargeable under section 523(a)(6). Thus, by simply reframing the MBTFA violation as a conversion, the affected parties may be in a position to claim and recover triple damages from a contractor who seeks the protection of an order of discharge in bankruptcy.

Conclusion

There is a strong argument that a violation of the MBTFA is also an act of conversion, which entitles the harmed individual to treble damages. In the context of bankruptcy, a judge may find that since the MBTFA violation is also a conversion, the treble damages are nondischargeable under section 523(a)(6). However, the determination of whether the injury should be nondischargeable under section 523(a)(6) as conversion, which meets the willful and malicious standard, will likely be an issue of fact, based in part on the severity of the injury and whether the contractor should have known that an injury was substantially likely to result.

NOTES

1. 11 USC 523(a)(4).

2. See *Board of Trs v Bucci (In re Bucci),* 493 F3d 635, 639 (6th Cir 2007).

3. *In re Johnson*, 691 F2d 249 (6th Cir 1982).

4. *People v Miller*, 78 Mich App 336, 342, 259 NW2d 877 (1977).

5. Daniel M Morley, *The Michigan Builders Trust Fund Act: An Overlooked Remedy?* 73 Mich B J 402, 402 (May 1994).

6. MCL 570.151 *et seq*.

7. Morley, *supra* note 5, at 402.

8. MCL 570.152.

9. MCL 570.153.

10. MCL 570.152.

11. *Id.*

12. Paul J Mastrangel, *The History and Application of the Michigan Building Contract Fund Act*,
33 Mich Real Prop Rev 32 (2006).

13. *BF Farnel Co v Monahan*, 377 Mich 552, 141 NW2d 58 (1966).

14. *DiPonio Constr Co v Rosati Masonry Co*, 246 Mich App 43, 49, 631 NW2d 59 (2001).

15. Daniel M. Morley and Megan M. Hard, In re Patel: *Synthesizing Corporate Officer Liability and Non-Dischargeability Under the Michigan Builders Trust Fund Act*, 36 Mich Real Prop Rev 194 (2009).

16. For a more complete discussion of the nondischargeability of debts under 11 USC § 523(a)(4), see Thomas R. Morris, *Trust Fund Statutes and the Discharge of "Trustee" Debts under Bankruptcy Code Section 523(a)(4), 28* Mich Bus L J 1, Spring 2008, p 11.

17. *In re Johnson,* 691 F2d at 257.

18. *See Board of Trs v Bucci*, 493 F3d at 639.

19. *Astro Bldg Supplies, Inc v Slavik (In re Slavik)*, 426 BR 711, 718 (Bankr ED Mich 2010).

20. *Id.* at 719.

21. *Patel v Shamrock Floorcovering Servs (In re Patel)*, 565 F3d 963, 969 (6th Cir 2009), quoting *In re Johnson*, *supra.*

22. *Id.* at 970.

23. *Huizinga v United States*, 68 F3d 139, 144 (6th Cir 1995).

24. *Behler-Young Co v Cousino (In re Cousino)*, 364 BR 289, 293 (Bankr ND Ohio 2006).

25. *In re Patel*, 565 F3d at 969-70.

26. 11 USC 523(a)(6).

27. *Kawaauhau v Geiger,* 523 US 57, 61 (1998) (emphasis in original).

28. *Markowitz v Campbell (In re Markowitz),* 190 F3d 455, 464 (6th Cir 1999) quoting Restatement (Second) of Torts § 8A, at 15 (1964) (internal citations omitted).

29. *Wheeler v Laudani,* 783 F2d 610, 615 (6th Cir 1986).

30. *See, e.g., Steier v Best (In re Best),* No 03-5098, 2004 US App LEXIS 13773 at *11 (6th Cir June 30, 2004) (unpublished).

31. *Kawaauhau, supra*, at 63-64; *see also Morganroth & Morganroth, PLLC v Stollman (In re Stollman)*, 404 BR 244 (Bankr ED Mich 2009).

32. *See, e.g., Morris v Brown (In re Brown),* No 11-6008, 2012 US App LEXIS 15304 (6th Cir July 23, 2012) (unpublished).

33. *Foremost Ins Co v Allstate Ins Co*, 439 Mich 378, 391, 486 NW2d 600 (1992).

34. *Warren Tool Co v Stephenson*, 11 Mich App 274, 299, 161 NW2d 133 (1968).

35. MCL 600.2919a.

36. *Check Reporting Servs, Inc v Michigan Nat'l Bank-Lansing,* 191 Mich App 614, 626, 478 NW2d 893 (1991).

37. *Sudden Serv v Brockman Forklifts, Inc*, 647 F Supp 2d 811, 815 (ED Mich 2008) (emphasis added).

38. *See Hogue v Wells,* 180 Mich 19, 24, 146 NW 369 (1914) (promissory note); *Citizens Ins Co v Delcamp Truck Ctr, Inc,* 178 Mich App 570, 575–576, 444 NW2d 210 (1989) (account overpayment).

39. *Citizens*, 178 Mich App at 572.

40. *Id.*

41. *Id.*

42. *Id.* at 573-74.

43. *Id.* at 576.

44. *Marshall Lasser PC v George*, 252 Mich App 104, 651 NW2d 158 (2002).

45. *Structural Eng'g Solutions, LLC v Vision Dev Props & Rentals, LLC*, No 286492, 2009 Mich App LEXIS 2422 (Nov 19, 2009).

46. *Id.*

47. *Id.* at *7.

48. *Masters v Hamama (In re Hamama),*182 BR 757 (Bankr ED Mich 1995).

49. *Id.* at 758.

50. *Id.*

51. *Id.* at 758-59.

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In re TOUSA: *When Can Indirect Benefits Constitute Reasonably Equivalent Value in Fraudulent Transfer Actions?*

By Paul R. Hage and Richard E. Kruger

Introduction

Over the past five years, it has become almost commonplace in Michigan and elsewhere to read about bankruptcy filings by troubled residential homebuilders both in legal publications and in the news generally. Insolvency attorneys, in particular, have become accustomed to reviewing corporate structure charts for these homebuilders, each of which shows the troubled parent at the top and a web of single-asset, limited liability company subsidiaries below. Each subsidiary represents a different development project, and, like any large organization consisting of various affiliated entities, it is not unusual for some of the affiliated entities to guarantee the obligations of other entities, or even the parent company itself. Such guarantees on behalf of a parent are sometimes referred to as "upstream guarantees."

It is important for all attorneys, not just insolvency attorneys, to understand that such upstream guarantees may not be enforceable, particularly when the upstream guarantee is given within two years before a bankruptcy filing. In these cases, the analysis typically hinges on whether the subsidiary received "reasonably equivalent value" in exchange for the granting of the guarantee or, alternatively, whether the guarantee from the subsidiary can be avoided as a constructive fraudulent transfer.

A handful of opinions in the bankruptcy case of TOUSA, Inc. ("TOUSA"), once one of the largest homebuilders in the country, have addressed the issue of whether, and to what extent, indirect benefits provided by a parent (*i.e.* corporate synergy, the ability to avoid or delay a bankruptcy filing) can be considered for purposes of determining whether "reasonably equivalent value" was received by a subsidiary in exchange for the subsidiary's guarantee of the parent's liabilities. Most recently, the Eleventh Circuit Court of Appeals reversed a district court ruling and affirmed the decision of the bankruptcy court finding that liens granted by TOUSA's subsidiaries to secure its debt constituted fraudulent transfers under section 548(a)(1)(b) of title 11 of the United States Code (the "Bankruptcy Code").[1] This article provides an overview of fraudulent transfer law, analyzes the TOUSA opinions, and then summarizes the current state of the law with respect to the indirect benefits defense to fraudulent transfer actions in Michigan and the Sixth Circuit.

Overview of Constructive Fraudulent Transfers Under the Bankruptcy Code

Using either bankruptcy law or Michigan's version of the Uniform Fraudulent Transfer Act ("UFTA"),[2] a trustee in bankruptcy can avoid and recover for the benefit of creditors a transfer made or obligation incurred by a debtor where little or no value is received by the transferor in exchange for such transfer or obligation. More specifically, section 548(a)(1)(B) of the Bankruptcy Code provides, in pertinent part, as follows:

> (a)(1) The Trustee may avoid any transfer…of an interest of the debtor in property, or any obligation… incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily
>
> * * *
>
> (B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation….[3]

In short, to avoid a transfer or obligation incurred as a constructive fraudulent transfer, the trustee in bankruptcy must prove

that: (i) the transfer was made or obligation incurred for less than reasonably equivalent value, and (ii) the transfer was made when the transferor debtor was insolvent or, alternatively, that the transfer rendered the transferor debtor insolvent. In constructive fraudulent transfer actions, the transferor's intent is not relevant.

This article focuses on the "reasonably equivalent value" element, which is a two-step process. The first step is an analysis of whether the debtor received any value in exchange for the transfer or obligation incurred.[4] The second step is an analysis of "whether the value of what was transferred was reasonably equivalent to what the debtor received."[5] Because neither the Bankruptcy Code nor the UFTA defines the phrase "reasonably equivalent value," courts have struggled to establish a method for determining whether "reasonably equivalent value" was provided in exchange for a transfer or obligation incurred. Section 548(d)(2)(A) helps somewhat in that it defines the term "value" as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor…."[6]

Because neither the Bankruptcy Code nor the UFTA defines the phrase "reasonably equivalent value," courts have struggled to establish a method for determining whether "reasonably equivalent value" was provided in exchange for a transfer or obligation incurred.

Generally, courts consider the totality of the circumstances surrounding the transaction in determining whether "reasonably equivalent value" was provided.[7] The Sixth Circuit Court of Appeals has directed that courts should compare "the value of the property transferred with the value of what was received in exchange for the transfer."[8] The Sixth Circuit has also stated that:

> [T]he proper focus is on the net effect of the transfers on the debtor's estate, the funds available to the unsecured creditors. As long as the unsecured creditors are no worse off because the debtor, and consequently the estate, has received an amount reasonably equivalent to what it paid, no fraudulent transfer has occurred.[9]

Michigan courts have noted that reasonably equivalent value "does not require absolute equivalence between the property the grantor gives up and what he receives in return; there is room for some inequality."[10] To the contrary, the statute seeks to "strike a balance between the need to permit transactors to make deals, some good and some not so good, and the need to fix a point beyond which courts will not permit grantors to enter into transactions that will too profoundly impair their ability to discharge obligations to creditors."[11]

Once a constructive fraudulent transfer is avoided under section 548(a)(1)(B) of the Bankruptcy Code, it can be recovered for the benefit of creditors by the trustee in bankruptcy pursuant to section 550(a) of the Bankruptcy Code from the initial transferee or, subject to certain statutory defenses, any subsequent transferees.[12]

A Summary of the TOUSA Opinions

The Factual Background

TOUSA was a Florida-based company that specialized in designing, constructing, and marketing residential real estate through various subsidiaries. In June 2005, a fully owned subsidiary of TOUSA formed a joint venture to acquire certain real property located in Florida (the "Transeastern Joint Venture"). In order to finance the Transeastern Joint Venture, the company borrowed approximately $560 million from a group of lenders (the "Transeastern Lenders"). TOUSA guaranteed all of the Transeastern Joint Venture's obligations under the loan.

The timing for the Transeastern Joint Venture could not have been worse. As the housing bubble began to burst first in places such as Florida and southeastern Michigan and, thereafter, throughout the country, the Transeastern Joint Venture failed, such that by the end of 2006 the Transeastern Lenders declared a default and commenced a lawsuit against both the Transeastern Joint Venture and TOUSA on its guaranty. The Transeastern Lenders alleged $2 billion in damages. After substantial negotiations, the parties agreed to a settlement of the litigation in early 2007. The settlement included, amongst other consideration, a payment of $420 million by TOUSA to the Transeastern Lenders.

To finance the settlement TOUSA entered into a new $500 million loan with a new group of lenders (the "New Lenders"). To obtain this financing, TOUSA granted a lien to the New Lenders on substantially all of its assets. However, because TOUSA was primarily a holding company, the New Lenders also received guarantees and liens on substantially all of the assets of TOUSA's subsidiaries (the "Conveying Subsidiaries"), each of which was insolvent by this point. Additionally, each of the Conveying Subsidiaries provided an upstream guarantee of TOUSA's obliga-

tions to the New Lenders. Importantly, none of the Conveying Subsidiaries were obligors or guarantors of the original debt owed to the Transeastern Lenders.

The proceeds of the loan from the New Lenders were wired to a new subsidiary of TOUSA, Universal Land Title, which was not one of the Conveying Subsidiaries. Thereafter, consistent with the settlement agreement, such funds were wired by Universal Land Title to the Transeastern Lenders in full settlement and satisfaction of the claims alleged by the Transeastern Lenders against the Transeastern Joint Venture and TOUSA.

In January 2008, less than six months after the completion of the settlement transaction, TOUSA and each of the Conveying Subsidiaries filed petitions for relief under chapter 11 of the Bankruptcy Code. The Official Committee of Unsecured Creditors appointed in the debtors' bankruptcy cases thereafter brought an adversary proceeding to avoid, as constructive fraudulent transfers under section 548(a)(1)(B): (i) the liens granted by the Conveying Subsidiaries to the New Lenders, and (ii) the $420 million in cash paid to the Transeastern Lenders. The New Lenders and the Transeastern Lenders claimed that the transfers were not fraudulent because the subsidiaries had received reasonably equivalent value from the exchange. The value that the lenders claimed the Conveying Subsidiaries received included the economic benefit of avoiding a default by TOUSA (which likely would have resulted in bankruptcy filings by both TOUSA and the Conveying Subsidiaries), the elimination of potentially expensive litigation, and certain tax benefits.

The Bankruptcy Court Opinion

In *Official Comm of Unsecured Creditors of TOUSA, Inc v Citicorp North America, Inc (In re TOUSA I),*[13] after a thirteen-day trial, the United States Bankruptcy Court for the Southern District of Florida issued a 182-page opinion holding that: (i) the obligations incurred and the liens granted by the Conveying Subsidiaries to the New Lenders were fraudulent transfers that could be avoided, and (ii) the payment of the loan proceeds to the Transeastern Lenders also constituted fraudulent transfers that must be disgorged.

The court began its legal analysis by holding that the Conveying Subsidiaries were insolvent both before and after the transactions were made, relying on expert testimony.[14] Next, turning to the issue of whether "reasonably equivalent value" was provided, the court held that the Committee proved that "none of the Conveying Subsidiaries received reasonably equivalent value in exchange for the obligations and transfers."[15]

While acknowledging that both direct and indirect benefits can be considered for purposes of determining whether "reasonably equivalent value" is provided, the court noted that indirect benefits must be both "tangible and concrete" and also quantifiable with "reasonable precision."[16] Regarding the burden of proof, the court stated:

> To make out the elements of a fraudulent conveyance claim, a plaintiff must prove that a debtor did not receive direct benefits reasonably equivalent to the value which it gave up. If the plaintiff meets that burden, the burden is then on defendants to produce (if they can) evidence that the debtors indirectly received sufficient concrete value.[17]

After finding that the Conveying Subsidiaries did not receive any direct benefits in exchange for the granting of the liens, the upstream guaranty and the payment of the loan proceeds, the court held that the lenders had failed to carry their burden of producing evidence of indirect benefits that were tangible, concrete, and quantifiable.[18] In the court's view, an indirect benefit is cognizable only if all three requirements are satisfied.[19] First, the benefit must be received, even if indirectly, by the debtor (*i.e.* by an individual Conveying Subsidiary).[20] The fact that value is received by a group of affiliated entities does not automatically result in a benefit being received by a particular debtor, even if both entities are engaged in a common business enterprise.[21] Second, the purported indirect benefits must be limited to cognizable "value" which, based on the definition of that term in section 548(d)(2)(A) of the Bankruptcy Code, requires either: (i) satisfaction of an antecedent debt, or (ii) actual property received.[22] Since this case did not involve the satisfaction of a debt owed by a Conveying Subsidiary, "property" received was the only relevant "value."[23] Third, the court found, the "property" received must be "in exchange for" the transfer at issue.[24]

Applying these principles, the court held that many of the indirect benefits championed by the lenders were legally irrelevant.[25] Contrary to the lenders' arguments, in the absence of substantive consolidation, the Bankruptcy Code prohibited all of the TOUSA

The court began its legal analysis by holding that the Conveying Subsidiaries were insolvent both before and after the transactions were made, relying on expert testimony.

entities from being lumped together for purposes of determining reasonably equivalent value.[26] Thus, the litigation-settlement value received by TOUSA was irrelevant for purposes of determining whether the Conveying Subsidiaries participated in a fraudulent transfer.[27] The court found that avoidance of a bankruptcy filing by TOUSA did not constitute reasonably equivalent value because the alleged corporate synergies (*i.e.* access to centralized cash management, payroll and purchasing systems) did not constitute value as they were not "property" and were not received "in exchange for" the transfers (indeed, they were enjoyed by the Conveying Subsidiaries long before the transaction at issue).[28] For the same reason, the ability of the Conveying Subsidiaries to avoid or delay their bankruptcy did not constitute value because such benefits are not "property" and, thus, are not cognizable as "value" under the statute.[29] Finally, even if some or all of these alleged indirect benefits could be considered as value, the court stated: "It is clear…that the purported benefits, even if legally cognizable, and whether considered individually or as a whole, have value (if any) that falls well short of 'reasonably equivalent' value."[30]

Accordingly, the court found that most of the $420 million paid to the Transeastern Lenders was a fraudulent transfer and ordered that such funds be disgorged. The court also ordered that all of the liens granted by the Conveying Subsidiaries be avoided. Finally, the court ordered the lenders to pay the Committee's attorneys' fees and expenses associated with the pursuit of the litigation.

Where the right facts are present, a claim of reasonably equivalent value through indirect benefits is a viable defense to a constructive fraudulent transfer action in Michigan and the Sixth Circuit.

The District Court Opinion

The Transeastern Lenders and the New Lenders appealed. Due to the size and complexity of the cases, the appeals were assigned to two separate district court judges. On February 11, 2011, the district court judge handling the Transeastern Lenders' appeal issued an opinion in *3V Master Fund Ltd v Official Comm of Unsecured Creditors of TOUSA, Inc (TOUSA II),*[31] wherein it thoroughly rejected the analysis of the bankruptcy court and quashed the bankruptcy court's order as it related to the liability of the Transeastern Lenders.

Initially, the district court took issue with the bankruptcy court's conclusion that the defendants had "failed to carry their burden of producing evidence of indirect benefits that were tangible and concrete."[32] "In so ruling," the district court stated, "the Bankruptcy Court improperly shifted the burden of proof to the Senior Transeastern Lenders and other Defendants."[33] Under established caselaw, the court continued, "the burden of proving lack of 'reasonably equivalent value' under [section 548(a)(2)(A)] rests on the trustee challenging the transfer."[34]

The district court also held that, as a matter of law, the bankruptcy court had too narrowly defined "value."[35] The district court relied heavily on an opinion by the Third Circuit Court of Appeals wherein that court had held that "[t]he mere 'opportunity' to receive an economic benefit in the future constitutes 'value' under the Code."[36] The district court also relied on a decision by the Eighth Circuit Court of Appeals that explained that the correct way to determine "value" was not to define it "only in terms of tangible property or marketable financial value," but instead to "examine all aspects of the transaction and carefully measure the value of all benefits and burdens to the debtor, direct or indirect, including 'indirect economic benefits.'"[37]

Regarding indirect benefits, the district court concluded the non-tangible benefits, including "the opportunity to avoid default, facilitate the enterprise's rehabilitation and to avoid bankruptcy, even if it proved to be short lived," could constitute "value" for purposes of section 548(a) of the Bankruptcy Code.[38] Moreover, benefits to the corporate enterprise generally (*i.e.* the entire TOUSA family) should also factor into reasonably equivalent value for purposes of the fraudulent transfer analysis.[39] In essence, the district court treated TOUSA and its subsidiaries as if they were one, substantively consolidated, entity.

As such, the district court determined that the bankruptcy court clearly erred when it found that the Conveying Subsidiaries had not received reasonably equivalent value from the transaction. To the contrary, the district court found that the transaction gave the Conveying Subsidiaries the opportunity to avoid bankruptcy, continue as going concerns, and make further payments to their creditors.[40] These benefits, the district court found, did not need to be quantified to establish reasonably equivalent value.[41] "Inherently, these benefits have immense economic value that ensure the debtor's net worth has been preserved, and, based on the entirety of this record, were not disproportionate between what was given up and what was received."[42]

The Eleventh Circuit Court of Appeals Opinion

The committee appealed the district court's decision as to the reasonably equivalent value issue. In *Senior Transeastern Lenders v Official Comm of Unsecured Creditors (In re TOUSA III)*,[43] the Eleventh Circuit Court of Appeals held that "the bankruptcy court did not clearly err when it found that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for their liens."[44]

The court noted that the bankruptcy court and district court disagreed as to the correct definition of "value" but opted not to decide which court employed the correct definition.[45] Instead, the court gave "considerable latitude" to the bankruptcy court's findings of fact and focused solely on whether the findings were clearly erroneous.[46] The court examined the bankruptcy court's findings and found that the record supported that "the almost certain costs of the transaction of July 31 far outweighed any perceived benefits."[47] Finding no clear error, they affirmed the bankruptcy court's decision that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for the liens.[48]

The court next addressed the asserted potential benefit of the possible avoidance of bankruptcy. Initially, the court of appeals noted that the continued existence of a corporation is not a presumed benefit.[49] Instead, the court reiterated the bankruptcy court finding that "even assuming that *all* of the TOUSA entities would have spiraled immediately into bankruptcy without the July 31 Transaction, the Transaction was *still* the more harmful option."[50]

The court next addressed the Transeastern Lenders' and the New Lenders' argument that they were "held liable for failing to foresee the unforeseeable."[51] The Transeastern Lenders and the New Lenders complained that the bankruptcy court's findings were driven by hindsight and did not account for the "unexpected downturn…described by Alan Greenspan as 'a once in a century credit tsunami' and by Warren Buffet as an 'economic Pearl Harbor.'"[52] To the contrary, the court agreed with the bankruptcy court, which held that TOUSA's failure was "more like a slow-moving category 5 hurricane than an unforeseen tsunami" and "as foreseeable as the bombing of Nagasaki after President Truman's ultimatum" rather than as unforeseeable as Pearl Harbor.[53]

In summation, the court of appeals determined that the bankruptcy court made the correct inquiry, specifically, "based on the circumstances that existed at the time the investment was contemplated, whether there was any chance the investment would generate a positve return."[54] The court of appeals then held that the bankruptcy court did not err when the bankruptcy court answered the inquiry in the negative, especially considering that "there is no reason to treat bankruptcy as a bogeyman, as a fate worse than death."[55]

Accordingly, the court of appeals found that the funds paid to the Transeastern Lenders and the liens conveyed to the New Lenders constituted constructive fraudulent transfers that could be avoided and recovered under sections 548(a)(1)(B) and 550(a) of the Bankruptcy Code.

The Treatment of Indirect Benefits in Michigan and the Sixth Circuit

Where the right facts are present, a claim of reasonably equivalent value through indirect benefits is a viable defense to a constructive fraudulent transfer action in Michigan and the Sixth Circuit.

For example, the Michigan Court of Appeals recently stated in *Zervos Group, Inc v Thompson Asphalt Prods, Inc*:

> The phrase "reasonably equivalent value," which was derived from [section] 548 of the federal Bankruptcy Code, 11 USC 548, has also been construed to include indirect benefits to the debtor from the transfer.[56]

Noting that an analysis of *all* facts and circumstances was required to decide whether a debtor received "reasonably equivalent value," the court concluded that it was required to examine "all aspects of the subject transaction" and consider "the value of the benefits and burdens to the debtor, both direct and indirect."[57]

Similarly, the Sixth Circuit Court of Appeals discussed the "indirect benefit rule" in *In re Wilkinson,* wherein it stated:

> Value can be in the form of either a direct economic benefit or an indirect economic benefit. "It is well settled that 'reasonably equivalent value can come from one other than the recipient of the payments, a rule which has become known as the indirect benefits rule.'"[58]

What is a fair deal to a corporate family in one court's mind may be viewed as a classic fraudulent transfer by another.

Citing to the Second Circuit Court of Appeals' opinion in *Rubin v Manufacturers Hanover Trust Co,* the Sixth Circuit continued:

> [A] debtor may sometimes receive "fair" consideration even though the consideration given for his property or obligation goes initially to a third person.... [T]he transaction's benefit to the debtor need not be direct; it may come indirectly through benefit to a third person.... If the consideration given to the third person has ultimately landed in the debtor's hands, or if the giving of the consideration to the third person otherwise confers an economic benefit upon the debtor, then the debtor's net worth has been preserved, and [the statute] has been satisfied-provided, of course, that the value of the benefit received by the debtor approximates the value of the property or obligation he has given up.[59]

While allowing for consideration of indirect benefits, the Sixth Circuit shifts the burden of proof (as did the TOUSA courts) and requires the defendant to show *concrete and quantifiable* indirect benefits. The Sixth Circuit noted in *In re Wilkinson*:

> Once a plaintiff has established that consideration for the transfer passes to a third-party, the burden of demonstrating and quantifying reasonably equivalent value for the transfer shifts to the defendant…. The burden of showing that the benefit is concrete and quantifiable can be challenging in a case where the alleged benefit is goodwill, corporate synergy, a business opportunity, the continuation of a business relationship, or some other intangible benefit.[60]

Interpreting *In re Wilkinson,* a Michigan bankruptcy court recently ruled: "an indirect benefit to the debtor from a transfer is not considered 'value,' and therefore cannot be 'reasonably equivalent value,' unless it is (1) an 'economic' benefit; (2) concrete; and (3) quantifiable."[61] A demonstration of concrete and quantifiable economic value is evident when a transfer or obligation does not negatively impact the transferor's net worth. "The focus," the court reiterated, "should be on the overall effect on the debtor's net worth after the transfer."[62]

While the indirect benefit defense is viable in Michigan and in the Sixth Circuit, the above-referenced caselaw suggests that it may be a difficult burden for any fraudulent transfer defendant to prove in the context of upstream guarantees due to the shifting of the burden and the requirement of a showing of concrete and quantifiable economic benefits.

Conclusions

TOUSA is just one of several cases highlighting the fact that there is significant room for disagreement regarding the concept of "reasonably equivalent value," particularly in the context of complex commercial transactions involving multiple affiliated corporate entities. What is a fair deal to a corporate family in one court's mind may be viewed as a classic fraudulent transfer by another.

While TOUSA is a case involving a distant bankrupt company, it serves as a warning to lenders and their counsel across the country. This is particularly true in Michigan given that the courts in this jurisdiction have adopted a burden-shifting analysis similar to that approved by the Eleventh Circuit Court of Appeals in *In re TOUSA III*.

In any event, lenders and their counsel who are structuring a deal involving liens or upstream guarantees need to consider that those liens or guaranty obligations may subsequently be challenged as constructive fraudulent transfers if the conveying affiliates were rendered insolvent as a result of such transactions. Accordingly, additional due diligence may be appropriate to determine: (i) whether, and to what extent, the conveying affiliates will enjoy the proceeds of the loan, and (ii) whether such affiliates are solvent.

NOTES

1. 11 USC 548(a)(1)(b).

2. In Michigan, the constructive fraudulent transfer provision of the UFTA can be found at MCL 566.35(1), which provides:

> (1) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

3. 11 USC 548(a)(1).

4. Bazoian Phelps & Rhodes, *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes*, 3.02[1], p 3-4 (2012).

5. *Id.*

6. 11 USC 548(d)(2)(A).

7. *Official Unsecured Creditors Comm of Long Dev v Oak Park Village, Ltd (In re Long Dev),* 211 BR 874, 881-82 (Bankr WD Mich 1995); *Zervos Group, Inc v Thomson Asphalt Prods, Inc*, No 265397, 2006 Mich App LEXIS 1520 at *29 (May 2, 2006) (all aspects of the subject transaction must be examined in order to determine the value of the benefits and burdens to the debtor, both direct and indirect"); *Webb Mtn, LLC v Executive Realty P'ship, LP (In re Webb Mtn, LLC),* 414 BR 308, 355 (Bankr ED Tenn 2009) ("valuation considerations are inherently fact-laden, turning on the case-specific circumstances surrounding the debtor's decision to enter into the challenged transaction.").

8. *Corzin v Fordu (In re Fordu),* 201 F3d 693, 707 (6th Cir 1999).

9. *Congrove v McDonald's Corp (In re Congrove),* 222 Fed Appx 450, 454 (6th Cir 2007); *Lisle v John Wiley & Sons, Inc (In re Wilkinson)*, 196 Fed Appx 337, 344 (6th Cir 2006).

10. *World Invs, Inc v Bruinsma (In re TML, Inc),* 291 BR 400, 433 (Bankr WD Mich 2003) (citing *Allard v Flamingo Hilton (In re Chomakos),* 170 BR 585, 593-94 (Bankr ED Mich 1993)).

11. *In re Chomakos,* 170 BR at 593-94.

12. 11 USC 550(a).

13. *Official Comm of Unsecured Creditors of TOUSA, Inc v Citicorp North America, Inc (In re TOUSA I),* 422 BR 783 (Bankr SD Fla 2009).

14. *Id.* at 858.

15. *Id.* at 865-66.

16. *Id.* at 866 (citing *Pummill v Greensfelder, Hemker & Gale, PC (In re Richards & Conover Steel Co),* 267 BR 602, 614 (8th Cir BAP 2001)).

17. *Id.* (citing *Welt v Jacobson (In re Aqua Clear Techs, Inc)*, 361 BR 567, 582 (Bankr SD Fla 2007)).

18. *Id.* at 867.

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.* at 868.

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.* at 869.

31. *3V Capital Master Fund, Ltd v Official Comm of Unsecured Creditors of TOUSA, Inc (In re TOUSA II),* 444 BR 613, 680 (SD Fla 2011).

32. *Id.* at 653.

33. *Id.*

34. *Id.*

35. *Id.* at 654.

36. *Id.* at 655-56 (citing *Mellon Bank, NA v Official Comm of Unsecured Creditors of RML, Inc (In re RML, Inc),* 92 F3d 139, 148 (3d Cir 1996)).

37. *Id.* at 657 (citing *United States v Crystal Evangelical Free Church (In re Young),* 82 F3d 1407, 1415 (8th Cir 1996)).

38. *Id.* at 660.

39. *Id.* at 666.

40. *Id.* at 663-666.

41. *Id.*

42. *Id.* at 666.

43. *Senior Transeastern Lenders v Official Comm of Unsecured Creditors (In re TOUSA III),* 680 F3d 1298 (11th Cir 2012).

44. *Id.* at 1301.

45. *Id.* at 1311.

46. *Id.* (quoting *In re Chase & Sanborn Corp,* 904 F2d 588, 593 (11th Cir 1990); *Mayo v Pioneer Bank & Trust Co,* 270 F2d 823, 829-30 (5th Cir 1959)).

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.* at 1312 (citing *In re TOUSA,* 422 BR at 847.)

51. *Id.* at 1312.

52. *Id.*

53. *Id.* at 1313.

54. *Id.* (quoting *In re RML, Inc,* 92 F2d at 152).

55. *Id.* (quoting *Olympia Equip Leasing Co v Western Union Tel Co,* 786 F2d 794, 802 (7th Cir 1986)).

56. *Zervos Group, Inc v Thompson Asphalt Prods, Inc,* No 265397, 2006 Mich App LEXIS 1520 (May 2, 2006) (citing *Boyd v Sachs*, 153 BR 457, 498 (WD Mich 1993); *Leibowitz v Parkway Bank & Trust Co (In re Image Worldwide),* 139 F3d 574, 579 (7th Cir 1998) ("indirect benefits may be considered as part of the inquiry into reasonably equivalent value in a transaction")).

57. *Id.*

58. *In re Wilkinson*, 196 Fed Appx at 342 (citing *Frontier Bank v Brown (In re Northern Merch, Inc),* 371 F3d 1056, 1058 (9th Cir 2004); *In re Jeffrey Bigelow Design Group,* 956 F2d 479, 485 (4th Cir 1992)).

59. *Id.* (citing *Rubin v Manufacturers Hanover Trust Co*, 661 F2d 979, 991-92 (2d Cir 1981)).

60. *Id.* (citing *Unencumbered Assets Trust v Biomar Techs, Inc (In re National Century Fin Enters),* 341 BR 198, 217 (Bankr SD Oh 2006); *Fidelity Bond & Mortgage Co v Brand (In re Fidelity Bond & Mortgage Co),* 340 BR 266, 287 (Bankr ED PA 2006); *Dayton Title Agency, Inc v White Family Cos (In re Dayton Title Agency, Inc)*, 292 BR 857, 875 (Bankr SD Oh 2003)).

61. *Gold v Marquette Univ (In re Leonard),* 454 B.R. 444, 457 (Bankr ED MI 2011) (citing *In re Wilkinson*, 196 Fed Appx at 342).

62. *Id.*

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"Only If" I Had Named the Correct Debtor: The Overhaul Of MCL 440.9503

By Joseph P. McGill*

Introduction

Uncertainty arising from Article 9's requirements for identification of individual debtors has plagued creditors in Michigan for years. In an effort to address this issue (and others), significant amendments to the Michigan Uniform Commercial Code ("Code") will be effective July 1, 2013.[1]

This article addresses amendments to the new naming requirements for financing statements filed against individual debtors. Two alternative approaches have been analyzed and debated by the UCC Article 9 Review Committee of the National Conference of Commissioners on Uniform State Laws ("Joint Review Committee"). Statutory modifications have been prepared to address this issue and multiple other provisions of the Uniform Commercial Code.[2]

As has always been the case, individuals may be known by multiple names including, but not limited to, birth certificate, state-issued identification, driver's license, passport, or a commonly known nickname. Previously, the Code provided no guidance on which is the correct name of the debtor for entry on the financing statement. Unfortunately, a financing statement that does not provide a correctly named debtor does not perfect the security interest.[3] Such statements are deemed "seriously misleading" and fail to comply with the naming requirement of section 9503.

Two alternative approaches have been suggested by the Joint Review Committee. These alternatives are respectively referred to as the "Only If" rule or the "safe harbor." Michigan has adopted the "Only If" rule in the amended version of MCL 440.9503(1)(d). Specifically, a financing statement complies with the Code and perfects a security interest "only if" it provides the name of the individual debtor indicated on an unexpired state-issued driver's license or personal identification card.[4]

The analysis below answers many questions secured parties may face in complying with the "Only If" rule.

"Seriously Misleading" and the Effect of Errors

The UCC provides little guidance with respect to appropriate identification of the debtor in a secured transaction. UCC 9-502 merely states that:

> A financing statement is sufficient only if it does all of the following:
>
> (a) Provides the name of the debtor.[5]

The UCC provides no explanation of the meaning of the term "name of the debtor." This becomes extremely significant if errors or omissions in the debtor's name make the financing statement "seriously misleading." Specifically, UCC 9-506 provides as follows:

> (1) A financing statement substantially satisfying the requirements of this part is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading.
>
> (2) Except as otherwise provided in subsection (3), a financing statement that fails sufficiently to provide the name of the debtor in accordance with section 9503(1) is seriously misleading.
>
> (3) If a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement that fails sufficiently to provide the name of the debtor in accordance with section 9503(1), the name provided does not make the financing statement seriously misleading.
>
> (4) For purposes of section 9508(2), the "debtor's correct name" in subsection (3) means the correct name of the new debtor.[6]

As may be seen from subsection (2), failure to comply with UCC 9-503(1) regarding the name of the debtor will result in the fi-

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nancing statement being determined as "seriously misleading." Subsection (3) provides some relief if the searcher is using the "filing office's standard search logic." The financing statement will not be rendered as seriously misleading if this logic would result in a disclosure of the name of the debtor on the financing statement, even if it fails to comply with the "Only If" rule, the financing statement will not be rendered as seriously misleading. The amended UCC 9-503 does provide assistance from the inherent ambiguity created by the multiple vagaries resulting from the language in UCC 9-506(3) related to "standard search logic."

Naming the Debtor: Amendment of MCL 440.9503

The amended UCC 9-503 also addresses naming requirements related to trusts and estates, the applicable language and changes concerning identification of individual debtors is set forth below. Subsection (1)(d) contains the "Only If" language, while subsection (e) provides the catch-all for individuals not holding a state-issued driver's license or personal identification card. Newly added subsection (7) establishes the priority of state-issued identification where one or more driver's license or personal identification card has been issued. Specifically, the language reads as follows:

> (1) A financing statement sufficiently provides the name of the debtor if it meets all of the following that apply to the debtor:
>
> * * *
>
> (d) Subject to subsection (7), if the debtor is an individual to whom this state has issued a driver license or state personal identification card that has not expired, only if the financing statement provides the name of the individual which is indicated on the driver license or state personal identification card.
>
> (e) If the debtor is an individual to whom subdivision (d) does not apply, only if the financing statement provides the individual name of the debtor or the surname and first personal name of the debtor.
>
> * * *
>
> (7) If this state has issued to an individual more than 1 driver license or state personal identification card of a kind described in subsection (1)(d), the one that was issued most recently is the one to which subsection (1)(d) refers.

The "Only If" alternative selected by the Michigan legislature distinguishes between two groups of individual debtors. For debtors holding an unexpired driver's license issued in Michigan, the UCC will require that a financing statement provide the name indicated on the license or state-issued personal identification card. When a debtor does not hold an unexpired driver's license, the requirement can be satisfied in either of two ways.

A financing statement is sufficient if it provides the "individual name" of the debtor. Alternatively, a financing statement is sufficient if it provides the debtor's surname (i.e., family name) and first personal name (i.e., first name other than the surname).[7] A financing statement does not "provide the name of the individual which is indicated" on the debtor's driver's license unless the name it provides is the same as the name indicated on the license. This is the case even if the name indicated on the debtor's driver's license contains an error.[8]

The following examples based on comments drafted by the Joint Review Committee help to illustrate the point:

> **Example 1:** Debtor, an individual whose principal residence is in Michigan, grants a security interest to SP in certain business equipment. SP files a financing statement with the Michigan filing office. The financing statement provides the name appearing on Debtor's Illinois driver's license, "Joseph Allan Jones." This filing would be sufficient under Code 9503(1)(d), even if Debtor's correct middle name is Alan, not Allan.[9]

A filing against "Joseph A. Jones" or "Joseph Jones" would not "provide the name of the individual which is indicated" on the debtor's driver's license. However, these filings might be sufficient if Jones has no current (i.e., unexpired) Michigan driver's license since it provides the surname and first name.[10] Determining the name that should be provided on the financing statement must be done carefully, particularly when changes in a principal residence occurs.

Changes in Principal Residence

The "Only If" alternative refers to a license issued by "this state." Ordinarily, perfection of a security interest by filing is determined

[A]n individual debtor in a secured transaction may be known by multiple names including, but not limited to, birth certificate, state-issued identification, driver's license, passport, or a commonly known nickname.

by the law of the jurisdiction in which the debtor is located.[11] Usually, an individual debtor is located at the individual's principal residence.[12] Thus, Michigan's amended UCC 9-503 will apply during any period when the debtor's principal residence is located in Michigan, even if during that time the debtor holds or acquires a driver's license from another state. When a debtor's principal residence changes, the location of the debtor under UCC 9-307 also changes, and perfection by filing generally will be governed by the law of the debtor's new location. As a consequence of the application of UCC 9-316, a security interest that is perfected by filing under the law of the debtor's former location will remain perfected for four months after the relocation and, thereafter, will remain perfected if the secured party perfects under the law of the debtor's new location. Likewise, a financing statement filed in the former location may be effective to perfect a security interest that attaches after the debtor relocates.[13]

> **Example 2:** Debtor, an individual whose principal residence is in Michigan, grants a security interest to SP in certain business equipment. SP files a financing statement in Michigan that provides the name indicated on Debtor's Michigan driver's license. On January 1, Debtor relocates to Indiana. Upon the relocation, the law governing perfection of the security interest changes from the law of Michigan to the law of Indiana.[14]

Under Indiana's UCC 9-316, however, a security interest perfected by the Michigan filing remains perfected, normally for four months. If SP does not file in Indiana before the four-month period expires, then the security interest will become unperfected and will be deemed never to have been perfected as against a purchaser of the collateral for value. In addition, under Indiana's version of UCC 9-316, the Michigan financing statement normally would remain effective to perfect a security interest in collateral acquired by the debtor within the four months after the relocation to Indiana.[15]

Michigan's amended UCC 9-503 will apply during any period when the debtor's principal residence is located in Michigan, even if during that time the debtor holds or acquires a driver's license from another state.

What Is the "*Individual Name*" of the Debtor?

Article 9 does not define the "individual name" of a debtor. Nor does it define which element or elements in a debtor's name constitute the surname. In some cases, determining the "individual name" of a debtor may be difficult since names can take many forms in the United States. In applying non-UCC law for purposes of determining the sufficiency of a debtor's name on a financing statement, due regard should be given to the instruction in UCC 1-103(1)(a) that the UCC "must be liberally construed and applied to promote its underlying purposes and policies," which includes simplifying and clarifying the law governing commercial transactions. Thus, determination of a debtor's name in the context of the Article 9 filing system must take into account the needs of both filers and searchers. Filers need a simple and predictable system in which they can have a reasonable degree of confidence that, without undue burden, they can determine a name that will be sufficient so as to permit their financing statements to be effective.[16]

Likewise, searchers need a simple and predictable system in which they can have a reasonable degree of confidence that, without undue burden, they will discover all financing statements pertaining to the debtor in question.[17] The Code encourages courts to take into account the purpose of the UCC to make the law uniform among the various jurisdictions.[18] Of course, once an individual debtor's name has been determined to be sufficient for purposes of amended UCC 9-503, a financing statement that provides a variation of that name, such as a "nickname" that does not constitute the debtor's name, does not sufficiently provide the name of the debtor under this section. However, a financing statement that otherwise complies with the "Only If" rule is not rendered ineffective by also providing a debtor's trade name.[19]

When in doubt about an individual debtor's name, a creditor may choose to file multiple financing statements with multiple versions of the debtor's name and search in a similar fashion. Keep in mind that even if the name provided in the financing statement is correct, the "filing office" will reject the financing statement if it does not identify an individual debtor's last name.[20]

UCC 9-506 and 9-503 balance the interests of filers and searchers.[21] Searchers are not expected to ascertain every nickname, trade name, or "doing business as" the debtor may use. However, it is the secured party's responsibility to provide the name of the debtor sufficiently in a filed financing statement.[22] UCC 9-506(3) sets forth the only situation in which a financing statement that fails suffi-

ciently to provide the name of the debtor is not seriously misleading.

As stated in UCC 9-506(2), if the name of the debtor provided on a financing statement is insufficient and subsection (3) is not satisfied, the financing statement is seriously misleading.

UCC 9-506(3) provides that "a financing statement that fails sufficiently to provide the name of the debtor in accordance with 9503(1)" is "seriously misleading." Such a financing statement is ineffective even if the debtor is known in some contexts by the name provided on the financing statement and even if searchers know or have reason to know that the name provided on the financing statement refers to the debtor.

Conclusion

It is of primary importance for a secured party to properly identify a debtor in a financing statement to secure perfection of the security interest. Unlike other legal entities such as corporations, LLCs, trusts, and/or partnerships, identification of individual debtors provides additional complications arising from ascertaining the correct name of the individual. The July 1, 2013 amendment to UCC 9-503 implicitly acknowledges these difficulties and adopts bright-line rules for which names are sufficient and which are not. Amended UCC 9-503 appears well-designed to facilitate compliance with the naming requirement. As with all other statutory enactments, factual circumstances and judicial interpretations are bound to provide further clarification of the new requirements. To protect perfection of security interests, parties to secured transactions must remain attentive to the requirements of the law and changes in factual circumstances that may impact the value of such interests.

NOTES

1. 2012 PA 88 (http://legislature.mi.gov/documents/2011-2012/publicact/pdf/2012-PA-0088.pdf).
2. The National Conference of Commissioners on Uniform State Laws, Joint Committee, Commercial Code, Article 9, 2010 Amendments to Official Comments, August 25, 2010 (http://www.uniformlaws.org/shared/docs/ucc9/ucc9_2010%20amendments%20to%20official%20comments_082510.pdf).
3. "Twenty Questions About An Individual Debtor's Name Under Amended Article 9 Section 9-503(A)(4) Alternative A" 3 *William & Mary Bus L Rev* 139, (Feb 2012).
4. MCL 440.9503, as amended effective July 1, 2013.
5. MCL 440.9502(1), as amended effective July 1, 2013.
6. MCL 440.9506.
7. Proposed Comments to Article 9, at p. 36.
8. *Id.* at pp. 37-38.
9. *Id.*
10. *Id.*
11. MCL 440.9301(a).
12. MCL 440.9307(2)(a).
13. MCL 440.9316(8).
14. Proposed Comments to Article 9, at p. 38.
15. *Id.*
16. *Id.*
17. *Id.* at p. 39.
18. MCL 440.1103(1)(c).
19. Proposed Comments to Article 9, at p. 39.
20. MCL 440.9516(2)(c)(iii), as amended effective July 1, 2013.
21. MCL 440.9503 and MCL 440.9506.
22. MCL 440.9506(3).

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When in doubt about an individual debtor's name, a creditor may choose to file multiple financing statements with multiple versions of the debtor's name and search in a similar fashion.

Mapping the Fall: The Descent from Troubled Company to Bank Fraud Perp

By Brian Phillips and Scott Eisenberg

The Steep and Slippery Road to Fraud – A Hypothetical Example of "Why"

Ten years ago, things were good. Bob's business was profitable. Not gangbusters, but good nonetheless. Bob was working hard every day, making ends meet with a decent amount left over. He had just added some additional staff to handle some of the daily grind, and he was focusing more on the growth of the company.

Over the next five years, the business really started to expand. In fact, it expanded faster than Bob's wildest dreams. His largest customer was calling him on an almost daily basis with new opportunities. Their business was doing well too, and Bob was reaping the benefits. New business was popping up all over the place and as a result, sales were booming. Handling all of the growth was a good problem. Bob needed more trucks, more people, and more credit from his suppliers. And that's what he got. Bob's bank was only too happy to finance the new trucks he needed, and also nice new cars for Bob and his wife. The suppliers loved Bob, too. Some of them not only offered a higher credit line but also went so far as to extend Bob's terms to allow for a longer pay period. The company hired a full contingent of back office staff, doubled its capacity in the shop, and moved into a new building purchased by Bob's new company, Bob's Real Estate Holdings, LLC.

Then, slowly at first, it started to happen. Over the course of several years, Bob's largest customers began to stagnate. Bob's sales stopped growing; then they started to drop. Employee health care costs increased. The price of raw and other direct materials went up significantly, and Bob's contracts did not allow him to pass the higher costs through to his customers. All the new staff and equipment drove Bob's cost of sales higher. Without the continuous increase in volume enjoyed in past years, profitability began to suffer.

As Bob's profitability shrank, so did his cash. The company began to rely more and more on its vendors and bank lines of credit, which slowly and continuously edged closer and closer to their limits.

Finally, with cash at zero, payroll due on Friday, the company's largest customer demanding a price cut, vendors holding shipments and the bank line of credit nearly out of availability, Bob did it. In a desperate move, Bob and his controller opened an account at a new bank, deposited some of this week's cash receipts into the new account (money that contractually should have gone to pay down the company's line of credit), and paid the week's payroll from there.

It was fraud, and Bob knew it was wrong. But he also knew that it was just a one-time thing. He did not have to report anything to the bank until month-end; he had been able to make up the difference within the next week, so everything would be ok again. And it was.

But two months later it happened again. This time, Bob did not have to open the new bank account because it was already there for him to use. It took a little longer to get the diverted funds paid back, but he still did it. Unfortunately, the timing of this diversion was such that it crossed over a month-end reporting period. Bob's controller had to report to the bank: balance sheet, income statement, and borrowing base report for the line of credit. It would not do to show a separate bank account, and, without the receivable balance, the line of credit was actually at a negative availability and thus out of formula. However, again, it was only temporary, so Bob and his controller delayed the reporting. When they did file the required reports, they just backdated the corrections and reported

no problems as of monthend. In other words, they falsified the bank reporting.

It was fraud again, and Bob knew it. He also knew that it was just a one-time thing. Sure, he had reported falsely to the bank, but he fixed the balances within a week or two and been able to make payroll again. After all, if he could not make payroll, he would be forced to close down. Then, where would the bank be? They needed him to stay alive if they were going to get their money back at all. And that was all he was doing, staying alive. If the bank could not understand that, then too bad. They did not know his business. Bob had to do what he had to do. What did the bank know about running a business?

Bob began to work with an investment banker to help him find a partner who could bring in some capital and ease his cash flow burden. In the meantime, the cash problem continued to get worse, and, eventually, Bob and his controller could not fix the cash flow problems with "temporary" fraudulent reporting. More money had to be diverted to the secret bank account to pay for payroll, vendors, and others. And when even that was not enough, more money had to be borrowed against the bank line of credit, which meant falsifying more bank reporting to show that funds were available for borrowing.

Over the course of the next 12-months, it got so bad the company actually ended up tracking two sets of books for their accounts receivable; one within the internal accounting system that tracked reality and one for the bank reporting. The bank was getting more and more suspicious. They began to require weekly borrowing base reports, and they were having trouble understanding how Bob's accounts receivable kept going up, along with his borrowing, while his sales and profitability were dropping.

At this point, the bank scheduled a review of Bob's books and operations. They were bringing in a consultant and had the right to do so under the terms of the loan agreements. Not only did Bob have the line of credit outstanding, but he had all of the new equipment notes, a couple of mortgages, and the loans for the nice cars he and his wife drove. Knowing the bank would put him out of business if they found out about the secret bank account and all of the false reporting, and not wanting to lose his business that only a few years earlier had shown so much promise, Bob and his controller worked feverishly. While delaying the consultant's access to the company as long as possible, they tried to shore up all of the false reporting by creating false backup documents, reconciling schedules, and the like. Bob's descent into the world of fraud was complete.

The Very Definition of Fraud

Bob (and his controller) were now fraudsters. Although he certainly had not intended to go there from the beginning, Bob undoubtedly got there in the end. Two sets of books, false bank reporting, a secret bank account, and diversion of bank collateral all adds up to a fairly typical bank fraud scenario.

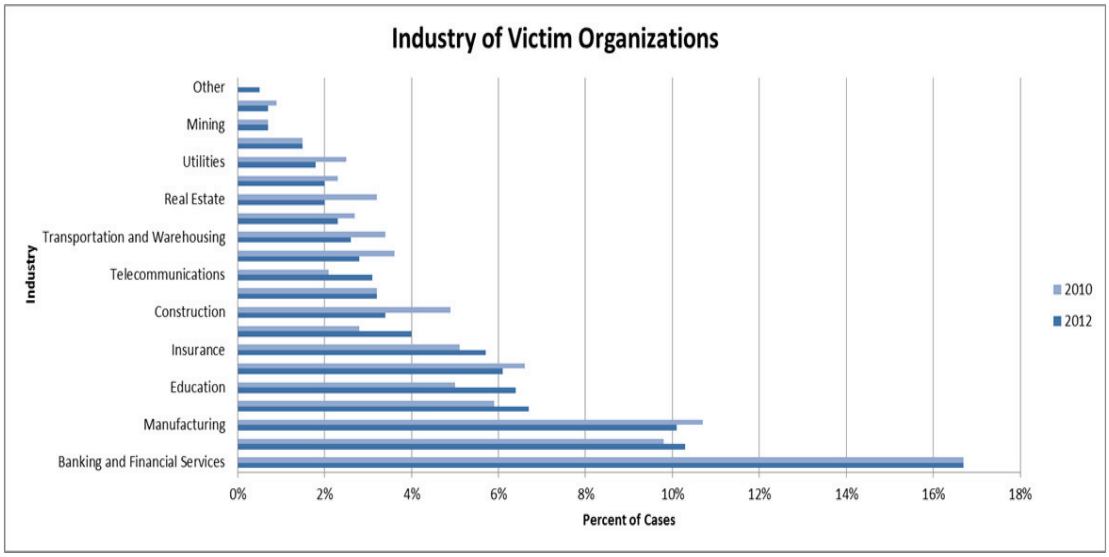
Dictionary.com defines fraud broadly as, "deceit, trickery, sharp practice, or breach of confidence, perpetrated for profit or to gain some unfair or dishonest advantage." It differs from errors or simple omissions in that it involves intent—the intent of the perpetrator or perpetrators to deceive, even if the intent is only a "one-time deal."

In financial terms, we tend to categorize fraud from the perspective of the direct victim or victims. Bank fraud, such as that perpetrated by Bob in the above hypothetical example, victimizes the lender and its shareholders. Oftentimes, it is perpetrated by a borrower of funds, such as Bob, and can involve providing fraudulent reports, misleading or false information, and/or misappropriation or diversion of funds, generally with the purpose of hiding true financial position. In doing so, the perpetrator tends to gain greater access to funds than would otherwise be available (i.e., increased credit limits).

According to a global study issued bi-annually by the Association of Certified Fraud Examiners (ACFE), banks and other financial service firms have the highest risk of any industry for being victims of fraud (*See Chart 1*). Almost 17 percent of all fraud cases reported worldwide involve some form of bank fraud. The median loss incurred by the victim bank or other financial services institution was $232,000 in 2012.[1]

The government and manufacturing sectors followed in liklihood of victimization with approximately 10 percent of all cases reported each. No other industry made up more than 7 percent of cases.

Chart 1 – Industry of Fraud Victim Organizations (2012 Report to the Nations)



Almost 17 percent of all fraud cases reported worldwide involve some form of bank fraud. … No other industry made up more than 7 percent of cases.

Banking may be an especially vulnerable target for fraudsters like Bob because of their dealings with so many different customer industries, sizes, etc.

Regardless of the industry in which a bank customer operates, anything affecting that industry also affects that bank customer, which in turn could affect the bank or lender. In other words, it is not necessarily the banking industry itself that makes such institutions vulnerable to fraud, but rather all of the various industries to which the bank lends.

Fraud on the Rise

Worldwide Statistics

In terms of raw data, survey participants in the 2012 Report to the Nations estimated the typical organization loses 5 percent of its revenues to fraud each year. This is unchanged from the previous survey conducted in 2010, indicating that overall fraud losses are holding steady as a percentage of revenues. Applied to the 2011 Gross World Product, this figure translates to a potential projected annual fraud loss of more than $3.5 trillion (up from $2.9 trillion in 2010).

Participants reported a median loss of $140,000 per incident. Interestingly, this is down from a median loss of $160,000 per incident in the 2010 report. Additionally, cases involving losses in excess of $1 million dropped from approximately 25 percent to 20 percent between the two reports.

Taken altogether, the data point to a higher number of fraud incidents overall, up almost 40 percent during the two-year period.

Worldwide Incidents of Fraud	2010	2012
Estimated Total Worldwide Losses	2,900,000,000,000	3,500,000,000,000
	($2.9 Trillion)	*($3.5 Trillion)*
Reported Median Loss per Incident	$ 160,000	$ 140,000
Approximate Total Number of Incidents	18,125,000	25,000,000
	(18.125 million)	*(25 million)*
		Up 38% from 2010

This correlates with data from the National White Collar Crime Center (NW3C), which shows a spike in arrests for fraud and embezzlement during and after the two previous recessions. Following the savings and loan crisis and the subsequent economic downturn in 1990, white collar fraud arrests jumped 52 percent over the next two years. Similarly, in the two years following the 2000 burst of the dot-com Internet bubble, arrests jumped 25percent.[2]

In the midst and aftermath of the "Great Recession," we should expect nothing different. And as the U.S. economy struggles to come out the other side, we should expect that such instances will continue to be high for several years to come.

Closer to Home

In reviewing recent cases involving Amherst Partners, we have found that a number of financial advisory cases in the last two to three years (and nearly every case of significant size) have involved some aspect of fraud or potential fraudulent activity.

In most cases, Amherst was not initially engaged to perform a fraud investigation. A thorough review process and an eye toward the way things "ought to look," in conjunction with the engaged scope of the projects, identified abnormalities. Eventually fraudulent actions were uncovered. In most cases, no special reviews were necessary in order to uncover and track the fraud.

The Psychology of Fraud: Why Did They Do It?

Although there are certain aspects of most bank fraud schemes that recur, such as the falsification of reporting and the diversion of funds, most bank fraud schemes have a personality of their own and are developed to match the abilities and nuances of the industry and specific company in which the fraudster operates.

The following Amherst case summaries provide some examples of recent bank fraud schemes, the review method that ultimately uncovered the fraud, and the basic psychology of the individuals who ultimately perpetrated the fraud itself.

Example 1 – Empty Pockets, Empty Boxes:

Fraud Identification and Description—Representing the debtor, a plastic injection molder, Amherst reviewed the balance sheet and performed a standard inventory analysis. This analysis indicated reported inventory balances were not moving through the system in tandem with corresponding production and shipments. Upon further investigation, Amherst found the company had been placing packing stickers on empty boxes and stacking them in various places throughout the warehouse. These empty boxes were then counted as full of finished goods, inflating the company's borrowing availability from its lender and providing false indication of the ability to ship to customers in a timely manner.

Detection—The lender in this case had performed standard audit procedures without catching the inflated inventory. Why not? The answer is that standard collateral audit procedures are not designed sufficiently to catch most forms of fraud, and they generally leave out the best place to start. A simple common sense review of a snapshot of operations, not the tick and tie[3] auditing most collateral audits provide. Amherst's review of the balance sheet in this case generated one simple question, "For a company having difficulty paying its vendors in a timely manner, why do they have so much inventory?" Following the trail to find the answer uncovered the empty box scheme.

Psychology of the Fraudster—The owner of the company had started this business 30 years ago, was nearing retirement and was working toward handing over the reins to his son when the "Great Recession" hit the automotive industry hard. As a result of the automotive downturn, the plastics industry suffered tremendously, and the company was unable to make their loan payments or pay vendors on time. In the belief that the industry was going to return, and with the goal of providing the next generation with something that the owner had worked so hard on for so long, the owner of this company made the conscious decision to falsify bank reporting ("just until sales returned to normal")

[M]ost bank fraud schemes have a personality of their own and are developed to match the abilities and nuances of the industry and specific company in which the fraudster operates.

in order to gain more availability on his bank line of credit.

Motivation—Love of one's children and desire to not lose what was built over a lengthy period of time.

Example 2—The Accounting Puzzle:

Fraud Identification and Description—A debtor engaged Amherst to develop a 13-week cash flow forecast for the company's lender. One aspect often overlooked in the development of such a forecast is the establishment of a clean starting point. In reviewing the beginning accounts receivable balances, Amherst pulled the receivables aging from the company's accounting system and compared it to the amounts reported to the lender. It was immediately clear the two reports were materially different. On further investigation, Amherst learned the company had been reporting a separate amount to the lender for at least 12 months, inflating its borrowing base by more than $2 million.

Detection—The lender had performed at least one standard collateral audit, and the company had undergone at least one annual financial audit during this timeframe, neither of which identified the fraudulent reporting. Why not? In this case, the lender's audit staff accepted Microsoft Excel files from the company as source documents and did not actually perform a receivables roll-forward or detailed reconciliation on any of the largest customers (presumably due to size and volume of the accounts). The financial audit team did not take the simple step to tie year-end financial information to bank reporting, although they did review the company's status relative to bank covenants based on the audit results themselves.

Amherst, in starting to create the 13-week cash flow forecast, took the approach that the accounting "systems" of any entity are made up of pieces to a single puzzle. Each piece must fit with all of the others, or something is wrong. Once one piece is identified as not fitting, all other pieces become suspect as well. By accepting spreadsheets as source documents, the lender opened the possibility of manipulation once the data was outside the accounting puzzle. Amherst's insistence on using source documentation for the accounts receivable starting point uncovered the false reporting scheme.

Psychology of the Fraudster—Unlike Bob in our hypothetical example and the owner of the company in Example 1, the business owner in Example 2 set out to defraud the bank from day one. While the company itself was probably viable at a certain level, the owner felt that it was not big enough. He decided that the bigger the company, the more he could pay himself, his wife, his daughter, and the bigger and better things he could have. The owner of this small business bought new cars for the entire family, bought three nice homes throughout the country, took wonderful trips overseas, and generally lived the good life…until he was caught.

Motivation—Simple greed.

Example 3: Shipments to Nowhere

Fraud Identification and Description—Assigned as receiver for a struggling plastics company, Amherst began an immediate overall review of corporate assets, including accounts receivable. In reviewing the outstanding balances due from several of the company's largest customers, Amherst noted outlying invoice amounts that were inconsistent with the majority of all other invoices normally issued by the company. The invoice amounts were of an even dollar amount and up to 20 times larger than typical invoices issued by this company. On further investigation, Amherst discovered the company had issued false shipping documents and related invoices, which were supplied to the lender as source documentation support for daily/weekly sales and receivables balances.

Detection—In this case, the lender had not only performed periodic collateral audits but had gone so far as to require source documentation to

The design and implementation of internal control procedures and appropriate review processes can prevent the majority of opportunity to commit fraud.

back up periodic reporting by the company. Cash flow issues finally forced the company into receivership. In the meantime, unfortunately, the company's upper management, a former CPA, was able to manipulate the internal accounting systems in such a way as to develop a complete set of false source documents to back up the false reporting made to increase lending and cover certain payments.

Amherst's review of the receivable's balance led to a sense of something being out of the ordinary. Perhaps the most important aspect of this detection, however, was the fact that a simple sense of something being out of the ordinary was followed through to understand the entire transaction, resulting in the fraud detection within just a few days of Amherst being on site.

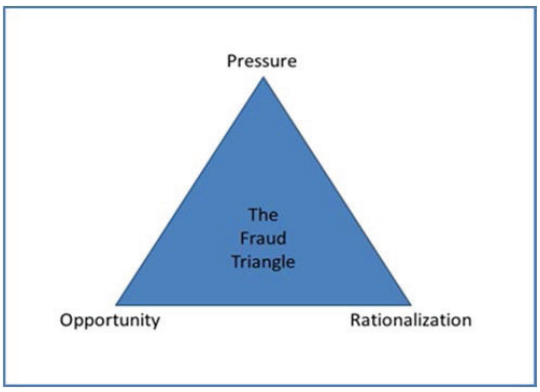
Psychology of the Fraudster—The part-owner and CFO of this company had previously been its outside CPA. He had bought into the company as an owner only recently and realized too late that it was not really doing as well as he had thought. Still believing that he could turn it around, however, and feeling a sense of responsibility and loyalty to the staff, he would do almost anything to avoid laying anybody off. One false invoice to cover a cash shortfall led to another, and another, and another. Before he knew it, the fraud was too deep to simply climb out of it, and he ended up out of business.

Motivation—Sense of responsibility and loyalty to staff.

As we can see from our hypothetical example with Bob, as well as the real life examples above, many fraudsters do not set out to be that way. A set of circumstances, some of which are truly out of their control, lead the fraudster down a path to committing their particular crime.

Three Elements Necessary to Commit Fraud

Fraud experts agree that the commission of fraud generally requires all three of the following elements to be present ("The Fraud Triangle").



Pressure…causes a person to commit fraud. Pressure can come from a multitude of places but generally involves some sort of significant financial need or problem. Normally, the individual also feels as if the problem needs to be solved in secret; that either reasonable forms of help are non-existent or no longer available to them.

Opportunity…provides the ability to commit fraud. The belief that one will not be caught in the commission of a fraudulent act is created by weak internal controls, poor oversight or governance, and/or the consolidation of authority within an organization. Opportunity is the element of fraud that organizations have most direct control and where risks can be most limited through appropriate actions.

The design and implementation of internal control procedures and appropriate review processes can prevent the majority of opportunity to commit fraud. From a financial perspective, this can include up-front analysis and periodic, thorough, lender reviews by qualified financial analysis with appropriate forensic training. Tick and tie auditing generally will not provide sufficient oversight to prevent fraud if the other points of the triangle (pressure and rationalization) are sufficiently strong and internal controls are sufficiently weak.

Rationalization…involves how the person committing fraud reconciles their behavior with their own internal notions of honesty and proper conduct. Individuals may rationalize their behavior in a number of ways. Common methods of rationalization include:

- A belief that, if not for their actions, the individual will lose everything (business, family, home, car, etc.).
- A belief that no help is available from the outside.
- A belief that the theft is merely a temporary "borrowing" and is fully intended to be repaid.

[A]s a down economy takes its toll on businesses, opportunities for the commitment of fraud increase. … Additional opportunities for fraud arise through concentration of authority within small businesses.

- A belief that the bank or other institution has somehow wronged the individual or individual's business and that something is "owed" to him/her for this digression.
- A lack of understanding as to the consequences of the fraudulent actions ("It's no big deal.").

An obvious question is: What can a lender do to increase the likelihood it will detect fraudulent activity early as opposed to later in the process? The following section discusses five actions that can help increase the detection of fraud.

Five Lender Techniques to Help Reduce Bank Fraud

Financial institutions generally have a number of procedures and techniques available to help prevent fraud. The frequency of use of these procedures and techniques, however, is up to the individual. As a primer, we have listed below five items a lender can be aware of which may provide indicators that a deeper look may be necessary:

1) Balance Sheet / Income Statement Relationships

   Most analysts use simple ratios as one tool to help determine a company's overall health. But whether it is a current ratio, a quick ratio, or other standards, these ratios don't necessarily bridge the gap between operations and the balance sheet. To do so, ask questions that require both sides of the financial statements to answer. How much inventory is on hand in comparison with monthly sales? How does the total accounts receivable balance or aging compare with monthly sales? What changes have taken place in fixed assets in comparison with the overall profitability of the company?

2) Third Party Verifications

   Consider verifying not only a few accounts receivable, but several accounts payable as well. There is no substitute for balance verification with a customer or vendor. Reviewing total transactions by customer or vendor can uncover anomalies as well.

3) Slow Moving Inventory

   Slow moving inventory items are prime areas to hide false assets. Overstating the quantities on hand will not affect current production planning or be required for shipment any time soon, so the fraudster can get a maximum amount of benefit with a minimal amount of effort. Test counting the slow moving inventory can lead to any number of discoveries.

4) Original Documentation

   Always insist on original reports from a company's internal accounting systems. By allowing a company to report in summary format using external software and without any detailed original documentation, the door is left open for easy manipulation.

5) Kick the tires

   Do not be afraid to walk around the plant, the shop floor, the showroom, or the building itself and take note of anything out of the ordinary or that you simply do not understand. Ask questions until full understanding is gained. Simple questions like, "Why is that pile of steel in the corner of the plant?" or "Where do you store the extra inventory before it hits the showroom floor?" can sometimes lead to much deeper discoveries. And if not, great! You simply learn more about the company and industry at hand.

Economic Impacts on the Fraud Triangle

As we see in each of the examples discussed above, the overall impact of poor economics, either globally or simply within the company itself increases the likelihood that fraud will be committed. Increases in fraud due to a down economy lie in the economy's effects on all three points of the fraud triangle.

Drops in the overall economy trickle down to every business, business owner, and individual in one way or another. For businesses, overall pressure is increased by falling sales, increasing losses, margin compression, tightening credit lines, and general uncertainty in the market place. Individuals also feel pressure due to lost or potential of lost job status, reduced pay and/or opportunity for economic betterment within an or-

ganization, and continual "bad news" in the media.

Similarly, the feeling that general changes in the economy are the fault of "those guys" (bank bail-outs, Wall Street greed, politician dishonesty, or other external factors) can lead an individual or business owner to rationalize actions that would otherwise not have been taken. The feeling that others "did this to me" increases the likelihood of individuals rationalizing fraudulent actions by shifting their thought pattern to, "I'm only doing what I have to do."

Finally, as a down economy takes its toll on businesses, opportunities for the commitment of fraud increase. Staff reductions can change and deplete otherwise sufficient internal controls. Cash shortfalls, especially, can cause changes in daily operations away from approved or standard internal control procedures. For example, the need to "walk" a cash receipt from the mailbox directly to the bank to cover the day's disbursements circumvents normal control procedures for cash receipts and opens the company up to additional potential fraud opportunities.

Additional opportunities for fraud arise through concentration of authority within small businesses. While otherwise considered sufficient, the increases in pressure and rationalization may require outside intervention to prevent increased opportunity in this area. Tighter outside monitoring and closer ongoing forensic analysis may be required in the case of small businesses to prevent the situation from presenting an irresistible opportunity for the owner/administrator under such tremendous pressure. The use of continual or periodic reviews and monitoring can not only limit opportunity for fraudulent actions, but it can also reduce the potential for rationalization by providing the individual with a sense that they are not out of options, on their own, etc. They can work with, not hide from, the lender.

Certainly, all of the above issues are present in today's economy. Although some economists believe we are now at or past the bottom of the economic trough, it is reasonable to believe these upward trends in the occurrences of fraudulent actions will continue for at least another two to three years.

NOTES

1. Association of Certified Fraud Examiners (ACFE), *Report to the Nations on Occupational Fraud and Abuse*, 2012.

2. National White Collar Crime Center (NW3C), *White Collar Crime Statistics*, October 2009.

3. Tick and tie: standard terminology used by most auditors to describe the general process of confirming the contents of two or more independent sources of information.

Brian Phillips is Managing Director of Amherst Partners in Birmingham, Michigan. Specializing in turnaround and crisis management, profit enhancement, debt restructuring and litigation support services, he has represented debtors, creditors, and customers in the automotive supply, manufacturing, retail, not-for-profit, government, technology, and service industries.

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Case Digests

Motor Dealers Act—Dealer Agreement and Relevant Market Area

LaFontaine Saline, Inc v Chrysler Group LLC, No 307148, 2012 Mich App LEXIS 2378 (Nov 27, 2012). Plaintiff automobile dealer (located in Saline, Michigan) executed three separate sales and services agreements (SSAs) with defendant manufacturer that granted plaintiff the non-exclusive right to purchase and resell Chrysler, Dodge, and Jeep vehicles at plaintiff's dealership. The Motor Dealers Act (MDA) provides that before a manufacturer enters into a dealer agreement establishing a new dealer, it must give written notice to each new dealer of the same line in the "relevant market area." When plaintiff executed its SSAs, the MDA defined the relevant market area as a radius of six miles of the intended site in a county with a population of more than 25,000, but the definition was changed effective August 4, 2010, to nine miles in a county with a population of more than 150,000. Plaintiff is located in a county with a population of more than 150,000, and, on February 2, 2010, a second dealer entered into a Letter of Intent (LOI) agreement with defendant regarding the Dodge vehicle line. Sometime in 2010, plaintiff learned that defendant intended to award the Dodge vehicle line to the second dealer, and, on September 3, 2010, plaintiff sent a letter to defendant advising it that the other dealer was located within the new nine-mile relevant market area of plaintiff. Defendant responded via a letter to plaintiff advising that it "intend[ed] to approve the establishment of a Dodge car and truck vehicle line" at the second dealer.

On December 9, 2010, plaintiff filed a complaint for declaratory relief requesting that the trial court enter an order precluding defendant from awarding the Dodge vehicle line to the second dealer. Defendant and the second dealer filed motions for summary disposition pursuant to MCR 2.116(C)(8) and MCR 2.116(C)(10), arguing that the LOI constituted a dealer agreement that was effectuated before the 2010 statutory amendment such that the six-mile relevant market area governed whether plaintiff had standing to challenge the new vehicle line. The defendants also argued that the amended nine-mile relevant market area did not have retroactive effect.

The trial court entered an order granting defendants' motions for summary disposition, concluding that the LOI constituted the operative dealer agreement, and given that the LOI was executed before the 2010 statutory amendment, the pre-amendment six-mile relevant market area governed for purposes of standing. Because plaintiff fell outside the six-mile relevant market area, the trial court ruled that plaintiff lacked standing to challenge the new vehicle line under MCL 445.1576(3) and granted defendants' motions and dismissed plaintiff's complaint.

The court of appeals reversed and remanded for further proceedings. The court stated that the central issue was whether the LOI was a "dealer agreement" under the MDA. This definition was also amended in 2010, but the interpretation was governed in this case by the earlier definition. The court determined that the LOI did not qualify as a dealer agreement because it only concerned the facility and not the right to purchase and sell the Dodge vehicle line. Consequently, any future dealer agreement between the defendants would necessarily be executed after 2010 PA 139 took effect; thus, plaintiff is located within the "relevant market area," and plaintiff could maintain an action under MCL 445.1576(3) to determine whether good cause exists to establish the proposed Dodge vehicle line at the second dealer. Whether good cause exists for the establishment of the Dodge vehicle line at the second dealer is not contingent on future events that may not occur. Thus, the court stated that the case was ripe for adjudication and the trial court erred in concluding otherwise.

Single Business Tax—Capital Acquisition Deduction for Publishers

Random House, Inc v Department of Treasury, No 307035, 2012 Mich App LEXIS 2376 (Nov 27, 2012). Plaintiff is incorporated in the state of New York and is "primarily engaged in the publication and sale of books in interstate commerce." From 1993 to 1996, plaintiff transacted business in Michigan and timely filed Michigan Single Business Tax (SBT) returns for those years. In March 1998, plaintiff filed an amended Michigan return requesting a refund from defendant for a capital acquisition deduction (CAD) "for costs incurred in its book publication activities." In particular, plaintiff had expended funds purchasing original, or "master manuscripts" from authors. For the four years from 1993 through 1996, plaintiff requested refunds of $53,130, $75,235, $41,259, and $29,856. The Department of Treasury denied plaintiff's requested refunds, and plaintiff filed suit in the Court of Claims contesting denial of the refunds. Although the case was held in abeyance for more than ten years, it was reinstated to the active docket at the request of the parties. Plaintiff moved the trial court for summary disposition, arguing that the "costs were of the same type that were capitalized and depreciated for federal tax purposes as required by federal auditors in a prior audit." The Department of Treasury countered by arguing that plaintiff's focus on a master manuscript was misleading and that plaintiff had purchased the rights to publish books and had acquired an intangible asset. The trial court granted plaintiff's motion, concluded that plaintiff was entitled to claim a CAD for the tax years in issue, and ordered defendant to refund plaintiff $194,480 plus statutory interest.

The court of appeals stated that under the SBT's CAD provision it had to determine whether plaintiff's costs were for (1) tangible assets and (2) if so, whether those tangible assets were eligible for depreciation, amortization, or accelerated capital cost recovery under the IRC. The focus was a determination of what exactly was being purchased by plaintiff. Plaintiff argued that the costs at issue were associated with purchasing physical "master manuscripts," while the Department of Treasury asserted that the master manuscripts are merely ancillary to plaintiff's actual pur-

chases, which are intangible publication rights. As a result of an IRS audit in 1987 and 1988, plaintiff was required to capitalize and depreciate its costs associated with the purchase of master manuscripts. Thus, these costs were not only eligible for depreciation under the IRC, but the IRS actually required plaintiff to depreciate these costs. The Department of Treasury characterized physical depreciation in the colloquial context, rather than in the applicable and appropriate accounting context as provided by the IRC. Plaintiff's costs in this case were clearly "of a type that are, or under the internal revenue code will become, eligible for depreciation, amortization, or accelerated capital cost recovery for federal income tax purposes" as required by the statute, MCL 208.23(c). Thus, the court of appeals affirmed the trial court's order of a refund to plaintiff.

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June 8, 2013	9:00 a.m.	JW Marriott, Grand Rapids
December 7, 2013	10:00 a.m.	Honigman, Detroit

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