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BLS
Business Law Section

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The editorial staff of the *Michigan Business Law Journal* welcomes suggested business law topics of general interest to the Section members, which may be the subject of future articles. Proposed business law 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, ICLE, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432, dan@icle.org. General guidelines for the preparation of articles for the Michigan Business Law Journal can be found on the Section's website at http://michbar.org/business/bizlawjournal.cfm.

Each issue of the *Michigan Business Law Journal* has a different primary, legal 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
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
Spring 2015	Commercial Litigation Committee	November 30, 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.

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

From the Desk of the Chairperson

By Jeffrey J. Van Winkle

When you receive this issue of the *Michigan Business Law Journal*, we will have just ended the fiscal year for the Business Law Section, which also means that we have transitioned to new officers and refreshed committee leadership. I have the great privilege of following Marguerite M. Donahue, who is now the immediate Past Chairperson. I am sure that she is very thankful to be the immediate Past Chairperson, since the Business Law Section was very active during her term. During the past year, under her leadership, the Business Law Section was actively involved with the initial implementation of the Business Court Legislation. Not only has the Business Law Section had an Ad Hoc Committee for many years on this topic, several other committees, including the Commercial Litigation Committee, were very helpful in moving this law into a reality. The Section, through its committees, will continue to be involved in the implementation of the Business Court Litigation as training sessions are planned and as the circuit courts commence implementation of business law cases on their dockets. As a Section, we believe this is another step for Michigan to improve its reputation as a business-friendly state.

The Business Court Legislation was not the only relevant activity in the legislature for the Business Law Section this year. The Michigan Business Corporation Act was amended, and amendments to the Non-Profit Corporation Act continue to make progress through the legislative process. I am grateful for the many individuals, including Justin Klimko, James Carey, Jane Forbes, and Agnes Haggerty, who have all worked diligently on these different matters. Additionally, the committees they work with have been supportive and helpful in this process.

Many of you receiving this Journal will likely have skipped over the first few pages in order to dive directly into some of the wonderful content that is provided by the Section to you on a regular basis. No one is paid to provide the content to you. But from the "Did You Know" column by Ann Baker, our diehard representative active in the Section and the Deputy Director of the Corporations, Securities & Commercial Licensing Bureau, to the "Case Digest" at the end of the Journal, the content is superb. But please take a moment and look at the list of the committees that immediately precedes all of the content. Our Section needs the assistance and support from each of its members. Quite honestly, paying dues is not enough. Your participation on a listserv, service on a committee, or helping as a volunteer in some other way is tremendously important to the advancement of business law and the development of a business friendly reputation in the state of Michigan. Visit the Section website at http://www.michbar.org/business to see how you can help.

I look forward to the opportunity to serve as the Section Chairperson during the upcoming year. I am humbled by this opportunity because I am well aware of the tremendous skill and capacity of many business lawyers in this state. My goal is to continue the tradition of excellence as a Section leader and to advance the reputation of our state as a solid place to do business.

During the next 12 months, we will explore how we, as a Section, need to further enhance resources and opportunities for business lawyers in this state. And we will be surprised by some of the unexpected developments about which we know nothing yet—of that I'm confident. I look forward to this great adventure. I invite you to call me or e-mail me with any comments, suggestions, or other advice that you may have. My phone number is (616) 608-1113, and my e-mail is jvanwinkle@clarkhill.com.

At a time when many new lawyers entering the practice do so with great apprehension about the opportunities and future ahead of them, worries about the financial burden from the years of law school that weigh them down, we, as the existing Bar, have an opportunity to provide encouragement, mentorship, and sometimes simply our friendship to many of these newer lawyers. Take time to build a relationship with a newer lawyer this year and demonstrate graciousness to other practitioners.

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For more than 12 years the Business Law Section has partnered with ICLE in the publication of *The Michigan Business Law Journal*. The Business Law Journal provides informative articles on topics of importance to business law practitioners. Legislation, court decisions, use of technology, and policies and procedures of the Bureau of Commercial Services (now Corporations, Securities and Commercial Licensing Bureau) have been highlighted in this column.

Online access to the Corporation Division's database and filed documents using Business Entity Search www.michigan.gov/entitysearch was highlighted in Fall 2001 and Fall 2004 columns; Summer 2006 noted the addition of submission by e-mail to MICH-ELF; Summer 2006 and Fall 2007 discussed the expansion of File-Online; and in the Fall 2012 issue, the expected implementation of a new information storage and retrieval system in 2013 for the Corporation Division was featured.

Development and implementation of a new information storage and retrieval system for the Coporation Division to allow documents to be submitted electronically and eliminate the need to establish a MICH-ELF account has been delayed. Information regarding transition to the new system will be posted on the Bureau's website.

Woodbury v Res-Care Premier, Inc

The trial court in *Woodbury v Res-Care Premier, Inc* concluded Center Woods, Inc. had the right of first refusal to purchase property known as #2 Center Woods and that defendant Ruth Averill failed to provide sufficient notice of the sale. The trial court voided a sale between Averill and Res-Care Premier, Inc. Res-Care Premier, Inc. appealed. The Michigan Court of Appeals reversed and remanded the case.[1] The Michigan Supreme Court granted leave to appeal and held oral arguments on April 10, 2013. A Supreme Court Order dated July 26, 2013 directed the parties to file supplemental briefs and invited the Business Law Section, the Michigan Chamber of Commerce, and the Department of Licensing and Regulatory Affairs to file briefs amicus curiae.[2]

Averill purchased #2 Center Woods in 1991 and sold it to Res-Care Premier, Inc. on September 25, 2009. The Woodburys are the owners of #3 Center Woods. Center Woods, Inc. was incorporated in 1941 and dissolved by operation of law in 1993 for failure to file its 1991 annual report. Center Woods, Inc. completed renewal of existence under section 925 of the Nonprofit Corporation Act ("the Act") on October 13, 2009, the same day the action was filed.

Res-Care argued that Center Woods' failure to maintain its corporate status should prevent it from seeking to enforce a right of first refusal. As to whether Center Woods, Inc. was entitled to notice, the court of appeals stated "[h]ere, there is no question that Center Woods did not exist at the time of the sale."[3] Referring to dissolution under common law, the court stated "there is no one to serve, because, in law, a dissolved corporation is a dead person, so much so that, in the absence of statute and revival, even pending actions by or against it would abate."[4] Regarding the corporation's ability to renew its existence the court stated "Simply because someone can reinstate a corporation under MCL 450.2925 does not mean anyone will."[5]

Section 831 of the Nonprofit Corporation Act provides for dissolution for failure to file an annual report or pay an annual filing fee.[6] Sections 833 and 834 of the Act provide for the continued existence of a dissolved corporation and for the officers, directors, shareholders, and members to continue to function in the same manner as if dissolution had not occurred.[7] The corporate existence of a corporation dissolved for failure to file reports may be renewed by filing the missing annual reports and paying fees and penalties as provided in section 925 of the Act. Section 925 has no limitation period within which the renewal of existence must occur and provides, "Upon compliance with the provision of this section, the rights of the corporation shall be the same as though a dissolution or revocation had not taken place, and all contracts entered into and other rights acquired during the interval shall be valid and enforceable."[8]

The Michigan Supreme Court identified several issues to be addressed in the supplemental briefs:

1. Whether section 925(2) of the Nonprofit Corporation Act applies retroactively or prospectively to validate "all contracts entered into and other rights acquired" during dissolution;
2. Whether renewal under section 925 permits an administratively dissolved corporation to enforce contracts and rights not related to winding-up in light of MCL 450.2833 and MCL 450.2834;
3. Whether *Bergy Bros, Inc v Zeeland Feeder Pig, Inc,* 415 Mich 286, 327 NW2d 305 (1982), correctly interpreted MCL 450.1925, the analogous provision in the Business Corporation Act; and,
4. Whether the common-law doctrine of corporation by estoppel applied in this case.

Additionally, assuming that section 925(2) does apply retroactively to validate "all contracts entered into and other rights acquired," the parties were directed to address:

5. Whether Center Woods' rights to a thirty-day notice of the sale of the property at issue and the right of first refusal were "acquired" during the interval of Center Woods' dissolution; and if not,
6. Whether those rights were nevertheless enforceable after Center Woods renewed its corporate good standing pursuant to section 925.

Finally, assuming that the rights to notice and first refusal are enforceable, the parties were directed to address:

7. What remedy is available to

Center Woods against the seller and purchaser of the property at issue, given that the sale was finalized during the interval of Center Woods dissolution; and

8. Whether Res-Care preserved any objection to the trial court's choice of remedy in this case.[9]

A September 17, 2013 Supreme Court Order referred to a stipulation signed by the parties for adjournment of the oral argument and placed the case on the November 2013 Session Calendar. The Attorney General's office sent a letter the Supreme Court on October 9, 2013, on behalf of the Bureau, urging the Court "that rather than simply dismissing the case upon the parties' stipulation, the Court also vacate the Court of Appeals' decision given the mischief it may cause if left in place."

Securities Regulation in Michigan

Executive Order 2012-13 transferred the Securities Division to the Department of Licensing and Regulatory Affairs (LARA), effective November 5, 2012. LARA assigned the Securities Division to the Bureau of Commercial Services, renamed as Corporations, Securities and Commercial Licensing Bureau (CS&CL). Bureau Director Alan J. Schefke is the Securities Administrator.

Enforcement of all statutes administered by the Bureau is centralized in the Enforcement Division. Licensing of broker-dealers, agents, investment advisers, and investment adviser representatives and Regulation D and mutual fund filings are handled by the Licensing Division. Audit & Examinations Division handles examination of firms and product exemption and registration filings. Regulatory Compliance Division handles final orders, hearing requests, and final order monitoring. Investor Education is handled by Testing, Education & Program Services.

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Section 605 of the Uniform Securities Act (2002), MCL 451.2605, provides substantially the same rule making authority as the predecessor act. Review of the existing rules, transition orders, and draft rules prepared under 2008 PA 551 is being conducted. It is anticipated that a Request for Rulemaking will be submitted to Office of Regulatory Reinvention this fall.

Incorporation Transparency and Law Enforcement Assistance Act

Senator Levin, Senator Grassley, Senator Feinstein and Senator Harkin introduced the Incorporation Transparency and Law Enforcement Assistance Act (S. 1465) on August 1, 2013. This bill is part of global effort to provide access to information about the owners of corporations and limited liability companies and to strengthen the ability of law enforcement to investigate suspect corporations and LLCs.

Corporations and LLCs are established in the United States without having to reveal who the owners are or who the owners will be. The bill would require a list of the beneficial owners of each corporation and LLC to be submitted to the state, to maintain the information for a period of years after the company dissolves, and to provide the information to law enforcement upon receipt of a subpoena or summons. Corporations and LLCs would be required to update the beneficial ownership information regularly. In states that have a formation agent licensing system, the information could be maintained by a licensed formation agent.

The information would include each beneficial owner's name, address, and a unique identifying number from a state driver's license or a U.S. passport. Individuals who do not possess a driver's license or passport from the United States would be permitted to submit their names, addresses, and identifying information from a non-U.S. passport to a formation agent residing in the state. The formation agent would submit a written certification that the formation agent had obtained the information and verified the identity of the non-U.S. owners.

The bill contains exemptions for publicly traded corporations, banks, broker-dealers, commodity brokers, registered investment funds, registered accounting firms, issuers, and utilities. It would exempt corporations with a "substantial U.S. presence," including at least 20 employees physically located in the United States. Businesses set up by governments, churches, charities, and nonprofit corporations would also be exempt.

The bill would require the U.S. Department of the Treasury to issue a rule requiring formation agents to establish anti-money laundering programs. Formation agents would be responsible for ensuring that corporations and LLCs are not being formed for wrongdoers. Corporations and LLCs bidding on federal contracts would be required to provide beneficial ownership information to the federal government.

SEC Changes to Rule 506[10]

On July 10, 2013, SEC approved final rule changes to Rule 506 to permit issuers to use general solicitation and general advertising to offer their securities.[11] The changes require the issuer to take reasonable steps to verify that the investors are accredited investors. All purchasers of the securities must fall within one of the categories of persons who are accredited investors under existing Rule 501 of Regulation D, or the issuer reasonably believes that the investors fall within one of the categories at the time of the sale.

An individual qualifies as an accredited investor under existing Rule 501 if he or she has either 1) net worth or joint net worth with a spouse that exceeds $1 million at the time of purchase, excluding the value of a primary residence, or 2) annual income that exceeded $200,000 in each of the two most recent years or a joint annual income with a spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year.

The rule amendments take effect 60 days after publication in the *Federal Register*. The effective date is September 23, 2013.

NOTES

1. 295 Mich App 232, 814 NW2d 308 (2012).
2. 494 Mich 879, 833 NW2d 330 (2013)
3. 295 Mich App 244-245.
4. *Id.* at 245 (quoting *Gilliam v Hi-Temp Prods*, 260 Mich App 98, 112, 677 NW2d 856 (2003)).
5. *Id.* at 249.
6. MCL 450.2831
7. MCL 450.2833 and MCL 450.2834
8. MCL 450.2925
9. 494 Mich 879, 833 NW2d 330 (2013).
10. See http://www.sec.gov/news/press/2013/2013-124-item1.htm, http://www.sec.gov/rules/proposed/2012/33-9354.pdf and http://www.sec.gov/rules/final/2013/33-9415.pdf.
11. 78 Fed Reg 44771.

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 Eric M. Nemeth

At Risk Cash Transaction for Business Clients – The Computers Are Watching

It is Monday morning at your law office, and you get a telephone call from one of your smaller business clients. He is frantic to say the least. Over the weekend, his employee payroll checks bounced at the bank as well as several checks to suppliers. He assures every skeptical recipient of a business check that the checks should be good. In fact, more than a couple of threats of violence along with threats of going to the police are mixed into the conversation.

After the local bank branch opens, the branch manager tells your client that there was a seizure of the business accounts, and that is all that the manager is willing to say. The mystery for your client soon ends when two federal special agents arrive (usually IRS—Criminal Investigation, but sometimes Secret Service) and tell your client that the currency was seized because the currency was involved in a transaction, or attempted transaction, in violation of 31 USC 5324(a) regarding "structuring." Your client, desperate to clear up the "misunderstanding," speaks to the special agents further. They explain that the U.S. Department of the Treasury received information that the pattern of cash deposits of the business were suspicious and appear to have been structured to avoid depositing more than $10,000 at one time. See IRS Form 8300 required under IRC 6050I.

Your client assures you that all of his business income is 100 percent legal. In addition, your client swears on all that is precious to him that every penny of income is properly reported. For purposes of this column, you can assume that your client is completely truthful in those representations. *It does not matter.* The special agents are not conducting an examination of the business or even investigating the business—at least not yet. They are investigating the nature of the cash deposits. The reason is that it appears that your client deposits cash in round numbers, i.e., $6,000, $8,000, $9,900 but never in excess of $10,000 at one time. In fact, sometimes there are multiple cash deposits in one day; i.e., $6,000 at 10:00 a.m. and $6,000 at 4:00 p.m. Sometimes at the same branch and other times at different branches.

The special agents tell your client that the suspicious deposits total $153,000 and that is the amount that was already seized. That is right—seized. Your client told you that he did not say "much" to the special agents but he did talk to them for about one hour. The special agents left their business cards and your client—eager to cooperate—signed a few forms. Your client also tells you that he did get a letter from his bank a few weeks ago about his banking but he threw it away because it was no problem to his mind.

The scenario just described is happening with increasing frequency in Michigan and across the country. Special units of criminal investigators are using ever more sophisticated computer algorithms to process suspicious activity reports (SAR) from financial institutions looking for unusual cash deposit activity. Financial institutions are more than happy to comply with the requirements of the Federal government's anti-money laundering statutes and regulations related to the Bank Secrecy Act (BSA). Basically, no financial institution will risk its charter to protect customers.

The complexity of the BSA and other criminal and civil statutes, exposures and liabilities potentially at issue are beyond the scope of this column. This discussion focuses solely on the seizure and potential forfeiture of the money. 18 USC 981(a)(1)(A) and (C) provide that any property involved in a transaction, or attempted transaction may be seized and forfeited to the United States Government.

Assuming that the special agents (and United States Attorney's Office) believed that a structuring violation took place, administrative proceedings will be brought to perfect the forfeiture of the property. A writ will be signed by a Federal Magistrate before seizure. There will be a public legal notice (usually the local legal news).

Your client(s) (it could be the business, and/or individuals) will need to file a claim of ownership within 30 days from the date of last publication. Assuming a claim is filed (practitioner's note: careful consideration of who makes a claim must be undertaken), then a judicial or administrative review is available to the claimant. Remember though, that during this entire procedure, your client does not have the cash. The inconvenience and stress is significant. An exception under 18 USC 983(f) is possible for undue hardship but it is limited in practice. Simple inconvenience is not hardship.

At this point, you and your client will have to determine if an administrative review by the IRS for remission or mitigation of forfeiture should be pursued, or alternatively seek judicial review which will be handled by the United States Attorney's Office. Both processes will have heavy involvement by the special agents and are lengthy, potentially expensive, and could include the waiver of important constitutional rights. They will want to interview your client to explain the deposit activity for consistency with the business activity.

The challenge for professionals in these circumstances is that the structuring is usually evidenced by months of banking transactions. Clients will sometimes tell you that they thought there was a tax or penalty if cash deposits were more than $10,000 so they did structure the deposits. More than one client has told me that bank tellers discouraged cash deposits of over $10,000 because the teller had to file reports. Recall that our scenario above assumed full tax compliance.

Each factual scenario is different. You will need to determine if your client ever received a warning letter or even a termination from a bank because of the deposit activity. How did your client respond? Did the deposit activity change? If so, how? You will need to carefully review your client's cash sales. If your client routinely has cash sales of $3,000-$7,000 daily, that presents a different and more defensible situation than if there are $12,000 of daily cash sales. You will have to investigate the procedures for banking transactions. Always talk to the accountant, bookkeeper, and manager(s) if applicable, and look at the banking records yourself as the government already has done so. Lastly, because of the potential for criminal sanctions, consult with an experienced practitioner in this area of the law—one who is familiar with both the civil and criminal implications.

As we march to an ever more "cashless" and electronic society, large cash transactions are becoming more rare but easier to track. The sophisticated algorithms in software that automatically review deposit activities at financial institutions are incredibly vigilant about spotting and reporting anything remotely suspicious regardless of how "friendly" the local teller and branch manager may be. Your clients need to be advised that forfeiture is an ever-present and growing reality.

Eric M. Nemeth of Varnum LLP in Novi, Michigan practices in the areas of civil and criminal tax controversies, litigating matters in the various federal courts and administratively. Before joining Varnum, he served as a senior trial attorney for the Office of Chief Counsel of the Internal Revenue Service and as a special assistant U.S. attorney for the U.S. Department of Justice, as well as a judge advocate general for the U.S. Army Reserve.

By Michael S. Khoury

Developing Policies – The Forest and the Trees

Privacy, security, big data, encryption, social media, risk management, liability—all of these and many more concepts are often discussed when addressing the role of technology in business. These topics, however, are often addressed as discreet problems requiring discreet solutions. Today, the tendency to "silo" organizational challenges is a significant problem in business management. These thoughts were raised during my reading of an excellent article in the ABA Business Law Section magazine, *Business Law Today*. In his article, "A Board's Legal Obligation for the Cloud: You Have to Carry an Umbrella,"[1] one of the country's more experienced lawyers in cybersecurity discussed the obligations of management and the board of directors "to consciously and consistently monitor [the] operations" of the company.[2] The author discusses a number of cases dealing with the duties of management and the board of directors to oversee proper operations of the company, but this issue is much broader.

When clients are considering the role of technology, data, privacy, and security in their operations, it is imperative that these issues be considered in a holistic manner. Let me give some examples. The preparation of an employee manual or set of policies requires consideration of wage and hour laws, employee benefits rules and ERISA, OSHA, and confidentiality considerations among many other issues. Similarly, the creation of policies associated with security and privacy needs to be considered as part of the general legal infrastructure.

The importance of big data in business intelligence has been frequently discussed. Obtaining, maintaining, and analyzing massive data bases can assist companies in tracking markets and predicting customer activity to improve profitability and increase revenues. Maintenance of data, however, is subject to a variety of rules. First, does the company actually have the right to use the data? This requires an inquiry into the source of the data and the ability of the company to actually use it. Second, the company needs to evaluate whether the data is subject to regulatory scrutiny. Is it subject to Gramm-Leach-Bliley[3] or HIPAA[4] or to an agreement with the owner of the data restricting the use of such data? On the latter point, an agreement may be contained in the company privacy policy that obligates the company to the users and customers. If the privacy policy does not permit the use of the data, it is a violation of these legal obligations.

A similar analysis should be done to address whether, for how long, and in what manner or not the information is protected or can be used under state data breach laws. In Michigan, for example, any data that ties an individual to a Social Security number, driver's license, or other personal information may only be retained for as long as it is necessary to use that data for the purposes for which it was collected.[5] Once used, Michigan law requires the data be purged from the company's system.

On the privacy front, we usually focus on the relationship between the company and its customers, but the company can only act through its employees. We sometimes neglect to stress to employees that they respect that privacy. It is unacceptable to have a robust institutional privacy policy if the company fails to implement it internally by not training employees to ensure compliance. It is the responsibility of the company to identify which employees will have access to information and data that is required to be kept private and secure, to establish protocols and policies to ensure that compliance, and to follow-up with training and oversight of the operations to ensure that policies that seem compliant on paper are not ignored in actual practice.

Where is this all going? It should be clear to business law practitioners that technology-related topics have morphed from simpler hardware and software concerns to issues relating to data, security, and privacy. None of these can be addressed in a vacuum. They need to be considered as a whole in the operations of the company. The business lawyer who is working with the company to review or prepare policies, procedures, and guidelines relating to the privacy of information, the security of data and the company systems, business continuity, and overall compliance needs to consider how the specific requirements relate to the world as a whole. Privacy policies, security policies, infrastructure maintenance, and other guidelines that have become standard operating procedure in the company cannot be considered discreet issues. Each of these needs to be addressed when considering the entity's legal infrastructure.

NOTES

1. John P. Tomaszewski, "A Board's Legal Obligations for the Cloud: You Have to Carry an Umbrella," *Business Law Today*, August 2013.

2. *Id.*.

3. Gramm-Leach-Bliley Act, P. L. 106-102, 113 Stat. 1338 (1999).

4. Health Information Portability and Accountability Act of 1996, P. L. 104-191, 110 Stat. 1936 (1996).

5. Michigan's Data Breach Notification Act can be found at MCL 445.72.

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Making Lemonade – Strategies for Dealing With an Insolvent Counterparty

By Jonathan E. Lauderbach and R. Michael Azzi

Introduction

No one likes not getting paid, but it is an unavoidable outcome of some business transactions. What many clients like even less is having to hire a lawyer to obtain payment that the client believes should come in the ordinary course of business. Managing client expectations can be among the most challenging aspects of dealing with a client whose customer or borrower has defaulted on an obligation. Whether the client is a lender that provided financing to a borrower in exchange for a promissory note and accompanying security interest or the client is a manufacturer that sold goods on credit, the success of the relationship between attorney and client can turn on the attorney's ability to map out a strategy to turn a lemon into lemonade. While the precise situation may vary, the fundamental issues remains the same, with clients almost always seeking a solution that allows them to maximize payment on the outstanding debt while minimizing risk of nonpayment and being left with an uncollectable account receivable. This article seeks to identify issues business lawyers should be aware of when counseling clients dealing with an insolvent counterparty, to provide ways to maximize a client's prospect of payment, and to mitigate the risk associated with continuing business with a potentially insolvent counterparty.

The Client and the Counterparty—Understanding the Relationship

Consider the following situation—a client lends money to a counterparty in exchange for a promise to pay for the goods, services, or property at issue. In the beginning, the counterparty makes payments as promised, but ultimately falls behind or stops making payments altogether. While the client may have involved an attorney in drafting the underlying credit agreement (e.g., the promissory note, invoice language, or supply agreement), this will not always be the case. Rather, the attorney first becomes involved when the credit relationship has already soured or payment has completely stopped, and the client wants to take steps to collect.

Often, the attorney's first instinct may be to begin taking immediate affirmative steps to resolve the problem—sending a strongly worded demand letter, calling the debtor's counsel, or counseling the client to stop shipping goods absent payment. To address a client's problems with an insolvent or soon-to-be insolvent counterparty, however, perhaps the most important first step is to take the time to develop an understanding of the parties' business relationship. While attorneys are well aware that cases do not occur in a vacuum, the business realities sometimes do not come into focus until too late, with demands already made, both sides dug in to their respective positions, and the business relationship deteriorating beyond repair. Certainly, some business relationships inevitably sour, and aggressive collection efforts become necessary. Before engaging in any communication with the counterparty, however, three important questions regarding the parties' business relationship should be answered.

First, is the relationship between the parties ongoing, or a single, isolated transaction? When dealing with a long-time customer, a relationship exists—not only a business relationship, but also a personal relationship between the employees or owners of each company. Understanding the personalities at issue will often help develop a strategy to approach the problem of non-payment. Some counterparties or debtors may respond better to an informal sit-down with the client, while others may require working through attorneys to keep emotions in check. Relatedly, is the other party a major customer or a relatively minor customer? A client may be more willing to work with a major customer to achieve a mutually beneficial outcome than a minor, one-time customer.

Second, what are the client's goals? Certainly, maximizing payment is always a top

[A]nother important consideration is ascertaining the extent of the counterparty's financial troubles, including whether the counterparty is insolvent.

priority, and being paid in full is the ideal. But clients may often have goals beyond payment. For example, a client may be willing to extend payment terms or forbear on collection in exchange for a security interest in the debtor's assets, or to discount the account receivable at issue in exchange for additional business at a later date to the extent the counterparty achieves more solid financial footing. Dealing with an insolvent or cash-strapped party sometimes requires creative solutions, and understanding what the client's goals are at the outset can inform these negotiations and go a long way to quickly resolving the issue while minimizing expense to the parties.

Third, is the client's position in any way secured? There are obviously many different types of security, including mortgages; security interests in accounts receivable, inventory, and bank accounts; statutory liens, such as mechanics' liens, construction liens, and reclamation rights; and common law rights, to name a few. While clients may bring these security interests to an attorney's attention early in the process, many times they do not because the client does not believe they relate to the issue at hand. For example, a mortgage may secure a different promissory note than the one at issue. However, a counterparty's default under one agreement may constitute a default under another, or at a minimum provide leverage in settlement negotiations. Consequently, identifying these interests before engaging the counterparty is important. Additionally, clients—particularly those without much experience with litigation and security interests—may believe they have a security interest in certain goods or property but have failed to properly perfect that interest, or are otherwise unaware that a priority security interest may exist. Being aware of any such deficiencies and related problems is not only helpful while dealing with the counterparty, but the client may be able to take steps to remedy the problem before proceeding with settlement discussions and collection efforts, thereby improving their bargaining position.

Insolvency on the Horizon—Identifying the Problem

In addition to understanding the business relationship, another important consideration is ascertaining the extent of the counterparty's financial troubles, including whether the counterparty is insolvent. This can often prove to be a difficult endeavor, as a counterparty oftentimes will not readily acknowledge financial problems until it is too late with bankruptcy or dissolution the only remaining option. To the extent possible, attorneys should counsel clients on warning signs of pending or deepening financial difficulties, which will enable clients to identify potential collection issues early and in turn maximize the possibility of resolving the matter in a manner agreeable to both parties. These "warning signs" include, but are not necessarily limited to, the following:

1. Delayed invoice payments, or a deviation from standard invoice payment practice. For example, if the counterparty generally pays for goods purchased on credit 30 days after invoicing but has steadily increased the purchase lag-time to 45 or 60 days, this may indicate that a cash-flow problem is on the horizon.
2. Requests for an extension of credit or modification of credit terms. Sometimes, this may be couched in a manner that attempts to hide the counterparty's financial troubles, such as when a company asks for new credit to maintain its competitiveness in their industry, to accommodate third-party delays in payment, and so forth.
3. Lawsuits filed against the counterparty. Oftentimes, lawsuits are a good indicator of problems. Of course, not all lawsuits are evidence of financial difficulty, but a pattern of complaints for breach of contract, non-payment, or to enforce security agreements—particularly to the extent such complaints have been reduced to judgment—often are the bellwether of looming or deepening insolvency. Clients or attorneys can run litigation search reports to determine whether any such lawsuits are pending.
4. Liens recorded against the counterparty's real and personal property. This may include judgment liens, construction liens, mechanic liens, tax liens, UCC financing statements, or a host of other impairments of the counterparty's property interest. A client may want to run lien or title searches on the counterparty's property to determine if there are finan-

cial issues that warrant concern.

5. Layoffs, restructuring, or other downsizing activities may also give a client pause to reconsider their lending relationship with the counterparty. Each business is different, but downsizing often equates to financial difficulties that may impair a client's ability to receive payment.

Again, ideally a client will routinely counsel their attorney on these issues and bring problems to the attorney's attention before they become too severe and limit the parties' options in how to resolve them. To maximize the chance of this occurring, a business attorney should discuss with his or her client what signs to look for when dealing with any lending or credit relationship with a customer. The sooner a problem is identified increases the chance that a favorable outcome may be achieved.

Addressing Insolvency Pre-Bankruptcy—Maximizing Payment and Security

Once the problem is identified, development of the appropriate solution depends on the nature of the parties' relationship and the client's needs. It is important to remember that not all defaults will result in a bankruptcy filing. For those that do, a bankruptcy filing in and of itself does not mean that the client does not have options to recover all or a portion of the debt. The success of any workout depends on early intervention and keeping options open.

An early step in the pre-collection stage should be to determine whether the obligation can be restructured to enhance the client-creditor's position should the counterparty's financial continue to deteriorate. This includes inquiring whether the debtor has any assets in which it could grant the client a security interest. All options should be explored. It may be that the debtor owns real estate or machinery and equipment that could be posted as collateral for the unpaid obligation. Even if the client's mortgage or security interest would be a second lien on the subject asset, it still merits exploration to the extent that the value of the asset may exceed the amount owed to the first lien creditor. It is a good idea to run a lien or title search to determine the nature and extent of any other liens on the property. For smaller businesses, personal guaranties of the debtor's owners may also be an option, and the guaranty can be secured by the owners' property, both real and personal.

If the creditor-client is the seller of goods on credit and the purchaser-debtor has defaulted in its obligations, the seller may have reclamation rights and the right to stop goods in transit. Reclamation is a remedy provided to sellers of goods under UCC 2-702 and allows sellers of goods on credit to reclaim those goods from the seller's possession in the event of the buyer's insolvency.[1] It is important that the reclaiming seller carefully follows the procedure set forth in UCC 2-702(2).[2] The seller must make its demand within ten days after the goods are received by the buyer.[3] While not required by the statute, it is prudent for the seller to make the demand in writing and to send it by a means where delivery can be confirmed, such as overnight courier. If the seller complies with UCC 2-702, and the goods are not subject to the lien of the buyer's lender and have not yet been consumed or sold, then the seller has the right to a return of the goods and may use peaceable self-help to obtain possession.[4] In the event that the goods cannot be obtained in this fashion, then a claim and delivery action can be commenced.

Sometimes the seller will become aware of the buyer's insolvency after the goods have been shipped to the buyer but before their delivery. In this instance, under UCC 2-705, the seller may stop delivery of the goods while in transit. The seller must notify the bailee, i.e., the carrier having possession of the goods, and the bailee must then hold the goods and deliver them according to the seller's instructions. The seller must pay the bailee for any costs or damages from stopping delivery.

It is also prudent at this stage to inform the client of steps to protect its right to payment for future transactions. For example, a seller that extends credit in connection with a sale of goods has rights under Michigan law to require that the counterparty-debtor provide adequate assurance of future performance.[5] While the propriety of an adequate assurance demand is fact-specific, the "warning signs" listed above may likely provide the necessary support. Adequate assurance can take the form of requiring cash with order or cash on delivery for future sales, or the posting of a letter of credit from a bank to guarantee payment of any future shipments of goods.

An early step in the pre-collection stage should be to determine whether the obligation can be restructured to enhance the client-creditor's position should the counterparty's financial continue to deteriorate.

Recognition of insolvency or inability to perform also provides an opportunity for the creditor to enhance its position by negotiating the terms on which the creditor will forbear from taking legal action in light of the default. A forbearance agreement can put the creditor in a stronger position in the event of litigation down the road if it is negotiated properly. For example, given the leverage that the creditor has at this stage of the workout, the agreement can provide that the debtor acknowledges that it is in default and waives any defenses or counterclaims against the creditor. This provision in a forbearance agreement can avoid costly and time-consuming litigation down the road.

In addition to the foregoing remedies, if the debtor has provided collateral to the creditor in the form of a mortgage on real estate or security interest and personal property, the creditor may wish to foreclose the lien. In the case of a security interest in personal property, this is done through repossession of the collateral. If the collateral can be repossessed without breaching the peace, it can be done without court intervention. If the breach of the peace would occur, then the creditor will have to proceed through litigation in the form of a claim and delivery action.

A forbearance agreement can put the creditor in a stronger position in the event of litigation down the road if it is negotiated properly.

If the foregoing out-of-court efforts are unsuccessful, or if they are initially successful but the debtor fails to perform as agreed or defaults on the forbearance agreement, the collection process begins. The first step in commencing the collection proceeding is to review all existing loan agreements, promissory notes, supply contracts, or any other applicable documents or agreements between the parties to determine if there are any preconditions to the collection that exists. For example, promissory notes or supply agreements may provide the borrower or purchaser with a grace period or a right to cure after notice of default. Once it is determined that there are not any preconditions, or if the preconditions are satisfied, the creditor should consider filing a lawsuit to enforce its rights.

It is important for the attorney counseling the creditor-client to provide both the pros and cons of initiating litigation. Even in the most conciliatory workouts, litigation is by its nature adversarial. Filing a lawsuit can seriously impair the ability of the parties to continue to negotiate toward a consensual resolution. If this is a concern, it is important that the client maintain open lines of communication with the debtor to make sure that the filing of the lawsuit is not viewed as the end of negotiations. On the other hand, sometimes it is the filing of the lawsuit itself that makes the debtor realize that the creditor is serious about enforcing its rights and precipitates a resolution that otherwise would not have occurred.

If litigation does ensue, it is important for the attorney and client to have a clear understanding of the client's objective. Indeed, the procedural wrangling of litigation and the breadth and cost of discovery cause some lawyers to lose sight of the forest and focus only on the trees. Also, as discussed above, litigation can distract both sides from continuing to explore a consensual resolution.

In some cases, the client's primary objective is to obtain possession and control of the collateral. This does not necessarily have to occur at the end of litigation. Rather, in connection with a claim and delivery action (a lawsuit to obtain possession of personal property), a creditor may obtain interim relief and obtain possession of the subject property pending final judgment if it can demonstrate that the debtor's financial condition and/or anticipated actions would cause a substantial impairment in the value of the collateral.[6] If the matter proceeds to final judgment, the creditor would receive not only a money judgment but an order allowing liquidation of the collateral to satisfy the debt.[7]

In other cases, the client's primary objective is not to disrupt the debtor's business but rather to preserve and maintain continuity of operations to whatever extent possible. If this cannot be accomplished with the debtor's present management, the creditor may wish to initiate a receivership action. A receiver is appointed by a court of equity and directed to take possession of specified property for the purpose of managing it or disposing of it for the benefit of creditors or other stakeholders.[8] For example, a receiver may be appointed to protect property based on evidence that the debtor's continued possession will subject the property to risk of depreciation or damage, or any other past performance that may indicate the debtor's assets that would be used to pay the judgment at issue are at risk.[9] At the direction of the court, a receiver may also be appointed to take control of an operating business enterprise and essentially step into the shoes of management and run the company, thereby disposing of the income generated.

While receiverships can be an efficient method of gathering up the debtor's assets and distributing them for the benefit of the debtor's creditors, it is important to have an end game in mind at the outset of the receivership. For example, in the context of a mortgage loan default, it is important to initiate proceedings to foreclose the mortgage so that the receivership does not continue indefinitely but rather is part of a measured and methodical approach to collecting rents or other income and disposing of the property in an orderly fashion. Or in the context of a manufacturing company, it is important to have a clear vision of what the receivership is intended to accomplish so that the receiver and the creditors have realistic expectations about the point at which the receivership will be terminated and the assets are sold or are otherwise disposed.

Bankruptcy – Understanding the Process

In some cases, a creditor may also conclude that it is advantageous to force the debtor into bankruptcy by filing an involuntary bankruptcy petition. However, involuntary bankruptcies are rare, as the Bankruptcy Code sets forth strict limits as to who may file an involuntary petition.[10] For example, a combination of creditors with a minimum aggregate claim amount is required.[11] Additionally, improperly filing an involuntary bankruptcy petition may subject the creditor to liability to the debtor, including costs, attorney fees, and damages suffered as a result of the debtor's conduct.[12] Even if a petition is granted, the costs associated with the bankruptcy petition may be substantial depending on the bankruptcy's nature, as attorneys, consultants, and other professionals may be required to obtain relief in the creditor's favor. The far more common bankruptcy filing is commenced by the debtor as a voluntary case.

Once notice of the commencement of the bankruptcy case is received by the creditor and/or its counsel, the attorney should identify the chapter of the Bankruptcy Code under which the case was commenced (e.g., Chapter 7, 11, or 13 in most cases), and become familiar with the basic procedures associated with the case under the Bankruptcy Code. Whether a bankruptcy is a reorganization under Chapter 11 (or Chapter 13) or a liquidation under Chapter 7 will likely impact the client's claim against the debtor, including when, if, and how the claim may be paid. The attorney should also obtain schedules of the debtor's assets and liabilities, which will further inform this analysis.

Furthermore, a proof of claim should be filed with the Bankruptcy Court no later than 90 days after the first scheduled meeting of creditors. Failure to adhere to this deadline can result in the client's claim against the debtor being barred in the bankruptcy proceedings.[13] The ability to collect on the claim will depend on a variety of factors, including whether the client is secured, the value of the security interest, the number of creditors, and solvency (or lack thereof) of the debtor.

Additionally, the attorney and client should immediately cease all collection efforts against the debtor. This likely includes, but is not limited to, all garnishments, post-judgment creditor exams under state law, lawsuits, collateral repossession, lien foreclosure, and eviction proceedings. The Bankruptcy Code includes an "automatic stay" provision, which in essence stops all proceedings against the debtor, allowing the debtor to develop a comprehensive plan within bankruptcy to either reorganize its debt or liquidate its assets for the benefit of creditors. While there are exceptions to the automatic stay (e.g., the property at issue is not "property of the estate" as defined in the Bankruptcy Code), and procedures exist to petition the bankruptcy court to lift the automatic stay, failing to abide by the stay in the first instance may subject the client and the attorney to sanctions from the court.

Although the automatic stay provides broad protection to the debtor, the client may still be able to exercise reclamation rights and stop goods in transit under the UCC and applicable bankruptcy law.[14] The time frame is short and the requirements strict, including potentially needing to file a motion in the bankruptcy court to enforce these rights. However, the remedy may provide the client with valuable relief regarding its debt, recovering unpaid goods that are in or about to be in the debtor's possession. The attorney should become familiar with the timing requirements to exercise these rights under the Bankruptcy Code, as well as any potential motion required to assert such rights, which may depend on the collateral at issue.

Finally, in addition to understanding the client's rights related to its claim against the debtor, the attorney should be familiar with any claims the debtor (or the bankruptcy

Although the automatic stay provides broad protection to the debtor, the client may still be able to exercise reclamation rights and stop goods in transit under the UCC and applicable bankruptcy law.

estate) may assert against the client. Under the Bankruptcy Code, the debtor can "claw-back" certain pre-petition payments to a creditor in certain instances. These claims, known as "preferences," generally encompass money that was paid to the creditor in the 90 days prior to the bankruptcy filing for past-due indebtedness when the debtor was insolvent.[15] When a preference is asserted against a creditor, the creditor bears the burden of proving that the transaction at issue falls within one of the enumerated defenses to such a claim, namely that (1) the payment was a contemporaneous exchange in value, not a previous debt, (2) the payment was made in the "ordinary course of business" in exchange for goods, or (3) the money was provided in exchange for "new value" from the creditor. While not an exhaustive list, identifying preference risks and possible defenses early in the bankruptcy will not only permit the attorney to develop a strategy to defend or settle any likely preference claim but explain to the client the realities of the bankruptcy preferences under the Bankruptcy Code.

Conclusion

No one likes not getting paid. No client wants to throw good money after bad. But with early identification of the problem and clear communication with the client about its objectives, the client's position and ability to obtain payment can be protected both in a non-bankruptcy workout or after commencement of a bankruptcy proceeding. We hope that the foregoing is helpful in mapping out that strategy to turn the lemon into lemonade.

NOTES

1. MCL 440.2702 (adopting UCC reclamation provision).
2. *Id.*
3. *Id.*
4. *Id.*
5. MCL 440.2609.
6. MCR 3.105.
7. *Id.*
8. MCL 600.2926.
9. *Reed v Reed*, 265 Mich App 131, 693 NW2d 825, 854 (2005); *Weathervane Window, Inc v White Lake Constr Co,* 192 Mich App 316, 480 NW2d 337 (1991); *In re Contempt of Cornbelt Beef Corp,* 164 Mich App 114, 416 NW2d 696 (1987) (citing *Michigan Minerals, Inc v Williams*, 306 Mich 515, 11 NW2d 224 (1943)).
10. 11 USC 303.
11. 11 USC 303(b).
12. 11 USC 303(i).
13. 11 USC 520(b)(9).
14. MCL 440.2705; 11 USC 546(c)(1); *Yenkin-Majestic Paint Corp v Wheeling-Pittsburg Steel Corp (In re Pittsburg-Canfield Corp*), 309 BR 277 (6th Cir 2004).
15. 11 USC 547(b).

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Borrowers' Challenges to Loan Modification Procedures and the Exclusive Statutory Remedy

By Thomas M. Schehr and Thomas H. Trapnell

Introduction

When a borrower files a lawsuit challenging the foreclosure of a mortgage, it is highly likely that one of the claims will allege that the mortgage lender or servicer failed to follow statutory loan modification procedures. Foreclosed borrowers frequently allege that defects in their lender's or servicer's loan modification procedures give courts a basis to rescind foreclosure sales, even in lawsuits filed years after the subject property has been sold at a sheriff's sale. Although borrowers attempt to bring these claims in a variety of ways, including claims for fraud and violations of Home Affordable Modification Program (HAMP) guidelines, borrowers often attempt to use Michigan's foreclosure by advertisement statutes—specifically, MCL 600.3205a *et seq*. (the "Loan Modification Statute")—as a vehicle for claims to rescind foreclosure sales. Although MCL 600.3205a *et seq*. has been repealed effective June 30, 2014, its replacement, MCL 600.3206, contains some similar provisions. The history of the Loan Modification Statute, and the state of the law at the time of its repeal, can therefore provide guidance on how courts may approach borrowers' modification-related claims under the new statute.

Until quite recently, attempts to use alleged violations of the Loan Modification Statute as a means of undoing a sheriff's sale were routinely rejected by the courts. Indeed, the legislative history of the Loan Modification Statute suggests that the Michigan Legislature intended this act as a means of facilitating communication between borrowers and servicers to avoid unnecessary foreclosures, rather than giving borrowers a cause of action against lenders and servicers that could be asserted long after the expiration of the redemption period. Although the *Mitan v Federal Home Loan Mortgage Corp* decision of the Sixth Circuit in December 2012[1] arguably shook up the status quo, the effect was minimal because the Michigan Supreme Court effectively abrogated the Sixth Circuit's decision nine days later in *Kim v JPMorgan Chase Bank, NA*.[2] Since *Kim*, courts have confirmed that a strict construction of the statute is appropriate.

This article begins with a discussion of the origins and legislative history of the Loan Modification Statute and then tracks the shift from the prior established interpretation of that act—that a borrower cannot invoke the statute to undo a completed sheriff's sale—to *Mitan* and *Kim*. The article also addresses the decisions after *Kim*, which confirm that the exclusive remedy for an alleged violation of the Loan Modification Statute is conversion of a foreclosure by advertisement to a judicial foreclosure. The article closes with a brief discussion of MCL 600.3206, which replaced the Loan Modification Statute this year.

The Origins and Provisions of the Loan Modification Statute

Borrowers' adversarial use of the Loan Modification Statute can obscure the benevolent intentions of the statute's sponsors. When the house bills that became MCL 600.3205a *et seq.* were introduced in March 2009, Representatives Shanelle Jackson, Andy Coulouris, and Bert Johnson presented them as a means of promoting cooperation between distressed borrowers and their mortgage servicers. After extensive discussions with mortgage lenders and consumer advocates, the law's sponsors concluded that miscommunication and misunderstanding, rather than bad faith, were to blame for many foreclosures:

> Many lenders expressed a desire to see if foreclosure could be avoided only to have repeated phone calls and letters go unanswered. Borrowers, on the other hand, were often afraid to contact lenders, tried but couldn't connect with the person who could help negotiate a solution, or were inundated with foreclosure relief scams to the point that it became difficult to know who to trust.

House Bill 4454, which became sections 3205a and 3205b, sought to remedy this situation by requiring a servicer's designated agent to serve written notice on a borrower in default prior to proceeding with foreclosure by advertisement. After the notice is mailed, the borrower must contact the designated agent, or have a housing counselor to do so on his behalf in order to initiate loan modification negotiations. If the borrower chooses to initiate this process, the borrower is responsible for providing the designated agent with all requested documentation.

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House Bill 4455, which included the language codified in section 3205c, describes the calculations the designated agent must make in order to assess a borrower's eligibility for a loan modification. This provision also addresses borrowers' remedies if a lender or servicer began foreclosure by advertisement without complying with the act's requirements. As set forth in the legislative analysis, section 3205c was intended to have the following effect:

> If foreclosure proceedings were begun in violation of the above provision[s], the borrower could file an action in circuit court to convert the foreclosure proceeding to a judicial foreclosure. A court would have to enjoin foreclosure by advertisement and order it to proceed as a judicial foreclosure if the borrower had participated in the negotiating process, a modification agreement could not be reached, and the borrower was eligible for modification under the FDIC workout program.

The current version of section 3205c reflects this intent: not only must a borrower have participated in the statutorily required steps for negotiating for a loan modification, but the borrower must actually be eligible for a loan modification in order to seek relief under the statute. Importantly, section 3205c(8) provides aggrieved borrowers with only one remedy: to file suit in state circuit court to convert pending foreclosure by advertisement proceedings into a judicial foreclosure. The circuit court is only authorized to grant this relief if it finds that the borrower does, in fact, qualify for modification under statutory standards.

The Loan Modification Statute Becomes a Weapon for Distressed Borrowers

Problems with realizing the intended amicable purpose of the Loan Modification Statute soon became apparent. Many distressed borrowers appear to be confused by their duties under the statute; indeed, borrowers often allege that they are under no duties at all, and that their servicer must offer them a loan modification. Additionally, borrowers frequently allege confusion about their duty to respond to letters from the servicer's or lender's "designated agent" if they wish to invoke statutory procedures and protections. Many borrowers seem to think that they can invoke statutory protections by any communication at all with their lender or servicer, directly or indirectly, at any time.

Borrowers' professed confusion appears to be compounded by lenders' and servicers' in-house loss mitigation letters, in many instances sent under the HAMP. Moreover, when borrowers respond to HAMP solicitation letters by forwarding financial and other information directly to the lender or servicer, borrowers (or their attorneys) often argue that this is sufficient to trigger loan modification obligations under section 3205c. Yet another problem is that borrowers often do not appear to understand that their exclusive statutory remedy is to file a lawsuit in state circuit court while the foreclosure is still pending.

Borrowers have whipped up a maelstrom of foreclosure-related lawsuits alleging violations of the Loan Modification Statute. As a result, a borrower's ability to challenge a foreclosure sale after the sale takes place, based on allege noncompliance with the Loan Modification Statute, has been the subject of several recent decisions.

Courts' Established Interpretation of the Loan Modification Statute: "You Snooze, You Lose."

Initially, many courts made short work of borrowers' post-sale lawsuits alleging violations of the Loan Modification Statute. One representative case is *Stein v U.S. Bancorp*, decided by Judge Julian Abele Cook in February 2011.[3] The plaintiffs, Paul and Lynn Stein, were borrowers whose mortgage was held by U.S. Bancorp and serviced by Wells Fargo. The Steins fell behind on their mortgage payments at some unspecified point in 2009 and received a section 3205a notice from Wells Fargo's designated agent, offering to discuss loan modification with them. The Steins duly responded to the agent and eventually accepted the designated agent's proposal for a modification. Nevertheless, the designated agent advised the Steins two months later that their loan modification had been rejected because they did not satisfy "one or more guidelines established by the investor." Thereafter, foreclosure by advertisement proceedings began, ultimately resulting in a sheriff's sale of the subject real property.

Following the sheriff's sale, the Steins sued both U.S. Bancorp and Wells Fargo. Among other claims, the Steins argued that the court should enjoin the foreclosure—even though it had already occurred—based on a series of alleged violations of the Loan Modification Statute. Judge Cook found several flaws in the Steins' statutory claims but rejected them primarily based on the remedy provision of section 3205c(8):

> This provision allows a mortgagor to file an action to convert a foreclosure by advertisement into a judicial foreclosure. The remedy available to the Steins under this provision—assuming *arguendo* that they were eligible for it—was one that they were required to specifically seek out prior to the consummation of the foreclosure by advertisement. The provision allows certain borrowers to determine the *type* of foreclosure proceeding, not to avoid foreclosure altogether or set aside an already-completed foreclosure. Moreover, there is no evidence that the Steins availed themselves of this provision while they retained title, rights, or an interest in the property. Their failure to do so cannot constitute the type of fraud, accident, or mistake that would be required to set aside the foreclosure.[4]

This position is reflected in numerous other decisions of claims under the Loan Modification Statute. Courts tended to take the legislature at its word that in providing one remedy in section 3205c(8), other remedies were excluded, especially post-foreclosure.[5] Alternatively, courts held that borrowers lacked standing, after the expiration of the redemption period, to sue under the Loan Modification Statute because alleged noncompliance with the act did not constitute "fraud or irregularity" in connection with foreclosure sales.[6]

Mitan is abrogated by *Kim*

One of the strongest blows to the established interpretation of the Loan Modification Statute, albeit temporary, was struck by a borrower proceeding *pro se*. Keith Mitan, as the personal representative of his father's estate, filed a lawsuit in August 2010 against Freddie Mac alleging that the foreclosure of his mortgage violated various provisions of the Loan Modification Statute and that Freddie Mac's interest in the property, as the sheriff's sale purchaser, was therefore void.

The federal district court dismissed Mitan's claims on summary judgment, and Mitan appealed. The Sixth Circuit reversed, in an opinion issued on December 12, 2012.[7] In doing so, the court drew a distinction between "notice" defects and "structural" defects, relying heavily on *Davenport v HSBC Bank USA*,[8] a case that was decided before the Loan Modification Statute had even been proposed in committee:

> Notice defects render a foreclosure voidable. Structural defects, on the other hand, render the foreclosure absolutely void.... [T]he failure to comply with the loan-modification process as outlined in the statute is a structural defect because it deprives the borrower of the opportunity to demonstrate eligibility for a loan modification that would avoid foreclosure altogether.... It follows that, as a matter of Michigan law, a lender that fails to follow the loan-modification procedures set forth by the statute has engendered a structural defect and is thus without authority to commence a foreclosure.[9]

The *Mitan* decision was essentially abrogated nine days later by the Michigan Supreme Court's decision in *Kim v JPMorgan Chase, NA*.[10] The borrowers in *Kim* argued that Chase lacked statutory standing to foreclose their mortgage prior to recording the assignment of the mortgage. The borrowers argued that this defect rendered the foreclosure void.

The Michigan Supreme Court disagreed, expressly rejecting *Davenport* and the distinction between "structural" and "notice" defects in the process. The court referenced a long line of Michigan decisions holding that

> Many borrowers seem to think that they can invoke statutory protections by any communication at all with their lender or servicer, directly or indirectly, at any time.

procedural defects render foreclosures voidable, rather than void, and stated:

> Therefore, we hold that defects or irregularities in a foreclosure proceeding result in a foreclosure that is voidable, not void *ab initio*…. We leave to the trial court the determination of whether, under the facts presented, the foreclosure sale of plaintiffs' property is voidable. In this regard, to set aside the foreclosure sale, plaintiffs must show that they were prejudiced by defendant's failure to comply with [the recording provisions of Michigan's foreclosure by advertisement statute]. To demonstrate such prejudice, they must show that they would have been in a better position to preserve their interest in the property absent defendant's noncompliance with the statute.[11]

The Sixth Circuit recognized that *Kim* abrogated *Davenport* on this point in *Conlin v Mortgage Elec Registration Sys*.[12]

Post-*Kim* Developments

The requirement stated in *Kim* that a borrower demonstrate prejudice from foreclosure defects was rapidly expanded to the analysis of alleged Loan Modification Statute violations. One of the first such cases was *Acheampong v Bank of New York Mellon*,[13] decided by Judge Avern Cohn on January 16, 2013. The borrower claimed that a mortgage servicer violated Michigan's foreclosure by advertisement statute by failing to meet with him in person to discuss loan modification; the servicer countered that the borrower lacked standing to make this claim following the expiration of the redemption period. Judge Cohn's opinion provides a lengthy analysis of the remedies available under section 3205a *et seq.*, concluding that *Kim*, not *Mitan*, is the governing standard for analyzing alleged violations of the Loan Modification Statute. Judge Cohn then rejected the borrower's allegations under this standard:

> In his supplemental brief, plaintiff says that *Mitan* makes clear that "a lender's failure to properly evaluate a borrower for a loan modification pursuant to Michigan statutes causes prejudice to the borrower because it deprives him of the opportunity to avoid foreclosure…. Plaintiff's argument has no merit. First, plaintiff makes little more than a conclusory allegation that he would have been in a better position to preserve his interest in the property absent defendant's alleged non-compliance with the loan modification statute. Second, a breach of the loan modification statute does not preclude the bank from foreclosing…. Thus, a violation of the loan modification statute, standing alone, is not enough to show fraud or irregularity.[14]

Cloos v One West Bank[15] provides additional indications of what the prejudice analysis looks like in the loan modification context. In rejecting borrowers' claims for violation of the Loan Modification Statute, the court noted that "simply showing that they were denied a modification they qualified for would be unavailing, as loan modification is not mandatory upon demonstration of qualification. Rather, if a mortgagee declines to modify a loan despite the mortgagor's eligibility, the mortgagee is not permitted to pursue foreclosure by advertisement, and must instead proceed via judicial foreclosure." Additionally, the Sixth Circuit has explicitly acknowledged that *Kim* rejected *Davenport*'s distinction between defects, which render a foreclosure void as opposed to voidable. *Conlin v Mortgage Elec Registration Sys*.

After the Repeal: What Happens Next?

MCL 600.3206 (the "New Statute"), like its predecessor, requires certain foreclosing entities to designate an agent to contact a borrower and offer to meet to discuss loan modification, and it bars foreclosure proceedings until after this meeting if the meeting is requested by the borrower. Notably, the New Statute has no remedy provision. Moreover, even had the Legislature included a remedy, the prejudice analysis set forth in *Kim* would undoubtedly remain applicable.

NOTES

1. 703 F3d 949 (6th Cir 2012).
2. 493 Mich 98, 825 NW2d 329 (2012).
3. No 10-14026, 2011 US Dist LEXIS 18357 (ED Mich Feb 24, 2011).
4. *Id.* at *29.
5. *See, e.g., Tipton v Flagstar Bank*, No 305911, 2012 Mich App LEXIS 1939, at *2 (Oct 9, 2012) (unpublished); *PNC Mortgage v Lambert, II*, No 302178, 2012 Mich App LEXIS 715, at *18 (Apr 19, 2012) (unpublished); *Smith v Bank of America Corp*, 485 Fed Appx 749, 755, 2012 US App LEXIS 12504 (6th Cir 2012) (unpublished).

6. *See, e.g., Elhady v. CitiMortgage, Inc.*, No 304745, 2012 Mich App LEXIS 1379 (July 19, 2012) (unpublished); *Awad v General Motors Acceptance Corp*, No 302692, 2012 Mich App LEXIS 804 (Apr 24, 2012) (unpublished); *Drew v. Traci Kemp-Brooks*, 802 F Supp 2d 889, 893 (ED Mich July 21, 2011).

7. 703 F3d 949 (6th Cir 2012).

8. 275 Mich App 344, 739 NW2d 383 (2007).

9. 703 F3d at 952-953.

10. 493 Mich 98, 825 NW2d 329 (2012).

11. *Id.* at 115-116.

12. 714 F3d 355 (6th Cir 2013).

13. No 12-13223, 2013 US Dist LEXIS 6415 (ED Mich Jan 16, 2013).

14. *Id.* at 23-24.

15. No 12-14956, 2013 U.S. Dist. LEXIS 63472 (ED Mich May 3, 2013).

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The Expansion of Disparate Impact and Its Effect on the Financial Services Industry

By Michael A. Kus and Rick Kalisher*

Introduction and Background

In June 2013, the Supreme Court of the United States ("Supreme Court") granted *certiorari* in the case of *Mt. Holly Gardens Citizens in Action, Inc v Township of Mount Holly* ("*Mount Holly*").[1] *Mount Holly* involves a claim brought by a neighborhood association in Mount Holly Township, New Jersey that alleges unlawful discrimination by the township in violation of federal law, including the Fair Housing Act ("FHA") and Title VIII of the Civil Rights Act of 1968.[2] At first blush, one might think this case is fairly narrow in scope and does not involve significant or far-reaching legal issues. As this article will illustrate, nothing could be further from the truth.

Underlying *Mount Holly* is the theory of "disparate impact," in which the plaintiff claims that a facially neutral policy violates anti-discrimination laws because it adversely affects a disproportionate number of members of a protected class. Court watchers see *Mount Holly* as a case with the potential to resolve the question of whether facially neutral housing and lending policies that nevertheless disproportionally affect minority residents may be subject to litigation under the FHA. Should the case proceed to a supreme court decision, it will have direct implications for the financial services industry and other businesses or organizations that operate in a legal and regulatory environment subject to anti-discrimination laws.

Disparate impact is a legal concept that evokes memories of civil rights litigation in the 1970s. Cases using the theory of disparate impact have been litigated from time to time but, until recently, have not been a prominent part of the legal lexicon. However, since 2011, disparate impact is again a significant concept in litigation as well as the headlines[3] and is being applied in ways that are far more expansive than ever. More importantly for financial institutions, disparate impact has been the basis for two recent lawsuits against lenders in Michigan.[4] Now the concept of disparate impact is before the Supreme Court, which makes a discussion of this concept both timely and appropriate.

To appreciate the significance of *Mount Holly*, it is important to understand the background of disparate impact. The concept of disparate impact owes its origin to the seminal Supreme Court case of *Griggs v Duke Power Co.*[5] *Griggs* was an employment discrimination case brought by minority employees against their employer, a power plant operator in North Carolina. Most of the employees at the power plant were white, and there had long been evidence of overt racial discrimination against minorities at the plant.[6] In the aftermath of the passage of Title VII of the Civil Rights Act of 1964 ("Act"), evidence of overt discrimination appeared to diminish. However, minority employees at the plant argued that something equally insidious took its place. The plant instituted a policy of requiring all employees to have a high school education or pass a standardized general intelligence test as a condition of employment or advancement. Minority employees at the plant argued that they were still being discriminated against because far more white employees and job applicants had a high school education than did minority employees and job applicants, and whites with a similar level of education tended to perform better on the standardized tests than non-whites. The plant argued that the education and test requirements were reasonable and racially neutral. Both the district court and the United States Court of Appeals for the Fourth Circuit found that, in the absence of a demonstration of discriminatory purpose or intent on the part of the plant with respect to the education and test requirements, there was no violation of the Act.

The Supreme Court in its review examined a question of first impression: could racially neutral hiring and advancement requirements be deemed discriminatory, and thus in violation of the Act, in the absence of discriminatory intent or purpose on the part of the employer? The court held that they

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could. The court opined that the purpose behind the Act was "the removal of artificial, arbitrary, and unnecessary barriers to employment when the barriers operate to invidiously discriminate on the basis of racial or other impermissible classification."[7] While it was satisfied that the plant had no discriminatory intent or purpose for the education and test requirements, the court also found no evidence that these requirements fulfilled a genuine business need or were a harbinger of job success at the plant.[8] Consequently, the court ruled that the education and test requirements were simply an artificial barrier that had a disparate impact upon minority plant employees and job applicants. Thus, for the first time, a party could be deemed guilty of racial discrimination even though it did not "intend" to discriminate.

The *Griggs* holding is not limited to employment issues. Since *Griggs*, the concept of disparate impact has been expanded to lending and fair housing practices and has been a hot topic of discussion among courts, legislators, and regulators. In February 2013, the United States Department of Housing and Urban Development attempted to provide clarity to this concept when it issued its Final Rule pertaining to Implementation of the Fair Housing Act's Discriminatory Effects Standard.[9] "This rule formally establishes a three-part burden shifting test currently used by HUD and most federal courts, thereby providing greater clarity and predictability for all parties engaged in housing transactions as to how the discriminatory effects standard applies."[10] In summary the three-part test consists of: (1) the charging party or plaintiff bears the initial burden of proving its *prima facie* case that a practice results in discrimination on the basis of a protected characteristic; (2) if the charging party or plaintiff proves its *prima facie* case, then the burden of proof shifts to the respondent or defendant to prove that the challenged practice is necessary to achieve one or more of its substantial, legitimate, non-discriminatory interests; (3) if the respondent or defendant satisfies this burden, then the charging party or plaintiff may still prevail by proving that the substantial, legitimate, non-discriminatory interests could be served by a practice that has a less discriminatory effect.[11] This three-part test tracks the Supreme Court's analysis in *Griggs*.

A lawsuit involving this three-part test would be very fact-specific, very time consuming as it relates to discovery, motions, and trial, and very expensive. The linchpin of the lawsuit is a wide variety of complex and highly detailed statistical data including, but not limited to, United States Census information, data required to be furnished by lenders under the Community Reinvestment Act ("CRA"), and its implementing Regulation BB (enacted to reduce discriminatory credit practices against low-income neighborhoods, a practice known as red-lining),[12] as well as data required of lenders under the Home Mortgage Disclosure Act ("HMDA") (requiring financial institutions to maintain and annually disclose data about home purchases, home purchase pre-approvals, home improvement, and refinance applications involving one- to four-unit and multifamily dwellings).[13] And, because the underlying claim of the lawsuit is an alleged practice that wrongfully impinges on a protected classification, race, color, religion, national origin, sex, marital status, or age, as defined in many federal statutes,[14] such a lawsuit has the potential to attract unwelcome media attention.

Application of Disparate Impact Theory to Lenders and Lending Practices

In recent years, the United States Department of Justice ("Justice Department") has used the disparate impact theory to file legal cases against lenders all over the country over practices that appeared to be facially neutral, but which the Justice Department alleged disproportionately impacted a protected group, typically minorities.

The FHA contains no express language permitting disparate impact claims. Nonetheless, most federal circuit courts of appeal—as well as the Department of Justice, the Department of Housing and Urban Development and the Consumer Financial Protection Bureau—have taken the position that disparate impact claims are available under the statute. These courts and government agencies have similarly insisted that disparate impact claims may also be brought under the Equal Credit Opportunity Act[15] (ECOA), despite the absence of such language in the ECOA authorizing such claims.[16]

Russlynn Ali, then the Secretary of Education for Civil Rights, said during a press conference in March 2010 that "disparate impact is woven throughout civil rights enforcement in [the Obama] administration."[17] Thomas Perez, Assistant Attorney General

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for Civil Rights, the most important civil rights office in the government, has called disparate impact "the linchpin" of civil rights enforcement.[18]

In Michigan, the Justice Department has filed cases alleging that lenders violated the law by engaging in practices which had a disparate impact upon a protected class:

- *United States v Citizens Bank:*[19] The Justice Department brought suit against Citizens alleging that Citizens failed to locate branch offices, provide loan services, and draw applications from areas in metropolitan Detroit populated primarily by minorities.
- *United States v Community State Bank*:[20] The Justice Department brought suit against Community State Bank, a small rural Michigan bank, alleging that it failed to locate branch offices, provide loan services, and draw applications from nearby metropolitan areas in Southeastern Michigan populated primarily by minorities.

Other cases in which the Justice Department has brought disparate impact claims against the financial services industry include:[21]

- *United States v Countrywide*:[22] The Justice Department brought suit against Countrywide and its affiliates because it allegedly offered subprime loans to minorities but prime loans to similarly financially situated non-minorities. This practice was said to discriminate against minorities because sub-prime loans carry a higher interest rate to account for the higher risks associated with these loans.
- *United States v Wells Fargo*:[23] The Justice Department alleged that minority customers in Chicago were charged higher interest rates and paid higher broker fees than similarly financially situated non-minority customers.
- *Adkins v Morgan Stanley*:[24] In Detroit, the Justice Department alleged that the financial services firm pushed high risk mortgage loans on minority borrowers at a far greater rate than non-minority borrowers with the same income and credit background.
- *United States v SunTrust Mortgage*:[25] The Justice Department alleged that minorities were charged disproportionately higher interest rates than non-minorities.
- *United States v C & F Mortgage;*[26] *United States v Prime Lending:*[27] The Justice Department alleged that minorities were charged disproportionately higher interest rates than non-minorities and that loan officers received extra compensation for engaging in this practice.
- *Greater New Orleans Fair Housing Action Center v HUD*:[28] In the aftermath of Hurricane Katrina, homeowners were given an amount of funds to rebuild based on the value of their homes before damage, rather than based on the amount of damage. Consequently, non-minority homeowners received far more money with which to rebuild than did minority homeowners.

All of these cases settled, without any of the defendants admitting that they engaged in discriminatory practices. One must presume that a combination of factors, including the cost of defense, the monetary risk of losing, the potential media exposure, and the weight and might of the federal government, encouraged all of these defendants to settle.

New Orleans v HUD offers a classic case of disparate impact using the definition outlined above. Everyone is treated equally as far as receiving rebuild funds using the same neutral standard: the amount of rebuild funds is tied to the pre-damage value of the home. The alleged discrimination arises from the fact that minority-owned homes were typically worth far less than non-minority owned homes. Therefore, minority home owners received less money with which to rebuild their homes even if the damages were comparable.

As a matter of law or public policy, is the disparate impact theory a tool that the government may fairly use to rectify alleged discriminatory practices or policies in cases against the financial services industry?

In *Magner v Gallagher*,[29] the city of St. Paul, Minnesota didn't think so. *Magner* involved an effort, beginning in 2002, by the city of St. Paul (through city official Magner) to more rigidly enforce its housing code for rental properties. A property owner, Gallagher, objected to this policy and brought suit under the FHA, claiming that St. Paul's efforts, while neutral on their face, reduced the availability of low income housing, which in turn proportionately impacted minority citizens. The district court dismissed the case on summary judgment because there was no evidence of discriminatory *intent* on the part of St. Paul and, as noted above, the concept of disparate impact is not specifically set forth in the FHA. The United States Court of Appeals for the Eighth Circuit ("Eighth Circuit") reversed and reinstated the case. In so doing, the Eighth Circuit applied the three-part test prescribed by HUD. On the first step, the Eighth Circuit ruled that Gallagher had met his burden of proving that the St. Paul housing code, while neutral on its face, had the effect of reducing the amount of available low cost housing, which disproportionately harmed minority prospective homeowners. On the second step, the Eighth Circuit ruled that St. Paul hat met its burden of demonstrating a legitimate, non-discriminatory basis for the housing code, specifically, promoting safe and healthy housing conditions. On the third step, the Eighth Circuit ruled that Gallagher raised a genuine issue of material fact as to whether St. Paul could have found a less discriminatory alternative to achieve its legitimate goals. St. Paul appealed to the Supreme Court on the grounds that the district court's initial dismissal of the case should stand.

By early 2012, the Supreme Court was poised to hear oral argument in *Magner* and, possibly, pass judgment on the efficacy of the disparate impact theory. But then an unusual thing happened. After many years of litigation and, presumably, considerable legal expense, St. Paul dropped its appeal. At the same time that St. Paul dropped its appeal, the Justice Department announced its decision not to participate in two other unrelated "whistleblower" cases brought under the Federal False Claims Act, which also involved the city of St. Paul. Some have suggested that the Justice Department was concerned that the Supreme Court might strike down the use of the disparate impact theory in housing cases,[30] so the government agreed not to participate in the False Claims Act cases against St. Paul in exchange for St. Paul dropping its appeal in *Magner*.[31] Whatever the underlying reason, the *Magner* case was never heard by the Supreme Court.

This brings us full circle back to *Mount Holly*. The defendant in *Mount Holly*, like the defendant in *Magner*, believes that the disparate impact theory is not a tool the government may fairly use. *Mount Holly* involves an effort by the Township of Mount Holly, New Jersey ("Township") to refurbish and redevelop a predominantly minority populated part of town that it considered blighted. The Township bought and razed most of the homes in the blighted area but then did nothing further pending resolution of litigation brought against it. Minority Township residents sued claiming the actions of the Township were discriminatory due to the disparate impact on minority residents. The district court granted summary judgment in favor of the Township, but the United States Court of Appeals for the Third Circuit ("Third Circuit") reversed. The Third Circuit believed that the plaintiffs could have met their burden of establishing a *prima facie* case if not for three errors on the part of the district court: (1) the district court failed to allow into evidence the plaintiffs' statistical evidence submitted in support of their disparate impact argument, (2) the district court failed to review evidence showing that minority residents were disproportionately affected by the Township's actions, (3) the district court erred by agreeing with the Township that 100 percent of minority and non-minority residents of the Township were treated the same way.[32] This is the antithesis of disparate impact analysis. The proper analysis is not simply how different people are *treated*, but how they are *affected*.

> [I]s the disparate impact theory a tool that the government may fairly use to rectify alleged discriminatory practices or policies in cases against the financial services industry?

The Third Circuit's reasoning is significant because it gives the Supreme Court options that it may not have had in the more narrowly decided *Magner* case. The Supreme Court could strike down the use of a disparate impact theory. Why might it do so? A review of the three-part disparate impact test prescribed by HUD reveals that the standard by which a plaintiff can establish a *prima facie* case under step one of the test is fairly low—simply demonstrate that a lender's policy or procedure disproportionately and negatively affects a protected class. In response, a lender can easily meet its burden under step two of the test to demonstrate a legitimate business need for its lending policies by pointing to the safety and soundness lending requirements of the Federal Deposit Insurance Corporation. Step three of the test is where the proverbial rubber will meet the road. Step three allows a court, with the benefit of hindsight, to find that a lender could have found a less discriminatory way to address its legitimate business needs. The Supreme Court could hold that the disparate impact theory and the three-part test and fact analysis, coupled with the ability to impose a subsequent penalty, is unfair. Or, the Supreme Court could, as it often does, rule much more narrowly and direct the district court to properly admit statistical evidence of disparate impact and revise its flawed analysis as to how the disparate treatment theory works.

Advice to Clients in Financial Services Industry

With the specter of disparate impact looming over the financial services industry, and the issue far from decided, what are businesses involved in the financial services industry, such as banks, credit unions, servicing entities, brokers, finance companies, etc. to do? How do members of the bar, as attorneys and counselors to the financial services industry, determine what to advise their clients?

An excellent source of insight for the answers to these questions may be found in the settlement agreement between the United States and Citizens Republic Bancorp[33] and the consent order in *United States v Community State Bank*,[34] which are a matter of public record and can be located with a simple Internet search. Both are highly instructive as to what the government found wrong with the policies and actions of these financial institutions and, more importantly, what the government demanded be done about it.

Disparate impact litigation relies heavily on statistical analysis. In a data-driven world, it is a certainty that hard actuarial data will be used when making a determination of disparate impact. Therefore, it is increasingly important to understand the type of data that will be used to measure the effect of your client's policies and procedures. Below are some thoughts on what counsel should consider when working with clients in the financial services industry.

Geography

Your client's geographical footprint, such as its delineated Assessment Area for purposes of the Community Reinvestment Act (CRA) and Regulation BB,[35] will form the basis of any demographic analysis. Therefore, it is essential for a client to understand the applicable data from the U.S. Census Bureau, which is available online, free of charge. Census data provides extremely detailed breakdowns of the racial, ethnic, and gender makeup of areas as small as individual census tracts, all the way up to larger areas known as Metropolitan Statistical Areas (MSAs). And while it is essential for your client to understand the demographic composition of their footprint, it is equally important to understand the composition of the areas that *surround* it. Market boundaries that appear to be arbitrary, or that avoid areas with significant minority composition, may invite a finding of red-lining, unless a compelling case can be made that such boundaries are necessary and reasonable. When assessing your client's geographic exposure, it is useful to ask:

- What is its market area, and does it differ from where the client actually does business?
- Where are its offices or branches in relation to its market area?
- Has it conducted a recent assessment of its market area, with emphasis on the protected classifications of race, color, religion, national origin, sex, marital status, or age?
- What is the composition of the areas surrounding your client's market area, and does that area differ from your client's market area?
- For a regulated financial institution client, is there a difference between its market area and its CRA Assessment Area? If so, why?

Policies and Procedures

When developing new strategies and products, it is very important that management, including any board of directors, take the time to consider the impact in its market area. If a particular product or strategy has limited availability, it is very important that such limits serve the legitimate, non-discriminatory business needs of your client. Evidence of this deliberation should be retained in your client's files or in the minutes of its board meetings. It is important to ask:

- Do the minutes and files clearly establish how the strategy or product reflects your client's substantial, legitimate, and non-discriminatory interests?
- Do the minutes and files reflect the deliberative process, including the discussion of any alternatives that were considered, why one alternative was selected and, equally important, why others were rejected?

When developing new strategies and products, it is very important that management, including any board of directors, take the time to consider the impact in its market area.

Compliance Training

The limitations, requirements, prohibitions, and restrictions to which financial service providers are subject are significant, and the penalties associated with violations can be severe. For your client to successfully navigate these ever-more-complex regulations, they must have a plan to ensure that their employees understand these rules. Some important questions to ask include:

- Does your client have "fair lending" or other similar training programs that train personnel on what is acceptable and what is not acceptable under all applicable state and federal lending laws and statutes?
- Are these policies and procedures subject to periodic review and adjustment?
- Are your client's employees, particularly any "loan originators," clear on what terms, conditions, and interest rates may be offered?
- Are there clear policies and procedures in place for making exceptions to any applicable standards, and if so, do these exception policies satisfy your client's substantial and legitimate interests without violating applicable anti-discrimination laws and regulations?

Customer Development and Community Outreach

The third part of the three-part test developed in *Griggs* involves, for want of a better description, second-guessing the decisions that a business has made. To prevail under the third part of the test, a financial service provider must establish that its business model and products appropriately balance two potentially conflicting interests: the substantial and legitimate needs of the business, and the rights of the affected community not to be unlawfully discriminated against on the basis of race, color, religion, national origin, sex, marital status, or age. A lender's policies and procedures will often yield disparate results because of the need to distinguish between credit-worthy and non-credit-worthy customers, which are further constrained by regulatory limits on the risks that may be taken. Recognizing the potential for such *prima facie* evidence of disparate impact, it becomes important for your clients to make efforts that mitigate that outcome. You should ask:

- Has your client assigned a senior member of its management team to develop business in predominantly minority or underserved segments of its market area?
- Does your client have educational outreach programs designed to teach members of protected classes how to improve their financial circumstances, including programs to help them improve their credit scores?
- If your client knows that segments of its market are underserved, have they researched any available programs, such as home-improvement programs, or developed programs of their own, that could improve the chances that non-qualifying persons might qualify for your client's products or services?

As this history and discussion reveals, the concept of disparate impact has broad applicability and far-reaching impact. In a sense, every business "selects" the parties with whom it will do business, and *bona fide* businesses nearly always have legitimate and substantial needs they want to protect. Thus, it is virtually impossible to make selection decisions without there being some type of measurable disparate impact on the overall pool of potential customers. Under disparate impact analysis, the question will always be whether a business has selected the *least* discriminatory means to accomplish its legitimate and substantial goals. As long as disparate impact remains a legally viable theory, that question may be answerable in a court of law long after decisions have been made and policies or actions put in play. Now, more than ever, while we await the Supreme Court's decision in *Mount Holly*, the watchwords *thought*, *care*, *due diligence*, and *documentation* should be foremost in the mind of anyone conducting business in the financial services industry.

Under disparate impact analysis, the question will always be whether a business has selected the *least* discriminatory means to accomplish its legitimate and substantial goals.

NOTES

1. 658 F3d 375 (3d Cir 2011), *cert granted*, 133 S Ct 2824 (2013).
2. 658 F3d 377-378.
3. *Challenging HUD's Racial Quotas*, The Wall Street Journal, July 17, 2013, Page A14.
4. *United States v Citizens Republic Bancorp, Inc and Citizens Bank*, No 11-11976, 2011 US Dist LEXIS 55221 (ED Mich May 24, 2011); *United States v Community State Bank*, 3:13-cv-10142-LPZ-LJM (E.D. Mich. 2013).
5. 401 US 424 (1971).
6. 401 US 424-425.

7. 401 US 431.

8. 401 US 431, 432.

9. 78 Fed Reg 11460 (February 15, 2013).

10. *Id.*

11. 78 Fed Reg 11482.

12. 12 USC 2901; 12 CFR 228.

13. 28 USC 2801

14. See, for example, Equal Credit Opportunity Act, 15 USC 1691, et seq.

15. 15 USC 1691, et seq.

16. 78 Fed Reg 11460.

17. Terry Eastland, *Thomas Perez Makes a Deal*, The Weekly Standard, May 27, 2013, Vol. 18, No. 35

18. *Id.*

19. *United States v Citizens Republic Bancorp, Inc and Citizens Bank*, 2:11-cv-11976-LPZ-LJM (ED Mich 2011).

20. *United States v Community State Bank*, 3:13-cv-10142-LPZ-LJM (ED Mich 2013).

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24. *Adkins v Morgan Stanley,* No 12 CV 7667, 2013 US Dist LEXIS 104369 (SD NY July 25, 2013).

25. *United States v SunTrust Mortgage, Inc*, 3:12-CV-00397-REP (ED Va 2012). For the consent order, see http://www.justice.gov/crt/about/hce/documents/suntrustsettle.pdf.

26. *United States v C & F Mortgage Corporation*, 3:11-CV-00653-REP (ED Va 2011). For the consent order, see http://www.justice.gov/crt/about/hce/documents/candfsettle.pdf.

27. *United States v Prime Lending*, 3:10-CV-02494-P (ND Tex 2011). For the consent order, see http://www.justice.gov/crt/about/hce/documents/primelendsettle.pdf.

28. *Greater New Orleans Fair Housing Action Ctr v United States Dep't of Hous & Urban Dev*, 395 US App DC 67, 639 F3d 1078 (2011).

29. 619 F3d 823 (8th Cir 2010), *cert dismissed*, 132 S Ct 1306 (2012).

30. Hans von Spakovsky, *More Justice Department Chicanery: Thomas Perez and "Disparate Impact,"* Judiciary, Legal, US News, June 1, 2013.

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32. 658 F3d 383.

33. http://www.justice.gov/crt/about/hce/documents/citizenssettle.pdf.

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Banks Bona Fide: A Good-Faith Approach to Lender Liability

By John E. Anding and Theodore J. Westbrook

Gracious Good Faith, on wings upborne; thou oath in Jupiter's great name!
-Quintus Ennius

Good Faith, Good Faith, the saying did not hold
In him that did object the same to thee.
-William Shakespeare, *The Tragedy of King Richard the Third*, Act II, Scene IV

Introduction

As a nation, the United States' relationship with financial institutions has always been complicated. From the moment the ink dried on the Constitution to the present day, Americans have been troubled by their desire for the services and potential wealth creation banks can provide, even in the face of sometimes greedy, unscrupulous bankers and financial crises. Shortly after the founding, while Alexander Hamilton and the Federalists argued passionately in support of the wealth-creating potential of banks, Thomas Jefferson wrote, "I sincerely believe…that banking establishments are more dangerous than standing armies."[1]

Jefferson lost on both counts; banks and a standing army are here to stay. However, many American individuals and businesses continue to espouse Jefferson's suspicion of banking institutions. The role of these institutions in recent financial crises, most notably the subprime mortgage crisis that reverberated into a major economic recession beginning in 2008, has only strengthened the public's distrust of banks.[2]

Yet, as a practical matter, it is difficult for a citizen or small business to sue a bank and win. Banks have a powerful lobby and our legislators have been more Hamiltonian than Jeffersonian when it comes to bank regulation; many statutory and regulatory provisions favor banks over their customers. As a result, banks may avail themselves of many defenses in court, and several causes of action against banks are available only to the government. The average person attempting to hold a bank accountable for its wrongdoing faces a real challenge surviving summary disposition, let alone winning a judgment. Moreover, Michigan's Consumer Protection Act ("MCPA"), which once provided aggrieved parties and their attorneys with a means to attack unfair and deceptive practices by banks and others, has in recent years been all but eviscerated by a series of Michigan Supreme Court decisions.[3] Thus, even before considering the superior resources banks can (and do) commit to litigation, a plaintiff seeking to hold a bank accountable for wrongdoing may be at a disadvantage.

Though establishing a bank's liability for wrongdoing can be challenging under any circumstances, the litigator hoping to do so has at least one powerful tool that should be considered in many lender liability and banking cases: *good faith*. A thread running through several areas of law applicable to banking and commercial relationships is the duty to act in good faith. This factually intensive standard, which has been defined mainly by the common law as a duty to act reasonably or honestly, applies to many types of banking conduct and transactions. Good faith is a concept built into the Uniform Commercial Code ("UCC"), the Uniform Fraudulent Transfers Act ("UFTA"), the Bankruptcy Code, and, increasingly, into consumer protection legislation. When an individual or business seeks to hold a bank accountable for wrongdoing, and can find support for allegations that the bank has not acted in good faith, the bank is perhaps in its most vulnerable state. Thus, whether lawyers represent clients seeking to sue banks, or banks wish to protect themselves from liability, familiarity with the concept of good faith and where it may be effectively attacked or supported is invaluable.

What follows is an analysis of what it means for a bank to act in good faith. We examine the ways in which courts across the country and in Michigan are defining good faith under the various contexts in which good-faith disputes with banks can arise: under the UCC; under the UFTA; under the

Bankruptcy code; and under new mortgage lending regulations. And we look to the future, considering imminent consumer protection laws coming into effect in 2014.

The UCC: Honesty and Reasonableness

Michigan's Uniform Commercial Code ("UCC") provides banks with a "holder in due course" defense that may act to limit a bank's liability for accepting and retaining fraudulently or illegally obtained funds.[4] Under many circumstances,[5] if a bank accepts and retains fraudulently or illegally obtained funds in the form of a negotiable instrument, it can keep the funds as a holder in due course if:

> (a) The instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity.
>
> (b) The holder took the instrument (*i*) for value, (*ii*) in good faith, (*iii*) without notice that the instrument is overdue or has been dishonored or that there is an incurred default with respect to payment of another instrument issued as part of the same series, (*iv*) without notice that the instrument contains an unauthorized signature or has been altered, (*v*) without notice of any claim to the instrument described in section 3306, and (*vi*) without notice that any party has a defense.[6]

As seen above in subsection (b)(ii), however, a bank's assertion that it should be considered a holder in due course of property, instruments, or funds comes with a caveat: the bank must demonstrate its good faith.

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Good faith is similarly important to articles 3 and 4 of the UCC, which address how losses resulting from forged drawers' signatures should be allocated.[7] This issue arises in instances in which banks accept or process payments that are ordered through fraudulent checks; i.e., where an unauthorized person has forged the signature of the account holder and the funds have been removed from the account as a result. UCC 3-405, 3-406, and 4-406 provide banks with defenses to the loss falling upon them; if the customer is negligent and precluded from asserting the forgery, the item is technically properly payable. These defenses, however, are subject to counter-defenses, including the bank's failure to show good faith.[8]

In other cases involving banks, UCC article 1, which imposes an overriding obligation of good faith to all UCC transactions, may deprive a bank that fails to act in good faith of the protections otherwise afforded by technical defenses. As most practitioners who have advised individuals regarding their lending relationships with banks are already aware, banks are typically able to impose heavily imbalanced contractual terms on their debtors. This may take many forms, including the common one-two punch of a set of terms making default nearly impossible for the debtor to avoid along with extremely flexible remedies provided to the bank on the debtor's default, including acceleration of all monies owed, unilateral imposition of onerous penalty terms, and other recourse. The UCC-imposed duty of good faith can be an arrow in the bank customer's quiver when the case turns on whether the bank either (1) had the contractual right to take a certain alleged wrongful action affecting the debtor or (2) breached a contractual obligation to the debtor. This is especially true when a bank's contractual rights or obligations do not clearly support or prohibit the contested conduct; however, in certain circumstances the bank's duty of good faith can *override* explicit contractual terms, paving the way for the lender's liability to the customer or the customer's defense to the lender's claims.[9] It is thus critical, particularly for the plaintiff, to understand what good faith means in the UCC context and how it can be demonstrated or attacked.

Under the common law, "the covenant of good faith and fair dealing is an implied promise contained in every contract."[10] Although in Michigan the breach of this implied covenant does not provide a cause of action in tort,[11] explanations of the implied promise reflect use of an objective standard in determining if the implied promise has been breached.[12] Such cases predominantly involve situations where the contract terms reserve to one party the discretion to determine whether the other party has met its performance obligations.[13] Courts applying Michigan law in the UCC context, however, have looked to the good faith standard supplied by the UCC.[14] Before the UCC was amended to change the article one definition of good faith, Michigan courts relying on the UCC article 1 definition held that good faith was "evaluated according to a *subjective* test rather than an *objective* 'reasonably prudent person' standard."[15] This interpretation of good faith, when applied in lender liability cases, meant that financial institutions often could escape liability if the bank could show that its employees did not know about, and did not recklessly disregard, any indications that wrongdoing was afoot.[16]

The 2012 Michigan legislature extensively amended Michigan's UCC, effective July 1, 2013.[17] These amendments changed the overarching article 1 definition of good faith from "honesty in fact in the conduct or transaction concerned" to "honesty in fact and the observance of reasonable commercial standards of fair dealing."[18] This change in the UCC-wide definition of good faith occurred specifically to conform to amendments in several articles that had *already* added objective reasonableness to those definitions of good faith.[19]

For jurisdictions that have adopted the new UCC article 1 definition of good faith as "honesty in fact *and* the observance of reasonable commercial standards of fair dealing," but have yet to address its boundaries, recent cases decided under this definition are instructive. One such case involved the question of whether the bank or the customer should bear the risk of loss after a fraudulent wire transfer. In that case, *Choice Escrow & Land Title LLC v BancorpSouth Bank*, the Federal District Court for the Western District of Missouri examined the meaning of "objective good faith."[20] The court noted that as of yet, "[w]ith regard to objective good faith, there is little case law on the subject *vis-a-vis* the Funds Transfers provisions of the UCC," but agreed with the test formulated by the Maine Supreme Court:

> The factfinder must…determine, first, whether the conduct of the holder comported with industry or commercial standards applicable to the transaction and, second, whether those standards were reasonable standards intended to result in fair dealing. Each of those determinations must be made in the context of the transaction at hand.[21]

After applying this test, the district court concluded that the bank had comported itself within the industry standards offered by the Financial Institutions Examination Council's 2005 guidance, and determined that those standards were reasonable standards intended to result in fair dealing. Thus, the bank had acted in objective good faith.

Caselaw interpreting the UCC-specific applications of good faith thus suggests that where the plaintiff asserts a UCC-based cause of action against a bank, or the bank asserts UCC-based defenses, the bank's good faith may be at issue. Although what constitutes good faith may be a factually intensive question dependent on the transaction in question, in the UCC context at least, the bank's conduct is constrained by its duty to be both *honest* and *reasonable*.[22]

The UFTA: Knowledge and Participation

In the context of fraudulent transfers, good faith is important as part of a defense to avoidance. Where a litigant asserts a claim that a bank should disgorge funds it received that were fraudulently transferred to it, Michigan's Uniform Fraudulent Transfers Act ("MUFTA") provides defenses if the bank "gave value" for the property or the funds it obtained and accepted such property or funds "in good faith."[23] Section 8(a) of the Uniform Fraudulent Transfer Act ("UFTA") states that "[a] transfer or obligation is not voidable under Section 4(a)(1) against a person *who took in good faith* and for a reasonably equivalent value or against any subsequent transferee or obligee." (Emphasis added.) When a bank is the transferee, having received ill-gotten funds that a defrauded creditor (or a bankruptcy trustee standing in such creditor's shoes) seeks to recover from the bank, the burden is on the bank to show that it acted in good faith in receiving the funds—or else the bank will have to give up the money.[24] Often, however, the burden of showing good faith has been a light one.

A sophisticated bank would seem to have the resources and acumen to reasonably investigate where its deposits come from if some circumstance surrounding an account puts up a red flag. Yet, in some cases, banks have been allowed to keep the proceeds of fraudulent transfers even when they appeared to have a strong suspicion that the deposited money was obtained fraudulently. A line of cases in California is illustrative of the somewhat lax approach that some courts have taken. In *Jaik Koo v Wilshire State Bank*, the court decided, in line with a series of previous cases, that bad faith is present under the California UFTA only if the bank actively colluded with the transferor; in other words,

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willful negligence is still good faith, according to the court.[25] Under this logic, a bank could know very well that it is receiving fraudulently obtained money, but as long as it was not an active participant in the fraud, the transfer will not be avoided. This striking result may not reflect the state of the law, however, even in California. In *Brincko v Rio Props. (In re Nat'l Consumer Mortg, LLC)*, the District of Nevada, interpreting California law, predicted that the California Supreme Court would find bad faith under the UFTA where a bank had notice of facts that would suggest to a reasonable person that a transfer was fraudulent.[26] This test is clearly the stricter one for banks, which must plead and prove their good faith as an affirmative defense. Other states have grappled with this issue, [27] and the Michigan Supreme Court has not yet weighed in on this issue. Federal decisions interpreting the bankruptcy code, given the similarity between avoidance under the code and the UFTA, provide some guidance in this area. Those decisions, however, create a similar dilemma: can a bank demonstrate good faith when it should have known that fraud is involved or strongly suspected fraud and did nothing?

Currently, perhaps the fiercest debate of all in the courts over the definition of good faith is in the context of fraudulent transfers in bankruptcy proceedings.

Bankruptcy: Objective or Subjective?

Currently, perhaps the fiercest debate of all in the courts over the definition of good faith is in the context of fraudulent transfers in bankruptcy proceedings.[28] Because of various bankruptcy cases involving the aftermaths of Ponzi-like fraud schemes over the course of the last three years, courts have been faced with the task of further refining what good faith means under the bankruptcy code, specifically section 548(c).[29]

The crux of the debate is whether courts ought to use a subjective or objective test when determining the transferee's knowledge of fraud. Does the court compare the transferee's behavior to a reasonable community standard, or does it look only to the particular transferee's behavior, and whether the transferee acted with integrity and honesty?

In a truly sweeping and exhaustive opinion, Judge Hughes of the Bankruptcy Court for the Western District of Michigan investigated this question in great depth.[30] (Disclosure: Drew Cooper & Anding represented the plaintiff as special trial counsel in this case.) The decision in *Meoli v Huntington Nat'l Bank (In re Teleservices)* is perhaps the most thorough investigation of good faith we are likely to see. In the case, a shell company, Teleservices, was depositing funds with Huntington Bank on behalf of a corporation, Cyberco, whose president orchestrated a massive fraud on investors. As the relationship between Huntington, Cyberco, and Teleservices progressed, Huntington became ever more suspicious of the Teleservices and Cyberco accounts and undertook some background research. Over time, Huntington turned up unsettling information about Cyberco and Teleservices but continued to do business with them, even as Huntington told the companies to find another lender.

Eventually, the FBI discovered that Cyberco was running a massive Ponzi scheme predicated on fraud. In bankruptcy, Teleservices' trustee claimed that the transfers to Huntington were avoidable under the bankruptcy code and MUFTA, but Huntington argued that it had taken the money in good faith.

Because this was actual fraud and not simply constructive fraud, Judge Hughes adopted a subjective good faith test. Under this test, rather than looking to objective community standards, Judge Hughes examined Huntington's own behavior. In doing so, he found that initially Huntington was acting in good faith; perhaps a little wary, but honest. But as Huntington—collectively through its employees—investigated and discovered worrying information (e.g., an FBI subpoena, an active FBI investigation, unusual account activity, the criminal history of Cyberco's CEO) at a certain point, Huntington had turned a blind eye to the fraud. Accordingly, any transfer that occurred after Huntington's turning of a blind eye was avoidable.

In bankruptcy, arguing a bank's bad faith, or challenging its claim of good faith, can be a potent weapon. Note too that Judge Hughes's test for establishing good faith, a subjective test, which is arguably easier for a bank to meet than an objective test, is not the norm for determining good faith in the bankruptcy context. Most circuits have used and continue to use a totally objective test, under which "if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent."[31] The Sixth Circuit has not yet settled the issue, and other courts within the Sixth Circuit are just starting to engage with the *Teleservices* opinion. For instance, in *In re Davis*, a Middle District of Tennessee Bankruptcy Court case, Judge Latta posits that Judge Hughes's test is actually a hybrid subjective/objective test that looks at the transferee's subjective intent in light of objective factors.[32] In short, good faith remains an elusive concept under the bankruptcy code but at a minimum reflects a similar general structure to how that concept has been defined elsewhere: either as a measure of subjective honesty and integrity or objective reasonableness, or both.

Dodd-Frank: New Duties and Safe Harbors

In 2011, a Connecticut court noted that "no court has recognized a duty to inquire into a borrower's ability to repay, even if the lender was a commercial bank," and that "[c]ertainly, the borrower has no claim when the lender relies upon the borrower's representations and does not independently verify them."[33] Starting in January of 2014, however, courts will be required to recognize mortgage lender's duties to investigate borrowers. Under the sweeping legislation spurred by financial crisis, banks will soon have a duty to make a good-faith effort to investigate a borrower's ability to repay the loan.[34]

With this extra leg-work now required, banks can be expected to adapt to the new regulations and adopt rigorous investigation procedures to shield themselves from liability. Banks might lend less readily, as would-be mortgagors "fail" their background checks.

Responding to concerns that the new duty to conduct a good-faith investigation could slow the mortgage market to a creep, the Consumer Finance Protection Bureau (CFPB) created by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") developed a safe harbor for lenders to greatly reduce the risk of liability: the "qualified mortgage." If a lender follows a prescribed series of underwriting considerations, the lender is presumed by law to have made a good-faith effort to follow the ability-to-repay requirements of the statute.[35]

It remains to be seen how the courts will interpret the new legislation when lenders and borrowers clash in the courtroom. For example, what will remain of otherwise viable lender liability claims where the banks have scrupulously followed the qualified mortgage guidelines? Will the safe harbor end up protecting banks that act in bad faith, simply because they adhered to the technicalities of the rule? Will the "good faith" requirement imposed by the new law be interpreted as identical to following the qualified mortgage guidelines, or will a broader definition—either a subjective or objective test—prevail? These questions will not be answered until the legislation has taken effect and the first cases against lenders wind their way through the courts.

Some consumer advocates have expressed concern that the safe harbor provision "won't prevent borrowers from suing their lenders, but it will make it cost-prohibitive and challenging."[36] To some extent, that is the intent of the lawmakers—to make it harder to sue a lender and win.[37] On the other hand, upon the passage of the Dodd-Frank legislation, many banking lawyers initially predicted an explosion of suits against banks and recommended that lenders begin working overtime to manage all sorts of new litigation risks.[38] But after the CFPB started operating, and started clarifying the legislation with rules and guidelines, the avenues for borrowers to approach success in court appear to be narrowing.

Perhaps because of public perception of the qualified mortgage as a complete shield from lender liability, lenders themselves have been keen to point out that the granting a qualified mortgage to a borrower does not per se immunize lenders from litigation.[39] This is where good faith could come into play: borrowers may still be able to attack qualified mortgages by showing that lenders did not affirmatively comply with the qualified mortgage requirements in good faith.[40] If the borrower can show that the lender, for example, cut corners when considering the qualified mortgage factors, the borrower may be able to penetrate the safe harbor defense.

For all the machinations over the explosion of litigation under Dodd-Frank, the act itself does not create any federal causes of action.[41] But preexisting private causes of action under statutes like the Truth In Lending Act or Fair Debt Collection Practices Act should be available to enforce the relevant Dodd-Frank amendments. Yet, concern remains that with the CFPB's immense rulemaking authority, and pressure from the bank lobby, more private causes of action will be regulated out of existence, as was the case with the Real Estate Settlement Procedures Act.[42]

Whatever uncertainty there may be about the future, and despite the generous safety

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net that the regulations have provided to lenders, it is important to remember that mortgage lenders do, as of January 2014, have an affirmative duty to make a good-faith investigation into a borrower's ability to repay the loan. That duty has generally not existed before. Even before the new legislation takes effect, courts are beginning to consider these new duties of good faith and care. In *Jolley v Chase Home Finance, LLC*, the California Court of Appeals acknowledged that while lenders generally have had no duty to borrowers outside of the provisions of the loan agreement, public policy, in light of the imminent legislation, demands recognition of the trend "to require lenders to deal reasonably with borrowers."[43] This type of analysis shows the potential of this new statutory structure to impact the landscape of lender liability litigation in a meaningful way. Like the court in *Jolley*, other courts may allow plaintiffs to survive summary judgment where they never would have before. Due to the new regulations, courts may be more willing to require a jury to determine whether a lender acted in good faith and dealt reasonably with borrowers. This aspect of the new legislation, at least, may favor potential plaintiffs asserting claims against their lenders.

Conclusion

In disputes against their customers and others affected by their conduct, banks typically enjoy significant advantages in terms of available statutory defenses, superior resources, and often favorable case-law. That being so, and though the definition of "good faith" may vary according to the context in which it is raised, and its relevance varies case by case, good faith is a widely present standard with which banks must comply in most of their commercial relationships. As such, it could be considered the great equalizer in the field of lender liability.

Those of us who represent individuals or small businesses in opposition to a bank must acknowledge the difficulty of the task, but when banks act in bad faith, success is possible. Banks' attorneys, too, must keep good faith in mind and advise their clients as to what is required of them. We may be Jeffersonians living in a Hamiltonian society, distrustful of the very banks we rely on so heavily, but if we as attorneys can hold banks to standards of honesty and integrity—good faith—banks and the public can coexist peacefully.

NOTES

1. Thomas Jefferson to John Taylor, May 28, 1816, in *The Writings of Thomas Jefferson, Vol. 10* (ed. Paul L. Ford) 31 (1899).

2. In a 2011 survey conducted by the Corporate Executive Board Co., just 17 percent of Americans reported feeling confident in banks and financial institutions. 40 percent felt unconfident. *See* http://www.bankrate.com/financing/banking/only-17-trust-financial-provider/, last visited July 22, 2013.

3. Though the MCPA remains on the books, the Michigan Supreme Court interpreted § 4(1) of that act, exempting conduct that is "specifically authorized by law" to encompass any activity—even if expressly prohibited by law—if the actor is part of a regulated industry or requires licensing. *See Smith v Globe Life Ins Co*, 460 Mich 446, 462-66, 597 NW2d 28 (1999). Although courts applying the MCPA should have followed *Dressel v Ameribank,* 247 Mich App 133, 635 NW2d 328 (2001), *rev'd on other grounds*, 468 Mich 557, 664 NW2d 151 (2003), leaving banks and savings banks exposed to liability under § 4(2) of the MCPA, courts have erroneously appled *Newton v Bank West*, 262 Mich App 434, 686 NW2d 491 (2004) instead, creating a "*Newton* precedent" line of cases holding that banks are not liable under the MCPA, citing § 4(1). Victor, *How Banks and Savings Banks Escaped Liability From the Michigan Consumer Protection Act*, 17 SBM Consumer Law Section Newsletter 3 (2013).

4. MCL 440.3305.

5. MCL 440.3305(1)(a) does provide limited counter-defenses to the holder in due course defense.

6. MCL 440.3302.

7. UCC arts. 3-4 govern negotiable instruments, check collections, and certain banking practices.

8. UCC 4-406(e), UCC 3-406(a).

9. *See, e.g., Gilmore v Ute City Mortgage Co*, 660 F Supp 437, 442 (D Colo 1986) (finding that where lender rescinded commitment to lend and commitment was contingent upon lending committee approval, duty of good faith would not be met, and bank would have breached contract, if lender failed to submit commitment to lending committee); *KMC Co v Irving Trust Co*, 757 F2d 752, 759-60 (6th Cir 1985)(finding that even where literal terms of credit agreement allowed bank control over customer's receivables and operating credit availability, duty of good faith required bank to provide notice and an opportunity to seek alternative financing before curtailing financing); UCC § 2-309 cmt. 8 ("The application of principles of good faith and sound commercial practice normally call for such notification of the termination of a going contract relationship as will give the other party reasonable time to seek a substitute arrangement."); *White v Wachovia Bank, NA*, 563 F Supp 2d 1358 (ND Ga 2008) (holding that plaintiffs could overcome dismissal based on contract language allowing depository bank to process items in "any order" where plaintiffs alleged that bank violated duty of good faith by intentionally manipulating order of processing to maximize overdraft fees).

10. *Hammond v United of Oakland, Inc*, 193 Mich App 146, 152, 483 NW2d 652 (1992); Restat 2d of Contracts 205 ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement").

11. *Belle Isle Grill Corp v City of Detroit,* 256 Mich App 463, 476, 666 NW2d 271 (2003) ("Michigan does not recognize a claim for breach of an implied covenant of good faith and fair dealing").

12. *Dumas v Auto Club Ins Ass'n,* 437 Mich 521, 569-570, 473 NW2d 652 (1991) (Levin, J. dissenting) (explaining the implied duty as "the obligation not to engage in a particular form of conduct, and to hold the contracting parties to their reasonable expectations"); *Hammond v United of Oakland, Inc*, 193 Mich App 146,

152, 483 NW2d 652 (1992) (describing it as a promise "that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract") (quoting *Fortune v National Cash Register Co*, 373 Mass 96, 104, 364 NE2d 1251 (1977)). *See also* Claybrook, *Good Faith in the Termination and Formation of Federal Contracts,* 56 Maryland L Rev 555, 572 (1997) ("Application of the common law would impose an objective, rather than a subjective test of whether the [party] acted in good faith….")

13. "Michigan courts will recognize an action for breach of an implied covenant of good faith and fair dealing where 'a party to a contract makes the manner of its performance a manner of its own discretion." *Paradata Computer Networks v Telebit Corp*, 830 F Supp 1001, 1005 (ED Mich 1993) (quoting *Burkhardt v City Nat'l Bank,* 57 Mich App 649, 652, 226 NW2d 678 (1975)).

14. *See, e.g., Genesee Merchants Bank & Trust Co v Tucker Motor Sales*, 143 Mich App 339, 346, 372 NW2d 546 (1985).

15. *Michigan Nat'l Bank v Metro Institutional Food Serv, Inc* 198 Mich App 236, 241, 497 NW2d 225 (1993) (citing the Article 1 definition of good faith in determining that a subjective test of good faith was required); *see also Karibian v Paletta*, 122 Mich App 353, 359, 332 NW2d 484 (1983) ("MCL 440.1201(19) defines good faith as: 'honesty in fact in the conduct or transaction concerned.' This is a "subjective test of good faith . . .").

16. *See, e.g.*, *Continental Cas Co v Fifth/Third Bank*, 418 F Supp 2d 964, 973 (ND Ohio 2006) ("'Mere failure to follow commercially reasonable banking procedures or to comply with its own policies' does not per se equal bad faith" and concluding the bank had acted in good faith) (quoting *Pavex Inc v York Fed S&L Ass'n*, 716 A2d 640, 646 (Pa Super Ct 1998)).

17. Legislative history related to the amendments available at http://www.legislature.mi.gov/(S(3pwnnsmdstykms55saypj2jl))/mileg.aspx?page=getObject&objectname=2011-HB-5081, last visited July 22, 2013.

18. MCL 440.1201(19); MCL 440.1201(2)(t).

19. Cmt a to UCC 1-201, available at http://www.uniformlaws.org/shared/docs/ucc1/ucc1_sect1-201_1096.pdf, last visited July 22, 2013. See also *Experi-Metal, Inc v Comerica Bank*, No 09-14890, 2010 US Dist LEXIS 68149 (ED Mich July 8, 2010 (relying on the objective prong of good faith as defined in MCL 440.4605); *Buckeye Ret Co v Manakey Group*, No 290506, 2010 Mich App LEXIS 1756 (Sept 21, 2010) (noting that the former version of Article Three did not contain its own definition of good faith, but that the trial court should have relied on the current version, which did).

20. *Choice Escrow & Land Title LLC v BancorpSouth Bank*, No 10-03531-CV-S-JTM, 2013 US Dist LEXIS 36746 (WD Mo, Mar 18 2013).

21. *Id.,* at *20 (citing *Maine Family Credit Union v Sun Life Assurance Co,* 1999 ME 43, 727 A2d 335, 343 (1999)).

22. Note, however, that the UCC's requirement of good faith does not abrogate or override Michigan's "banker's statute of frauds," MCL 566.132(2). In other words, the duty of good faith does not prevent a bank from making oral or unsigned written promises to lend or forbear and then failing to honor them, regardless of the bank's subjective intent or the reasonableness of its conduct.

23. *See, e.g.,* MCL 556.38(1) (MUFTA provision that an otherwise avoidable fraudulent transfer is not avoidable "against a person who took in good faith and for reasonably equivalent value"); 11 USC 550(b) (Bankruptcy Code provision that the trustee may not recover avoided fraudulent transfers from "a transferee that takes for value, including satisfaction of or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided.").

24. While this burden has been recognized by the courts, new updates of the model UFTA may make explicit in the code the burden on the transferee to show good faith. *See* http://www.uniformlaws.org/shared/docs/Fraudulent%20Transfer/2013jan15_AUFTA_MtgDraft.pdf, Accessed July 31, 2013.

25. *Jaik Koo v Wilshire State Bank*, No A134975, 2013 Cal App Unpub LEXIS 2357 at *24 (Mar 29, 2013).

26. *Brincko v Rio Props (In re Nat'l Consumer Mortg, LLC)*, No 2:10-CV-00930-PMP-PAL, 2013 US Dist LEXIS 5986 at *51 (D Nev, Jan 14 2013).

27. *See, e.g., Smith v Whitman*, 39 NJ 397, 402, 189 A2d 15 (1963) (holding that good faith is lacking only where the transferee knowingly aids the transferor).

28. *See* Sinclair & McPherson, *Teleservices Court Rejects Objective Good-Faith Standard*, 31-3 ABIJ 20 (2012).

29. 11 USC 548(c).

30. *Meoli v Huntington Nat'l Bank (In re Teleservices Group, Inc)*, 444 BR 767 (2011).

31. *Jobin v McKay (In re M & L Bus Mach Co)*, 84 F3d 1330 (10th Cir 1996) (citations omitted); *see also Meoli*, *supra* at 796 n 110 (collecting cases articulating an objective standard for good faith).

32. *Tabor v Kelly (In re Davis)*, No 05-1594-GWE, 2011 Bankr LEXIS 4762 (Bankr WD Tenn Oct 5, 2011).

33. *Deutsche Bank Nat'l Trust Co v Belizaire*, No FSTCV0650027045, 2011 Conn Super LEXIS 1842 (July 13 2011).

34. Dodd-Frank Wall Street Reform and Consumer Protection Act 1411-12.

35. The "Safe Harbor" for qualified mortgages is "conclusive" for standard mortgages, but only a "rebuttable presumption" for higher-priced, i.e., subprime mortgages. *See* http://files.consumerfinance.gov/f/201301_cfpb_ability-to-repay-summary.pdf, last accessed July 31, 2013.

36. da Costa, Polyana. *CFPB Adopts Ability-To-Repay Rule*, last accessed July 23, 2013, http://www.bankrate.com/financing/mortgages/cfpb-adopts-ability-to-repay-rule/.

37. *See* Kane, *Lender Liability on QM Rule? Cordray Attempts to Reassure,* American Banker. Accessed July 23, 2013. http://www.americanbanker.com/dodd-frank/lender-liability-on-qualified-mortgage-rule-cordray-attempts-to-reassure-1052926-1.html.

38. Hurwitz, *Litigation Risk for the Residential Mortgage Industry in the Wake of the Dodd-Frank Act*, 27 Rev of Banking & Financial Services 1 (2011).

39. *See, e.g.,* American Bankers Association. *Qualified Mortgage Safe Harbor vs. Rebuttable Presumption: The Difference and Why it Matters* http://www.aba.com/aba/documents/news/SafeHarborPaper121611.pdf, last accessed July 29, 2013.

40. *Id.*

41. *See* NCLC's *Consumer Banking and Payments Law* Section 8.2.5 (4th ed 2009 and Supp)

42. For an example of the CFPB's thought process in affirming or rejecting certain private causes of action, see "Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), Final Rule; Official Interpretations," 78 Federal Register 31 (14 February 2013), pp. 10696-10899, (weighing the bank lobby's concerns about litigation exposure, in the context of RESPA, against consumer advocates' desire to protect borrowers.)

43. *Jolley v Chase Home Fin,* 213 Cal App 4th 872, 903, 153 Cal Rptr 3d 546 (2013).

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Possible Benefits of Personal Goodwill in the Sale of Closely-Held Businesses

By Anthony Ilardi and Douglas S. Parker

Introduction and Background

Many business owners have suddenly faced the specter of double taxation when they sell the business they have spent years building. If the owner has structured the business as a C corporation[1] and is selling it in an asset transaction (which is often required by a buyer), then the proceeds from the sale are taxable to the corporation and what is left is taxable again when distributed to the owner.[2]

A partial solution to this unfortunate result is to allocate part of the purchase price to "personal goodwill." While the IRS has often argued against the use of personal goodwill, courts have found that it can be used so long as certain criteria are met. The fundamental concept in the personal goodwill analysis is that the price paid for a business in an asset sale consists of two separate transactions. The first is a purchase of the business assets from the selling corporation. These assets include the physical assets of the business as well as its intangible assets, but not the personal goodwill of the owner. The second transaction is a purchase of the personal goodwill directly from the owner. In several cases, courts have found that personal goodwill is an asset separable from the assets owned by the corporation and, so long as it has not been transferred to the corporation, is owned by the business owner.

Criteria for Use of Personal Goodwill

The cases in which the Tax Court and federal circuit courts have considered personal goodwill have established a set of criteria that should be met for personal goodwill to be effectively used. If any one of these is not present, it is likely that a court will find that no part of the purchase price is allocable to personal goodwill. The criteria needed to establish personal goodwill include:

- The selling entity is a C corporation.
- The transaction is structured as a sale of assets and not equity.
- The business of the selling entity involves a high level of owner involvement, ideally in a business that involves personal services.
- There must be no employment agreement or non-competition agreement between the selling entity and the owner.
- The sale of personal goodwill by the owner must be contemplated in the transaction documents and the earlier that it is part of the negotiations the better.
- The allocation of purchase price between personal goodwill and the other assets of the business should be reasonable and, ideally, supported by an independent appraisal.
- The owner enters into a consulting or employment agreement with the buyer.

What follows is a brief survey of the more relevant cases that have led us to where we are today when it comes to performing an analysis of whether personal goodwill is available.

Survey of Significant Cases

1998 Tax Court Cases Establishing the Framework for Analyzing Personal Goodwill

Martin Ice Cream Co v Commissioner is the case most often cited as the one in which the concept of personal goodwill was acknowledged by the Tax Court.[3] In this 1998 case, Martin Ice Cream Company transferred a portion of its ice cream distributorship business to a new company, Strasberg Ice Cream Distributors, Inc. (SIC) in a split-off transaction in which one of the shareholders of Martin Ice Cream became the sole stockholder of SIC. Soon thereafter, SIC's business was sold to its most important customer, Haagen-Dazs, in an asset transaction for $1.4 million. The owner of the business included a large portion of the gain from the sale on his personal income tax. The IRS determined that all of the taxable gain from the sale should be attributed to the company. The Tax Court agreed with the owner, holding that the owner's personal relationships with customers of the business and supermarkets to which ice cream was distributed were never corporate assets of the company until their sale to Haagen-Dazs but, rather, were the exclusive property of the owner who merely made them available to the company.

In its opinion, the Tax Court introduced many of the criteria that remain important in an analysis of whether personal goodwill is available to a business owner. The court noted that the owner built the business on the strength of his personal relationships with the supermarkets to which he distributed ice cream. This asset was never transferred to the company because he never entered into a covenant not to compete nor even an employment agreement with the company. The court went on to state that it "…has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation."[4] It also noted, "[t]he substance of a transaction can be found in the negotiations leading up to the closing."[5] The owner was a party to the to the asset purchase agreement and signed the related bill of sale both as an individual and in his capacity as president of the company. While the court did not address whether the amounts of the purchase price allocated between assets of the company and the owner's personal goodwill was appropriate, it did appear to concur with the owner allocating a large portion of the gain to himself. It stated that there were two assets sold in the transaction, and the asset that amounted to personal goodwill was much more valuable than the other, the business records of the company.[6] Finally, while the court did not discuss it extensively in its opinion, it did note that the owner entered into a consulting and noncompetition agreement with the buyer pursuant to which he was paid a fixed amount over a three-year period.

While the IRS has often argued against the use of personal goodwill, courts have found that it can be used so long as certain criteria are met.

Later in 1998, the Tax Court decided *Norwalk v Commissioner*.[7] This case arose in connection with a corporate liquidation, rather than a sale of assets. Under IRC 336 a liquidating corporation must recognize as gain the excess of the fair market value of its assets distributed in liquidation over its basis in the assets.[8] In *Norwalk*, the IRS took the position that the corporation's assets included goodwill, which, if self-created, has no basis. The owners argued to the contrary that the corporation did not own the intangibles and so there was no distribution of intangible assets (including goodwill) to tax. The court decided in favor of the owners on this question.

The court focused on the character of goodwill, describing things from which it may arise and noting that there is no specific rule to follow when determining its value, but, rather, it is decided on specific facts. The court cited *Martin Ice Cream*, stating that there is no salable goodwill where the business is dependent on key employees, unless they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships become property of the corporation.[9] In this case, the owners had each previously entered into an employment agreement with the corporation that included a covenant not to compete, but those agreements had expired in accordance with their terms not quite two years before the liquidation. The court found that because the employment agreements were no longer enforceable, the goodwill of the owners did not attach to the corporation.[10]

More Recent Cases

In 2008, the Tax Court decided *Solomon v Commissioner*,[11] a case in which the court sided with the IRS when the owners asserted they were entitled to treat a portion of the sale of a division of their ore processing business as personal goodwill. The owners sold the division to a competitor, giving the buyer a virtual monopoly for that line of business. The owners claimed that a portion of the purchase price was attributable to personal goodwill in the form of a customer list. The IRS maintained that the company realized long-term capital gain on its distribution of the customer list to the owners.

The owners cited *Martin Ice Cream*, pointing out that, in addition to the company, the owners were parties to the purchase agreement and directed the court's attention to an exhibit to that agreement allocating a portion of the purchase price attributable to the customer list to certain of the owners. The court, however, distinguished *Martin Ice Cream* from the facts in this case, stating that (1) as a business of processing, manufacturing, and sale, rather than one of personal services, the corporation in this case did not depend entirely on the goodwill of its employees for success; (2) notwithstanding the allocation in the exhibit, the owners were not parties to the transaction other than in a limited capacity to guaranty that they would not compete with buyer; and (3) the buyer required a noncompete but not employment or consulting agreements, making it unlikely that the buyer was purchasing the personal goodwill of the principals.[12] The court also considered the value of the customer list, noting that it had little value, ignoring the "mere fact" that the exhibit allocated a portion of the purchase price to the list.[13] Instead, the court put more weight on the fact that since the buyer would have a virtual monopoly, it had no need for customer lists or relationships established by the sellers. It also noted that a side agreement entered into between the company and the buyer (and, pointedly, not the owners) pursuant to which the two parties agreed to work together for a smooth transition of production and the company would refer its customers to the buyer was conclusive evidence that the owners did not own the customer list.[14]

Muskat v United States[15] is a case decided by the First Circuit Court in 2009 and is noteworthy in the emphasis the court placed on the importance of including discussions of personal goodwill during the negotiation process and referencing it in the transaction documents. In *Muskat,* the 37 percent owner of a meat processing and distribution business received payments pursuant to a noncompetition agreement entered into by the owner and the company as part of the sale of the business. In his tax return, the owner reported these payments as being received in exchange for his agreeing to not compete with the buyer. Four years later, he filed an amended return re-characterizing the payments as being compensation received for the transfer of his personal goodwill in the business.

This case turned less on the pure merits of whether the owner had sold personal goodwill, but more on a significant procedural hurdle that the taxpayer was unable to overcome: to disavow the agreement of the parties, the taxpayer would have to adduce by "'strong proof," which following an earlier First Circuit decision would receive a showing "that at the time of execution of the contract, it was the intention of the parties to allocate a different amount…."[16] To be sure, the owner had some good facts supporting his claim of having sold personal goodwill. As the court noted, during the time that he ran the family business, its annual revenues soared, and he had developed valuable relationships with customers, suppliers, and distributors.[17] The owner agreed to continue to run the business and entered into an employment agreement and a non-competition agreement with the company after it was purchased. There was also no mention of the owner entering into an employment or non-competition agreement with the company before the sale. Nonetheless, the court pointed out that there were no discussions of personal goodwill during the negotiations and that it was not mentioned in the transaction documents.[18] In short, the owner simply failed to present "strong proof" that the allocation should be disregarded. While *Muskat* does not change any of the substantive rules, it does point out how critical it is that the parties' agreement expressly set forth the desired tax treatment. An owner's unilateral attempt to alter the agreed treatment at a later date is almost always doomed to failure.

In 2010, the Tax Court decided another case in favor of the IRS despite arguably all of the facts but one (maybe two) arguing for another outcome. In *Kennedy v Commissioner,*[19] the assets of a benefits consulting business were sold in a transaction that was effected by three contracts, an asset purchase agreement, a consulting agreement, and an agreement for assignment of know-how and goodwill. This last agreement was carefully drafted with the advice of legal counsel and a tax advisor to document the sale of the owner's personal goodwill to the buyer of the business. Pursuant to the allocations set forth in these agreements, the owner reported 75 percent of the payments received from the buyer in his tax returns as personal goodwill taxable at capital gains rates. The IRS determined that the payments were not related to personal goodwill and should be taxed as ordinary income, and the court agreed.

As in *Muskat*, most of the criteria used in an analysis of the existence of personal goodwill were in favor of the owner: he did not have an employment agreement or a non-compete with the company, the business was one of personal services that the owner had built, he commanded loyalty from his customers that numbered less than 50, and the owner agreed to provide consulting services for the buyer after the transaction for five years. The transaction documents were drafted to contemplate payments to the owner expressly

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for personal goodwill, and the concept was part of the negotiations among the parties to the sale. However, the allocation to personal goodwill was not raised until several months after the transaction was first discussed and within a month of the closing.

The IRS made several arguments in support of its position including that: (1) the company owned the customer lists, and, without them, the owner could not transfer goodwill; (2) the owner could not prove he owned the goodwill because he provided no appraisal of the asset, and he did not have contracts with any clients; (3) even if the owner owned the goodwill, it was based on customer relationships that had no value unless he continued to perform services for them; (4) the owner did not own the goodwill, rather the company did, and it employed him; and (5) following substance-over-form, payments from buyers are for services or the noncompete.

As noted above, the court held that the taxpayer did not sell personal goodwill to the buyer; however, it did so for reasons other than those provided by the IRS.[20] Significantly, the court held that the burden of proof was on the owner and not the IRS because in order to shift the burden to the IRS, a taxpayer must meet substantiation and recordkeeping requirements that the owner did not contend they met.[21] The court then went on to conclude that the payments to the owner were for services rather than goodwill, citing a lack of economic reality to the allocation of payments to goodwill and calling the 75 percent allocation a "tax-motivated afterthought that occurred late in the negotiations, not grounded in any business reality and driven by a desire to minimize taxes.[22] Furthermore, the court noted that after the sale, the owner spent a significant amount of time at the business for which he was not compensated and found that the amounts paid would be reasonable compensation for the non-compete and his services provided for 18 months without compensation.[23] Since payments for a non-compete and services are both taxed as ordinary income, the court saw no need to allocate between the two.

The court distinguished the facts in this case from those in *Martin Ice Cream*, noting that in *Martin,* the party in question was the corporation and not the owner and that the court had no occasion to address how the owner should be taxed on the payments, inasmuch as the owner had no case before the court; therefore, the court was not called upon to opine on whether the payments should be treated as payments for services or payments for a capital asset.[24] If nothing else, *Kennedy* illustrates an important point: even where the parties agree on an allocation, the IRS may attack it, even though the taxpayers may not be able to disavow the allocation.

In a relatively short opinion issued by the Ninth Circuit Court in 2011, *Howard v United States*,[25] the court made it clear that when a business owner is party to an employment and non-competition agreement with his company, he does not own any personal goodwill to sell separately to a buyer that purchases the business. In *Howard*, the taxpayer sold his dental practice pursuant to a purchase agreement that specifically declared that the goodwill of the business represented a personal asset that was being conveyed by the owner. The court acknowledged that personal goodwill exists in theory and that where the success of a business depends entirely on the personal relationships of the practitioner, the practice does not generally accumulate goodwill.[26] However, the court also cited *Norwalk,* noting that a professional may transfer his or her goodwill to a practice by entering into an employment contract or a covenant not to compete with the business.[27]

In fact, the owner had entered into an employment agreement and had agreed to not compete with the company during his employment and for three years thereafter. The court rejected the owner's argument that these agreements were impliedly terminated when the purchase agreement was entered into and noted that, even if it accepted this argument, such a release would constitute a dividend payment to the owner, the value of which would be equivalent to the price paid for the goodwill.[28]

The most recent case decided regarding personal goodwill was *H&M, Inc v Commissioner. of Internal Revenue,*[29] in which the Tax Court issued a 2012 decision in favor of a taxpayer who had sold his insurance agency business in a transaction that did not appear to even mention personal goodwill. The company received a relatively small amount for the sale of its assets, while the owner received considerably more as compensation for his six-year employment agreement with the buyer. The IRS argued that some of these wages were actually payments to the company for the sale of its assets, specifically for the company's goodwill. The company argued that the payments should not be re-characterized, and, if they were, they would be goodwill of the owner and not the company. The court agreed with the owner, citing *Martin Ice Cream* for the existence of personal goodwill and *Norwalk* for the ability of an owner to transfer personal goodwill to a company by entering into a covenant not to compete or other agreement so that the owner's relationships become property of the company.[30] The court went on to conclude that the compensation payments were reasonable given his responsibilities and the personal goodwill that the owner brought to the buyer.[31] While this case did not make any obvious progress in defining the criteria used when analyzing personal goodwill, it is interesting to see that the most recent case is one in which the Tax Court affirmed some of its fundamental holdings regarding the existence of personal goodwill.

Conclusion

When contemplating the sale of a C corporation's business in an asset sale, the owner should consider the advantages of allocating a portion of the sale price to personal goodwill. In doing so, one should be mindful that if the IRS challenges the allocation, a court will not make its determination by balancing the criteria listed at the beginning of this article, rather each of the criteria must be met. Fail any one, and personal goodwill treatment is likely not to be available.

Of the criteria developed in *Martin* and its progeny, the easiest to evaluate is whether or not the owners have transferred ownership of any personal goodwill that exists to the company by entering into an employment or non-competition agreement with the company. This is a fact that is easy to determine, and, if there is such an agreement, it is clear that a court will side against a taxpayer who reports a portion of sale proceeds as being paid directly to him or her in exchange for personal goodwill. This was discussed by the Tax Court in *Martin Ice Cream*, made even more clear by that court in *Norwalk*, and has been mentioned by every court considering the issue since. Some hope was given to owners who have employment or non-competition agreements with their companies by the Tax Court in *Norwalk,* which still recognized the existence of personal goodwill where the agreements had been terminated over a year before the sale of the business. At the other extreme, in *Howard* the Ninth Circuit Court held that such agreements did not terminate automatically on the sale of a business. An unanswered question remains of how much time must elapse after the termination of such agreements and entering into a sale transaction.

As important to the determination of the existence of personal goodwill but less easy to evaluate is whether the owners are highly involved in the operation of the business, whether their personal relationships are critical to the company's success, and whether the business involves providing services. These factors go to the very definition of personal goodwill as something created by, and therefore owned by, the owners of a business. Although this is sometimes easy to demonstrate, as in the case of an accountant or dentist, it is not always the case. Consider the Tax Court in *Solomon,* which essentially disregarded the owners' customer relationships due to the buyer having a monopoly after the purchase of the business, leaving the customers with little other choice. One good way to help prove the value of such relationships is to have it quantified by an independent appraiser, which is discussed below.

Another critical criterion for taking advantage of personal goodwill in a transaction is to have the sale of personal goodwill by the owners clearly documented as part of the transaction. Fortunately, this is a relatively easy criterion to meet. The best way to do so is to have the transaction comprised of two separate sales, one of the assets of the company and the other a sale of personal goodwill by the owners. This can be done in a single agreement, but, if it is, the owners should be parties to the agreement, the allocation should be clearly stated, and the proceeds attributable to personal goodwill should be paid directly to them. The less certain aspect of this criterion is how early in the planning and negotiation stages must personal goodwill be considered as part of the transaction. The courts in *Muskat* and *Kennedy* discussed this in their analysis when deciding in favor of the IRS. It is worth noting that in each of these cases, the court referenced the negotiations as a way to stress the importance of another issue. In *Muskat*, where the taxpayer tried to take advantage of personal goodwill in an amended return filed four years after the transaction, the court pointed out that personal goodwill was not mentioned in the transaction documents or in the negotiations. In *Kennedy*, the Tax Court mentioned that personal goodwill became an issue late in the

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transaction negotiations as part of its discussion of how the allocation of 75 percent of the purchase price to personal goodwill was a tax-motivated afterthought not grounded in business reality. One comes away with the impression nonetheless that the court may not have had such a problem with the timing of the negotiations if the allocation had been more realistic.

This brings us to the criterion of having a reasonable allocation of purchase price between personal goodwill and the assets owned by the company. In *Kennedy,* the Tax Court believed that a 75 percent allocation to personal goodwill lacked economic reality. Similarly, the same court sided with the IRS in *Solomon,* where it found that personal goodwill in the form of customer lists had little value. Unfortunately, valuation is often based on assumptions, and ones made by the taxpayer are open to challenge. The best solution is for an owner or selling company to obtain a written appraisal by a qualified appraiser of the value of personal goodwill from an independent source. Many accounting firms are equipped to prepare such appraisals, and being armed with one will prove invaluable when defending the amount of purchase price allocated to personal goodwill. Keep in mind that the appraiser should have the right qualifications to minimize a successful challenge by the IRS. The downside to this is that such appraisals can be expensive and time consuming.

Many accounting firms are equipped to prepare such appraisals, and being armed with one will prove invaluable when defending the amount of purchase price allocated to personal goodwill.

The last criterion to consider is whether the owners entered into some kind of employment or consulting agreement with the buyer after the sale of their business. Courts have not placed much emphasis on this, but it would seem to be a critical component in the transfer of personal goodwill to the buyer. Since personal goodwill is the property of owners that is created in large part by their personal efforts and relationships, then its benefits must be transferred to the buyer to justify the consideration paid to the owners. If the owners do nothing for the buyer after the transaction closes, the buyer cannot expect to realize the benefit of something that is personal to the owners. Therefore, a commitment by the owners to provide services to the buyer for a period of time after the closing would seem to be critical to the analysis. Indeed, the Tax Court did cite the lack of such an employment or consulting agreement when it distinguished the facts in *Solomon* from those in *Martin Ice Cream* but did not place great emphasis on it for purposes of its decision.

Like most considerations when contemplating the sale of a business, whether to pursue a transaction where personal goodwill is a component comes down to a question of cost and benefit. An owner must determine if the possible tax benefits outweigh the likely higher transaction costs and the expense of obtaining an independent appraisal. However, before even attempting to address this question, an owner should make sure that the critical factors described above have been met.

NOTES

1. The corporation would be taxed on its gains, with a federal tax rate of 35 percent plus the Michigan Business Tax rate of 6 percent. The distribution to the shareholders would be taxable at a top federal rate of 20 percent plus the Michigan individual tax rate of 4.25 percent.

2. A limited liability company that has elected to be taxed as a corporation presents the same issues, unless an election to be treated as an S corporation was made. While many tax advisors recommend businesses operate as pass-through entities, (i.e., an S corporation, partnership, or limited liability company taxed as a partnership), there can be downsides to operating as an S corporation or partnership. For example, if a pass-through entity's debt is cancelled, e.g., in a bankruptcy proceeding, the equity owners generally must include the cancelled debt in income. *See* Treas Reg 1.108-9.

3. *Martin Ice Cream Co v Commissioner*, 110 TC 189 (1998).

4. *Id.* at 207.

5. *Id.* at 212.

6. *Id.* at 207.

7. *Norwalk v Commissioner*, TC Memo 1998-279.

8. IRC 336.

9. *Norwalk*. at 7.

10. *Id.* at 9.

11. *Solomon v Commissioner*, TC Memo 2008-102.

12. *Id.* at 11.

13. *Id.* at 10.

14. *Id.* at 9.

15. *Muskat v United States,* 554 F3d 183 (1st Cir 2009).

16. *Leslie S Ray Ins Agency, Inc v United States*, 463 F2d 210 (1st Cir 1972). Other courts follow the more stringent so-called *Danielson* rule, enunciated by the Third Circuit in *Commissioner v Danielson*, 378 F2d 771 (3rd Cir 1967). Under the *Danielson* rule, a taxpayer may not disavow an agreed allocation by parole evidence absent fraud, mistake, or duress.

17. *Muskat*. at 2.

18. *Id.* at 14.

19. *Kennedy v Commissioner*, TC Memo 2010-206.

20. *Id.* at 9.

21. *Id.*

22. *Id.* at 10.

23. *Id.*

24. *Id.* at 11.

25. *Howard v United States.,* No 10-35768, 2011 US App LEXIS 18092 (9th Cir Aug 29, 2011).

26. *Id.* at 2.
27. *Id.*
28. *Id.* at 7.
29. *H&M, Inc v Commissioner*, TC Memo 2012-290.
30. *Id.* at 7.
31. *Id.* at 8-9.

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Case Digests

Statute of Limitations for Open Accounts or Account-Stated Actions

Fisher Sand & Gravel Co v Neal A Sweebe, Inc, 494 Mich 543, 837 NW2d 244 (July 30, 2013). The four-year limitations period in MCL 440.2725 does not apply to open-account or account-stated actions, even when the underlying debt results from the sale of goods. An account-stated action is an action on a promise to pay a certain amount. An open-account action is a collection action on the single liability resulting from the parties' credit relationship. Both actions are distinct from the underlying transaction. Because MCL 440.2725 only applies to breach of contract actions for the sale of goods, open-account and account-stated actions are governed by the six-year limitations period in MCL 600.5807(8). The court of appeals thus erred in concluding that plaintiff's claims were time-barred under MCL 440.2725.

Agency—Unjust Enrichment

Bellevue Ventures, Inc v Morang-Kelly Inv, Inc, No 309743, 2013 Mich App LEXIS 1346 (July 30, 2013). Plaintiff, which sold used equipment under the name of a nonexistent corporation, had standing to sue for damages resulting from defendant's nonpayment for the equipment under an unjust enrichment theory. Although defendant claimed that the sale was made through an individual who was not defendant's agent, the individual held himself out as having authority, and defendant ratified this apparent authority by accepting the equipment. Even if the individual did not have authority, the trial court did not err in finding defendant liable under unjust enrichment, because inequity would result if defendant was permitted to retain the benefit it received from plaintiff without payment.

Secured Transactions—Enforcement

System Soft Techs, LLC v Artemis Techs, Inc, No 310091, 2013 Mich App LEXIS 1228 (July 16, 2013). In a dispute over enforcing a judgment for failure to pay for technology services, the trial court properly granted the bank's motion to intervene, quashing plaintiff seller's writs of garnishment and enjoining plaintiff from attempting to collect from defendant. The bank was a perfected, secured creditor with higher priority than plaintiff ("a mere judgment creditor") and had declared its loans to defendant in default, accelerated the balances owed, and entered into a forbearance agreement. UCC Article 9 does not require a secured party to foreclose, to order an account debtor to pay the secured party, or to enforce the claim by judicial procedure. Further, plaintiff's argument regarding the doctrine of marshaling was not ripe for review.

Taxation—Bad Debt Write-Offs

Menard Inc v Department of Treasury, No 310399, 311053, 311261, 311294, 312168, 2013 Mich App LEXIS 1507 (Sept 12, 2013). Plaintiff retailers entered into agreements with financing companies to issue private label credit cards (PLCC) and, in accordance with the terms of the agreements between the retailer and the financing companies, the retailer received reimbursement for the purchase and the applicable sales tax. When customers failed to pay the amounts owed on their PLCC, the financing company wrote off the bad debts, and plaintiff retailers also sought a refund of the sales tax attributable to the bad debt amount.

Pursuant to the plain language of MCL 205.54i and the rules governing taxation, the court of appeals held that plaintiff retailers were not entitled to such bad debt refunds. The plain language of the bad debt provision acknowledges that when the debt is paid, the taxpayer remains liable for remittance of the tax to the extent of the amount paid. In this case, consumers obtained the funds to pay for the goods through credit card lenders, and plaintiff retailers were paid in full in accordance with the reimbursement agreements for the goods, including the tax. Although MCL 205.54i does not define "person," the General Sales Tax Act defines "person" to include "municipal or private corporation whether organized for profit or not, company…." MCL 205.51(1)(a). Consequently, the payment of the bad debt by a third-party lender, an organized corporation, did not entitle retailers to a bad debt refund.

UCC-Breach of Warranty; Good Faith Obligation

Gorman v American Honda Motor Co, Inc, No 303005, 2013 Mich App LEXIS 1356 (Aug 6, 2013). Plaintiff brought an action asserting breach of warranty and other claims against defendants alleging that a motor vehicle she purchased from defendant was defective. Plaintiff bore the burden of establishing that defendants breached a written limited warranty, i.e., that during the period of the warranty defendants were notified of a defect that they failed to repair. Because plaintiff produced evidence that created only speculation and conjecture that defects disclosed to defendants during the warranty period went unrepaired, the trial court correctly granted defendants summary disposition on plaintiff's express warranty and implied warranty of merchantability claims. The trial court did not err by ruling that plaintiff failed to give defendants reasonable notice of her breach of warranty claims and that lack of notice provided an alternative basis that barred her breach of warranty claims. Because plaintiff's Michigan Consumer Protection Act (MCPA) claim was based on her breach of warranty claims—and the trial court correctly granted defendants summary disposition on those claims—the trial court also correctly granted defendants summary disposition on plaintiff's MCPA claim. Finally, Michigan does not recognize, nor does the UCC create, an independent cause of action for breach of the obligation of good faith it imposes.

UCC—Notice of Breach of Warranty

Bev Smith, Inc v Atwell, No 308761, 2013 Mich App LEXIS 1784 (July 18, 2013). In an action concerning the sale of a rare vintage 1965 race car, plaintiff's notice of breach sent more than three years after the execution of the bill of sale was not given within a reasonable time as required by UCC 2-607(3)(a). Thus, the trial court properly granted summary disposition on plaintiff's breach of contract claim. The trial court also properly granted summary disposition on plaintiff's fraud in the inducement claim because plaintiff possessed the means to discover the truth or falsity concerning defendant's representations but never inspected the vehicle.

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