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

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 (a) provides a forum to facilitate service and commitment and to promote ethical conduct and collegiality within the practice; (b) expands the resources of business lawyers by providing educational, networking, and mentoring opportunities; and (c) reviews and promotes improvements to business legislation and regulations.

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From the Desk of the Chairperson

By Tania E. (Dee Dee) Fuller

In this journey that I am taking as the Business Law Section chair, I have needed to learn more and more about our Section and about the State Bar of Michigan. Although I have been active in our Section for more than a decade, in recent months I have learned that my knowledge was limited. One of the things that amazed me is that there is so much going on everyday that most of us know nothing about.

As I expected, and you probably did too, the State Bar employs many people who provide services to its members. It has people who sit at the front desk, people who process bills, and even people who service the State Bar Web site. But in addition to the many people at the State Bar, I have learned that there are many services available to our Section members that I was simply not aware of, or, in some cases, I wasn't aware of the magnitude of what they did. For example, the State Bar has a Governmental Relations Director who keeps her finger on the pulse of the happenings in Lansing and in Washington D.C. It is her job to identify bills and issues that are being considered that may impact one or more sections of the Bar. If something is proposed that may reasonably impact one or more State Bar sections, our Governmental Relations Director attempts to make the affected sections aware of the proposal. From there, she attempts to find out if those particular State Bar sections want to support or oppose the proposed legislation. Sometimes different sections take opposing positions on the same matter, and it is Governmental Relations Director's job to work through those differences for the overall betterment of the State Bar. I have found that it is commonplace for the Business Law Section chair to receive frequent e-mail blasts from the Governmental Relations department in an attempt to give our Section a voice as laws are proposed.

The Governmental Relations Director is just one of many representatives from the State Bar available to serve our Section members. I suggest that you visit www.michbar.org to learn about some of the seemingly endless services that are available to us, including, but not limited to, individuals in the executive office, finance and administration office, information technology services office, member services office, and so much more.

While you are at the State Bar Web site, I also suggest that you look at the wealth of information available there relating to the Business Law Section and what we are doing. From the State Bar home page you: 1) click on the word "Sections" listed on the left; 2) select Business Law from the list of bar sections provided; 3) click on the word "go," . . . and you are there, at the Business Law Section Web page. Our Section Administrator does a great job keeping up our calendar and other materials on the site so that members receive up to date information about the Section's events and services. In my mind, however, the real jewels on the Business Law Section site are found in the past Michigan Business Law Journal articles and other educational materials that are available to each of us. These resources are provided in searchable PDF format so it is easy to find materials that are helpful as you navigate your way through the vast amount of data.

In the recent survey of our Business Law Section members, we learned that the Section's members seem to appreciate most the educational materials and seminars that the Section provides. Consequently, we are trying to find ways to provide more presentation materials to Section members, including printable seminar handout materials and streaming audio or MP3 downloads. We are hoping to begin providing these materials so they can be utilized by lawyers wanting a little extra instruction or even starting point information on a particular topic. Hopefully, once this service is functional, Business Law Section members who don't have the time or desire to attend Section sponsored educational and social events outside of their office can take advantage of these Section services from the comfort of their own office or home. Hopefully, you will hear more about these services in the months to come.

The bottom line is that there is a lot of information available to you as a member of the State Bar and the Business Law Section. Next time you have a few minutes, I suggest that you go to www.michbar.org to see what you have been missing. I hope you enjoy this issue of the Michigan Business Law Journal.

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Service of Process

Several statutes may apply to service of process on a corporation, limited liability company (LLC), limited partnership, or limited liability partnership, and there may be unique requirements applicable to foreign entities transacting business in the state. The organizational statutes, Revised Judicature Act (RJA), and MCR 2.105 contain information about service of process on corporations, limited liability companies, limited partnerships, and partnerships.

Agent for service of process

Domestic corporations, LLCs, and limited partnerships and foreign entities with a certificate of authority to transact business in the state are required to appoint and continuously maintain a resident and registered office in Michigan.[1] In addition, foreign partnerships registered as limited liability partnerships are also required to appoint and continuously maintain an agent for service of process, but domestic limited liability partnerships are not required to do so.

Foreign limited partnerships and LLCs are required in their application for authority to transact business to appointment the administrator[2] as their agent for service of process if the agent appointed under the act has resigned, the agent's authority has been revoked, or the agent cannot be found or served with the exercise of reasonable diligence.[3] In addition, MCL 450.5002 provides that by transacting business in this state without a certificate of authority, a foreign LLC appoints the administrator as its agent for service or process "with respect to a cause of action arising out of the transaction of business in this state."

A person who accepts election, appointment, or employment as a director or officer of a Michigan corporation organized under the Business Corporation Act or Nonprofit Corporation Act, or who was serving in that role when those acts were passed, is held to have appointed the corporation's resident agent as his or her agent for service of process.[4] A similar provision applicable to other Michigan corporations is in Public Act 156 of 1955, which provides that every director, manager, trustee, or other officer of any corporation organized under the laws of Michigan "shall be held, by acceptance or continuance, to have appointed the resident agent of such corporation as his true and lawful attorney in fact upon whom service of process may be made."[5]

Service of process on a corporation

MCL 600.1920 and MCR 2.105(D) provide for service of process on a domestic or foreign corporation by 1) serving an officer or the resident agent; 2) serving a director, trustee, or person in charge of an office or business establishment of the corporation and sending by registered mail, addressed to the principal office of the corporation; 3) serving the last presiding officer, president, cashier, secretary, or treasurer of a corporation that has ceased to do business by failing to keep up its organization by the appointment of officers or otherwise, or whose term of existence has expired; or 4) sending by registered mail to the corporation or an appropriate corporation officer and to the Bureau of Commercial Services if (a) the corporation has failed to appoint and maintain a resident agent or to file a certificate of that appointment as required by law, (b) the corporation has failed to keep up its organization by the appointment of officers or otherwise, or (c) the corporation's term of existence has expired. MCL 600.2582 requires a fee of $3 to be paid at the time service on a corporation is made by service on the Bureau of Commercial Services.

MCL 600.1920 contains special requirements applicable to insurers. It provides, "In all cases in which an insurer is a defendant, service shall not be made by leaving a summons and a copy of the complaint with a resident agent; and in cases in which a defendant is a foreign insurer, 2 summonses and a copy of the complaint shall be delivered to or mailed to the office of the commissioner of insurance by registered mail." MCR 2.105(F) contains a similar provision regarding service on an insurer made by serving the Commissioner of Insurance, as permitted by statute.

Service of process on unincorporated entities and individuals

The RJA and Michigan Court Rules contain specific provisions applicable to partnership associations, unincorporated associations, partnerships, and limited partnerships. Section 1917 of the RJA[6] and MCL 2.105(C) provide for service of process on a partnership or limited partnership by 1) serving any general partner; or 2) serving the person in charge of a partnership office or business establishment and sending a summons and a copy of the complaint by registered mail, addressed to a general partner at his or her usual residence or last known address.

MCR 2.105 (B)(4) provides for service of process on an individual doing business under an assumed name, by (a) serving a summons and copy of the complaint on the person in charge of an office or business establishment of the individual, and (b) sending a summons and a copy of the complaint by registered mail addressed to the individual at his or her usual residence or last known address.

Section 1923 of the RJA[7] and MCR 2.105(E) provide for service of process on a partnership association or an unincorporated voluntary association by 1) serving an officer, director, trustee, agent, or person in charge of an office or business establishment of the association; and (2) sending by registered mail, addressed to an office of the association. If an office cannot be located, a summons and a copy of the complaint may be sent by registered mail to a member of the association other than the person on whom the summons and complaint was served. MCL 450.4102 defines "limited liability company" as an unincorporated membership organization formed under the Michigan Limited Liability Company Act, and these provisions appear to be applicable to LLCs as

unincorporated membership organizations.

Public Act 686 of 2002 added subsection 4 to section 207 of the Michigan Limited Liability Company Act to provide a method for service on an LLC when the agent cannot be found. It provides "If a limited liability company fails to appoint or maintain an agent for service of process, or the agent for service of process cannot be found or served through the exercise of reasonable diligence, service of process may be made by delivering or mailing by registered mail to the administrator a summons and copy of the complaint."[8]

Service of process on public bodies

Service of process on a public, municipal, quasi-municipal, or governmental corporation, unincorporated board, or public body is addressed in section 1925 of the RJA[9] and MCR 2.105(G). Some entities that are organized as nonprofit corporations have characteristics of public corporations and may be treated as governmental entities for some purposes. For example, public school academies,[10] redevelopment corporations formed pursuant to the Urban Redevelopment Corporations Law,[11] and nonprofit corporations formed by home rule cities have characteristics of both private nonprofit corporations and governmental corporations.

Section 501 of the Revised School Code provides that a public school academy is a public school, a body corporate, and a governmental agency.[12] However, section 502 of the Revised School Code provides "A public school academy shall be organized under the nonprofit corporation act" but is not required to comply with the educational corporation provisions of the General Corporation Act.[13]

MCL 117.4n permits a city to provide in its charter for the city or one or more of its public corporations to become a member or joint owner in an enterprise with a private nonprofit corporation to create a nonprofit corporation to establish, operate, or maintain a medical facility for a public purpose. MCL 117.4o permits a home rule city to form a nonprofit corporation for purposes that are valid public purposes for cities. Except as otherwise provided in MCL 117.4o, a nonprofit corporation formed by a city is subject to all local, state, and federal laws and ordinances that apply to the city that authorized its formation.

Service of process on a public, municipal, quasi-municipal, or governmental corporation, unincorporated board, or public body may be made by serving 1) the chairperson of the board of commissioners or the county clerk of a county; 2) the mayor, the city clerk, or the city attorney of a city; 3) the president, the clerk, or a trustee of a village; 4) the supervisor or the township clerk of a township; 5) the president, the secretary, or the treasurer of a school district; 6) the president or the secretary of the Michigan State Board of Education; 7) the president, the secretary, or other member of the governing body of a corporate body or an unincorporated board having control of a state institution; 8) the president, the chairperson, the secretary, the manager, or the clerk of any other public body organized or existing under the constitution or laws of Michigan, when no other method of service is specially provided by statute. In addition, service may be made on an officer having substantially the same duties as those named or described above, irrespective of title. Service may be made by a person in charge of the office or an officer on whom service may be made and sending a summons and a copy of the complaint by registered mail addressed to the officer at his or her office.

Locating parties

Knowing the correct name of a business and the manner in which it is organized may be important in determining the appropriate steps required to obtain service. Business Entity Search www.michigan.gov/entitysearch can be used to search for corporations, limited partnerships, and LLCs. It does not include records for insurance companies, banks, municipal corporations, public bodies, sole proprietorships, or partnerships. The absence of a record may mean that the entity is not required to file with the Corporation Division. An individual carrying on business under an assumed name files a certificate with the county clerk in the county where business is conducted.

Corporate, LLC, and limited partnership names are required to contain a required word that denotes the entity as a corporation, LLC, or limited partnership.[14] However, there is no statutory provision to prevent entities that have not organized as such from using those words or abbreviations. Under section 2140 of the RJA, "evidence that such corporation, company, or association is doing business under a certain name shall be prima facie proof of its due incorporation or existence pursuant to law, and of its name."[15]

A corporation, limited partnership, or LLC may conduct business under one or more assumed names, and a required word is not required in an assumed name. In addition, a foreign corporation, limited partnership, or LLC may obtain a certificate of authority to transact business in Michigan under a qualifying name if the entity's true name is not available for use in Michigan.

If no record is found for an entity formed in another jurisdiction, the entity may still be subject to Michigan law. The Business Corporation Act, Nonprofit Corporation Act, and Michigan Limited Liability Company Act[16] provide that the provisions related to transacting business and conducting affairs do not apply in determining the contacts or activities that may subject a foreign corporation or foreign LLC to service of process or taxation in this state or to regulation under any other act of this state. Sections 711, 715, 731, and 735 of the RJA describe contacts and activities that may subject an entity to jurisdiction in Michigan even when no certificate of authority is required.

Organizational statutes, the RJA, and MCR 2.105 provide essential information for determining the steps

necessary to obtain service of process on a business. If service is made on a corporation by mailing to the corporation and to the Bureau of Commercial Services, be sure to include the $3 statutory fee. No fee is required, however, when service is made on an LLC by mailing to the Bureau of Commercial Services. The only time the agency forwards a summons and complaint is when it is sent to the Bureau as agent for a foreign limited partnership or foreign limited liability company.

NOTES

1. MCL 450.1241, 450.2241, 450.4207, 449.1105.
2. Department of Energy, Labor & Economic Growth.
3. MCL 449.190 and MCL 450.5002.
4. MCL 450.1246 and MCL 450.2246.
5. MCL 450.1122 and MCL 450.2122 provide that 1955 PA 156 is not applicable to a "corporation" as defined in MCL 450.1106 and MCL 450.2106, respectively.
6. MCL 600.1917.
7. MCL 600.1923.
8. MCL 450.4207(4).
9. MCL 600.1925.
10. Often referred to as charter schools.
11. MCL 125.901-125.922.
12. MCL 380.501.
13. MCL 380.502.
14. MCL 450.1211, 450.2211, 450.4204, 449.1102.
15. MCL 600.2140.
16. MCL 450.2012, 450.3012, 450.5008.

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 By Paul L.B. McKenney and Thomas H. Bergh

2010 Estate Planning's Great Uncertainty – What to Do?

Because of what may charitably be described as congressional mismanagement, estate planners and their clients are presented in 2010 with the "Great Uncertainty." For the first time since 1916 there is no federal estate tax, but with that fact come significant questions about what retroactive changes might be forthcoming, along with the likelihood of similarly situated estates being taxed under completely different regimens depending on the date of death. The genesis of this unfortunate state of affairs was the 2001 Tax Act. While that legislation was viewed as generally taxpayer friendly because the federal estate tax exemption equivalent was gradually raised and the rates lowered in increments, there was a major caveat. To avoid recognizing the massive revenue loss under the then budget scoring rules, the legislation was scheduled to sunset in 2011, leaving only one year, 2010, of no estate tax (as well as no generation skipping transfer ("GST") tax.).

Given the obvious problems with this approach, since the passage of the 2001 act, it had been assumed that Congress would put in place a "permanent fix" and that the one-year repeal would never come to pass. After years of inaction, in December 2009, the U.S. House of Representatives passed a bill making the 2009 $3.5 million estate tax and GST exemption and the 45 percent rates permanent. However, the U.S. Senate, preoccupied with health care legislation, failed to act. Thus, as of February 2010, there was no estate tax or GST. It is considered a 50/50 coin toss whether congress will enact a patch this year; the political considerations come from those who would lessen the estate tax rates versus those who, if Congress does nothing, will see the 55 percent pre-2001 Tax Act estate and GST rates and the lower $1 million exemption regime become permanent in 2011. President Obama's February 1, 2010 budget proposal assumes the 2009 regime becomes permanent. However, last year the administration's budget proposal made the same assumption.

There is also considerable discussion if Congress enacts legislation reinstating the estate tax for 2010 whether it will have retroactive effects. While the majority view of commentators is that retroactive legislation would be upheld, predicated on *United States v Carlton*, 512 US 26 (1994), the issue is not without doubt. Timing is also a major issue. For example, on a death in the first quarter of 2010 before any retroactive legislation, the estate tax return would not be due until the fourth quarter of 2010. The likely Tax Court Petition would be filed three years later, and a tax court decision would probably be circa 2015. By the time the Supreme Court ultimately decides the retroactive enactment issue, it would be a few years after that.

What Do I Do With My Clients?

The consensus is that there is no one size fits all solution in advising clients how to deal with the mess that has resulted from the 2001 act. Each situation is different, and in less tax sensitive situations no action may be required. Residents of Michigan are also at an advantage because there is no state estate or inheritance tax, although clients with residences or real property in other states should review their exposure to such taxes in those states. Our firm and numerous others have sent out newsletters advising clients of these events and suggesting a meeting or summary review to address client concerns If you decide to do the same, your carrier would probably prefer that you retain documentation to show who that information was sent to as well as its contents.

Where The Rubber Meets The Road

The key problem with the repeal of the estate tax is that for decades estate planners have out of necessity used tax terms with Internal Revenue Code defined meanings for subtrust funding and many other purposes. For example, in 2009, a funding provision in the trust of a high net worth individual might leave a bypass trust for children equal to the largest amount that could pass federal estate tax-free, and the balance to the surviving spouse. In 2009, this would have resulted in the children receiving in the aggregate a total of approximately $3.5 million, with the balance passing to the surviving spouse. However, with no federal estate tax in 2010, a literal interpretation could be the children inherit everything and the spouse nothing. Of course, it may be relatively easy to convince a court that this result was not intended by the decedent, but proactively providing a formula that matches that intent is a much better (and from the client's perspective a simpler and cheaper) approach.

Let us add a common situation to the above example. This is a second (or third marriage), and the children are from the decedent's prior marriage. What about a GST trust keyed to the maximum GST exemption amount, and a 2010 death with no GST? The "litigation breeder" aspects are readily apparent.

Solutions

There is some understandable client reticence to amending documents for the one-year only problem. Several state legislatures, including the Michigan Legislature, are considering a statutory fix based on the Virginia model, which would provide a default construction of an instrument using tax-based formulae under the pre-2010 Code. This one size-fits-all approach may contain the seeds of other problems. Another potential solution being utilized in Florida and possibly other states is an agreed upon probate court order construing common formulae terms to the pre-2010 Code. Assuming the beneficiaries would agree, a problem with "friendly" probate court orders is that they are subject to attack by the

IRS as not the result of arms-length settlement or litigation under the U.S. Supreme Court's decision, *Estate of Bosch,* 387 US 456 (1967). At this time, there is some consideration of Michigan adopting a Virginia-like 2010 legislative patch for the construction of testamentary instruments. Stay tuned.

Disclaimers

Disclaimers have been a very effective post-mortem planning tool as they expressly permit a post-death second look. Depending on what Congress does or does not do, there will be an unprecedented number of disclaimers under IRC 2518 filed this year. The problem with disclaimers is that they have to be acted upon within nine months of the date of death to be effective for federal estate tax purposes, and the validity of any reinstatement of the federal estate tax will not be resolved for many years.

Lifetime Gifts

The gift tax continues in effect today. However, the maximum rate on taxable gifts is presently only 35 percent. It is recommended that annually gifting clients at least continue to make annual exclusion gifts. GST is an issue as the automatic allocation rules are not in effect today since the GST tax does not exist either, it is not clear what, if any, role the concepts of allocation for current gifts have.

Introduction of Post-Death Carryover Basis

For decades, under IRC 1014, there has been an income tax step-up in basis of assets at death. For example, a taxpayer bought stock for $10 and owned it in his or her individual name. At the time of death, when it was worth $50, the estate, the successor of the decedent, took a new $50 income tax basis. During the Carter administration, Congress repealed the step-up in basis at death rules and instituted a carryover basis regime. That meant that a trust, estate, or beneficiary received the interest with the deceased's income tax basis, subject to some minor modifications. Congress then promptly retroactively repealed the carryover basis at death regime as an administratively unworkable fiasco. It was fairly called far worse.

As of today, a new modified carryover basis regime is in effect. See IRC 1022. There are special rules allowing a $1.3 million increase to the basis of a decedent's assets, with a potential additional $3 million increase for surviving spouses. See IRC 1022(b)(2)(B) and (c)(2)(B). There are obvious problems for fiduciaries when funding devises regarding:

- Who receives the high and low basis assets? and
- How to allocate the artificial $1.3 million basis step-up amongst various assets?

Fiduciary Issues

The biggest problem for the fiduciary is creating winners and losers among the beneficiaries on the distribution of assets in 2010's distorted tax landscape. First, how does a fiduciary decide which beneficiary receives a high, or low, basis asset? Second, how is the arbitrary $1.3 million basis step-up allocated? Third, fiduciaries are on proverbial thin ice in giving tax advice to beneficiaries.

The biggest question for many fiduciaries is—does the fiduciary need to retain cash to pay a retroactively enacted federal estate tax? Some beneficiaries will insist on a prompt distribution of assets before Congress can readopt the estate tax and GST. Fiduciaries are well-advised to revise their pre-acceptance checklist to look at issues spawned by 2010's historic and bizarre death tax landscape.

Conclusion

First, you need to communicate with your clients and document that action. Second, selectively consider the wisdom of 2010 patches to wills and trusts to effectuate a given client's intent. There is no boilerplate solution to this congressional mismanagement. As noted above, the validity for any retroactive reinstatement of the federal estate tax and GST will not be finally adjudicated for many years. Good luck, and stay alert for developments in this area.

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Proof of Claim: Whether to File, and If So, How to File

By Judy B. Calton, Rozanne M. Giunta, and Adam D. Bruski

Introduction

With the dismaying increase in bankruptcies nationally, and in Michigan in particular, this article addresses the mechanics of and certain issues in filing proofs of claim in bankruptcy, so that the business lawyer can determine whether to assist his or her client in preparing and filing proofs of claim or whether to involve a bankruptcy lawyer in the process.

A proof of claim provides the economic basis for a creditor's participation in the bankruptcy case. With limited exceptions, the creditor must file a proof of claim to receive a distribution from the estate. Moreover, the claim must meet certain requirements to overcome an objection. With the advent of electronic case filing, the mechanics of filing proofs of claim have changed. Moreover, it is now common in large cases for claims agents to be appointed and special procedures unique to each case established for filing proofs of claim.

The consequences of filing a proof of claim need to be considered when deciding to file a claim. Some creditors should decide not to file claims to preserve jurisdictional and other defenses or rights.

What Is a Claim

The Bankruptcy Code[1] ("the Code") defines claim in the broadest way. A "claim" means:

> 1. right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
>
> 2. a right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.[2]

A debtor in a bankruptcy case has the duty to file a matrix with the names and addresses of the debtor's creditors at the time a voluntary petition is filed, or fourteen days after entry of the order for relief in an involuntary case.[3] This matrix provides the mailing list the bankruptcy court uses to give creditors notice of the commencement of the bankruptcy case, the deadline to file proofs of claim and, in many cases, a copy of the proof of claim form.

The debtor also has the duty to file schedules of its liabilities within fourteen days after the order for relief.[4] The debtor is supposed to schedule the name and address of each creditor and dollar amount owed to the creditor.

The debtor can schedule any liability as contingent, unliquidated, or disputed simply by placing a mark in a box, with no explanation as to the nature of the dispute or a reason why the claim is deemed contingent, unliquidated, or disputed.

These papers filed by the debtor do not constitute a proof of claim. The filing of a claim requires an affirmative act by the creditor.

When Filing of the Proof of Claim Is Required

In General

As summarized below, with certain exceptions in Chapter 9 and Chapter 11 cases, a creditor must file a proof of claim to receive a distribution from the estate.[5]

Chapter 7 Liquidation Cases

A creditor in a Chapter 7 case must file a proof of claim to receive a distribution regardless of how it is scheduled.[6] There is a federal rule establishing a national deadline for when the Chapter 7 claim must be filed: "not later than 90 days after the first date set for the meeting of creditors called under § 341(a) of the Code."[7] Because the deadline runs from the "first date set" for the § 341 meeting, subsequent adjournments or continuances of the meeting will not extend the deadline for proof of claims. The § 341(a) meeting is to be scheduled between 20 and 40 days after the order for relief.[8] Because the date of the § 341(a) meeting varies in every case, the

deadline for filing proofs of claim similarly varies, to be between 110 and 130 days after the order for relief. A notice is mailed to the debtor, the trustee, and creditors and indentures giving at least 20 days notice of the § 341 meeting.[9] The notice is on Official Form 9, which provides an exact date by which the claim must be received.

If the Chapter 7 case is filed as a no-asset case, the notice to creditors tells them that the notice of deadline will be sent at a later time.[10] Some jurisdictions bar the filing of a claim in a no asset case.

If a creditor filed a proof of claim in the debtor's Chapter 11 or Chapter 13 case, and the case is subsequently converted to Chapter 7, the creditor does not need to file a new proof of claim but can rely on its previously filed claim.[11] The creditor, however, cannot rely on appearing in the debtor's schedules to obtain a distribution. It must file a proof of claim.

Chapter 9 Municipal Cases

A Chapter 9 debtor is required to file a list of creditors.[12] That list is used to create the mailing list to creditors.[13] There is no express requirement for a Chapter 9 debtor to file schedules as in the other chapters.[14] The only express required listing of claims is the list of 20 largest creditors in the case.[15] Nevertheless, the claims on the list required by Section 924 are treated as if they were filed proofs of claim for any claim that is not listed as disputed, contingent, or unliquidated.[16] Thus, there is no need for any Chapter 9 creditors who agree with how they are scheduled to file a proof of claim.

Unlike Chapter 7 cases, there is no federal rule establishing the deadline for filing proofs of claim in Chapter 9 municipal cases. The court sets the deadline on a case by case basis.[17]

Chapter 11 Reorganization Cases

A debtor in bankruptcy, other than a debtor in a Chapter 9 municipal bankruptcy, is required to file schedules of assets and liabilities that describe the claims against the debtor.[18]

In a Chapter 11 reorganization case, a creditor whose claim is scheduled as not disputed, contingent, or unliquidated, and who agrees with what is scheduled does not need to file a proof of claim, but can rely on those schedules.[19] In all other situations, the Chapter 11 creditor *must* file its proof of claim to receive a distribution.

Unlike Chapter 7 and 13 cases, where there is a national deadline for filing proofs of claim, in Chapter 11 cases, the deadline is set on a case by case basis.[20] The Bankruptcy Court for the Eastern District of Michigan, however, has a local rule establishing 90 days after the date first set for the § 341 meeting as the deadline for filing claims.[21]

Chapter 12 Family Farmer Cases

In a case under Chapter 12, as in Chapter 7 cases, the deadline for filing prepetition claims against the estate of the debtor is 90 days after the first date set for the meeting of creditors required by section 341 of the Code.[22] The creditor must file a proof of claim to receive a distribution.

Chapter 13 Individual Debt Adjustment Cases

In a case under Chapter 13, as in Chapter 7 cases, the deadline for filing prepetition claims against the estate of the debtor is 90 days after the first date set for the meeting of creditors.[23] The creditor must file a proof of claim to receive a distribution.

Exceptions to the Deadlines

The rules setting the deadlines for filing claims also provides for certain exceptions. The more common are:

- A claim by a governmental unit is timely filed if done within 180 days of the date of the order for relief.[24]
- The deadline may be extended for infants or incompetents.[25]
- A claim arising from the rejection of an executory contract or unexpired lease may be filed in such time as the court may direct.[26]

Late Filed Claims

A claim that is filed late, either according to the deadlines set forth in the Bankruptcy Rules or according to a deadline established by the court, is subject to disallowance under Section 502(b)(9).[27] A hearing by the court is not required to disallow a claim on the basis of untimeliness.[28]

However, the United States Supreme Court provided tardy filers with at least the possibility of a reprieve in *Pioneer Inv Servs Co v Brunswick Assocs Ltd P'ship*, 507 US 380 (1993). In that case, the court determined that Bankruptcy Rule 9006(b)(1) allows a bankruptcy court to permit a late filing on a showing that the error was a result of "excusable

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neglect."[29] In determining what was sufficient to constitute excusable neglect, the court noted that the issues were equitable and should take into account "all relevant circumstances surrounding the [creditor's] omission."[30] Specifically, the court looked at "the danger of prejudice to the debtor, the length of the delay and its potential impact on judicial proceedings, the reason for the delay, including whether it was within the reasonable control of the [creditor], and whether the [creditor] acted in good faith."[31]

Pioneer Inv Servs Co involved a tardy claim filed in a Chapter 11 proceeding. Rule 9006 contains references to specific deadlines that the court cannot enlarge.[32] Among the deadlines that cannot be enlarged is the rule that sets the 90-day claims deadline for Chapter 7, 12, and 13 proceedings.[33] Therefore, for those cases, the proof of claim deadline is not subject to the same leeway as in a Chapter 11. However, it is important to note, as described above, the Chapter 7, 12, and 13 proof of claim deadline has its own specific set of exceptions that allow for variance under certain circumstances.[34]

There is no federal requirement that the proof of claim be served on the trustee, the debtor, or any other party, although local rules may require such service.

The Mechanics of Filing

The Official Form

A proof of claim should conform substantially to Official Form 10.[35] This form is often distributed to creditors as part of the materials they receive in connection with the notice of the debtor's bankruptcy petition. It can be obtained from either the court itself or the Web site of the federal courts' administrative office.[36] The basics of the form are that it asks the creditor to identify itself and the debtor and the amount of the claim. It further asks the creditor to classify its claim depending on whether the claim is unsecured, secured, or entitled to priority under one of the provisions of 11 USC 507(a). Note also that Official Form 10 states that it should not be used to make a claim for an administrative expenses arising after the commencement of the case and that request for such expenses should be filed pursuant to 11 USC 503.

Customized Forms in Chapter 11 Cases

It has become the practice in large Chapter 11 cases for the debtors to seek and obtain an order establishing specialized procedures and customized forms for filing proofs of claim. Rule 3001 requires only that a proof of claim be "a written statement setting forth a creditor's claim" and that such statement "conform substantially" to the official form.[37] Sometimes the customization is as basic as the name of the court being prefilled at the top or including the name of the debtor or a selection box to check the appropriate debtor entity in jointly administered cases. However, in other instances, the actual use of the form can be modified if approved by the court. For instance, while, as noted above, Official Form 10 itself specifically disallows its use for the filing of administrative expense claims, in certain recent cases, the form has been specifically modified to allow its use as a means of asserting certain administrative claims. For example, in the Chrysler bankruptcy, the form for prepetition claims also specifically allowed assertion of section 503(b)(9) claims and rejected executory contract damages.[38]

Filing with the Court

In General

Claims can be filed with the court in one of two general ways. The first is via the federal courts' electronic case filing system ("ECF"). The second is by paper, delivered to the court in person, or by US mail or courier service. There is no federal requirement that the proof of claim be served on the trustee, the debtor, or any other party, although local rules may require such service.

ECF

The default method for filing all papers with the bankruptcy courts since 2005 is through use of ECF. For instance, in the Eastern District of Michigan, the local rule states that "[a]ll paper shall be filed using the ECF procedures."[39] The Web site interface for the ECF system allows a creditor to enter the information for its claim and upload supporting documentation electronically. Because the filing is electronic, the court will accept a photocopy or facsimile of the creditor's original signature, so long as the filer maintains the original signature in its files.

ECF Exceptions

There is an exception in the ECF Administrative Procedures for bankruptcy courts in both districts of Michigan for people who are not users of the ECF system, which allows them to file a paper proof of claim.[40] This opt-out provision will generate some paper claims. However, the bulk of the non-ECF claims filing comes as a result of court-ordered procedures that direct creditors to file their claims by mail.

The most common occurrence of such a directive is in larger cases where the court appoints a claims and noticing agent for the debtor. These third-party providers specialize in the receipt and processing of voluminous numbers of claims. The court-issued notice for filing claims will inform creditors of the address to which they should submit their claims. The claims are then processed by the claims agent and made available to both the debtors and (usually) to the creditors through access to an online database that will show the amount and nature of the claims asserted by each creditor. A check of this Web site and inclusion of a second claim copy to be time-stamped and returned to the creditor are good methods to ensure that a claim was received by the agent.

The claims agent typically does not accept proofs of claim electronically. Thus, when filing proofs of claim with a claims agent, the claim must bear the original signature of the creditor and be sent sufficiently in advance of the bar date to be received by the bar date. Mailing prior to the deadline is insufficient if the claim is actually received after the deadline.[41]

Signing the Proof of Claim

A proof of claim is signed under penalty of perjury.[42] Presenting a false proof of claim against a bankruptcy estate can be criminal bankruptcy fraud.[43] Moreover, Bankruptcy Rule 3001(b) requires the creditor or the "creditor's authorized agent" to execute the proof of claim.[44] Because of the potential criminal liability for presenting a false claim, it is prudent for the attorney to have the client sign the claim. If the attorney is going to sign the claim on behalf of the client, the attorney should have the authorization to execute the claim documented, whether in a power of attorney or otherwise.[45]

Necessity of Supporting Documentation

A proof of claim filed and executed in accordance with the rules is *prima facie* evidence of the validity and amount of the claim.[46] Thus, a filed proof of claim is deemed allowed unless an objection is filed to it.[47] To be able to overcome an objection, a claim based on documentation must have that documentation submitted with the claim. Such documentation often takes the form of contracts, invoices, shipping records, and other primary materials. However, it is also acceptable to submit summaries of the information comprising the claim—for instance, an accounts receivable listing.[48] The Bankruptcy Rules require that:

> [w]hen a claim, or an interest in property of the debtor securing the claim, is based on a writing, the original or a duplicate shall be filed with the proof of claim. If the writing has been lost or destroyed, a statement of the circumstances of the loss or destruction shall be filed with the claim.[49]

Further, if the creditor is asserting a secured claim, it is necessary to provide proof of the perfection of that security interest.[50] The failure to include the supporting documentation is grounds for disallowance of the claim.[51]

Should the Client File a Proof of Claim?

In General

Except in limited circumstances in Chapter 9 and Chapter 11 cases where a creditor agrees with how its claim is scheduled, the creditor must file a proof of claim to receive any distribution. The filing of a proof of claim, however, should not be a knee-jerk reaction, but instead should involve the weighing of the detriments to filing a claim against the likelihood of receiving a distribution, and the size of that potential distribution. These potential detriments are summarized below.

Submission to Bankruptcy Court Jurisdiction

Bankruptcy court personal jurisdiction over a party is rarely an issue because minimum contacts with the United States, as opposed to contacts with the state in which the bankruptcy court sits, are sufficient to give the bankruptcy court jurisdiction over the party.[52] Thus, the bankruptcy court has jurisdiction over a domestic creditor regardless of whether the creditor submits a proof of claim and waives the jurisdictional defense.

A foreign creditor, however, may not have the aggregate minimum contacts sufficient for the bankruptcy court to exercise jurisdiction over it. In such a case, the filing of a proof of claim would be consent to the personal jurisdiction of the bankruptcy court.[53]

Waiver of Jury Trial Rights/Waiver of Ability to Have Case Tried By District Court

Unless the right to a trial by jury is expressly granted by statute, a jury trial right is governed by the Seventh Amendment to the

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United States Constitution. There is no statutory grant of the right to trial by jury in bankruptcy proceedings.[54] The United States Supreme Court has established that the right of a creditor to trial by jury in an action brought by a trustee "depends on whether the creditor has submitted a claim against the estate."[55] If the creditor files a claim, the action involves the public right of the claims allowance/disallowance process for which the creditor has no jury trial right.[56] Thus, the filing of a proof of claim can be a waiver of a jury trial right.

The loss of the jury trial right can also lead to the loss of the creditor's right to have the reference of the proceeding withdrawn from the bankruptcy court so the action can be tried in the district court. A bankruptcy judge can only conduct a jury trial if both parties expressly consent.[57] If the creditor will not consent to the bankruptcy court conducting the jury trial, the inability of the bankruptcy court to try a case can be grounds for withdrawal of the reference to have the case tried in the district court.[58] Thus, waiving a jury trial right by filing a proof of claim could also be waiver of the ability to have the case tried in the district court instead of the bankruptcy court.

The likelihood of a cause of action being asserted against the creditor and the value of a jury trial or conduct of the trial by the district court in such action should be considered before any claim is filed.[59]

While the advantages of selling the claim are clear, the detriments should also be considered.

Waiver of Sovereign Immunity

A detailed discussion of the scope of sovereign immunity in bankruptcy is outside the purview of this article.[60] In any event, the Bankruptcy Code provides that when a governmental unit files a proof of claim, it is deemed to have waived sovereign immunity with respect to a claim by the estate against the governmental unit that arose out of the same transaction or occurrence out of which the governmental unit's claim arose.[61] Similarly the filing of a claim could waive other governmental jurisdictional defenses. [62]

Risk of Capping Ability to Collect Lease Rejection Damages

The Bankruptcy Code caps the claim of a lessor for damages resulting from the termination of a lease according to a formula essentially of the greater of one year's rent or 15 percent of the rent for the remaining term of the lease.[63]

If the debtor lessee has posted a letter of credit as security for its lease obligations, the draw on the letter of credit reduces the debtor's obligations on the capped lease rejection damages claim.[64] On the other hand, if the lessor does not file a proof of claim, its ability to draw on the letter of credit security deposit is not limited by the formula capping lease rejection damage claims.[65] Thus, if the letter of credit amount exceeds the capped formula, the lessor would be better off foregoing filing a proof of claim and drawing on the letter of credit.

Selling the Client's Claim

In the last several years, a major market has grown for trade in distressed debt. Once the debtor has filed the schedules listing its liabilities, scheduled creditors in major cases can expect to receive offers to purchase their claims from claims buyers. These offers present the opportunity for the client to turn its claim into immediate cash of a known amount, instead of holding the claim for an unknown amount of time before the client will receive an unknown distribution. In addition to obtaining liquidity by selling its claim, the creditor can establish a tax loss or meet regulatory, accounting, or auditing requirements.[66]

While the advantages of selling the claim are clear, the detriments should also be considered.

The typical claims purchase agreement provides for the seller to warrant the validity of the claim and to indemnify and hold the purchaser harmless if there is an objection to the claim.[67] Thus the claims seller needs to assess the odds of an objection to the claim being filed and the costs of paying the purchaser's attorneys to defend the claim. For example, if the seller's proof of claim amount exceeds the scheduled amount, the odds of an objection being filed to reduce the claim to the scheduled amount are high.

Further, if a preference or fraudulent transfer avoidance action is brought against the seller, the action is bound to include a count that the claim should be disallowed under 11 USC 502(d). While there is authority that disallowance under 11 USC 502(d) does not apply to a holder of a claim who has purchased the claim, that authority is controversial and has not yet been adopted by other courts.[68]

Conclusion

The filing of a proof of claim is a creditor's ticket to participate in the debtor's bankruptcy proceedings. Once the decision is made that filing a claim is in the creditor's best interests, the practitioner assisting a client must pay special attention to the specific procedures and deadlines applicable to each individual case. As lateness or improper filing are the most common objections raised by debtors, the business attorney representing a creditor should give serious consideration to consultation with a bankruptcy practitioner if he or she has any questions or concerns regarding the process.

NOTES

1. The Bankruptcy Code is Title 11 of the United States Code, 11 USC 101 *et seq.*

2. 11 USC 101(5).

3. Fed R Bankr P 1007(a)(1), (2).

4. Fed R Bankr P 1007(b)(1)(A).

5. There is also a split in authority as to whether the failure to file a proof of claim asserting setoff rights is a waiver of the setoff rights, even though setoff does not seek a distribution from the estate, but reduces liability on a claim asserted against the creditor by a debtor. *Compare In re Britton,* 83 BR 914, 918 (Bankr ED NC 1988) (failure to file setoff proof of claim is waiver of setoff right) *with In re Davidovich*, 901 F2d 1533, 1539 (10th Cir 1990) (failure to file a proof of claim does not waive setoff right).

6. Fed R Bankr P 3002(a).

7. Fed R Bankr P 3002(c).

8. Fed R Bankr P 2003(a).

9. Fed R Bankr P 2002(a)(1).

10. Fed R Bankr P 2002(e).

11. Fed R Bankr P 1019(3).

12. 11 USC 924.

13. Fed R Bankr P 1007(a)(1).

14. Fed R Bankr P 1007(b)(1). A Chapter 9 municipal debtor is not required to file the schedule of claims against the debtor because 11 USC 521 is not applicable to Chapter 9 of the Bankruptcy Code. 11 USC 901(a).

15. Fed R Bankr P 1007(d).

16. 11 USC 925.

17. Fed R Bankr P 3003(c)(3).

18. 11 USC 521(a)(1)(B)(i); Fed R Bankr P 1007(b)(1)(A).

19. Fed R Bankr P 3003(c)(2).

20. Fed R Bankr P 3003(c)(3).

21. Bankr ED Mich LR 3003-1. This deadline also applies to requests for payments under 11 USC 503(b)(9).

22. Fed R Bankr P 3002(c).

23. Fed R Bankr P 3002(c).

24. Fed R Bankr P 3002(c)(1).

25. Fed R Bankr P 3002(c)(2).

26. Fed R Bankr P 3002(c)(4). Usually the time is set as the later of the claims bar date or 28 days after the date of the rejection.

27. *See United States, IRS v Chavis (In re Chavis)*, 47 F3d 818 (6th Cir 1995) (finding a timeliness requirement for allowance of a claim, even prior to enactment of Section 502(b)(9), especially in Chapter 13 cases).

28. *In re Greenig,* 152 F3d 631, 633 (7th Cir 1998).

29. *Pioneer Inv Servs Co v Brunswick Assocs Ltd P'ship,* 507 US 382-84.

30. *Id* at 395.

31. *Id.*

32. Fed R Bankr P 9006(b)(2) and (b)(3).

33. Fed R Bankr P 9006(b)(3), excepting out enlargement of Fed R Bankr P 3002(c).

34. Fed R Bankr P 3002(c).

35. Fed R Bankr P 3001(a).

36. Official Form 10 (Form B 10) is available for download at http://www.uscourts.gov/bkforms/bankruptcy_forms.html.

37. Fed R Bankr P 3001(a).

38. *In re Old Carco LLC,* 09-5002-AJG, Bankr SDNY 2009. The *Chrysler* form is available for download at http://chryslerrestructuring.com/.

39. Bankr ED Mich LR 5005-4.

40. See Procedure 3(b), Administrative Procedures for Electronic Case Filing, United States Bankruptcy Court for the Eastern District of Michigan, as amended through May 7, 2008, available at http://www.mieb.uscourts.gov/rulesAndForms/index.html and Administrative Procedure III.A.3, Electronic Case Filing Administrative Procedures, United Bankruptcy Court, Western District of Michigan, as amended through January 12, 2004, available at http://www.miwb.uscourts.gov/content/cmecf/adminProc.asp. Any party filing 10 or more cases per year must use the ECF system. Administrative Order No. 09-07. Bankruptcy Eastern District of Michigan.

41. *In re Whitten*, 49 BR 220 (Bankr ND Ala 1985)

42. Official Form 10 (Form B10).

43. 18 USC 152(4).

44. Fed R Bankr P 3001(b). If the claim is filed on behalf of the creditor by the debtor or trustee under Fed R Bankr P 3004 or a co-debtor under Fed R Bankr P 3005, the creditor does not sign the proof of claim, instead the filing debtor, trustee or co-debtor signs it.

45. *In re Bailey,* 151 BR 28 (Bankr NDNY 1993);

46. Fed R Bankr P 3001(f).

47. 11 USC 501(a).

48. *See* Official Bankruptcy Form 10 (Form B10).

49. Fed R Bankr P 3001(c).

50. Fed R Bankr P 3001(d).

51. *Caplan v B-Line, LLC (In re Kirkland)*, 572 F3d 838 (10th Cir 2009).

52. *Airport Blvd Apts, Ltd v NE 40 Partners, LP (In re NE 40 Partners, Ltd),* 411 BR 352 (Bankr SD Tex 2009) (citing *Busch v Buchman, Buchman & O'Brien, Law Firm,* 11 F3d 1255, 1258 (5th Cir 1994)); Fed R Bankr P 7004(e) (providing for nationwide proof of service).

53. *Lykes Bros SS Co v Hanseatic Marine Serv (In re Lykes Bros SS Co),* 207 BR 282, 287 (Bankr MD Fla 1997) (foreign company which filed proof of claim submitted itself to jurisdiction of bankruptcy court for purposes of liability for violating the automatic stay by actions in a Belgian court).

54. *Cf.* 28 USC 1411(a) ("[T]his chapter and title 11 do not affect any right to trial by jury that an individual has under applicable nonbankruptcy law with regard to a personal injury or wrongful death tort claim.").

55. *Granfinanciera, SA v Nordberg*, 492 US 33, 58 (1989).

56. *Langenkamp v Culp*, 498 US 42 (1990).

57. 28 USC 157(e).

58. 28 USC 157(d).

59. *See e.g. In re Hooker Invs, Inc,* 122 BR 659 (SDNY 1991), *appeal denied*, 937 F2d 833 (2d Cir 1991) (refusing exception to bar date for claims to creditors who were defendants in adversary proceeding and did not want to waive jury trial rights).

60. *See generally Central Virginia Cmty Coll v Katz*, 546 US 356 (2006) (Bankruptcy Clause in the U.S. Constitution empowers Congress to abrogate state sovereign immunity in bankruptcy).

61. 11 USC 106(b).

62. For example, Section 113(h) of the Comprehensive Environmental Response Compensation and Liability Act of 1980 limits judicial review of certain government activities. The filing of a proof of a claim by the government can waive that bar, so the bankruptcy court can adjudicate the issues. *In re National Gypsum Co*, 139 BR 397, 411 (ND Tex 1992).

63. 11 USC 502(b)(6).

64. *Solow v PPI Enters (US) (In re PPI Enters (US),* 324 F3d 197, 208-210 (3d Cir 2003).

65. *EOP-Colonnade of Dallas Ltd P'ship v Faulkner (In re Stonebridge Techs, Inc)*, 430 F3d 260, 269-270 (5th Cir 2005).

66. *In re Enron Corp.*, 2005 WL 3873893 *16 Fn 9 & 10 (Bankr SDNY 2005), *reversed on other grounds*, 379 BR 425 (SDNY 2007).

67. There is a standard Loan Syndication and Trading Association form for traded claims that includes warranty, indemnity and other provisions. *Enron Corp v Springfield Assocs, LLC (In re Enron Corp)*, 379 BR 425, 444 & fns 96, 97 (SDNY 2007).

68. *In re Enron Corp*, 379 BR 425.

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Strategic Use of a Real Estate Receiver or Bankruptcy as an Alternative to Foreclosure

By Lawrence M. Dudek

Introduction

State and federal court receiverships are becoming a popular means of managing distressed properties and, in some instances, a method of making an orderly transition of ownership as an alternative to mortgage foreclosure.[1] In the current economic climate, lenders may seek use of a real estate receivership to avoid the need to be in the chain of title and to avoid liabilities associated as owner. In some instances, the use of a receivership may provide a preferred alternative to a foreclosure as a means of managing and disposing of a troubled asset. As an alternative to a state or court receivership, the use of a bankruptcy proceeding may provide a mechanism for a Chapter 11 Debtor in Possession ("DIP") to transition ownership through a section 363 sale.

Basis for Appointment of a Receiver

By statute in Michigan, the use of a receivership is available in state circuit court where "allowed by law." MCL 600.2926-2927.[2] It is well recognized that the mortgagee may obtain court appointment of a state court receiver to aid in the enforcement of an assignment of rents.[3] In addition, MCL 600.2927(2) permits the parties to a mortgage to provide that the failure of the mortgagor to pay real property taxes or insurance premiums will be deemed waste and that a receiver may be appointed to prevent such waste.[4]

As a general rule, a receiver is available only as ancillary relief; there is no independent remedy of the right to a receiver.[5] A request for appointment of a receiver may be sought as ancillary relief in a pending judicial foreclosure action. The remedy of a receiver should also be available where the mortgagee seeks foreclosure by advertisement if the appointment is necessary to aid the enforcement of an assignment of rents. In the absence of any proceedings for foreclosure, appointment of a receiver may nevertheless be available to prevent waste if necessary.

If federal court diversity jurisdiction exists, the remedy of a receiver may be available under federal law. Federal Rule of Civil Procedure 66 governs an action in which the appointment of a receiver is sought.

Since creditor's rights claims are not typically based on a federal question, diversity of citizenship jurisdiction under 28 USC 1332 generally must exist to invoke federal court jurisdiction.[6] Once federal court jurisdiction over the substantive dispute is established, the federal court has ancillary jurisdiction to appoint a receiver and over actions commenced by the receiver in carrying out the receiver's duties.[7] Federal common law applies in determining whether to appoint a receiver in a diversity action.[8] Federal courts are not bound by state law in determining whether an equitable remedy exists.[9]

In some respects, the appointment of a receiver is analogous to the granting of an injunction, and the court will consider the same types of factors as would be considered in determining whether to grant the equitable relief of an injunction.[10]

As under state law, the general rule is that a federal court will not appoint a receiver in equity unless the appointment is ancillary to some other final relief requested by the moving party.[11] The appointment of a receiver is not an end in itself.[12]

A federal receiver may manage, operate, or sell properties located in multiple states. 28 USC 754 provides that a receiver appointed in a civil action or proceeding involving property (real, personal, or mixed) situated in different districts shall, upon giving bond as required by the court, be vested with complete jurisdiction and control of all such property with the right to take possession of the property. The purpose of 28 USC 754 is to give the appointing court jurisdiction over property in actual or constructive possession and control of the debtor, wherever such property may be located.[13]

Ultimately, the appointment of a receiver is an equitable remedy which, in the final analysis lies within the sound discretion of

the court. A court is not required to appoint a receiver solely because the parties have agreed to such relief by the terms of the mortgage; the decision to appoint a receiver ultimately lies with the sound discretion of the court's exercise of its equitable powers.[14]

In ruling on a request for a receiver, the court is likely to consider all of the attendant facts and circumstances, which could include: (i) the amount of any unpaid taxes or insurance premiums, (ii) the length of time for which any payments of taxes or insurance have been past due, (iii) whether the mortgagor has experienced difficulties in the enforcement of the assignment of rents, (iv) the value of the mortgaged property that secures the debt; (v) the amount of any likely deficiency that will exist following a sale; (vi) the nature of the recourse, if any, available to the mortgagor for any deficiency; (vii) the likelihood that any deficiency will be collectable from the mortgagor or any guarantors; (viii) whether the mortgagor has been guilty of any misconduct or mismanagement, such as misappropriating rents for purposes other than preservation of the property; and (ix) the management abilities and capabilities of the mortgagor.

As a general rule, a receiver is available only as ancillary relief; there is no independent remedy of the right to a receiver.

Powers of a Receiver

A "general" receiver is analogous to a bankruptcy trustee under either Chapter 7 or 11 of the Bankruptcy Code, in that the receiver controls all the assets and operates the debtor's businesses with the intent of either selling such assets as a going concern or liquidating the assets for distribution to creditors.[15] The general receiver's purpose is to protect property that is directly involved in the underlying litigation where such property might otherwise be dissipated, wasted, misappropriated, or unlawfully diverted. Receivers appointed under such circumstances are generally conferred extensive authority over the entity's affairs.[16] The appointment of a general receiver is most typically a remedy granted post-judgment to facilitate efforts of the judgment creditor to collect on the judgment.[17]

A "special" or "limited" receiver takes possession and control of designated assets of the debtor leaving the remainder of the debtor's assets and businesses in the debtor's possession. A receiver who takes charge of mortgaged real estate during a foreclosure is an example of a limited receiver. However, in those instances where the mortgagee is a special purpose entity whose sole asset is the mortgaged premises, the receiver may be more in the nature of a general receiver.

A receiver's powers are strictly governed by the terms of the order appointing the receiver.[18] The contents of the order appointing the receiver are critical in determining both the components and scope of the receivership estate as well as the powers of the receiver. The receivership estate in cases involving a defaulted loan generally cannot exceed the collateral securing the loan.

The court must determine the scope of the powers to grant to the receiver. At a minimum, a receiver over income producing commercial real estate is likely to be granted authority to collect rents from occupants of the property, make payment of expenses, including taxes and insurance, and to report to the court and the parties. The receiver could also be granted authority to manage the property, negotiate and enter into leases for the property, make tenant improvements, pay leasing commissions, and enforce the rights of the owner against occupants of the property. The receiver could also be authorized to enter into management contracts, pursue tax appeals, borrow funds required to preserve the receivership estate on behalf of the mortgagor, and take other actions with respect to management and preservation of the asset. In an appropriate case, the receiver could further be authorized to make a sale of the real estate asset with liens attaching to the proceeds of sale with the same force and effect as existed against the subject real estate.

In the first instance, the scope of the receiver's rights and responsibilities will be determined by the ability of a mortgagee, mortgagor, and other interested parties to reach a consensual agreement with respect to the appointment of a receiver and the powers to be granted to the receiver.[19] If the interested parties are unable to agree on the scope of the receiver's responsibilities, the court will likely consider a number of factors, including those on which the decision was made to appoint a receiver.

In an appropriate case, the receiver may also be authorized to borrow money and to grant liens on the receivership asset to secure repayment.[20] In most instances, the existing lender will be the likely source of any loans to the receiver, and the court may be willing to consider granting a super-priority lien to secure repayment of such a loan, although the state law with respect to the ability of a

receiver to grant such liens is somewhat limited.

In contrast to limited state law regarding authority of a receiver to borrow and grant liens, the authority of a trustee or DIP to borrow under the Bankruptcy Code is well defined. Bankruptcy law is clear on the issues of both the ability of a Chapter 11 DIP or trustee to utilize rents from the property as cash collateral and to borrow funds on an unsecured or secured basis. Bankruptcy Code section 363(c)(2) authorizes a DIP to operate its business under section 108 and to use cash collateral if the DIP has the consent of each entity that has an interest in the cash collateral of if the court authorizes the use of cash collateral after notice and hearing. Approval of the use of cash collateral requires the debtor to provide the creditor whose rights are affected with "adequate protection." Bankruptcy Code section 364 authorizes the DIP to secure a range of unsecured and secured credit. The DIP may grant liens securing repayment, depending on the availability and need for credit and court approval, including liens equal in priority to existing liens.

A court-appointed receiver will generally take custody of the receivership property subject to existing leases and licenses. The order of appointment should grant the receiver authority to enter into new leases for the premises. Even if the appointment order confers a general power to enter into leases, it may be advisable for the receiver to enter into a particular lease only on entry of a specific court order approving the terms of the lease following notice to all interested parties and hearing. Leases entered into by the receiver and any court orders authorizing entry into the lease should expressly provide for the effect of a later foreclosure or receivership sale on the rights under the lease. In most instances, the parties will want to provide that the lease will survive any later sale of the receivership assets and that the terms of the lease executed by the receiver will be binding upon the purchaser of the property. The lender, receiver, and lessee should also consider the advisability of using a subordination and nondisturbance agreement and recording evidence of the agreement.

There is no clear authority in Michigan that would grant a real estate receiver the power to reject existing leases. A receiver may have the ability to rescind an existing lease if the lease contravenes a provision of a prior recorded mortgage or the lease was entered into while the mortgagor was in default and the lease is not commercially reasonable. The receiver may be able to reject or rescind such a lease on a theory that the lease was fraudulent or the result of some other avoidable transfer, or if the lease was entered into at a time that the lessor was insolvent and the lease does not provide for payment of fair consideration.

A receivership may also be a vehicle to transition ownership of the property. While Michigan does have an expedient remedy available to lenders in the nature of foreclosure by advertisement, there may be benefits to the lender in using a receivership sale to insulate or minimize the liability associated with the lender's ownership of the property that is the likely result of a foreclosure sale. Insulation from potential liability may be particularly attractive where there are environmental issues associated with the property, the project is only partially constructed, or the project is a condominium where there may be potential issues relating to fiduciary duties arising out of acquiring ownership of units.[21]

There is no clear authority in Michigan that would grant a real estate receiver the power to reject existing leases.

In Michigan, there is a post-foreclosure sale redemption period following a foreclosure.[22] Typically, a receiver's sale will terminate any redemption rights existing in favor of the mortgagor and others having a right to redeem, such as subordinate lien holders. Courts generally are reluctant to permit actions that operate to clog or interfere with the mortgagor's rights of redemption.[23] On the other hand, there is no apparent prohibition on the ability of a court to authorize the receiver to include the redemption rights in the sale, and, in the absence of demonstrable prejudice to the mortgagor or other interest holder, the court may be inclined to approve such a sale over any objection of the mortgagor or other party with a right to redeem. In the current market, where many borrowers have no equity in commercial real estate properties, it is unlikely that the mortgagor will be able to demonstrate any prejudice as a result of a sale of the redemptive rights. Court approval is also likely where the interested parties agree to such a sale, or the mortgagor implicitly consents to the sale by defaulting or not actively contesting the sale.

There may also be an issue as to whether a sale may proceed with liens attaching to proceeds in the event that there is no express consent on the part of all lien holders to such a procedure. In the final analysis, the ability

of a receiver to make a sale of the subject real estate, free and clear of liens, is likely to depend on the ability to secure title insurance for the purchaser.

Whereas the state court procedure for sale by a receiver of the property subject to the receivership is not clearly defined by statute or court rule, there is a detailed procedure set forth for a sale by a federal court receiver.[24]

A sale of property through a receiver should be accomplished through one or more court orders. All parties having an interest in the property to be sold should be provided notice and an opportunity to be heard prior to any sale of the property. The order allowing a receiver to sell the property should memorialize any affirmative consent of the interest holders to the sale and the fact that notice and opportunity for hearing was provided to all interest holders. In many instances, the willingness of a title insurer to insure a sale by a receiver will be a significant, if not determinative, consideration in determining if such a sale is a feasible method of liquidating the receivership asset and paying off liens.

A sale of property through a receiver should be accomplished through one or more court orders.

The order authorizing the sale should refer to the legal basis for the sale through the receiver (such as borrower's and other interest-holders' consent, statutory authority, or court decision). It may be helpful for the order to designate the receiver as the "attorney in fact" for the borrower/owner of the property. The order should authorize the receiver to execute a purchase agreement subject to judicial approval. The purchase agreement can be executed by the owner/borrower "by and through" the court-appointed receiver, as authorized by court orders and court approval in the form of a "confirmation order" made a condition of closing. Court approval for a sale through the receiver in the initial order appointing the receiver, together with the confirmation order, should provide a basis for a title insurer to issue title insurance. The order appointing the receiver and authorizing the receiver to sell the property should both be attached as exhibits to the deed and recorded. The motion for approval of the sale and confirmation should be served on the borrower/owner and all others having liens on the property. Consideration should also be given to the possible need to notify others who may have an interest in the property, such as tenants or easement holders.

Authority of Receiver Under the Michigan Construction Lien Act

If the subject real estate project is encumbered by construction liens, the Michigan Construction Lien Act ("the CLA"),[25] provides a detailed statutory scheme for the appointment of a real estate receiver and the grant of various powers to the receiver. A circuit court is authorized to appoint a receiver over property against which a construction lien has been filed pursuant to the CLA upon request by a construction lien claimant or a mortgagee to complete construction, if the court finds that (i) a substantial unpaid construction lien exists or (ii) that the mortgage is in default and the lien claimant and or mortgagee "are likely to sustain substantial loss if the improvement is not completed."[26]

The receiver under the CLA act may petition the court to permit completion of construction of the improvements in whole or in part, to borrow money to complete the construction, and to grant security, by way of mortgage or otherwise, for the borrowings.[27] The receiver may also petition the court for authority to borrow funds for other purposes, "including such purposes as preserving and operating the real property."[28] The type of security that the court may authorize includes a mortgage lien or an assignment of rents as additional security.[29] The court is to determine the priority of any security granted by the receiver and may authorize the grant of liens that will prime an existing mortgage and other liens against the property. This will be helpful if the priority of the construction loan mortgage over the construction liens is in dispute and the construction lender is willing to advance additional funds only if the repayment is secured by a lien with priority over the construction liens.[30] In that instance, the construction lender can (with the approval of the court) make a new loan to the receiver and be granted a super-priority lien as to proceeds advanced under the new loan.

To appoint a receiver under the CLA, the court is required to make a finding that the value added to the real property that will result from the construction is likely to exceed the cost of additional construction.[31] In determining the cost of the additional construction, the court is to include (i) direct costs, (ii) all estimated overhead and administrative costs, and (iii) the costs of any interest expense on the funds that are borrowed to complete construction.[32] In addition, a receiver appointed under the Michigan act may petition the

court for authority to sell the property interest that is under foreclosure.[33]

Bankruptcy 363 Sale

In appropriate circumstances, the bankruptcy process may provide a method of achieving a sale of the subject real estate as an alternative to a foreclosure or receivership. Under certain circumstances, section 363(b)(1) of the Bankruptcy Code allows the trustee or DIP to sell or lease property of the estate other than in the ordinary course of business on notice and hearing. A sale not in the ordinary course of business may be by private sale or public auction.

Courts require a sound business purpose for the use of section 363 and a strong showing that a sale outside the plan confirmation process is justified.[34] A common justification for a section 363 sale is that the value of the assets will rapidly deteriorate and that the seller urgently needs the cash from the sale to continue its remaining businesses to avoid a liquidation that will lead to a lower recovery by creditors.[35]

Section 363(f) permits a trustee or DIP to make a sale of property free and clear of liens if one of five tests can be satisfied.

(1) Applicable non-bankruptcy law permits sale of such property free and clear of the liens.[36]

(2) The holders of all liens consent.[37]

(3) The sales price of the property is greater than the aggregate value of all liens on the property.[38]

(4) The lien is subject to a bona fide dispute.[39] The property may be sold while the dispute is being litigated so that liquidation of assets will not be delayed until final resolution of the dispute. Following a sale, the proceeds will be held and distributed in accordance with resolution of the dispute.[40] At least some courts hold that the trustee or DIP may rely on a dispute between third parties as a basis to conduct a sale under Section 363(f)(4).[41]

(5) The holder of the lien could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of the lien.[42]

The trustee or DIP has a duty to maximize the value of the estate for the benefit of the creditors and other interested constituencies. Any agreement by the trustee or DIP to make a sale of property not in the ordinary course of business requires court approval. In many instances, the court's approval of the sale will be conditioned on a requirement that the sale of the property be set for public auction to determine if there are any other bidders willing to pay a higher price. The use of an auction procedure will permit the trustee or DIP to maximize the value received on the sale.

The terms of a purchase agreement will often provide for the purchaser to serve as a "stalking horse," pursuant to which the buyer's offer is subject to receipt of higher and better offers in a public auction. An order of the bankruptcy court will set forth the auction's bidding procedures. The purchase agreement may address the procedures and terms of the bidding process, but any such procedures are subject to the bankruptcy court's approval. Items to consider including in an order setting bidding procedures are: (a) bidder qualification standards, good faith deposit requirements, provision of information regarding the bidder's financial qualifications, and ability to pay the purchase price; (b) standards for competing offers that can be accepted and requirements of minimum bid increments; (c) requirements of cash bids; (d) limitation on closing contingencies; and (e) payment of a break-up fee and/or reimbursement of expenses incurred payable to the stalking horse if not the successful purchaser.[43]

To obtain authorization for a section 363(f) sale of property "free and clear" of liens, Bankruptcy Rule 6004(c) requires the filing of a motion, which is served on the parties with liens or other interests in the property. The Bankruptcy Rules establish certain notice procedures for all sales of property that are not in the ordinary course of business.[44] If those procedures are modified (for example, less that twenty days' notice of sale), appropriate court orders should be obtained to assure that the sale in not subject to a later challenge based on procedural grounds.[45]

Relationship Between Bankruptcy Code and Receivership

If the mortgagor is intent on prohibiting imposition of a real estate receivership, the mortgagor may file a Chapter 11 proceeding under the Bankruptcy Code. Generally, on the filing of a bankruptcy petition, a receiver must cease all actions impacting property of the bankruptcy estate under section 543(a).[46] Section 543(b)(1) generally requires a receiv-

In appropriate circumstances, the use of a real estate receivership or bankruptcy section 363 sale may provide a preferred method of providing for transition of ownership of a distressed real estate asset.

er to turn over all property of the bankruptcy estate to the bankruptcy trustee.[47] A receiver is deemed to be a "custodian" under Section 101(11).[48]

One court has found that "turnover provisions of §543 are part of the statutory expression of the Congressional preference that a Chapter 11 debtor be permitted to operate and control its business during the reorganization process."[49] However, under section 543(b)(1), a bankruptcy court may allow a receiver to remain in place if the interests of creditors would be better served by allowing the receiver to remain in possession of the debtor's property.[50]

The receiver may file an emergency motion requesting that the receiver be excused from complying with the provisions of sections 543(a) through (c) of the Bankruptcy Code.[51] In addition, the mortgagee lender may seek relief from the automatic stay provisions of section 362 (d)(1) for cause or seek to excuse the receiver from having to turn over the property under sections 543(a) and (b)(1).

In considering whether the best interests of creditors would be served, the bankruptcy court may examine a variety of factors, including the likelihood of reorganization, the probability that funds required for reorganization will be available, whether there are instances of mismanagement by the debtor, and whether turnover would be injurious to creditors.[52] Section 543(d) "does not require or permit consideration of the interest of the debtor."[53]

Where the mortgaged property is the debtor's only asset and the value of the property is less than the amount of the indebtedness owed to the mortgagee, the bankruptcy court may decide to excuse compliance with the turnover requirements in section 543 and allow the receivership to continue if the receivership provides the most likely vehicle of enhancing the value of the property. One court recognized that if the mortgagee is more likely to advance additional funds for tenant improvements or operating expenses if the receivership continues, such a consideration may be a basis to excuse the receiver from the turnover requirement.[54]

After notice and hearing, a bankruptcy court will protect entities to which a custodian has become obligated with respect to such property or proceeds, product, offspring, rents, or profits of such property.[55] Similarly, after notice and hearing, the bankruptcy court will provide for the payment of reasonable compensation for services rendered and costs and expenses incurred by the custodian.[56] A request for a custodian's fees must contain a "sufficient itemization of effort expended and results accomplished to enable the Court to make a reasoned determination that the amount requested is 'reasonable compensation for services rendered.'"[57]

Conclusion

In appropriate circumstances, the use of a real estate receivership or bankruptcy section 363 sale may provide a preferred method of providing for transition of ownership of a distressed real estate asset. The receivership can be utilized as a method to preserve the value of the asset and to allow the lender to advance additional funds required for deferred maintenance, tenant improvements, and leasing commissions. In many instances, it may be possible for the lender and borrower to agree on the terms and conditions of the appointment and powers of the receiver to protect the interests of both parties. In an appropriate case, the receivership may be a mechanism to transition ownership to a new entity and to restructure the debt obligation. There are potential benefits to the lender in avoiding being in the chain of title, particularly where the property may have environmental issues or the project consists of a condominium development where the lender's acquisition of ownership could operate to subject the lender to potential fiduciary obligations to the other unit owners.

NOTES

1. Portions of this paper are based on the paper entitled, "Tis Better to Receive – The Use of a Receiver in Managing Distressed Real Estate," authored by Morris A. Ellison, Lawrence M. Dudek and Samuel H. Levine, The ACREL Papers (Fall 2009), American College of Real Estate Lawyers.

2. For circumstances in which the court may appoint a receiver over real estate *see* Lawrence M. Dudek, "The Uses of a Receivership Over Real Property," 21 *Mich Real Prop Rev* 41 (Summer 1994).

3. The nature of the mortgagee's rights under an assignment of rents granted pursuant to statute and the ability to obtain the appointment of a receiver to aid in its enforcement was set forth by the Michigan Supreme Court in *Smith v Mutual Benefit Life Insurance Company*, 362 Mich 114, 106 NW2d 515 (1960), which held that "[u]nder the Act, a receiver may be appointed to collect the rents and to apply them to the accrued interest, maintenance costs, insurance, and taxes. If there remains a deficiency following a sale, the receiver may continue to collect the rents following the sale and to make payments on the deficiency until expiration of the statutory redemption period."

4. The statute that permits the parties to define waste to include nonpayment of taxes and insurance was first enacted in 1937. There are a number of cases decided prior to the effective date of the statute that hold that it is only appropriate to appoint a receiver for nonpayment of taxes where a tax sale is imminent or likely to occur prior to the expiration of the statutory redemption period. Arguably, the statute preempts the holding of these earlier cases and evidences a legislative intent to permit the appointment of a receiver for nonpayment of taxes even if there is no danger of a tax sale prior to the expiration of the statutory redemption period. Cameron, *Michigan Real Property Law*, (2d Ed 1993) § 18.72.

5. *Lewis v Grand Rapids*, 222 F Supp 349 (WD Mich 1963); *National Lumberman's Bank v Lake Shore Mach Co*, 260 Mich 440, 245 NW 494 (1932).

6. See Inland Empire Ins Co v Freed, 239 F2d 289, 290 (10th Cir 1956).

7. *Haile v Henderson Nat'l Bank,* 657 F2d 816, 822 (6th Cir 1981).

8. *Waag v Hamm*, 10 F Supp 2d 1191 (D Colo 1998).

9. *Gordon v. Washington*, 295 US 30, 38, (1935). *Bookout v Atlas Fin Corp,* 395 F Supp 1338, 1341-42 (ND Ga 1974).

10. *Midwest Sav Ass'n v Riversbend Assocs P'ship*, 724 F Supp 661 (D Minn 1989).

11. *Id.*

12. *Id.*

13. *American Freedom Train Found v Spurney*, 747 F2d 1069 (1st Cir 1984).

14. *Denby v Ozeran*, 255 Mich 477, 238 NW 218 (1931); *Nusbaum v Shapero*, 249 Mich 252, 228 NW 785 (1930).

15. In Re Newport Offshore Ltd, 219 BR 341 (DRI 1998).

16. *Id.* at 346; *Duparquet Huot & Moneuse Co v Evans*, 297 US 216, 221 (1936).

17. MCL 600.6104(4) provides that "After judgment for money has been rendered in an action in any court of this state, the judge may, on motion in that action or in a subsequent proceeding … appoint a receiver of any property the judgment debtor has or may thereafter acquire."

18. *Peppertree Resorts, Ltd v Cabana Ltd P'ship*, 315 SC 36, 431 SE2d 598 (SC Ct App 1993) (receiver has those powers given to him by his order of appointment).

19. For an excellent discussion with regard to the considerations of the benefits and burdens to the mortgagor and mortgagee, see Honorable Mark A. Goldsmith and Gregory J. DeMars, *Receiverships in the Real Estate Setting*, 28 Mich Bus L J 36 (Summer 2008).

20. *Bailey v Bailey*, 262 Mich 215 at 220, 247 NW 160 (1933) ("When it becomes the duty of a court of equity to take property under its own charge, through a receiver, the property becomes chargeable with the necessary expenses incurred in taking care of and saving it, including the allowance to the receiver for his services" quoting from *Knickerbocker v McKindley Coal & Mining Co,* 172 Ill 535, 50 NE 330 (1898). The priority of repayment as to the first lien on the property is to be determined based upon the law and the facts and the purpose for which the money was used.

21. See, Philip B. Korb, "Use of Receiverships in Failed Common Interest Ownership Projects," The ACREL Papers (Fall 2009), ALI-ABA at page 57.

22. The mortgagor and others having an interest in the mortgaged property have a statutory right to redeem the property from the foreclosure sale. MCL 600.5714; MCL 600.2932. The redemption period is six months if the foreclosure is by advertisement and the mortgage was executed on or after January 1, 1965, on commercial or industrial property or multi-family residential property in excess of four units. MCL 600.3240(2). The redemption period is six months in a judicial foreclosure. MCL 600.3140. In a judicial foreclosure the court may order and compel delivery of possession of the mortgaged premises to the purchaser at the sale. MCL 600.3150. However, the court will not likely grant the purchaser possession until after the expiration of the redemption period. Cameron, *Michigan Real Property Law* (2d Ed 1993) § 18.93.

23. *Blackwell Ford v Calhoun*, 219 Mich App 203, 555 NW2d 856 (1996) *app den* 454 Mich 909, 564 NW2d 46 (1997) (Mortgagor's equity of redemption cannot be clogged and mortgagor, as part of original mortgage transaction and prior to default, cannot cut off or surrender his right to redeem, and any agreement that does so is void and unenforceable as against public policy).

24. 28 USC 2001, 2002, and 2004 govern sales of assets by a receiver appointed by a federal court action. A federal court receiver may sell real property by either public or private sale. A public sale must occur in the district where the receiver was appointed, unless otherwise approved by the court. In addition, the terms and conditions of the sale will be as directed by the court. The court must approve the form of notice of any public sale, and such notice must be published at least once a week for four (4) weeks prior to the sale. Real property may be sold by private sale if the federal court determines that such private sale is in the best interest of the receivership estate. As in a public sale, the court sets the terms and conditions of the sale. In a private sale, however, the court must appoint three disinterested appraisers to appraise each parcel of property. The private sale of real estate will not be confirmed by the court unless the sale price is at least two-thirds (2/3) of the property's appraised value, or if a competing offer for the property is received in an amount at least ten (10%) percent greater than the amount of the original offer. Notice of a proposed private sale must also be approved by the court and published in a newspaper of general circulation at least ten (10) days prior to the hearing on the confirmation of the sale.

25. MCL 570.1107.

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. MCL 570.1107.

32. *Id.*

33. MCL 570.1123(3). *See* Part VIII(G), *infra*.

34. *See In re Industrial Valley Refrigeration & Air Conditioning Supplies, Inc*, 77 BR 15, 21 (Bankr ED Pa 1987) (stating that the requirements for a Section 363 Sale include accurate and reasonable notice, a showing that the price to be paid is adequate, fair and reasonable, and a showing of good faith, e.g., the absence of lucrative insider deals); *See also In re Lionel Corp*, 722 F2d 1063, 1071 (2nd Cir 1983).

35. See e.g. In re TWA, No 01-00056, 2001 Bankr LEXIS 980 at *14-15 (Bankr D Del Apr 2, 2001).

36. 11 USC 363(f)(1).

37. 11 USC 363(f)(2).

38. 11 USC 363(f)(3).

39. 11 USC 363(f)(4).

40. *Moldo v Clark (In re Clark)*, 266 BR 163, 171 (9th Cir BAP 2001).

41. *In re Gulf States Steel, Inc*, 285 BR 497, 507 (Bankr ND Ala 2002) (citing *In re Gerwer*, 898 F2d 730, 733 (9th Cir 1990)).

42. 11 USC 363(f)(5).

43. See: Vicki R. Harding, *Buying and Selling Real Estate Out of Bankruptcy; Homeward Bound: Bankruptcy Sales and Lease Issues-Mastering the Maze*, The Institute of Continuing Legal Education, (November 2, 2006).

44. *See* FR Bankr P. §§ 6004, 2002.

45. *See, e.g.* FR Bankr P §§ 2002(a)(2), 9006(b).

46. 11 USC 543(a), provides in part:

> A custodian with knowledge of the commencement of a case under this title concerning the debtor may not make any disbursement from, or take any action in the administration of, property of the debtor, proceeds, product, offspring, rents, or profits of such property, or property of the estate, in the possession, custody, or control of such custodian, except such action as is necessary to preserve such property.

47. 11 USC 543(b)(1), provides:

> (b) A custodian shall—
>
> (1) deliver to the trustee any property of the debtor held by or transferred to such custodian, or proceeds, product, offspring, rents, or profits of such property, that is in such custodian's possession, custody, or control on the date that such custodian acquires knowledge of the commencement of the case; . . .

48. In the event of filing a bankruptcy petition, a state court receiver will be deemed a custodian under Section 101(11) and the receiver will be required to transfer assets to a DIP under Section 543 and Bankruptcy Rule 6002. 11 USC 101(11) defines a "custodian" as:

> (A) receiver or trustee of any property of the debtor, appointed in a case or proceeding not under this title; (B) assignee under a general assignment for the benefit of the debtor's creditors; or (C) trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors.

49. *In re Northgate Terrace Apartments, Ltd,* 117 BR 328, 332-33 (Bankr SD Ohio 1990).

50. *In re WPAS, Inc*, 6 BR 40, 43 (Bankr MD Fl 1980). *See also*, *In re Corporate & Leisure Event Prod, Inc*, 351 BR 724, 732 (Bankr D Ariz. 2006) (noting that though the ordinary rule is that a receiver must turn over property to a debtor in possession, bankruptcy courts have discretion to waive that requirement if the interests of creditors would be better served by continuing the receiver in possession). 11 USC 543(b)(1), provides:

> (d) After notice and hearing, the bankruptcy court-- …
>
> (1) may excuse compliance with subsection (a), (b), or (c) of this section if the interests of creditors and, if the debtor is not insolvent, of equity security holders would be better served by permitting a custodian to continue in possession, custody, or control of such property…

51. *See* Beausoleil-Mayer and Carter, *When Receivership and Bankruptcies Collide: An Overview*, 26th Annual Advanced Bankruptcy Course (May 1 - 2, 2008) at 15.

52. *Id.*.

53. *In re Foundry of Barrington P'ship*, 129 BR 550, 558 (Bankr ND Ill 1991) (*citing* 4 Collier on Bankruptcy §543.04 (15th ed.)).

54. *Id.*

55. 11 USC 543(c)(1).

56. 11 USC 543(c)(2).

57. *In re Ashley*, 41 BR 67, 73 (Bankr ED Mich 1984).

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The Gradual Demise of the Earmarking Defense to Preference Claims in the Sixth Circuit

By John P. Kuriakuz

Introduction

The Bankruptcy Code ("Code") aspires, among other things, to provide for an equitable distribution of assets among similarly situated creditors. Section 547 of the Code, for example, grants a debtor's trustee the authority to avoid certain transfers of the debtor's interest in property made during the ninety-day period immediately preceding the filing of the debtor's bankruptcy petition. Through Section 547, a debtor's trustee may initiate litigation against a particular transferee to recover property for equitable distribution among creditors.

Preference litigation is inundated with nuances regarding the timing, nature, and form of the alleged transfer. For example, where an alleged preferential transfer is made from a third party to the transferee and passes through the hands of the debtor, a question arises as to whether the transfer is one of an interest of the debtor in property for purposes of Section 547. This scenario occurs most frequently in refinancing transactions in which a new creditor provides funds to the debtor that are earmarked for payment to an old creditor.

The "earmarking doctrine" provides a transferee with a defense to a preference claim where the property transferred originated from a third party and was specifically designated for the transferee. The doctrine holds, in essence, that under these circumstances the property transferred never became property of the estate for purposes of Section 547. While the doctrine has been expressly adopted by the Sixth Circuit Court of Appeals and has enjoyed liberal application in previous years, more recent Sixth Circuit jurisprudence has evidenced the doctrine's gradual demise as a reliable defense to preference claims.

Preference Claims Generally

Section 547 of the Bankruptcy Code permits a debtor to avoid certain transfers of the debtor's property made during the ninety-day period immediately preceding the filing of the debtor's bankruptcy petition. Specifically, 11 USC 547(b) provides as follows:

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made--
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would receive if--
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.[1]

The purpose behind Section 547 is twofold: (1) to foster equality of distribution among creditors; and (2) to discourage "secret liens" on the debtor's collateral that remain unperfected until just prior to the filing of the debtor's bankruptcy petition.[2] By providing for disgorgement of payments made to a preferred creditor during the pre-petition ninety-day window, Section 547 seeks to deter "the race of diligence" among creditors to dismember the debtor prior to bankruptcy.[3]

Two elements of a preference claim are most relevant to the earmarking defense: (1) the alleged transfer must be a transfer of an

interest of the debtor in property; and (2) the alleged transfer must result in an impairment or diminution of the value of the estate.[4] The first element, which requires that the transfer be one of an interest of the debtor in property, stems directly from the prefatory language of 11 USC 547(b) cited above. The second element, on the other hand, is nowhere expressly set forth in Section 547. Rather, the diminution of estate element is implied by the requirement of 11 USC 547(b)(5) that the transfer enable the creditor to improve its position if a hypothetical distribution of assets were made pursuant to Chapter 7 of the Bankruptcy Code.[5] In other words, the "improvement-in-position test"[6] imposed by 11 USC 547(b)(5) requires a preference plaintiff to show that the transferee, under a hypothetical Chapter 7 distribution, would either: (i) receive a greater distribution relative to similarly situated creditors; or (ii) improve its priority position relative to other creditors and receive a larger distribution as a result of the improved position.

Section 547 of the Bankruptcy Code permits a debtor to avoid certain transfers of the debtor's property made during the ninety-day period immediately preceding the filing of the debtor's bankruptcy petition.

Mechanics of the Earmarking Defense

In *In re Hartley*,[7] the Sixth Circuit expressly adopted the earmarking doctrine as a defense to preference claims and succinctly stated the essence of the defense as follows: "funds loaned to a debtor that are 'earmarked' for a particular creditor do not belong to the debtor because he does not control them."[8] Elaborating more fully, the court explained, "[w]hen a third person loans money to a debtor specifically to enable him to satisfy the claim of a designated creditor, the general rule is that the proceeds are not the property of the debtor, and therefore the transfer of the proceeds to the creditor is not preferential."[9] Under such circumstances, the property is said to be "earmarked" for the designated creditor.[10]

Importantly, "[t]he earmark rule requires that the party making the loan choose the recipient of the funds,"[11] thereby denying the debtor dominion and control over the funds transferred. As a result of this rule, under the judicially created earmarking doctrine, certain transfers are deemed not to be a transfer of an interest of the debtor in property "even if the property passes through the hands of the debtor on its way to the creditor."[12]

However, the doctrine only applies if (i) the agreement is between a new creditor and the debtor for the payment of a specific antecedent debt, (ii) the agreement is performed according to its terms, and (iii) the transaction according to the agreement does not result in diminution of the debtor's estate.[13] Ordinarily, the trustee bears the burden of proving non-applicability of the doctrine.[14] The Sixth Circuit has left open the question of whether the earmarking doctrine may be applied to post-petition transfers.[15]

Dominion & Control: The Court's Bailor/Bailee Analogy

The dominion and control analysis of the earmarking doctrine is best illustrated in *Lyon v Contech Constr Prods, Inc (In re Computrex, Inc)*[16] in which the Sixth Circuit adjudicated the fate of a $4.5 million transfer from the debtor to its carriers that originated from a trade creditor for the purpose of paying the carriers. Computrex, the debtor, was in the business of processing freight payments for businesses that used multiple carriers to ship their goods.[17] In contravention to agreements with many customers, Computrex would delay payments to carriers for several days to collect as much interest as possible on the funds received from its customers.[18] While Computrex paid $4.5 million to Contech's carriers during the 90-day preference period, Computrex owed over $24 million to carriers of other customers.[19] Thus, the debtor's trustee argued, the $4.5 million paid to Contech's carriers preferred Contech over other similarly situated trade creditors.[20]

In support of its preference claim, the trustee argued that the debtor exercised sufficient dominion and control over the funds received from Contech to satisfy the requirement that the funds constitute property of the estate.[21] Specifically, the trustee cited evidence that the debtor commingled funds from all of its clients into one account, exercised discretion in determining the length of time it would "float" the checks until paying carriers, and ultimately decided which carriers would be paid first.[22]

The court, however, reached a different conclusion than the trustee, ruling that Contech never loaned or otherwise conveyed to the debtor any ownership interested in the $4.5 million.[23] Rather, the court found, the funds transferred by Contech to the debtor were provided with the sole purpose of paying Contech's carriers.[24] As the court explained, the agreement between Contech and the debtor did not contemplate any dominion or control by the debtor over the funds, other than simply disbursing the funds to Con-

tech's carriers as set forth in the agreement.[25] As the court explained, "[t]he relationship was strictly defined, and [the debtor]'s brief possession of Contech's funds was to be similar to that of a transfer station along the road to payment of Contech's carriers."[26]

The court likened the debtor's position to that of a bailee, whereby Contech, as the bailor, directed the debtor, as bailee, to take possession of Contech's funds and subsequently disburse those funds to Contech's creditors:[27] "The fact that a bailee, which has a possessory interest in the property entrusted to him, but no legal or equitable interest, may commingle the funds his clients entrust to him does not give the bailee any property interest in the funds."[28] Most notably, the court would "not condone a debtor's improper application of funds to justify that the funds were property of the debtor's estate," or include within the definition of control "the ability to steal the money, or use it for personal purposes in breach of duty."[29] Thus, as the court makes clear, evidence of dominion and control in contravention of an agreement does not provide valid support for defeat of an earmarking defense.

Earmarked Transfers Must Not Diminish the Estate

The importance of the diminution of estate analysis to the earmarking doctrine was best illustrated in *In re Trinity Plastics, Inc.*[30] In *Trinity Plastics*, the court analyzed payments made by two of the debtor's customers with checks that were jointly payable[31] to both the debtor and the debtor's raw material supplier. Both customers required the debtor's endorsement of the check before remittance to the supplier.[32] Rather than analyze the degree of dominion and control exercised by the debtor over the checks in question, the court focused its analysis on whether the transfers resulted in diminution of the estate.

Analyzing the check from the first customer, the court noted a pre-existing account receivable by the debtor from the customer at the time of the transfer. The court also noted a guarantee agreement between the first customer and the debtor as to the debtor's obligation to its supplier.[33] The court concluded that the first customer likely effected the transaction with a joint check so as to evidence offsetting of the account receivable by the amount paid to the debtor's supplier.[34] Thus, the court concluded, there was no diminution of estate with respect to the transfer made with funds from the first customer.[35]

As to the second customer, however, the court emphasized the absence of any guarantee agreement between the customer and the debtor.[36] As such, no right to contribution or reimbursement was created by virtue of payments made by the customer to the supplier. While the court openly suggested that the result might differ had the check been issued solely to the supplier, the court concluded that issuance of the joint check and transfer of the funds to the supplier had the effect of diminishing the debtor's estate by the amount of the check.[37] For this reason, the court held, the earmarking doctrine was properly invoked as to the first customer but not the second.[38]

Importantly, courts have also refrained from applying the earmarking doctrine where a debtor uses funds from a secured creditor to discharge portions of unsecured claims.[39] This situation arises frequently where a debtor borrows money from a line of credit on encumbered property to pay unsecured lenders. In this type of scenario, courts hold that the value of the estate is diminished by the value of the collateral given to secure the claim.[40]

Importantly, courts have also refrained from applying the earmarking doctrine where a debtor uses funds from a secured creditor to discharge portions of unsecured claims.

A Valid Earmarking Defense Requires More Than Mere Substitution of Creditors

The Sixth Circuit has rejected the proposition that earmarking categorically exists where one creditor is substituted for another creditor for the same amount of debt. In *In re Montgomery*,[41] the debtor used proceeds from unauthorized loans that he acquired in a check-kiting scheme to pay off debts to his lenders.[42] In its defense, one transferee argued that no preference was created because "he still owes the same sum to a creditor, only the identity of the creditor has changed."[43] The court, however, rejected the transferee's argument and found the earmarking doctrine inapplicable where the debtor ostensibly controlled the funds obtained by kiting checks and "could have used the kited checks to buy a 40-foot yacht, just as he could have used them to pay off creditors other than [the transferee]."[44]

Nor does the earmarking doctrine necessarily apply where a debtor issues a check to a bank that subsequently issues a cashier's check to the transferee.[45] Under these facts, while it is true that the bank simply replac-

es the transferee as a creditor for the same amount of debt, the earmarking doctrine does not apply unless the bank "controlled the disposition of the new credit by choosing the creditor or creditors to whom it was paid."[46] Thus, a valid earmarking defense must show more than mere substitution of creditors.

Thus, a valid earmarking defense must show more than mere substitution of creditors.

Earmarking Doctrine Applied in the Past with Success

Earmarking as a Result of a Creditor's "Independent Obligation" to the Transferee

In the past, a court might look to the obligations owed by a creditor to a transferee to determine whether the transfer is protected by the earmarking defense. In *Gold v Alban Tractor Co, Inc*,[47] a contractor on a construction project used monies allegedly owed to the debtor to pay the debtor's supplier. On appeal, the Eastern District of Michigan held that the bankruptcy court erred in precluding the earmarking defense [48] Prior to award of the project, the contractor and its surety executed a payment bond, as required by state statute, to ensure payments to suppliers.[49] Applying the earmarking doctrine, the court ruled that even though the contractor owed money to the debtor, it had an independent obligation to pay the supplier by virtue of the payment bond. Thus, the court concluded, the funds were not property of the debtor and the estate was not depleted by the payment to the supplier.[50]

"Express Purpose" as a Determinant of Earmarking

In perhaps the most liberal application of the earmarking doctrine, courts in the past have taken into account the express purpose of the debtor in effecting an allegedly earmarked transfer. In *Wilson v Chamness (In re Green Valentine, Inc)*,[51] for example, the debtor obtained a $406,000 home equity loan in order to pay two pre-existing creditors.[52] It was uncontested that the funds were initially deposited into the debtor's account and that the debtor directed disbursement of the funds to the pre-existing creditors.[53] Nonetheless, the bankruptcy appellate panel affirmed the bankruptcy court's holding that the earmarking doctrine applied. The court reasoned that the debtor "would not have individually procured the loan and mortgaged her house, unless [the pre-existing creditors] were paid."[54] Evidencing the "express purpose"[55] of the debtor, the court noted, was a letter from the debtor's attorney making assurances that the creditors would be paid at the time of the loan closing.[56]

In another lenient application of the earmarking doctrine, the preference defendant in *Daneman v Bank One, NA (In re Kalmar)*[57] successfully invoked the earmarking doctrine where the debtor's son used funds from his own brokerage account to pay off the debtor's unsecured line of credit during the preference period. The court weighed conflicting evidence regarding whether the debtor maintained dominion and control over the transferred funds. Although evidence showed that the debtor himself designated the unsecured creditor as the payee, the court ruled that this alone did not conclusively establish control over the funds.[58] Rather, the court considered evidence more persuasive that the debtor's son maintained exclusive control over his brokerage account and made the transfer directly from that account.[59] In addition, the court cited a lack of evidence that the debtor's son would have lent the money to his father without assurance that the line of credit would be paid in full.[60] The express purpose of the debtor and his son therefore weighed heavily in the court's determination that the preference claim was defeated by the transferee's earmarking defense.[61]

Combining Express Purpose with Lack of Dominion and Control

Combining analyses described above, one court used the express purpose of a debtor and his uncle (the source of the transferred funds) to conclude that the debtor lacked dominion and control over the transferred funds, thus rendering the earmarking doctrine applicable. In *Emerson v Federal Sav Bank (In re Brown)*,[62] the debtor was involved in a check-kiting scheme, causing overdrafts at two banks.[63] When the banks discovered the check-kiting scheme, the debtor asked his uncle for a $60,000 loan to deposit into both bank accounts to cover the overdrafts.[64] The debtor's uncle lent the money to the debtor and the debtor deposited the money that same day.[65] Applying the earmarking doctrine, the court rejected the trustee's position that the debtor could have used the funds however he wished.[66] The court cited testimony indicating that the funds were intended for the specific purpose of covering the overdrafts and that the debtor had no discretion to use the funds in any other way.[67]

As the court explained, there was "no proof to suggest that the debtor had a thought or opportunity to exercise control over those funds other than to deposit them as he did."[68] Furthermore, the court added, it was highly unlikely that the banks would have permitted the debtor to withdraw or otherwise use the funds once deposited.[69] Thus, by virtue of the express purpose of the debtor and his uncle, the $60,000 deposit into the debtor's accounts did not constitute property of the debtor and the trustee's preference claim was barred by the earmarking defense.[70]

The Decline of the Doctrine

No Earmarking Defense for the Late-Filing Perfector

Much of recent Sixth Circuit jurisprudence regarding the earmarking defense has centered on the issue of whether a mortgage refinancer may successfully invoke the earmarking defense to an alleged preferential transfer of a security interest in real property made pursuant to a refinancing. In most cases, the homeowner maintains a mortgage on the home while simply entering into a lower interest rate. While logic might dictate that the estate of the homeowner is augmented by the value of the interest savings that result from refinancing, the Sixth Circuit has declined to apply the earmarking doctrine to several refinancing transactions, rendering mortgages void to the delight of homeowners.

In *Chase Manhattan Mortgage Corp v. Shapiro (In re Lee)*,[71] the Sixth Circuit addressed the issue of whether a mortgage lien granted on real property refinanced with the original lender could be avoided as a preferential transfer. In *Lee*, the debtor refinanced his home with the original lender prior to filing for bankruptcy protection.[72] The original loan was refinanced and discharged over ninety days prior to the petition date.[73] The discharge of the original mortgage was filed over ninety days prior to the petition date and recorded forty-eight days prior to the petition date.[74] The new mortgage was recorded seventy-seven days prior to the petition date.[75]

As a threshold matter, the court in *Lee* analyzed whether the transfer of the new mortgage occurred within the ninety-day preference period. As noted above, while the new mortgage was recorded within the ninety-day preference period, the closing of the loan and disbursement of the proceeds occurred prior to this period. The court cited a split among circuits as to whether such refinancing transactions are to be viewed as multiple transactions or as one integrated transaction.[76] The Sixth Circuit ultimately adopted the multiple transaction approach, under which the underlying loan transaction and perfection of the security interest are treated separately.[77]

The significance of this distinction derives from 11 USC 547(e), which provides that a transfer of an interest in real property is deemed to take place at the time such transfer is perfected, so long as perfection takes place more than thirty days after the transfer took effect between the parties.[78] In other words, under 11 USC 547(e), when a mortgage lender records its security interest more than thirty days after closing of the loan, the transfer is deemed to have taken place at the time of recording. Thus, in adopting the multiple transaction approach, the Sixth Circuit in *Lee* deemed the debtor's transfer of the new mortgage as taking place seventy-seven days prior to the petition date, at the time of recording.[79] The new mortgage therefore secured an antecedent debt, rather than a simultaneous debt, thereby placing itself squarely within the purview of 11 USC 547(b) and its avoidance provisions.

Addressing the transferee's earmarking defense, the court first noted that because the transferee was the original lender, it could not be characterized as a "new creditor" as required for application of the earmarking defense.[80] Nonetheless, the court held, application of the earmarking doctrine to a transfer of a lien interest, as opposed to a transfer of funds, "extends the doctrine beyond its logical limits."[81] In so holding, the court reasoned that while a debtor in certain circumstances might serve as a conduit of earmarked funds, the debtor in a refinancing transaction does not serve as a conduit upon transfer of a lien interest.[82] Rather, the transfer of a mortgage in a refinancing involves the transfer of an interest in property owned and controlled by the debtor, and not by the third-party refinancer or the original lender.[83]

The court also rejected the transferee's argument that perfection of the new mortgage does not result in diminution of the debtor's estate.[84] The court referred to the time period between discharge of the old mortgage and recording of the new mortgage and concluded that during that interim period, the debtor's interest in his home was wholly unencumbered and therefore available for

Much of recent Sixth Circuit jurisprudence … has centered on the issue of whether a mortgage refinancer may successfully invoke the earmarking defense to an alleged preferential transfer of a security interest in real property made pursuant to a refinancing.

distribution to unsecured creditors up to the amount of non-exempt equity.[85] However, once the transferee recorded and perfected the new mortgage, seventy-seven days prior to the petition date, the property became encumbered in preference to the transferee and thereby diminished the estate, precluding application of the earmarking defense.[86] The court finally noted that application of the earmarking doctrine in this type of scenario would contradict the Bankruptcy Code's goal of discouraging "secret liens."[87]

A key predicate to the earmarking doctrine's failure in *Lee* was the court's adoption of the multiple transaction approach to the refinancing transaction. In electing the multiple transaction approach, the court cited a "common theme in the Supreme Court's bankruptcy jurisprudence over the past two decades [*sic*] that courts must apply the plain meaning of the Code unless its literal application would produce a result demonstrably at odds with the intent of Congress."[88] Implicit in the court's holding, therefore, is the proposition that exposing a mortgage lender to preference liability for failing to record a mortgage within the applicable 30-day period is not demonstrably at odds with the intent of Congress.

While the earmarking doctrine remains valid as a defense to preference claims in the Sixth Circuit, recent caselaw has evinced a far more limited application of the doctrine than in previous years.

This implication did not go without criticism. In his dissenting opinion, Judge Gilbert S. Merritt, Jr. argued that, under the facts presented, a strict application of the Bankruptcy Code's language yielded an absurd result. Prior to recording of the new mortgage, the original mortgage existed on the books of the register of deeds such that any creditor might know that the property was not owned by the debtor free and clear of liens.[89] Furthermore, rather than diminish the value of the debtor's estate, Judge Merritt argued, the refinancing likely augmented the estate's value by the amount of interest saved.[90] As Judge Merritt quipped, "no good deed goes unpunished."[91]

In strict adherence to the Sixth Circuit's holding, the Eastern District of Michigan has declined to apply the earmarking defense where a mortgage lender did not record the new mortgage until thirty-five days after the closing and one day prior to the filing of the debtor's bankruptcy petition.[92] Similarly, under the version of the Bankruptcy Code which preceded the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), pursuant to which a mortgage lender was given only ten days to perfect its security interest, the Eastern District of Michigan declined to apply the earmarking defense where the mortgage lender perfected its interest seventeen days after closing.[93] Perhaps most notably, the Middle District of Tennessee has declined to apply the earmarking defense pre-BAPCPA where the mortgage lender recorded the refinanced mortgage fourteen days after closing and the debtor maintained a right to rescind the refinancing during the fourteen-day period.[94]

Earmarking Defense Unavailable to Consumer Lenders Where Convenience Checks Give Borrowers Dominion & Control

Sixth Circuit earmarking jurisprudence in recent years has also dealt frequently with transfers of funds made by a credit card lender to a debtor to pay down balances owed to other lenders. Here, as with mortgage refinancing, logic might dictate that these transactions augment the value of the debtor's estate by the amount of interest savings. Indeed, in many cases the estate of the borrower benefits from an interest rate as low as zero percent with only a marginal change in principal balance. Nonetheless, the Sixth Circuit has rejected application of the earmarking defense to many of these transactions on the basis of the debtor's dominion and control over the borrowed funds.

In *MBNA America Bank, NA v Meoli (In re Wells)*,[95] Chase Bank, the debtor's credit card lender, offered the debtor "convenience checks" that could be used to "[t]ransfer balances, pay bills, make a purchase, [or] get extra cash."[96] The debtor used two of these convenience checks to pay down $10,000 of her credit card balance with MBNA America Bank.[97] After filing for bankruptcy protection, the debtor's trustee sought to avoid these payments as preferential transfers.[98]

Rejecting MBNA's earmarking defense, the court emphasized that Chase never specifically earmarked the funds for payment to MBNA.[99] Rather, as cited above, the funds could be used to "[t]ransfer balances, pay bills, make a purchase, [or] get extra cash."[100] As the bankruptcy appellate panel explained, "It makes no difference that Debtor never had the cash in hand since she had sufficient control over the disposition of the funds."[101] Thus, the earmarking defense did not apply to the funds transferred from Chase to MBNA.[102]

Supersedeas Bonds Offer Little Protection to Judgment Creditors

Judgment creditors wishing to shield themselves from preference liability with a supersedeas bond will find little success asserting the earmarking defense. In *ThermView Indus v Clemmens (In re ThermoView Indus)*,[103] a judgment creditor defended a preference action against a debtor who transferred $300,000 to an insurer to obtain a supersedaes bond which would stay enforcement of the judgment pending appeal. The judgment creditor argued that the $300,000 transfer to the insurer merely satisfied an antecedent debt with no diminution of the estate.[104] The court disagreed, however, holding that the supersedaes bond elevated the position of the judgment creditor to that of a secured creditor and diminished the estate by the full amount of the transfer. For these reasons, the court concluded, the judgment creditor's earmarking defense failed, and the appropriate remedy was to void the transfer.[105]

Conclusion

While the earmarking doctrine remains valid as a defense to preference claims in the Sixth Circuit, recent caselaw has evinced a far more limited application of the doctrine than in previous years. Using a debtor's dominion and control over funds as its mainstay, the Sixth Circuit has rejected the earmarking defense where raised by credit card lenders providing funds to consumers for balance transfers. In other contexts, applying strict statutory interpretation, the Sixth Circuit has justified avoidance of refinanced mortgages on the basis of a mortgage lender's delay in recording, even where the mortgage lender specifically designates the newly borrowed funds for payoff of the original loan amount. Without express adoption of the earmarking doctrine into the Bankruptcy Code with elaborating provisions, the doctrine's applicability over time may very well shrink to a nullity.

NOTES

1. 11 USC 547(b).

2. *Chase Manhattan Mortgage Corp v Shapiro (In re Lee)*, 530 F3d 458, 463 (6th Cir 2008).

3. *Lyon v Contech Constr Prods, Inc (In re Computrex, Inc)*, 403 F3d 807, 809-10 (6th Cir 2005).

4. *In re Lee*, 530 F3d at 464.

5. *Id.*

6. *Id.*

7. *In re Hartley*, 825 F2d 1067 (6th Cir 1987).

8. *Id.* at 1069.

9. *Id.* at 1070, *citing* 4 Collier on Bankruptcy para. 547.03, at 547-25 (15th ed 1987). *See also In re Lee*, 530 F3d at 468 ("The earmarking doctrine applies whenever a third party transfers property to a designated creditor of the debtor for the agreed-upon purpose of paying that creditor"); *Peoples Bank & Trust Co v Burns*, No. 02-5939, 2004 US App LEXIS 7553, at *7 (6th Cir Apr 16, 2004) ("The earmarking doctrine is an equitable doctrine by which the use of borrowed funds to discharge a debt is deemed not to be a transfer of property of the debtor, and therefore not voidable"); *Gold v Interstate Fin Corp (In re Schmiel)*, 319 BR 520, 525 (ED Mich Bankr 2005) ("It is probably more accurate to say that it represents a judicial recognition of the proposition of law that there cannot be a preferential transfer under § 547(b) in an earmarking situation because the so-called earmarked funds are not property of the debtor, as is required by § 547(b)").

10. *In re Lee*, 530 F3d at 468, *citing In re Villars*, 35 BR 868, 872 (SD Ohio Bankr 1983).

11. *In re Hartley*, 825 F2d at 1071-72.

12. *Id.* ("The earmarking doctrine, then, is a judicially-created defense that may be invoked by a defendant to a preference action in an attempt to negate § 547(b)'s threshold requirement--a transfer of an interest of the debtor in property").

13. *Id.*

14. *Peoples Bank & Trust Co.*, 2004 US App LEXIS 7553, at *11.

15. Id. at *10 ("Whether expanded application of the doctrine is warranted under the facts of this case remains to be determined, but we are unwilling, at this stage, to answer the question unequivocally in the negative").

16. *In re Computrex, Inc.*, 403 F3d 807.

17. *Id.* at 809.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.* at 810-11.

22. *Id.*

23. *Id.* at 811.

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.* at 812.

28. *Id.*, *citing In re Crouthamel Potato Chip Co*, 6 BR 501, 507 (ED Pa Bankr 1980) ("It has been consistently held that where there exists a true agency relationship, such as a bailment, a transfer by the agent of agency property to the principal is not a voidable preference. The reason is that the transfer is not of property of the debtor but of property of the principal").

29. *Id.* at 812-13, *citing Weiner v AG Minzer Supply Corp (In re UDI Corp)*, 301 BR 104, 114-15 (D Mass Bankr 2003) ("'Control' over commingled funds, for preference purposes, means the 'unfettered' right to use the funds . . . . 'Control' does not mean the ability to steal the money, or use it for personal purposes in breach of duty"), *citing Jenkins v Chase Home Mortgage Corp (In re Maple Mortgage)*, 81 F3d 592, 596 (5th Cir 1996) ("'while [the debtor] had discretion over the account itself, any presumption that it had unfettered discretion over the funds at issue in the transfer was rebutted' by the terms in the agreement governing the transfer").

30. *In re Trinity Plastics, Inc*, 138 BR 203 (SD Ohio Bankr 1992).

31. *See In re Belme*, 79 BR 355, 357 (SD Ohio Bankr 1987) (rejecting the proposition that "in any transaction where the check from a third party lender is issued in the joint names of the debtor and credi-

tor, rather than directly to the creditor, the earmarking doctrine is inapplicable per se and a preferential transfer results").

32. *In re Trinity Plastics, Inc*, 138 BR at 206.

33. *Id*. at 207.

34. *Id*.

35. *Id*.

36. *Id*. at 208.

37. *Id*.

38. *Id*.

39. *Port Side Transport, Inc v Van Huffel Tube Corp*, 127 BR 165 (ND Ohio 1989). *See also In re Belme*, 76 BR 121, 122 (SD Ohio Bankr 1987) (refusing to apply the earmarking doctrine to a situation where "a debtor grants to a third-party lender a lien upon a previously unencumbered interest in property"); *In re Van Huffel Tube Corp*, 74 BR 579, 586 (ND Ohio 1987) ("the earmarking doctrine does not apply to cases where unsecured debt is paid by means of a secured loan"); *In re Villars*, 35 BR at 872 (finding diminution of the estate where funds from a secured creditor "effected payment in full of an unsecured debt, and thereby the obtainment of a recovery in excess of the recovery of other creditors of the same class (unsecured)").

40. *Id*. at 167.

41. *In re Montgomery*, 983 F2d 1389 (6th Cir 1993).

42. *Id*. at 1395.

43. *Id*.

44. *Id*.

45. *In re Southern Indus Banking Corp*, 120 BR 921 (ED Tenn. 1989).

46. *Id*. at 923-24.

47. *Gold v Alban Tractor Co*, 202 BR 424 (ED Mich 1996).

48. *Id*.

49. *Gold v Alban Tractor Co (In re Gray Elec Co)*, 192 BR 706, 707 (ED Mich Bankr 1996).

50. *Gold*, 202 BR at 428-29.

51. *Wilson v Chamness (In re Green Valentine, Inc)*, No. 05-8010, 2005 Bankr LEXIS 1682 (6th Cir BAP Sept 8, 2005).

52. *Id*. at *4.

53. *Id*. at *10-11.

54. *Id*. at *9.

55. *Id*. at *10.

56. *Id*. at *9-10.

57. *Daneman v. Bank One, NA (In re Kalmar)*, 276 BR 214 (SD Ohio Bankr 2002).

58. *Id*. at 217.

59. *Id*.

60. *Id*.

61. *Compare Rabin v B & M Realty Corp (In re Plechaty)*, 201 BR 486 (ND Ohio Bankr 1996) (although the debtor's wife presented a check from her account to the transferee on behalf of the debtor, the debtor had filled out the check for her signature and therefore exercised sufficient control over the funds to defeat the earmarking defense); *Hunter v. Society Bank & Trust*, 149 BR 834, 852-54 (ND Ohio Bankr 1992) (although a third party provided funds to the debtor with directions to the debtor's bookkeeper to pay these funds to the transferee, the funds were commingled with the debtor's other deposits and there was no evidence that the third party controlled the transfer of the funds, and therefore insufficient evidence to invoke the earmarking doctrine); *Society Bank & Trust v Ochs*, 137 BR 251 (ND Ohio Bankr 1992) (although the funds transferred by the debtor originated from the debtor's family, a statement by the debtor's brother that the funds were "loaned to my brother, Arthur, to pay off the personal bank loans" was not sufficient to show earmarking).

62. *Emerson v Federal Sav Bank (In re Brown)*, 209 BR 874 (WD Tenn Bankr 1997).

63. Id. at 877-78.

64. *Id*. at 878.

65. *Id*.

66. *Id*. at 880.

67. *Id*. at 878.

68. *Id*. at 880.

69. *Id*. at 880-81.

70. *Id*.

71. *In re Lee*, 530 F3d 458.

72. *Id*. at 461.

73. *Id*.

74. *Id*.

75. Recording of the new mortgage took place 72 days after the closing. *Id*.

76. *Id*. at 468. For courts adopting the multiple transaction approach, *see*, *e.g.*, *Collins v Greater Atl Mortgage Corp (In re Lazarus)*, 478 F3d 12 (1st Cir 2007); *Encore Credit Corp v Lim*, 373 BR 7, 17 (ED Mich 2007); *George v Argent Mortgage Co, LLC (In re Radbil)*, 364 BR 355, 358 (ED Bankr Wis 2007); *Baker v Mortgage Elec Registration Sys (In re King)*, 372 BR 337, 341 (ED Ky Bankr 2007); *Peters v Wray State Bank (In re Kerst)*, 347 BR 418, 422 (D Colo Bankr 2006); *In re Schmiel*, 319 BR at 528; *Scaffidi v Kenosha City Credit Union (In re Moeri)*, 300 BR 326, 329-30 (ED Wis Bankr 2003); *Strauss v Chrysler Fin Co, LLC (In re Prindle)*, 270 BR 743, 746-47 (WD Mo Bankr 2001); *Sheehan v Valley Nat'l Bank (In re Shreves)*, 272 BR 614, 625 (ND WVa Bankr 2001); *Vieira v Anna Nat'l Bank (In re Messamore)*, 250 BR 913, 916 (SD Ill Bankr 2000). For the leading case adopting the single transaction approach, *see Kaler v Community First Nat'l Bank (In re Heitkamp)*, 137 F3d 1087, 1089 (8th Cir 1998).

77. *Id*. at 469-70.

78. 11 USC 547(e). Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), the relevant period was 10 days rather than 30 days.

79. *In re Lee*, 530 F3d at 470.

80. *Id*., *citing Collins v Greater Atl Mortgage Corp (In re Lazarus)*, 334 BR 542, 549 (D Mass Bankr 2005) ("The earmarking doctrine requires three specific parties: the 'debtor,' an 'old creditor,' and a 'new creditor' who pays the debtor's obligation to the old creditor").

81. *Id*. at 471.

82. *Id*. at 471-72.

83. *Id*.

84. *Id*.

85. *Id*. at 472.

86. *Id*.

87. *Id*.

88. *Id*. at 470.

89. *Id*. at 474-75.

90. *Id*.

91. *Id*.

92. *American Home Mortgage Inv Corp v Lim (In re Caurdy-Murphy)*, No 07-14384, 2008 US Dist LEXIS 92575, (ED Mich July 31, 2008).

93. *Encore Credit Corp*, 373 BR 7.

94. *In re Milliken*, No 304-05872, 2005 Bankr LEXIS 3202 (MD Tenn Bankr Oct 5, 2005). *See also Baker v Mortgage Elec Registration Sys, Inc (In re King)*, No 07-8045, 2008 Bankr LEXIS 2170 (6th Cir BAP Aug 20, 2008) (declining to apply the earmarking doctrine pre-BAPCPA where the mortgage refinancer recorded the mortgage 29 days after closing); *In re Schmiel*, 319 BR at 525 (declining to apply the earmarking doctrine where the mortgage refinancer recorded the mortgage 96 days after the closing and further stating that the

refinancer, by virtue of the new mortgage, did not receive an interest in property that was earmarked for it). *Compare Shapiro v Homecomings Fin Network, Inc (In re Davis)*, 319 BR 532 (ED Mich Bankr 2005) (declining to apply the earmarking doctrine pre-BAPCPA where the mortgage refinancer recorded the mortgage more than 10 days after the closing) *with Shapiro v Homecomings Fin Network, Inc (In re Davis)*, 318 BR 119 (ED Mich Bankr 2004) (applying the earmarking doctrine to the transfer of the funds from the new creditor to the old creditor, reasoning that such money never became property of the estate).

95. *MBNA America Bank, NA v Meoli (In re Wells)*, 561 F3d 633 (6th Cir 2009).

96. *Id*. at 634.

97. *Id*.

98. *Id*.

99. *Id*. at 635.

100. *Id*. at 634.

101. *Meoli v MBNA America Bank, NA (In re Wells)*, 382 BR 355, 361 (6th Cir BAP 2008).

102. *See also Yoppolo v MBNA America Bank, NA (In re Dilworth)*, No 07-8020, 2008 Bankr LEXIS 543 at *14 (6th Cir BAP Mar 12, 2008) (applying *Wells* and rejecting the assertion that "a bank-to-bank transfer should be treated differently than any other preferential transfer"); *Reisz v Napus Fed Credit Union (In re Anderson)*, 275 BR 264, 266 (WD Ky Bankr 2002) (earmarking doctrine did not apply where the debtor instructed a new creditor to pay the transferee and the transferee "failed to show that th[e] debtor lacked dispositive control over the payment of the funds"); *Yoppolo v Greenwood Trust Co (In re Spitler)*, 213 BR 995, 998 (ND Ohio 1997) ("for the earmarking doctrine to apply, it must be the new creditor, not the debtor, who stipulates as a condition of the loan that the proceeds be used to pay the pre-existing loan"); *In re Severn*, No 96-6057, 1996 Bankr LEXIS 1343 at *6-7 (ND Ohio Bankr Sept 9, 1996) (earmarking doctrine is inapplicable where the debtor, rather than the new creditor, chooses the recipient of the funds transferred).

103. *ThermView Indus v Clemmens (In re ThermoView Indus)*, 358 BR 330 (WD Ky Bankr 2007).

104. *Id*. at 336.

105. *Id*.

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Defending Against Preferential Transfers Post-BAPCPA: Understanding the "Ordinary Business Terms" Defense

By Anthony J. Kochis

Introduction

After a business debtor has filed for bankruptcy protection, creditors have a number of concerns, the primary ones being whether they will be paid for goods and services owing from the debtor or whether the debtor will continue to operate. A concern that creditors sometimes overlook is whether the debtor will sue the creditor to recover transfers made by the debtor prior to bankruptcy. In the ninety days immediately preceding a debtor's bankruptcy filing, the debtor is presumed to be insolvent, and the debtor may sue to recover payments made to creditors during this period.[1] This lawsuit is known as a preference action, and it can create a major headache for a creditor. If the debtor's preference action is successful, a creditor may be forced to return payments that it received from the debtor in the ninety days prior to the debtor's bankruptcy filing. Luckily, there are a number of defenses that a creditor may invoke in defense of a preference action, including the "ordinary course of business" defense and the "ordinary business terms" defense. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") significantly changed the preference landscape, including, among other things, changes to the "ordinary business terms" defense.

The "ordinary business terms" defense (objective standard) is located in section 547(c)(2) of the Bankruptcy Code.[2] Pre-BAPCPA, section 547(c)(2) read:

> (c) The trustee may not avoid under this section a transfer--
>
> (2) to the extent that such transfer was –
>
> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; *and*
>
> (C) made according to ordinary business terms.[3]

A creditor defending against avoidance of a preferential transfer under section 547(c)(2) was required to prove both subsection (B) (subjective standard) and subsection (C) (objective standard) because of the conjunction "and."

In an effort to make it easier for creditors to successfully invoke section 547(c)(2) in defense of a preference action, the United States Congress substituted the word "or" for the word "and" in section 547(c)(2).[4] The statute now reads:

> (c) The trustee may not avoid under this section a transfer—
>
> (2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—
>
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; *or*
>
> (B) *made according to ordinary business terms*[5]

A creditor defending against a preferential transfer post-BAPCPA has a much lighter burden because a creditor may now prove either subsection (A) (subjective standard) or subsection (B) (objective standard) because of the conjunction "or."

Although the changes to section 547(c)(2) appear relatively straightforward, since BAPCPA has taken effect, no consensus

has emerged regarding the interpretation of "ordinary business terms" under section 547(c)(2)(B). Issues such as the interpretation and weight of pre-BAPCPA caselaw are unresolved as courts struggle to determine whether the objective standard should continue to be interpreted as it was pre-BAPCPA, or whether it should be read in a more expansive light since it has been liberated from its conjunctive counterpart, the subjective standard. Further, courts have reached different conclusions regarding the evidentiary burdens required under section 547(c)(2)(B) and the means by which a creditor meets those evidentiary burdens. This article examines the objective standard and highlights post-BAPCPA interpretations of the objective standard.

The Objective Standard

To prevail under the objective standard, a creditor must prove that the debtor made the challenged transfer "according to ordinary business terms" or within the range of terms prevailing in the relevant industry.[6] Courts interpreting the objective standard begin their analyses by defining the relevant industry applicable to the debtor/creditor relationship.[7] The second step is to define what constitutes payment within "ordinary business terms" in the given industry.

Defining the Relevant Industry

In many situations, the parties disagree regarding how broadly or narrowly to construe the definition of the relevant industry. This is because courts interpreting the relevant industry are not uniform in their analysis,[8] and the relevant industry standard is not a one-size-fits-all definition. The Seventh Circuit highlighted the inherent difficulty in defining the relevant industry in a case where the debtor, a pizza maker, issued checks to its supplier, a sausage maker, commenting: "is [the relevant industry], the sale of sausages to makers of pizza? The sale of sausages to anyone? The sale of anything to makers of pizza?"[9]

It is often easier to define the relevant industry where both debtor and creditor are involved in the same or related industries. For example, in a situation where the debtor is an automobile manufacturer, and the creditor is a manufacturer and supplier of automobile component parts, it is safe to conclude that the relevant industry is the automobile industry. However, even among parties in the automobile industry, the definition of the relevant industry turns on the nature of the business and the relative size of the parties. In the automobile example, if the creditor is a high volume supplier, the creditor should take into account its sales volumes as compared to other similarly-situated creditors. A higher or lower sales volume will likely affect the timing, nature, and circumstances of transactions betweeen debtor and creditor and, therefore, affect the definition of the relevant industry. Similarly, if the creditor supplies automobile components that are unique in nature, a creditor should be mindful that the specific nature of the goods may also affect the timing, nature, and circumstances of the transactions and play a significant role in crafting the definition of the relevant industry.

A creditor should also keep in mind that it may be difficult to obtain payment information and trends regarding the relevant industry. There are several factors that prevent parties from gathering this information, such as antitrust issues, proprietary concerns, or the lack of available data due to the non-existence of competitors in the industry.[10] Accordingly, a creditor attempting to define the relevant industry must have a firm understanding of the evidence that will be used to support its case and must be prepared to offer sufficient admissible evidence to convince the court to accept its definition of the relevant industry. All of these factors must be thoroughly explored and understood before engaging in an ordinary business terms analysis.

Demonstrating "ordinary business terms"

The Bankruptcy Code does not define the term "ordinary business terms," but the federal circuit courts have developed several interpretations. For example, the Second Circuit has held that the objective standard requires a creditor to demonstrate that payments fall within the bounds of ordinary practice of others similarly situated.[11] The Seventh Circuit has held that the objective standard refers to a range of terms that are similar to the way the creditor engages, and that dealings outside that range are outside the scope of the objective standard.[12] Similarly, the Sixth Circuit has held that the objective standard means "that the transaction was not so unusual as to render it an aberration in the

The Bankruptcy Code does not define the term "ordinary business terms," but the federal circuit courts have developed several interpretations.

relevant industry."[13] In *Luper v Columbia Gas (In re Carled, Inc*), the Sixth Circuit attempted to further refine the definition of "ordinary business terms" by specifically rejecting two definitions of ordinary business terms:

> 1. "[W]e reject the definition of 'ordinary business terms' adopted by the district court, which would require that the transactions at issue resemble a *majority* of the industry's transactions"; and
>
> 2. "[W]e reject the definition adopted by the bankruptcy court requiring Columbia to establish the lateness as a pattern for a *significant* percentage of specific customers."[14]

The Sixth Circuit found the transfers at issue in *In re Carled, Inc* within the "ordinary business terms" of the relevant industry where the transfers were within the billing cycle and thus, not "aberrational, unusual, or idiosyncratic."[15] As demonstrated by *In re Carled, Inc,* a creditor invoking the objective standard is not required to present evidence of a single, uniform set of credit terms in the relevant industry and then apply that evidence to the alleged preferential transfers.[16] Instead, a creditor must fashion evidentiary support demonstrating that the alleged preferential transfers are not outside the realm of what would be considered normal within the relevant industry.

While not completely overruling pre-BAPCPA caselaw regarding the objective standard, the revision has created ambiguity regarding the weight that should be afforded pre-BAPCPA interpretations of the objective standard.

Creditors presenting evidence in support of their definition and application of the relevant industry standard often rely on the testimony of company representatives or employ experts to evaluate and summarize statistical data related to the alleged preferential transfers.[17] Typically, the experts have some sort of financial or accounting expertise. An expert should be advised of the facts comprising the debtor/creditor relationship and information pertaining to the alleged preferential transfers. With a firm understanding of the nature of the parties' relationship, an expert will generally gather information related to the relevant industry. Sources such as Capital IQ, the Credit Research Foundation, the Risk Management Association, and Dun & Bradstreet collect payment information in varying degrees. The expert must compare and contrast the relevant industry data with the debtor/creditor data. Ultimately, the expert must establish a standard of evidentiary reliability, and the court, as gatekeeper, must decide how much or how little weight to give the testimony of the expert.[18]

Section 547(c)(2)(B) Post-BAPCPA

In substituting "or" for "and," Congress lessened a creditor's evidentiary burden by requiring that a creditor demonstrate that the transfer was within either the "ordinary course of business" or "ordinary business terms."[19] This change has liberated the objective standard from the controlling influence of the subjective standard and placed the objective standard on equal footing.[20] While not completely overruling pre-BAPCPA caselaw regarding the objective standard, the revision has created ambiguity regarding the weight that should be afforded pre-BAPCPA interpretations of the objective standard.

Although the words "ordinary business terms" were not changed by BAPCPA, the context in which they appear in section 547(c)(2) has substantially changed.[21] In fact, some authorities have suggested that cases decided under former section 547(c)(2)(C) will be less instructive in interpreting new section 547(c)(2)(B).[22] Under pre-BAPCPA caselaw, courts often subordinated the importance of "ordinary business terms" in cases where the parties had an extensive history.[23] The evidentiary burden required to meet the objective standard was light where a prior history existed between the debtor and creditor because the objective standard was relevant, but less significant than the subjective standard.[24] Accordingly, the interpretation of the objective standard was often influenced, if not completely subordinated to, the subjective standard.

Some courts continue to apply pre-BAPCPA precedent to post-BAPCPA section 547(c)(2)(B). For example, in *Womack v Horob Livestock Inc (In re Horob Livestock Inc*), the court noted that pre-BAPCPA caselaw is instructive when interpreting the objective standard post-BAPCPA, stating that the application of section 547(c)(2)(B) is "well-settled."[25] While the court did not reach the merits of the application of the objective standard, the court relied upon controlling Ninth Circuit precedent.[26] Pre-BAPCPA Ninth Circuit caselaw applied a two-part test that examined a broad range of dealing between similarly situated debtors and creditors and required the creditor to prove that the transfers were within these business terms.[27] The Ninth Circuit has acknowledged that this is a lenient standard, which creditors should be able to satisfy with ease.[28] One potential concern is that courts construing the objective standard post-BAPCPA may view pre-BAPCPA prec-

edent as too lenient or undeveloped and require an additional showing by the creditor to meet the objective standard.

For instance, at least one court in the Fourth Circuit has held that the objective standard requires a creditor to present additional evidence post-BAPCPA, such as evidence of the relevant industry of the debtor and standards applicable to business in general.[29] Prior to BAPCPA, controlling Fourth Circuit precedent analyzed only the norm in the creditor's industry when determining whether a transfer was made according to ordinary business terms.[30] The additional evidence required by the court in *National Gas Distribs v Branch Banking & Trust Co (In re Nat'l Gas Distribs)* indicates that some courts will revisit, or at least more closely scrutinize, pre-BAPCPA interpretations of the objective standard.[31]

Revised section 547(c)(2) is supported by clear congressional intent to lighten a creditor's burden of proof in defending against preferential transfers.[32] Courts interpreting post-BAPCPA section 547(c)(2)(B) are faced with a quandary—now that the objective standard is a separate and equivalent defense, should courts require a higher evidentiary standard in order to account for the subordinated treatment and interpretation of the objective standard under pre-BAPCPA caselaw, or would requiring a higher evidentiary standard run counter to congressional intent to lighten a creditor's evidentiary burden?

Unfortunately, there are more open questions than answers regarding this issue, and it is unknown how courts in other jurisdictions will interpret post-BAPCPA section 547(c)(2)(B). A creditor should be mindful of these concerns and carefully examine the applicable caselaw in its jurisdiction regarding the objective standard. Although BAPCPA lightened a creditor's burden, a court construing pre-BAPCPA objective standard precedent may require additional evidence to demonstrate "ordinary business terms" post-BAPCPA.

How Post-BAPCPA Objective Standard May Be Applied

The legislative history of section 547 indicates that the purpose is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or creditors during the debtor's slide into bankruptcy.[33] Despite the varying interpretations of section 547(c)(2)(B), a creditor defending a preference action is better equipped to defend against alleged preferential transfers post-BAPCPA for a number of reasons. First, a creditor may defend against alleged preferential transfers by proving that the transfers are subjectively in the ordinary course of business between the parties. This allows a creditor to cast a wider net compared to pre-BAPCPA because creditors may defend against transfers that meet the subjective standard without worrying about meeting the requirements of the objective standard. Second, a creditor may defend against alleged preferential transfers by proving that the payments were made pursuant to ordinary business terms. This again is a wider net as compared to pre-BAPCPA because it is possible that transfers during the pre-preference period are completely out of sync with transfers during the preference period, but that the preference period transfers still conform to the industry norm. Under these facts, a creditor could argue that the transfers were made according to ordinary business terms, while ignoring the subjective standard, which was not possible under pre-BAPCPA section 547(c). Third, and maybe most importantly, a creditor may assert the subjective and objective standards at the same time, which results in layered defense that constitutes a much wider net than what was possible pre-BAPCPA.

What follows is a hypothetical example of how a creditor may layer the two defenses: suppose that debtor, NDebt Co., is in the business of manufacturing automobiles, and creditor, ABC Co., supplies automobile components. In the automobile industry, the average number of days for payment after invoice is approximately forty-five days.[34] In the course of dealing between ABC Co. and NDebt Co., payments average approximately twenty-five days after invoice.

Oblivious to the near certain demise of a company named NDebt Co., ABC Co. supplies NDebt Co. with automobile components, and NDebt Co. makes ten transfers of $10,000 each to ABC Co. within ninety days of NDebt Co.'s bankruptcy filing. Debtor, NDebt Co., now alleges that the aggregate amount, $100,000, constitutes preferential transfers in favor of ABC Co. and seeks to avoid the transfers. The payment history during the preference period is as follows:

Although BAPCPA lightened a creditor's burden, a court construing pre-BAPCPA objective standard precedent may require additional evidence to demonstrate "ordinary business terms" post-BAPCPA.

Shipment/Invoice Date	Payment Date	Days	Payment Amount
8/9/2009	9/1/2009	23	$10,000.00
8/15/2009	9/9/2009	25	$10,000.00
8/24/2009	9/19/2009	26	$10,000.00
8/19/2009	9/20/2009	32	$10,000.00
8/12/2009	9/23/2009	42	$10,000.00
8/14/2009	9/27/2009	44	$10,000.00
8/21/2009	10/5/2009	45	$10,000.00
9/5/2009	10/21/2009	46	$10,000.00
9/9/2009	10/22/2009	43	$10,000.00
10/7/2009	10/31/2009	24	$10,000.00
TOTAL			**$100,000.00**

Looking at the preference period payment history, four payments were made approximately twenty-five days after invoice, and five payments were made approximately forty-five days after invoice. Because payments approximately twenty-five days after invoice are in the ordinary course of business between ABC Co. and NDebt Co., ABC Co. may invoke the subjective standard to shield these transfers.[35] If successful, $40,000 would not be subject to avoidance under the subjective standard. Additionally, considering that the average number of days for payment after invoice is approximately forty-five days in the automobile industry, ABC Co. may also invoke the objective standard with respect to five payments. These five payments range between one and three days of the industry norm, and ABC Co. would have a strong argument that payments fluctuating between one and three days of the industry norm are not an aberration in the industry. Therefore, if successful, $50,000 would not be subject to avoidance under the objective standard. In total, by combining both defenses, ABC Co. is able to defend against $90,000 of the alleged preferential transfers. This result would not have been possible pre-BAPCPA because ABC Co. could not have layered the subjective and objective course defenses in this manner.

As the above example indicates, ABC Co. was able to defend against alleged preferential transfers by combining both the objective and subjective standards. A court applying pre-BAPCPA section 547(c) would have examined the parties' dealings with one another, the timing, the amounts at issue, the circumstances of the transactions, and then examined whether the particular transactions in question comport with the objective *and* subjective standards.[36] Considering that average transfers in the automobile industry are forty-five days after invoice in the above hypothetical, and the course of dealing between the parties is twenty-five days after invoice, ABC Co. would have a difficult time defending against the alleged preferential transfers under pre-BAPCPA standards. But because the objective and subjective defenses are now disjunctive, ABC Co. can simultaneously invoke sections 547(c)(2)(A) and 547(c)(2)(B) to defend against the alleged preferential transfers. By layering the subjective and objective defenses, a creditor may defend against a much larger range of allegedly preferential transfers.

Conclusion

Congressional revisions to section 547(c) have substantially altered the strategy and possibly the analysis involved in defense of preferential transfers. Strategically, post-BAPCPA section 547(c) appears to allow a creditor to invoke the subjective standard, objective standard, or simultaneously layer the objective and subjective standards to defend against a wider range of preferential transfers. Creditors should, however, be mindful that pre-BAPCPA caselaw may be less instructive and that courts may distinguish pre-BAPCPA precedent that subordinated the importance of the objective standard. Overall, when crafting a strategy and analysis in defense of alleged preferential transfers, creditors should be mindful of the underlying policy of section 547 to leave undisturbed normal financial relations between the parties prior to a debtor's bankruptcy filing. With these considerations in mind, a creditor will be well-suited to defend against preferential transfers under the objective standard.

NOTES

1. See generally, 11 USC 547. The elements of a preference are a transfer of an interest of the debtor in property:

(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made--
(A) on or within 90 days before the date of the filing of the petition; or
(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
(5) that enables such creditor to receive more than such creditor would receive if--
(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

2. 11 USC 101 et seq.

3. 11 USC 547(c) (1978) (emphasis added).

4. See *Collier on Bankruptcy* ¶ 547.LH[(5)] (15th ed. 2009) (discussing the 2005 BAPCPA amendments to Section 547).

5. 11 USC 547(c) (2009) (emphasis added).

6. *Luper v Columbia Gas (In re Carled, Inc)*, 91 F3d 811, 815 (6th Cir 1996) ("courts do not look only at the manner in which one particular creditor interacted with other similarly situated debtors, but rather analyze whether the particular transaction in question comports with the standard conduct of business within the industry").

7. *Scharffenberger v United Creditors Alliance Corp (In re Allegheny Health, Educ & Research Found)*, 292 BR 68, 86 (WD Pa 2003) ("[B]efore one can ascertain what constitutes the relevant industry norm, one must determine what constitutes the relevant industry").

8. For instance, the Fourth Circuit has stated that the objective standard requires analysis of the creditor's industry, while the Eighth Circuit has held that the objective standard requires analysis of the debtor's industry. Compare *Advo-System v Maxway Corp*, 37 F3d 1044, 1048 (4th Cir 1994) (courts must "look to the norm in the creditor's industry") with *Shodeen v Airline Software, Inc (In re Accessair, Inc)*, 314 BR 386, 394 (8th Cir BAP 2004) ("Section 547(c)(2)(C) requires the transferee to demonstrate that the debtor made the preferential transfer according to the ordinary business terms prevailing within the debtor's industry"), *aff'd*, 163 Fed Appx 445 (8th Cir 2006).

9. *In re Tolona Pizza Prods Corp*, 3 F3d 1029, 1033 (7th Cir 1993).

10. *In re Carled, Inc,* 91 F3d at 819.

11. *Lawson v Ford Motor Co (In re Roblin Indus),* 78 F3d 30, 41 (2d Cir 1996).

12. *In re Tolona Pizza Prods Corp,* 3 F3d at 1033.

13. *In re Carled, Inc,* 91 F.d at 818; see also *In re Fred Hawes Org, Inc,* 957 F2d 239, 246 (6th Cir 1992) ("A transaction is objectively ordinary if it does not deviate from industry norm but does conform to industry custom").

14. *In re Carled, Inc,* 91 F3d at 818 (emphasis in original).

15. *Id.*

16. See also *In re Tolona Pizza Prods Corp,* 3 F3d at 1033 (stating that ordinary business terms "does not mean that the creditor must establish the existence of some single, uniform set of business terms.")

17. *Official Comm of Unsecured Creditors v Robinson Lumber Co (In re Hardwood P-G, Inc)*, No 06-50057-C, 2007 Bankr LEXIS 2762 (Bankr WD Tex Aug. 13, 2007) ("There must be some basis in the practices in the industry to authenticate the credit arrangement at issue. Testimony of the transferee's company representatives about practices in the industry is sufficient to meet this burden") (internal citations omitted); *Schnittjer v Alliant Energy Co (In re Shalom Hospitality, Inc)*, 293 BR 211, 215 (Bankr ND Iowa 2003) ("Many courts have relied on expert testimony to establish industry practice as to the length of time it usually takes suppliers to be paid by customers, although expert testimony is not required").

18. See *Kumho Tire Co v Carmichael*, 526 US 137, 149 (1999) ("We conclude that Daubert's general principles apply to the expert matters described in Rule 702. The Rule, in respect to all such matters, 'establishes a standard of evidentiary reliability.' It 'requires a valid . . . connection to the pertinent inquiry as a precondition to admissibility.' And where such testimony's factual basis, data, principles, methods, or their application are called sufficiently into question, the trial judge must determine whether the testimony has 'a reliable basis in the knowledge and experience of [the relevant] discipline'") (internal citations omitted); *Daubert v Merrell Dow Pharms*, 509 US 579, 589 (1993) ("under the [Federal Rules of Evidence] the trial judge must ensure that any and all scientific testimony or evidence admitted is not only relevant, but reliable").

19. See generally, Scott A. Wolfson, *"And" to "Or" Means Preference No More: The Expansion of the "Ordinary Course" Bankruptcy Preference Defense*, Mich Bus L J, Spring 2006.

20. *National Gas Distribs v Branch Banking & Trust Co (In re Nat'l Gas Distribs)*, 346 BR 394, 403 (Bankr EDNC 2006) ("The yolk [sic] between the ordinary course of business defense and the ordinary business terms components of § 547(c)(2) has been removed by BAPCPA, and ordinary business terms has been released from the controlling influence of the ordinary course of business subsection") (internal quotations omitted).

21. *Id.* at 396.

22. *Collier on Bankruptcy* ¶ 547.04[(2)(a)(i)] (15th ed. 2009).

23. *In re Nat'l Gas Distribs*, 346 BR at 402 ("subsection (C) was perceived as somewhat less important because it focused on objective, larger-scale industry standards instead of the more immediate facts of the parties' relationship, which were reserved for discussion under the umbrella of subsection (B)").

24. *Advo-System v Maxway Corp*, 37 F3d at 1050 ("On the other hand, when the parties have an established relationship, the terms previously used by the parties in their course of dealing are available as a potential baseline. The industry norm, though still relevant, becomes less significant").

25. *Womack v Horob Livestock Inc (In re Horob Livestock Inc),* 382 BR 459, 487 (Bankr D Mont 2007).

26. See *id.* at 487 ("The application of § 547(c)(2)(B), which is now separated from § 547(c)(2)(A) with an 'or' rather than an 'and', is equally 'well-settled'") (citing *Sigma Micro Corp v Healthcentral.com (In re Healthcentral.com)*, 504 F3d 775, 791 (9th Cir 2007)).

27. *In re Healthcentral.com*, 504 F3d 775, 791 (9th Cir 2007) ("To satisfy § 547(c)(2)(C) the creditor must demonstrate that the relevant payments were ordinary in relation to prevailing business terms. As before, this effectively breaks down into two components. First the creditor must establish the broad range of business terms employed by similarly situated debtors and creditors, including those in financial distress, during the relevant period. Second, the creditor must show that the relevant payments were ordinary in relation to these prevailing business terms.") (internal quotations and citations omitted).

28. *Id.* ("In general, § 547(c)(2)(C) should not pose a particularly high burden for creditors").

29. See *In re Nat'l Gas Distribs,* 346 BR at 404 ("Now that 'ordinary business terms' is a separate defense, the court must consider the industry standards of both the debtor and its creditors. Furthermore, there are general business standards that are common to all business transactions in all industries that must be met").

30. *Advo-System v Maxway Corp*, 37 F3d at 1048 ("we hold that subsection C requires us to look to the norm in the creditor's industry when determining whether preference payments were made according to ordinary business terms").

31. The court reasoned that the additional evidence was justified because "[i]f the 'ordinary business terms' defense only requires examination of the industry standards of the creditor, there would be no review or check on the debtor's conduct." *In re Nat'l Gas Distribs*, 346 BR at 404. Further, the opinion suggests (but does not explicitly state) that pre-BAPCPA objective standard precedent may be too lenient. See *id.* at 405 ("Although the creditor's burden [under the objective standard] has been lightened by BAPCPA, it still has some weight, and it has not been lightened to the extent that BB&T can prevail in this proceeding").

32. See *supra* n.4.

33. H.R. Rep. No. 95-595, at 373 (1977); S. Rep. No. 95-989, at 88 (1977); see also *Savage & Assocs v Mandl (In re Teligent Inc),* 380 BR 324, 340 (Bankr SDNY 2008).

34. This figure is for the purposes of the hypothetical only.

35. This analysis assumes that ABC Co. could satisfy its evidentiary burden.

36. *Brandt v Repco Printers & Lithographers (In re Healthco Int'l)*, 132 F3d 104, 109 (1st Cir 1997) ("several factors . . . bear upon whether a particular transfer warrants protection under section 547(c)(2). These factors include the amount transferred, the timing of the payment, the historic course of dealings between the debtor and the transferee, and the circumstances under which the transfer was effected").

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Minimizing a Manufacturer's Exposure to Bankruptcy Preference Claims by Asserting Purchase Money Security Interests and Special Tools Liens

By Daniel M. Morley and Kristen A. Campbell

The Preference Problem

To say that many of Michigan's manufacturers are currently suffering a rash of losses as a result of bankruptcy filings is a monumental understatement. The automotive industry has been particularly hard hit.[1] To add insult to injury, it is not uncommon for manufacturers that have already suffered a loss as a result of a customer's bankruptcy to later receive a notice from the bankruptcy trustee or the debtor in possession[2] that demands that the manufacturer must pay back the monies received from their bankrupt customer within the ninety-day period[3] preceding the "petition date." This ninety-day period is known as the "preference period." The United States Bankruptcy Code[4] (the "Code") presumes that a debtor is insolvent during this ninety-day period.[5] All payments and transfers made to creditors by the debtor during this period are considered suspect and are referred to as "preference payments."

While it may not *seem* fair, the rationale for the disgorgement and return of preference payments under the Code is based on the concept of ensuring the fair and equal treatment of all unsecured creditors. The recovery of preference payments is intended to redistribute the bankruptcy estate's assets equitably among all of the bankrupt's unsecured creditors. Under the Code, the trustee (or the debtor in possession in a Chapter 11 proceeding) may set aside transfers of the debtor's interest in property: 1) to or for the benefit of a creditor; 2) for or on account of an antecedent debt owed by the debtor before such transfer was made; 3) made while the debtor was insolvent; 4) made on or within ninety days before the date the petition was filed (or if the creditor was an insider, on or within one year before the date the petition was filed); and 5) that enabled the creditor to receive more than the creditor would have received if the case were a Chapter 7 liquidation proceeding.[6] It is important to note that this section does not require proof of intent to receive a preference, notice of the debtor's insolvency, fraud, or any other subjective element.

In many cases, preference claims are the largest asset of the bankruptcy estate. The recovery of preference claims has frequently been referred to as the "bread and butter" for bankruptcy trustees and their attorneys. Often preference claims are the only source of cash with which to pay the fees and expenses of a Chapter 7 trustee, their legal counsel, and other priority expenses.

While a number of defenses to a preference claim are available to a creditor,[7] defending a preference action can be very costly. Preventing a preference claim altogether is preferable (pun intended) to defending such a claim. By altering a manufacturer's status from an unsecured creditor to a perfected secured creditor, a manufacturer may be able to effectively avoid a preference action in its entirety.

The Purchase Money Security Interest Solution

How can a manufacturer avoid a preference claim? In most instances, manufacturers deliver goods to their customers on a credit or on an open account basis. Credit terms may vary from "Net 30," to "Net 60," to "Net 90," or even longer in some instances. And as is often the case, and perhaps even more prevalent in the current economic climate, payments tend to be delinquent a month or more beyond what the contract terms permit. This means that not only is the manufacturer providing the goods on credit, the manufacturer is effectively providing its customers

with short-term financing for those goods. Often these open accounts can grow into the six-figure range or higher. Having to disgorge a six-figure preference payment after the customer files bankruptcy can be devastating to the manufacturer and may even result in the manufacturer's own bankruptcy filing.

As noted, a solution to this preference predicament can be achieved by altering the manufacturer's position from a "general unsecured creditor" to that of a "secured creditor." A payment made to a fully secured creditor during the ninety-day preference period is not preferential. In return for the payment to the secured creditor, the debtor receives a release of the lien in the collateral; and thus, there is technically no depletion of the debtor's estate,[8] so the creditor does not receive more than it would in a Chapter 7 bankruptcy proceeding.[9]

While a number of defenses to a preference claim are available to a creditor, defending a preference action can be very costly.

In short, an unsecured manufacturer needs to become a secured creditor. One solution lies in the manufacturer's acquisition of a purchase money security interest in the goods supplied to the debtor/customer on credit. The concept is this: by providing the customer with the goods on credit and allowing the customer to take title to the goods on delivery, the manufacturer is providing the debtor with the financing to purchase the manufactured goods.

A purchase money security interest[10] ("PMSI") is best described as a security interest held by a creditor that has financed the purchase of collateral to secure repayment of all or part of that purchase price. The typical instance of a PMSI occurs when a bank or other financial institution provides financing to a party to purchase a new piece of equipment (or other goods). In return for providing its financing, the bank takes a security interest in the equipment. In the event the borrower defaults on the loan, the bank then repossesses the equipment to satisfy all or a part of the indebtedness. Provided the bank follows the necessary formalities to perfect its security interest in the newly purchased equipment, the bank's PMSI in the equipment is of a higher priority than the other creditors that may hold general security interests in all of the debtor's assets. In the event of the borrower/customer's bankruptcy, the bank may recover the equipment from the bankruptcy estate to satisfy the debt.

Conceptually, there is no difference between the traditional debtor-creditor relationship involving a bank and borrower and when a manufacturer provides short-term financing to its customer.[11] Thus, to take advantage of the benefits of being a secured creditor, the manufacturer must follow the same requirements to obtain a PMSI in the equipment or other goods that it supplies. What are those requirements? First, there must be a debt. Second, there must be an agreement by which the borrower/customer grants a security interest in the goods to the manufacturer. Third, the manufacturer must timely record a financing statement that adequately describes the collateral in the state in which the borrower/customer is located.[12]

With regard to the first requirement, there is no question that when a manufacturer provides goods to a customer on credit terms, a debt exists.

The second requirement is that there is an agreement by the customer to grant a security interest in goods. How is this agreement created? In many instances, the security interest's terms can simply be included in the terms of the formal contract between the parties. It is recognized, however, that in many cases, such as the automotive industry, manufacturers contract through various proposals, purchase orders, and invoices as opposed to a single controlling contract. In these situations, the contract terms are simply boilerplate provisions included in the forms. The actual terms of the contract lie somewhere within the documents exchanged between the customer and the manufacturer. In these instances, the necessary terms to grant the manufacturer a security interest in the goods can be added to the boilerplate terms and conditions that comprise the manufacturer's standard form proposal, purchase order, and invoice documents.

Note, however, that the terms of a customer's purchase order may vary from the manufacturer's proposal and the invoice. Consequently, the insertion of additional security interest terms into the form documents may not automatically control the "battle of the forms" and may not, in all cases, conclusively establish a security agreement.[13] Therefore, the methodology that inserts the critical terms into the manufacturer's form documents should be carefully scrutinized. When possible, a formal security agreement signed by the customer is preferable to boilerplate security interest terms that are inserted into form purchase order documents.

Finally, the manufacturer will need to record a financing statement in the appropriate

office in the state in which the debtor/customer is located.[14] In Michigan, the proper location to file the financing statement is the Michigan Department of State, UCC Unit. The UCC-1 financing statement form must clearly describe the collateral. In the case of an equipment manufacturer, the use of serial numbers in the UCC-1 form is strongly encouraged for identification purposes. The financing statement must be filed within twenty days after the debtor takes possession of the collateral.[15] The filing of the financing statement before the debtor takes possession of the collateral is permissible.

Taking a PMSI in goods that will become inventory of the debtor is slightly more complicated. First, the manufacturer must conduct a search of the UCC records to determine which, if any, other creditors claim an interest in the inventory of the debtor. Then, the manufacturer must send an "authenticated notification" to the holders of any conflicting security interest in the customer's inventory.[16] The notice must be received within five years before the debtor/customer receives possession of the inventory.[17] The notice must state that the prospective PMSI holder expects to acquire a PMSI in the debtor/customer's inventory and describe the type of inventory that is to be financed.[18] The PMSI holder must again ensure that it files a financing statement within twenty days after the debtor/customer takes possession of the inventory.[19]

Also, it should be noted that a manufacturer with a PMSI in a "floating mass," such as a fluctuating pool of inventory, is subject to preference attack to the extent the manufacturer improves its position during the ninety-day period before bankruptcy.[20] In other words, if a manufacturer with a perfected security interest in the customer's inventory is better off on the date of the petition than it was ninety days before the petition, there is, by default, a preference.

While the purpose of this article is to provide a manufacturer with a process to attain protection from preference claims in the event of a customer's bankruptcy filing, following these procedures also provides the added benefit in the event the manufacturer remains unpaid for the goods irrespective of its customer's bankruptcy. If the manufacturer is a secured creditor, and a default in payment occurs, the manufacturer/lender can recover the collateral and sell it to pay down the customer's indebtedness.[21]

An Alternative Solution under the Michigan Special Tools Lien Act

Michigan entities that manufacture equipment and deliver the equipment to their customers before receiving final payment may also find it possible to avoid a preference claim if they follow the procedures to perfect a lien in the equipment under the Michigan Special Tools Lien Act. [22]

The purpose of the Michigan Special Tools Lien Act (the "Act") is to provide protection to manufacturers by allowing liens to be imposed on valuable and specially designed and created products used in manufacturing in order to collect amounts owed for the creation of the special tools.[23]

The Act provides a very wide-ranging definition of "special tool." This definition includes any tools, dies, jigs, gauges, gauging, fixtures, special machinery, cutting tools, or metal castings manufactured by a special tool builder.[24] A "special tool builder" is a person who designs, develops, manufactures, or assembles special tools for sale.[25] It is likely that much of the equipment that a manufacturer produces will fall under this definition of "special tool."

Since the lien arises out of the operation of law, there is no requirement that the manufacturer have an agreement with its customer by which the customer expressly provides lien rights to the manufacturer, unlike the case when obtaining a PMSI. However, there is a process that the manufacturer must follow to perfect its lien rights in the "special tool" it manufactures and delivers to its customer.[26]

Under the Act, the manufacturer of the special tool must permanently record on every special tool that it fabricates, repairs or modifies, the special tool builder's name, street address, city, and state.[27] Additionally, the Act specifies that the manufacturer "shall file a financing statement" in the same manner it would perfect a security interest under Michigan's Uniform Commercial Code.[28] It is advisable that the manufacturer record its financing statement as soon as it is able to identify the equipment, even before delivery of the equipment to the customer. In any event, the manufacturer should perfect its lien interest in the equipment by filing the financing statement within twenty days after the customer takes delivery of the equipment.

Pursuant to the Act, the special tool builder holds a lien in the equipment for the

If the manufacturer is a secured creditor, and a default in payment occurs, the manufacturer/lender can recover the collateral and sell it to pay down the customer's indebtedness.

amount that the customer owes for the fabrication, repair, and/or modification of the special tool.[29] The lien attaches when the actual or constructive notice is received by the customer (or the end user).[30] The Act provides that the filing of a UCC-1 financing statement constitutes actual and constructive notice of the manufacturer's special tools lien.[31] However, the Act does not preclude other types of "actual" or "constructive" notice of the lien. To further bolster a manufacturer's lien claim, the manufacturer should include a statement in the quotation and invoice documents that the "special tool" produced under the contract is subject to the lien provided in the Act. Arguably, the inclusion of such a statement in the quotation and invoice documents provides the necessary notice such that the failure to correctly file a UCC-1 financing statement may not defeat the manufacturer's lien claim.[32] However, in a very recent decision, the U.S. Bankruptcy Court for the Eastern District of Michigan has held that in order to obtain an enforceable special tools lien, the Act requires a two-step process: the permanent recording of information on the tool, and the filing of a financing statement in accordance with section 9-502 of the Uniform Commercial Code.[33]

As is the case where the manufacturer perfects a PMSI in equipment, in addition to providing protection from preference claims in a bankruptcy, the special tools lien affords a remedy where the manufacturer is unpaid. To enforce the lien, the special tool builder is required to give notice of the lien in writing to the customer[34] by either certified mail or by hand delivery.[35] The notice must state that a lien is claimed, the amount claimed due for the fabrication, repair and/or modification of the special tool, and a demand for payment.[36] If the manufacturer is not paid within ninety days of receipt of the notice, the manufacturer may take possession of the special tool and sell it.[37]

Comparing a PMSI to the Special Tools Lien

Both obtaining a PMSI and relying on a special tools lien have advantages and disadvantages. Whenever possible, the manufacturer should attempt to obtain and perfect both a PMSI and a special tools lien.

Customers may balk at including language within contract documents that grants the manufacturer a PMSI in the equipment or inventory. In many instances, the customer will insist that its principal financier will not permit any other party to acquire a lien interest in the customer's assets. While it is common that loan covenants with its principal financier may prohibit the customer from granting any additional security interests in the customer's assets, the manufacturer's argument is that it is not acquiring a security interest in any of the customer's existing assets. Rather, the manufacturer is simply seeking to obtain a security interest in goods that are not yet in existence and that the manufacturer will terminate its security interest in the collateral as soon as it receives payment.

Since a special tools lien is created by operation of law and it is not required to be provided for in an agreement between the parties, this discussion will rarely arise between a manufacturer and its customer where the Act's special tools lien is available to a manufacturer. However, it has been reported that at least one original equipment manufacturer has notified tier-one suppliers and tool vendors that, as a matter of policy, its suppliers and tool vendors are prohibited from permanently recording their names and addresses on tools.[38] Complying with this policy will eliminate the ability to claim a special tools lien.

Where equipment is delivered out of Michigan, unless the laws of the destination state provide a similar lien, the manufacturer may not be able to claim a special tools lien.[39] A manufacturer may be able to avoid this problem by inserting language in its contract documents that specifies that Michigan law applies to and governs the contract which provides an avenue for the filing of a special tools lien on the equipment even though it is located in another state.[40] Alternatively, the manufacturer should have its legal counsel scour the laws of the state of the equipment's destination to determine whether that state provides a lien similar to the special tools lien, and if so, take the steps necessary to create and perfect such a lien. Since Revised Article 9 the Uniform Commercial Code has been adopted in one form or another by all fifty states, this is not an issue with the creation of a PMSI, although attention should be given in reviewing the applicable provisions of the state where the UCC-1 financing statement will be filed to ensure the perfection of the PMSI.

Finally, in some circumstances the manufacturer may find it impractical or impossible to recover and sell the recovered equipment

Where equipment is delivered out of Michigan, unless the laws of the destination state provide a similar lien, the manufacturer may not be able to claim a special tools lien.

in the event of non-payment. There may be no other market for the type of equipment manufactured, or the equipment may be subject to asserted intellectual property rights that prohibit the sale of the seized equipment.[41]

An "Assist" in Reclamation Claims

A manufacturer that retains a PMSI in inventory or perfects a special tools lien in equipment delivered to its customer may also receive an added benefit in making a reclamation claim in the event the customer files for bankruptcy protection after the customer receives possession of the goods, but before it makes payment to the manufacturer. Under the Uniform Commercial Code, a seller has a right to reclaim goods sold on credit to an insolvent buyer by making written demand on the buyer within ten days after the goods are received by the buyer.[42]

The 2005 amendments to the Bankruptcy Code purported to grant even broader reclamation rights in bankruptcy cases than are available under the UCC. First, the Code was amended to expand the reach-back period from ten days to forty-five days.[43] As a result, sellers have more time to reclaim their goods under the Bankruptcy Code than under state law. Specifically, if the buyer files for bankruptcy protection, the seller's reclamation right extends to goods delivered up to forty-five days beforehand. Second, the 2005 amendments also expanded the grace period, giving the seller twenty days after a bankruptcy filing to deliver a reclamation notice where the forty-five-day reclamation period expires after the bankruptcy filing.[44] This effectively gives the seller up to sixty-five days after delivery of goods to a customer (forty-five-day reach-back plus twenty-day period to deliver the reclamation notice) to reclaim them. Additionally, and although not strictly a "reclamation" remedy, the amendments give the seller an administrative priority claim[45] equal to "the value of the goods received by the debtor within twenty days before [the date of the bankruptcy filing] in which the goods have been sold to the debtor in the ordinary course of such debtor's business."[46]

Traditionally, reclamation is a difficult remedy to obtain. Courts have determined that the goods must be identifiable and in possession of the debtor on the date of the reclamation demand. In other words, goods that are resold by the buyer, incorporated into finished products, or consumed in the buyer's business operations cannot be reclaimed.[47] The greatest impediment to a seller's reclamation claim, however, is the existence of a secured creditor with a perfected blanket security interest in the buyer's assets, including inventory and equipment.[48] The Bankruptcy Code provides that a seller's right of reclamation is "subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof."[49]

Cases interpreting the reclamation provisions of the Code have generally not been favorable to reclaiming creditors where there is a pre-petition lien in the debtor's assets. Typically, where there is a secured lender that holds a perfected security interest of a higher priority on the same assets (particularly, inventory) of the debtor as the reclaiming seller, the reclaiming seller loses. In *Simon & Schuster, Inc v Advanced Mktg Servs (In re Advanced Mktg Serv)*,[50] publisher Simon & Schuster delivered $5.1 million worth of goods to the debtor within the forty-five-day reclamation period, which the publisher timely sought to reclaim after the buyer filed for bankruptcy protection. The bankruptcy court held that Simon & Schuster failed to prove that it would likely succeed on its reclamation claim due to the priority of the senior lenders' liens on substantially all of the debtor's assets, including inventory.[51] The bankruptcy court held that the senior lenders' liens were superior to Simon & Schuster's reclamation claim.[52] Once the senior lenders' liens were satisfied through the sale of inventory, Simon & Schuster's reclamation claim would likely be of no value.[53]

A similar result was reached in *In re Dana Corp*.[54] In *Dana* the debtor objected to reclamation claims filed by hundreds of sellers, arguing that the claims were subject to pre-existing liens on the goods sought to be reclaimed.[55] The court ruled in favor of the debtor, determining that pre-petition collateral, including the reclaimed goods, was subject to the secured creditors' pre-petition liens. The debtor's post-petition financing allowed the debtor to use the lenders' pre-petition collateral, with a replacement lien on all pre- and post-petition collateral and proceeds. The pre-petition indebtedness was refinanced and paid off from the proceeds of the new loan.[56] The court held that the reclaimed goods were either liquidated in satisfaction of the pre-petition indebtedness or were pledged as collateral for the debtor-

Under the Uniform Commercial Code, a seller has a right to reclaim goods sold on credit to an insolvent buyer by making written demand on the buyer within ten days after the goods are received by the buyer.

in-possession loan.[57] In either event, the reclaimed goods were effectively disposed of, which rendered the reclamation claims valueless.[58]

To the extent a manufacturer correctly and timely perfects its lien in the goods through either a PMSI or a Special Tools Act lien, the lien of the manufacturer in the goods will be of a higher priority than the pre-existing blanket lien of a customer's secured lender.[59] Thus, the manufacturer should be able to nullify any argument that its reclamation claim is defeated by a pre-existing lien as advanced in *In re Advanced Mktg Servs,* and *In re Dana Corp*.

Other Considerations

When contemplating methods to avoid bankruptcy preference claims, another strategy that the manufacturer should consider in negotiating the terms of the contract is to make certain that the manufacturer receives as much of the contract price as possible while the manufacturer remains in possession of the equipment. In such instances, the manufacturer will be able to claim that the payments it received while it possessed the equipment are not subject to preference claims because the manufacturer holds a lien on the equipment while it is in the manufacturer's possession. While there is no Michigan case directly on point, this exact issue was discussed by the United States Bankruptcy Court for the Western District of Pennsylvania in *Erie Power Techs, Inc v Shaw Group (In re Erie Power Techs)*.[60] In this case, the plaintiff/debtor filed an action against a power generator manufacturer. Prior to the plaintiff/debtor's bankruptcy filing, the manufacturer entered into a contract with the debtor where the manufacturer was to provide fabrication services on steel piping in accordance with the debtor's specifications.[61] The contract price was in the original amount of $800,000 to be paid in an initial down-payment of $160,000, followed by four "milestone" payments when 25 percent, 50 percent, 75 percent and 100 percent of the work was completed. The final payment was due prior to the final shipment.[62]

While the first milestone payment was timely made, on June 12, 2002, the debtor made a single payment for the second and third milestone in the total amount of $320,000. The debtor made no payments after the June 12 payment, and the manufacturer completed the work under the contract. The debtor filed a Chapter 11 bankruptcy petition on August 29, 2003. The goods remained in the manufacturer's possession in South Carolina until approximately six months later when, pursuant to a stipulation of the parties, the manufacturer delivered the goods to the debtor on receipt of the final payment.[63]

The debtor later brought a lawsuit against the manufacturer to force the return of the $320,000 payment paid to the manufacturer on June 12, arguing that it was a preference payment because it was made by the debtor to the manufacturer within ninety days prior to the bankruptcy filing.[64] The manufacturer responded that it held a common law "artisan's lien" under South Carolina law on the goods while the goods were in its possession and, therefore, the transfer at issue was not a preference because the payment did not result in its receipt of any more funds than it would have received in a Chapter 7 bankruptcy.[65] The court recognized the validity of the common law artisan's lien and held in favor of the manufacturer.

The same should hold true in Michigan.[66] Michigan caselaw recognizes a common law lien in favor of persons who provide improvements to "articles."[67] Such a common law lien implies that the person possesses a right to detain or hold an article until it is paid for.[68] Additionally, Michigan has a statutory artisan's lien that may be applicable to manufacturers depending upon the type of goods produced.[69] To the extent a manufacturer receives a payment during the preference period but where the manufacturer retained possession of the goods, the manufacturer should be able to defeat a claim that the payment was preferential. On these bases, and from a practical standpoint, a manufacturer should consider negotiating payment terms such that the purchase price is paid, to the extent possible, while the manufacturer retains possession of the goods to defeat possible future preference claims.

Conclusion

These are difficult economic times. Michigan's manufacturing industry has been particularly hard hit. The bankruptcy of a key customer can be a costly, if not irremediable, occurrence for a manufacturer. However, manufacturers that understand and are prepared to assert their rights can minimize their losses. Legal counsel can provide vital assistance to manufacturers by helping them protect their businesses from unexpected preference claims. While these suggestions

Legal counsel can provide vital assistance to manufacturers by helping them protect their businesses from unexpected preference claims.

may not provide absolute protection, they may lessen a manufacturer's exposure to a preference claim.

NOTES

1. See, for example, *In re Chrysler, LLC*, Case No. 09-500002, (Bankr SD NY), *In re Metaldyne Corp*, Case No. 09-13412 (Bankr SD NY), *In re Visteon Corp*, Case No. 09-11786 (Bankr D Del), I*n re General Motors Corp*, Case No. 09-50026 (Bankr SD NY), *In re Grede Foundries, Inc,* Case No. 09-14337 (Bankr WD Wisc), *In re DURA Automotive Systems, Inc.*, Case No. 06-11202 (Bankr D Del), *In re Delphi Corp*, Case No. 05-44481 (Bankr SD NY), *In re Meridian Automotive Systems, Inc.*, Case No. 05-11169 (Bankr D Del), *In re Tower Automotive, Inc.,* Case No. 05-10578 (Bankr SD NY), and *In re Plastech Engineered Products, Inc*, Case No. 08-42417 (Bankr ED Mich).

2. Or in some cases, the unsecured creditors committee or a liquidation trustee appointed under a plan of reorganization.

3. Or up to one year in the event the payment was made to an "insider." 11 USC 547(b)(4)(B).

4. 11 USC 101 *et seq.*

5. 11 USC 547(f).

6. 11 USC 547(b).

7. These defenses may include what is referred to as the "contemporaneous exchange" defense, the "ordinary course of business" defense, and the "new value" defense. *See* 11 USC § 547(c) of the U.S. Bankruptcy Code.

8. *Ellis v Ford Motor Credit Comp (In re DeLavern),* 337 BR 239, 242 (Bankr WD Wash 2005); *Rocin Liquidation Estate v UPAC (In re Rocor),* 380 BR 567, 572-74 (CA 10 BAP 2007); *Schwinn Plan Comm v Transamerica Ins Fin Corp (In re Schwinn Bicycle Co)*, 200 BR 980, 993 (Bankr ND Ill 1996). See also*, Telesphere Liquidating Trust v Galesi (In re Telesphere),* 229 B R 173, 180 (Bankr ND Ill 1999).

9. 11 USC 547(b)(5). For further analysis of the function of 11 USC § 547(b)(5) see the recent opinion in *Shapiro v Art Leather Inc (In re Connolly North American, LLC)*, 398 BR 564, 571-572 (Bankr ED Mich 2008).

10. MCL 440.9103 (1) defines two terms that are "essential to the description of what constitutes a purchase-money security interest." Official Comment 3 to Revised § 9-103. The term *purchase-money collateral* means "goods or software that secures a purchase-money obligation incurred with respect to" that property. MCL 440.9103(1)(a). The related term *purchase-money obligation* is defined as "an obligation of an obligor incurred as all or a part of the price of the collateral or values given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used." MCL 440.9103(1)(b). *See* P. Mears & S. Dales, *Michigan's Revised Article 9 of the UCC,* § 3.17, p 3-16 (ICLE) (2004).

11. J. Meyer, *A Primer on Purchase Money Security Interests Under Revised Article 9 of the Uniform Commercial Code,* 50 U Kan L Rev 143, 166-167 (2001) provides the following example:

Revised section 9-324(a), which in general tracks former section 9-312(4), provides that a perfected PMSI in goods other than inventory or livestock has priority over a conflicting security interest in the same goods or their identifiable proceeds, if the PMSI was perfected when the debtor obtained possession or within twenty days thereafter. Consider the following hypothetical:

Jan. 2 Dealer borrows $100,000 from Bank for working capital and grants a security interest in "all equipment now owned or hereafter acquired." Bank perfects by filing a proper financing statement with the secretary of state on January 5.

Feb. 10 Dealer buys and takes delivery from ABC Manufacturing Co. of a new machine to be used in its business, and agrees to pay for the machine over four years. ABC obtains an enforceable security interest in the machine and files a proper financing statement in the proper place on February 15.

If Dealer goes broke, who has priority as to the new piece of machinery?

> Under the first-to-file rule, Bank would win because its security agreement covered after-acquired property and because it filed first. However, ABC can defeat Bank by establishing all the requirements of revised section 9-324(a). First, ABC must establish a PMSI under revised section 9-103. ABC can do this because the new machine is "purchase-money collateral" for a "purchase-money obligation." The security interest secures Dealer's obligation to pay the purchase price. Next, the machine is being used in Dealer's business and therefore is classified as equipment, not inventory. ABC also filed five days after Dealer took delivery, which is well within the twenty-day grace period. Thus, ABC has priority as to the machine because all the requirements of revised section 9-324(a) are satisfied [Footnotes omitted.}

12. If the debtor/customer is a corporation, limited liability company, or other "registered organization" it is "located" in the state of its organization. MCL 440.9307(5).

13. For a discussion of the "battle of the forms" issue see J. Trentacosta & J. Menges, *The Much-Maligned Purchase Order,* 86 Mich B J 32 (2007).

14. See footnote 12, *supra*.

15. MCL 440.9324(1).

16. MCL 440.9324(2)(a).

17. MCL 440.9324(2)(c).

18. MCL 440.9324(2)(d).

19. MCL 440.9324.

20. 11 USC 547(c)(5).

21. MCL 440.9609.

22. MCL 570.541 *et seq*.

23. House Legislative Analysis Section, HB5993 (May 8, 2002).

24. MCL 570.542(c).

25. MCL 570.542(d).

26. For a more complete discussion, see D. Loughlin, *Turning the Screws: Enhanced Rights Under the Michigan Special Tools Lien Act,* Mich Bus L J, Spring 2003, p 26, and W. Hawley, *Michigan Toolmakers' and Moldbuilders' Liens: Practical Considerations,* Mich Bus L J, Fall 2006, p 44.

27. MCL 570.563(1).

28. MCL 570.563(2), citing MCL 440.9502.

29. MCL 570.563(3).

30. Under the Act, the "end user" is a person who uses a special tool as part of his or her manufacturing process. MCL 570.542(b).

31. MCL 570.563(3), (4).

32. This argument is suggested in Roush Manufacturing, Inc.'s Reply to Objection to Roush's Motion for Relief from the Automatic Stay Arguing that Roush's Liens are Invalid in *In re Plastech Engineered Products, Inc, supra,* filed April 22, 2008 (Docket No. 1088).

33. *HS Die & Eng'g, Inc v Ford Motor Co (In re Plastech Engineered Products, Inc),* 418 BR 235 (Bankr ED Mich 2009).

34. And the "end user," if applicable.

35. MCL 570.565.

36. *Id.*

37. MCL 570.567. The special tool builder can take possession of the special tool without judicial process if it can do so without a breach of the peace. MCL 570.567(a). The process for selling the special tool is set out in detail in MCL 570.569.

38. See J. Gregg, *An Introduction to Tooling Liens in the Automotive Industry (Part I),* ABI Journal, June 2009, p 28, n 4.

39. See *Buffalo Molded Plastics, Inc v Plastic Mold Tech, Inc (In re Buffalo Molded Plastics, Inc)*, 354 BR 731 (Bankr WD Pa 2006), wherein the bankruptcy court for the Western District of Pennsylvania held that the Michigan Ownership Rights in Dies, Molds and Forms Act, MCL 445.611 et seq, pertaining to plastics mold liens, did not apply once the mold was delivered to Pennsylvania.

40. See J. Gregg, *An Introduction to Tooling Liens in the Automotive Industry (Part II),* ABI Journal, July/August 2009, p 36, 74.

41. Section 31 of the Michigan Special Tools Lien Act, MCL 570.571, prohibits the sale or possession of the special tool where it would be a violation of federal patent or copyright law.

42. MCL 440.2702(2).

43. 11 USC 546(c).

44. *Id.*

45. An administrative claim is the highest level priority claim (but for certain domestic support obligations) in bankruptcy cases, but ranks under secured claims in entitlement to payment. 11 USC §§ 503(b), 507(a)(2).

46. 11 USC 503(b)(9).

47. *In re Charter Co,* 54 BR 91, 92-93 (Bankr MD Fla 1985); *In re Flagstaff Foodservice Corp,* 14 BR 462 (Bankr SDNY 1981).

48. S. Kimmelman and V. Hamilton, *A Paper Tiger: The Reclamation Seller in Bankruptcy,* The Metropolitan Corporate Counsel, April 2008, p 7.

49. 11 USC 546(c).

50. 360 BR 421 (Bankr D Del 2007).

51. *Id.* at 426.

52. *Id.*

53. *See* Kimmelman and Hamilton, *supra.*

54. 367 BR 409 (Bankr SDNY 2007).

55. *See generally, id.*

56. *Id.*

57. A practitioner in the 6th Circuit should be aware of *Phar-Mor Inc v McKesson Corp,* 534 F3d 502 (6th Cir 2008) *cert den* 129 S Ct 2053 (2009), wherein the court appears to reject the holding in *In re Dana, supra,* regarding reclamation claims. However, it should be noted that the *Phar-Mor* decision is a pre-Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") (effective October 17, 2005) case. The holding in *Phar-Mor* may not apply to a post-BAPCPA claim. For a more detailed discussion of the possible implications of *Phar-Mor* see L. Gretchko, *Sixth Circuit's Phar-Mor Decision Breathes New Life Into Reclamation Remedy,* ABI Journal, September 2008, p 14.

58. *See also* Kimmelman and Hamilton, *supra.*

59. See MCL 440.9324(1) and (2) with respect to the priority of a purchase money security interest, and MCL 570.563(6) with respect to the priority of a Special Tools Lien.

60. 364 BR 896 (Bankr WD Pa 2007).

61. *Id.* at 897.

62. *Id.* at 897-898.

63. *Id.*

64. *Id.* at 897.

65. *Id.* at 899. *See also* 11 USC 547(b)(5).

66. The Sixth Circuit has also recognized the validity and priority of an artisan's lien in *Triad Int'l Maint Corp v Southern Air Transp, Inc (In re Southern Air Transp, Inc)*, 511 F3d 526 (6th Cir 2007).

67. *See*, for example, *Aldine Mfg Co v Phillips,* 118 Mich 162, 76 NW 371 (1898); and *Nickell v Lambrecht,* 29 Mich App 191, 185 NW2d 155 (1970).

68. *See* 15 Mich Civ Jur, *Liens* § 2 (2008).

69. MCL 570.185 *et seq.*

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"Conventional" Wisdom: Serving Foreign Defendants in Michigan Federal Courts

By Ryan S. Bewersdorf and David S. Ludington

Fast Facts

- The circuits are split as to whether, in a federal court case, a summons and complaint delivered by mail directly to the defendant abroad constitutes effective service of process under the Hague Service Convention.
- The Sixth Circuit Court of Appeals has yet to rule on the issue, though the majority of Sixth Circuit district courts have held that such attempts to serve process are ineffective.
- In 2008, the Eastern District of Michigan held, in an unpublished opinion, that service by registered international mail constituted effective service of process.
- Until the Sixth Circuit Court of Appeals or United States Supreme Court addresses the issue, Michigan attorneys filing suits against foreign defendants in federal court should take care to comply with the Hague Service Convention.

Introduction

On November 15, 1965, nearly 60 countries, including the United States of America, Canada, China, Russia, the United Kingdom, and most of the nations that compose the European Union signed[1] the Hague Service Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters (the "Convention").[2] The Convention sought "to create appropriate means to ensure that judicial and extrajudicial documents to be served abroad shall be brought to the notice of the addressee in sufficient time" and "to improve the organisation of mutual judicial assistance for the purpose of simplifying and expediting the procedure."[3]

This article addresses the applicability of the Convention to plaintiffs who are located in a signatory nation and seek to effect service on defendants located in another signatory nation by sending a summons and complaint by mail. The article discusses the two divergent views espoused by the circuit courts of appeals that have addressed the proper methods of service under the Convention, and the open question of whether the Sixth Circuit will permit service by mail under the Convention. It concludes with advice concerning how Michigan plaintiffs and their attorneys should proceed in serving process on foreign defendants.

Legal Background

The United States Supreme Court has held that "[b]y virtue of the Supremacy Clause, the Convention pre-empts inconsistent methods of service prescribed by state law in all cases to which it applies."[4] In other words, "[a]pplication of the Hague Service Convention is mandatory in all cases that come within its scope, which are those cases where there is 'occasion to transmit a judicial or extrajudicial document for service abroad.'"[5]

There are several ways to serve foreign defendants under the Convention. Articles 2 through 6 outline the procedure for signatory countries to designate a "Central Authority" that will receive requests for service of process coming from other countries.[6] Article 8 provides for service through "diplomatic or consular agents."[7] Article 19 allows service by any method provided for by the internal law of the nation in which service is to be made.[8]

The most contentious provision of the Convention concerning service of process is Article 10, which states:

> Provided the State of destination does not object, the present Convention shall not interfere with–
>
> a) the freedom to *send* judicial documents, by postal channels, directly to persons abroad,
>
> b) the freedom of judicial officers, officials or other competent persons of the State of origin to *effect service* of judicial documents directly through the judicial officers, officials or other competent persons of the State of destination,

> c) the freedom of any person interested in a judicial proceeding to *effect service* of judicial documents directly through the judicial officers, officials or other competent persons of the State of destination. [emphasis added][9]

Circuit courts of appeals are in conflict as to whether Article 10(a) allows a party to effect service by "sending" a copy of the summons and complaint directly to the defendant abroad.

The Second and Ninth Circuit Approach: "Send" Includes "Service"

In 1986, the Second Circuit Court of Appeals was the first federal appeals court to consider the issue. In *Ackermann v Levine*, the court held that the plaintiff, a German attorney, effectively served the defendant, an American real estate investor, by sending a summons and complaint to the office of the German Consulate in New York, which in turn sent the documents via registered mail to the defendant's address.[10] The plaintiff argued that the signatories intended the word "send" found in Article 10(a) to include "service," and the court agreed.[11] The opinion cited the *Practical Handbook on the Operation of the Hague Service Convention of 15 November 1965 on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters*[12] (the "*Handbook*") for the proposition that service of process by registered mail satisfied Article 10.[13] The court adopted the *Handbook* author's view that "the use of 'send' rather than the otherwise consistently used 'service' 'must be attributed to careless drafting.'"[14] Additionally, the *Ackermann* court held that the requirements for service of a foreign defendant under the Federal Rules of Civil Procedure did not render service ineffective, as "[t]he old Federal Rule 4 was superceded [sic] by the Hague Service Convention and thus presumptively should not limit application of the Convention."[15]

In 2004, another federal appeals court joined in the reasoning of the *Ackermann* decision. The Ninth Circuit Court of Appeals held in *Brockmeyer v May* that an American plaintiff who served a British company abroad by mailing a summons and complaint by first class mail satisfied the requirements of the Convention.[16] The court stated that its holding was consistent with the overriding purpose of the Convention: "facilitat[ing] international service of judicial documents."[17] Additionally, the court recognized that other signatory nations of the Convention were "essentially unanimous" in holding that the word "send" included "service," and cited a number of cases from Canada, Greece, and the Court of Justice of the European Communities.[18] Lastly, the *Brockmeyer* court observed that even the United States Department of State disapproved of caselaw holding that "service" was not within the meaning of "send" under Article 10(a).[19] Aligning itself with the Second Circuit, the court held that the Convention contemplated and permitted service by mail.

But the court did not end its inquiry there. Unlike the *Ackermann* court, which held that Federal Rule of Civil Procedure 4 was superseded by the Convention, the *Brockmeyer* court held that "Article 10(a) does not itself affirmatively authorize international mail service."[20] Rather, "in order for the postal channel to be utilized, it is necessary that it be authorized by the law of the forum state."[21] The court explored several provisions of Rule 4, including 4(f)(2)(C)(ii) (providing that "any form of mail requiring a signed receipt, to be addressed and dispatched by the clerk of the court to the party to be served" would suffice), 4(f)(3) (stating that service can be effected abroad "by other means not prohibited by international agreement as may be directed by the court," such as publication, e-mail, or ordinary mail), and Rule 4(f)(2)(A) (allowing service abroad "in the manner prescribed by the law of the foreign country for service in that country in an action in any of its courts of general jurisdiction").[22] Ultimately, the court held that the plaintiff's attempt to deliver a summons and complaint by first class mail without complying with one of Rule 4's provisions constituted ineffective service of process.[23]

The Fifth and Eighth Circuit Approach: Strict Statutory Construction Prevails

In 1989, the Eight Circuit undertook to examine Article 10(a) of the Convention in *Bankston v Toyota Motor Corporation*.[24] In *Bankston*, American plaintiffs attempted to serve Toyota Motor Corporation by sending a summons and complaint via registered mail to Tokyo, Japan.[25] The documents sent were written in English and no Japanese translations were attached.[26] The court concluded that such an attempt at service was not permitted by the

There are several ways to serve foreign defendants under the Convention. Articles 2 through 6 outline the procedure for signatory countries to designate a "Central Authority" that will receive requests for service of process coming from other countries.

Convention.[27] Applying the rules of statutory interpretation, the court began by analyzing the language of the Convention itself.[28] The court noted that, in contrast to the Convention's use of the word "send" in Article 10(a), "the word 'service' is specifically used in other sections of the Convention, including subsections (b) and (c) of Article 10."[29] Citing *Russello v United States*,[30] the court stated that "where a legislative body 'includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that [the legislative body] acts intentionally and purposely in the disparate inclusion or exclusion."[31] In the end, the *Bankston* court concluded that service was ineffective and remanded the case to the trial court with instructions to allow the plaintiff to correctly serve Toyota.[32]

Twelve years later, the Fifth Circuit had the opportunity to explore Article 10 of the Convention in *Nuovo Pignone, SpA v Storman Asia M/V*.[33] In *Nuovo Pignone*, the plaintiff attempted to effect service of process by mailing the complaint and summons via Federal Express to the president of the defendant corporation in Italy.[34] Whereas the plaintiff argued that 10(a) permitted service by mail, the defendant argued that the section referred "only to the transmission of legal documents *following* service, pointing to the fact that nowhere else in the Hague Service Convention is the word 'send' used to refer to service of process."[35] In evaluating the different circuit court interpretations of Article 10(a), the *Nuovo Pignone* court stated that it relied "on the canons of statutory interpretation rather than the fickle presumption that the drafters' use of the word 'send' was a mere oversight."[36] The court opined that despite the plaintiff's argument that the Convention's overall purpose "is furthered if article 10(a) is interpreted to allow service by mail … the purpose of the Hague Service Convention is not only to simplify the service of process, but to ensure that plaintiffs deliver notice to foreign addresses in sufficient time to defend the allegation."[37] Ultimately, the court determined that mail service was insufficient to ensure such a goal.[38]

The Sixth Circuit: An Open Question

The Sixth Circuit Court of Appeals has yet to decide whether Article 10(a) of the Convention allows for service by mail. Of the several district courts in the Sixth Circuit that have confronted the issue, all but two have concluded that 10(a) does not contemplate service on international defendants by mail.[39] One of those two courts was the Eastern District of Michigan.[40] It is possible, however, that despite the fact several district courts in the Sixth Circuit have refused to allow service of process under Article 10(a), the Sixth Circuit Court of Appeals could be persuaded by the reasoning of the Second Circuit in *Ackermann* and the Ninth Circuit in *Brockmeyer*, as well as statements made by the U.S. State Department, courts of other nations, and several commentators, and allow plaintiffs to serve defendants abroad by mail.

At a minimum, attorneys in Michigan serving international defendants should send a summons and complaint by registered international mail. But plaintiffs' attorneys should be aware that several countries have objected to service by registered mail,[41] so even these steps will not ensure effective service of process in many cases. In the event that a court deems service of process ineffective, the most common remedy is to allow the plaintiff a period of time to correctly serve the defendant.

Out of an abundance of caution, until the Sixth Circuit or United States Supreme Court resolves the issue, attorneys in Michigan should comply with the Convention provisions regarding service of process. The specific requirements of the Convention are beyond the scope of this article, but generally may include translation of documents into the official language of the destination country, service of documents upon the destination country's Central Authority, and more.

By complying with the Convention's requirements for service of process, attorneys benefit in two ways. First, compliance with the Convention ensures that attorneys will not draw a motion to dismiss for insufficient service of process. Second, compliance with the Convention increases the likelihood that any judgment awarded in a United States court will be collectable in the foreign jurisdiction.

At a minimum, attorneys in Michigan serving international defendants should send a summons and complaint by registered international mail.

NOTES

1. Hague Conference on Private International Law, *Status Table*, May 29, 2009, *available at* http://www.hcch.net/index_en.php?act=conventions.status&cid=17.

2. 20 UST § 361 [hereinafter "Hague Service Convention"].

3. Hague Service Convention, pmbl.

4. Volkswagenwerk Aktiengesellschaft v Schlunk, 486 US 694, 699 (citing US Const, Art VI).

5. Cupp v Alberto-Culver USA, Inc, 308 F Supp 2d 873, 879 (WD Tenn 2004) (citing *Schlunk*, 486 US at 699).

6. Hague Service Convention, arts. 2-6.

7. Id. at art. 8.

8. *Id.* at art. 9.

9. Hague Service Convention, art. 10 (emphasis added).

10. 788 F2d 830, 834, 837 (2nd Cir 1986).

11. *Id.* at 839.

12. 1 B. Ristau, International Judicial Assistance (Civil and Commercial) § 4-10 at 132 (1984).

13. *Ackermann*, 788 F2d at 839.

14. *Id.*

15. *Id.* at 840.

16. 383 F3d 798, 800, 802 (9th Cir 2004).

17. *Id.* at 802.

18. *Id.* at 802.

19. *Id.* at 803.

20. *Id.* at 803.

21. *Id.* at 804.

22. *Id.* at 804-06.

23. *Id.* at 808-09.

24. 889 F2d 172 (8th Cir 1989).

25. *Id.* at 172.

26. *Id.*

27. *Id.* at 174.

28. *Id.*

29. *Id.* at 173.

30. 464 US 16, 23, 104 SCt 296 (1983).

31. *Bankston*, 889 F2d at 174.

32. *Id.*

33. 310 F3d 374 (5th Cir 2002).

34. *Id.* at 377-78.

35. *Id.* at 383 (emphasis added).

36. *Id.* at 384.

37. *Id.*

38. *Id.*

39. *See Collins v Westfreight Sys, Inc*, No 7:08-227-KKC, 2009 US Dist LEXIS 33141 at *6 (ED Ky Apr 17, 2009) ("Plaintiff did not comply with the Hague Convention by serving [defendant] by certified mail through the Kentucky Secretary of State."); *accord Humble v Gill*, No 1:08-cv-00166, 2009 US Dist LEXIS 4552 at *5 (WD Ky Jan 22, 2009) ("Plaintiff's sending of a copy of the summons and complaint by registered mail to [defendant] in Canada is not a method of service permitted by 10(a) of the Hague Convention."); *Haun v HTC, Inc*, No 3:07-cv-180, 2007 US Dist LEXIS 69495 at *4 (ED Tenn Sep 19, 2007) ("The word 'send' in Article 10(a) is not the equivalent of 'service of process'[.] Article 10(a) simply provides a method of sending subsequent documents after service of process has been obtained through the Central Authority."); *Moore v Irving Materials, Inc*, No. 4:05-CV-184, 2007 US Dist LEXIS 52422 at *14 (WD Ky July 18, 2007); *Darko, Inc v Megabloks, Inc*, No 5:06CV1374, 2006 US Dist LEXIS 74542 at *6 (ND Oh Oct 13 2006); *Uppendahl v American Honda Motor Co*, 291 F Supp 2d 531, 534 (WD Ky 2003); *Cupp*, 308 F Supp 2d at 880; *Wilson v Honda Motor Company*, 776 F Supp 339, 341 (ED Tenn 1991). *But see Rae Group, Inc v AIESEC Int'l*, No 08-10364, 2008 US Dist LEXIS 83519 at *8 (ED Mich Oct 20 2008) ("Based on the history of the Hague Convention and the interpretation of Article 10(a) by persons responsible for its enforcement, the Court concludes that Article 10(a) allows service of process on an international defendant by registered international mail."); *Sibley v Alcan, Inc*, 400 F Supp 2d 1051, 1053 (ND Oh 2005) ("The drafters' intent is that "send judicial documents," as used in Article 10(a), includes service *of process.*") (emphasis in original).

40. *See Rae Group, Inc*, 2008 US Dist LEXIS 83519, at *8.

41. U.S. Department of State, *Service of Legal Documents Abroad*, *available at* http://travel.state.gov/law/info/judicial/judicial_680.html.

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Case Digests

Federal Diversity Jurisdiction—Corporation's Principal Place of Business

Hertz Corp v Friend, No 08-1107, 2010 US LEXIS 1897 (Feb 23, 2010). Two California citizens sued the Hertz Corporation in a California state court seeking damages for alleged violations of California's wage and hour laws. Hertz filed a notice seeking removal to a federal court, claiming that the plaintiffs and Hertz were citizens of different states and that the federal court had diversity-of-citizenship jurisdiction under 28 USC 1332. However, plaintiffs claimed that Hertz is a California citizen and that, hence, diversity jurisdiction was lacking under the "principal place of business" provision of 28 USC 1332(c)(1). To support its position, Hertz submitted a declaration by an employee relations manager that sought to show that Hertz's principal place of business was in New Jersey and not in California. Among other things, the declaration stated that Hertz operated facilities in 44 states and that California, which has about 12 percent of the population, has 273 of Hertz's 1,606 car rental locations, 2,300 of its 11,230 full-time employees, around $811 million of its $4.371 billion in annual revenue, and about 3.8 million of its approximately 21 million annual transactions. The declaration also stated that the "leadership of Hertz and its domestic subsidiaries" is located at Hertz's "corporate headquarters" in Park Ridge, New Jersey; that its "core executive and administrative functions . . . are carried out" there and "to a lesser extent" in Oklahoma City, Oklahoma; and that its "major administrative operations . . . are found" at those two locations.

The District Court of the Northern District of California accepted Hertz's statement of the facts as undisputed but concluded that Hertz was a citizen of California, applying Ninth Circuit precedent that instructs courts to identify a corporation's principal place of business by first determining the amount of a corporation's business activity state by state and, if the amount of activity is "significantly larger" or "substantially predominates" in one state, then that state is the corporation's principal place of business. If there is no such state, then the principal place of business is the corporation's "'nerve center,'" i.e., the place where the majority of its executive and administrative functions are performed. After applying this test, the district court found that the plurality of the relevant business activities was in California, and that the difference between the amount of those activities in California and in the next closest state was significant. Therefore, Hertz's principal place of business was California, and diversity jurisdiction was lacking. The Ninth Circuit affirmed.

The U.S. Supreme Court reviewed the federal circuits' interpretations to find a more uniform interpretation of the statutory phrase and concluded that "principal place of business" means the place where a corporation's officers direct, control, and coordinate the corporation's activities and is, in other words, the corporation's "nerve center." The court stated that in practice this normally is the place where the corporation maintains its headquarters, provided that the headquarters is the actual center of direction, control, and coordination and not simply an office where the corporation holds its board meetings. The court further recognized that there may be no perfect test that satisfies all criteria and that there will be hard cases to decide, such as corporations that divide their command and coordinating functions among officers who work at several different locations. Under this test, courts do not have to try to weigh corporate functions, assets, or revenues, but it is not a test that will, in all circumstances, automatically generate a result. The case was remanded to allow the parties to contest the case in light of the court's holding.

Petroleum Marketing Practices Act—Termination of Franchise or Failure to Renew

Mac's Shell Serv, Inc v Shell Oil Prods Co, LLC, No -8-240, 2010 US LEXIS 2203 (Mar 2, 2010). The Petroleum Marketing Practices Act, 15 USC 2801 et seq., limits the circumstances in which petroleum franchisors may "terminate" a franchise or "fail to renew" a franchise relationship. 15 USC 2802. In consolidated cases, service-station franchisees brought suit under the act, alleging that a franchisor had constructively "terminate[d]" their franchises and had constructively "fail[ed] to renew" their franchise relationships. The plaintiffs asserted these claims even though the conduct of which they complained had not compelled any of them to abandon their franchises and even though they had been offered and had accepted renewal agreements. The U.S. Supreme Court held that a franchisee cannot recover for constructive termination under the act if the franchisor's allegedly wrongful conduct did not compel the franchisee to abandon its franchise. In addition, the court concluded that a franchisee who signs and operates under a renewal agreement with a franchisor may not maintain a claim for constructive nonrenewal.

Agricultural Commodities Marketing Act—Remedies Officer's Liability

Department of Agriculture v Appletree Mktg, LLC, No 137552, 2010 Mich LEXIS 426 (Mar 10, 2010). Under the Agricultural Commodities Marketing Act (ACMA), Michigan apple producers created the Michigan Apple Committee (the Committee), an agency within the Michigan Department of Agriculture (the Department). Assessments placed on the purchase price charged to apple distributors fund the Committee. Under the ACMA, apple distributors deduct assessments from payments sent to producers, hold the funds in trust, and remit the monies to the Committee periodically. Defendant Appletree Marketing, L.L.C. (Appletree) was an apple distributor managed by Appletree's sole member. Although Appletree collected assessments for 2004 and 2005, it failed to remit any funds to the Committee and instead used the money to pay the company's other debts. If a distributor fails to pay assessed funds, the ACMA per-

mits the Committee to file a written complaint with the Department's director, who investigates and requests remittance. After 30 days, the director may file a complaint in court. The Department and director each followed these procedures in this case. When Appletree (which by this time was a bankrupt and defunct corporation) failed to pay on demand, plaintiffs filed a complaint against Appletree and its sole member to recover the 2004 assessments of $26,305.98 and later amended the complaint to include 2005 assessments of $28,878.66. In their complaint, plaintiffs alleged that Appletree violated the ACMA, and that both Appletree and its sole member committed common law and statutory conversion. Although the defendants consented to a judgment of $55,184.64 against Appletree to settle plaintiffs' ACMA claim, they sought summary disposition on plaintiffs' conversion claims. They argued that the ACMA provided the exclusive remedies for the failure to remit the assessment funds because the act created new rights and prescribed particular remedies. The trial court agreed and dismissed with prejudice plaintiffs' conversion claims against both defendants, entering a final judgment against Appletree based on liability under the ACMA in the amount of $77,051.23. The court of appeals affirmed the trial court's judgment, holding that any claim that Appletree wrongfully spent the money held in trust was based entirely on the duty imposed on Appletree by the ACMA. Since the plaintiffs' common-law and statutory conversion claims did not exist without the ACMA, the act provided the exclusive remedies for plaintiffs. The court of appeals further reasoned that because the member could not be liable under the ACMA, he could not be personally liable in any regard, and the trial court did not err by dismissing the claims of conversion against him.

The Michigan Supreme Court reversed the court of appeals, holding that the ACMA does not provide the exclusive remedy for its violation and thus does not supersede preexisting statutory remedies or abrogate common law remedies. Therefore, plaintiffs could pursue cumulative remedies provided by the ACMA as well as common law and statutory conversion. Moreover, Michigan law is well settled that a plaintiff may pursue an action against a corporate official in his or her personal capacity when the plaintiff alleges that the official's own tortious conduct harmed the plaintiff in the course of operating his business.

Employment Discrimination—Acts Outside Limitations Period as Background Evidence

Campbell v Department of Human Servs, 286 Mich App 230, ___ NW2d ___ (2009). Plaintiff alleged that her employer discriminated against her on the basis of her gender. Plaintiff had been employed with defendant since 1985, working in various positions with adjudicated youths. The basis of plaintiff's claim was defendant's decision to promote a male employee, instead of her, to the center director position at a youth facility. The parties did not dispute that plaintiff's claim was governed by the three-year period of limitations under MCL 600.5805(10). Defendant moved for summary disposition, claiming that plaintiff had failed to present evidence of acts within the three-year limitations period amounting to discrimination. Defendant further claimed that it offered an alternative, nondiscriminatory reason for promoting the male candidate instead of plaintiff to the position in question. A key issue in defendant's motion was whether acts that occurred outside the limitations period could be considered to support a claim based on an act that occurred within that period. Defendant asserted that acts outside the limitations period could not be considered on the basis of the holding in *Garg v Macomb Co Community Mental Health Services*, 472 Mich 263, 283-285, 696 NW2d 646 (2005), *amended*, 473 Mich 1205 (2005), in which the court held that a plaintiff could not bring a viable discrimination lawsuit for employment actions that occurred outside the limitations period and overruled the "continuing-violations" exception to the statute of limitations. Defendant contended that only events that occurred after January 28, 2002, properly could be considered in this case. Plaintiff maintained that *Garg* does not mandate the exclusion from evidence of acts outside the limitations period in order to show a pattern of discrimination, as long as the claim itself is based on an act within that period.

The court of appeals held that acts that occur outside of a statute of limitations period, even if they are not actionable, may, in appropriate cases, be used as background evidence to establish a pattern of discrimination. In this gender discrimination case, plaintiff presented sufficient evidence to raise a triable issue as to whether gender was a motivating factor in defendant's decision not to hire plaintiff.

Breach of Fiduciary Duty by Law Firm or Attorney

Alpha Capital Mgmt v Rentenbach, No 287280, 2010 Mich App LEXIS 446 (Mar 9, 2010). In an action against a law firm and one of its attorneys arising from events that occurred during a separation of business partners and their joint ownership interests in a company they had owned, plaintiff contended, among other things, that its law firm and one of the firm's attorneys breached fiduciary duties and committed other actionable wrongs by representing a former shareholder in a dispute concerning his buyout agreement. A jury found in favor of defendants on all counts alleged in the complaint and plaintiff appealed as of right from the trial court's entry of a no cause judgment regarding the jury verdict.

Although an attorney's duties of loyalty and confidentiality continue even after an attorney-client relationship ends, under common law and the rules of professional responsibility the continuing duties of loyalty and confidentiality apply only to matters in which the new client's interests qualify as both adverse to those of the former client *and* substantially related to the subjects of the attorney's former representation. An attorney does not necessarily breach the duty of loyalty and confidentiality to a former

client by representing a new client whose interests are merely adverse to those of the former client. The attorney's fiduciary duty to a former client is breached only by undertaking representation of a client who has interests that are both adverse and substantially related to work the attorney performed for the former client. In this case, neither trial testimony nor plaintiff's appellate brief identified any confidential information in defendants' possession that somehow advantaged the other party. Even assuming that the attorney in question possessed confidential information, plaintiff did not explain how this information advantaged the other party, and defendants apparently performed only the most routine work on behalf of that party. Moreover, aside from sharing the same general nature, these legal services lacked any substantial relationship to the attorney's activities on behalf of plaintiff. Accordingly, the court of appeals rejected plaintiff's position that as a matter of law defendants breached their fiduciary duties.

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