STATE BAR OF MICHIGAN
BLS
BUSINESS LAW SECTION

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Columns

Articles

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STATE BAR OF MICHIGAN

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The editorial staff of the *Michigan Business Law Journal* welcomes suggested business law topics of general interest to the Section members, which may be the subject of future articles. Proposed business law topics may be submitted through the Publications Director, Brendan J. Cahill, *The Michigan Business Law Journal*, 39577 Woodward Ave., Ste. 300, Bloomfield Hills, Michigan 48304, (248) 203-0721, bcahill@dykema.com, or through Kanika S. Ferency, ICLE, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432, ferencyk@icle.org. General guidelines for the preparation of articles for the Michigan Business Law Journal can be found on the Section's website at http://connect.michbar.org/businesslaw/newsletter.

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

Issue	Primary Theme/Committee	Article Deadline
Fall 2018	Uniform Commercial Code Committee	July 31, 2018
Spring 2019	Commercial Litigation Committee	November 30, 2018
Summer 2019	LLC & Partnership Committee	March 31, 2019
Fall 2019	Financial Institutions Committee	July 31, 2019

ADVERTISING

All advertising is on a pre-paid basis and is subject to editorial approval. The rates for camera-ready digital files are $400 for full-page, $200 for half-page, and $100 for quarter page. Requested positions are dependent upon space availability and cannot be guaranteed. All communications relating to advertising should be directed to Publications Director, Brendan J. Cahill, the *Michigan Business Law Journal*, 39577 Woodward Ave., Ste. 300, Bloomfield Hills, MI 48304, (248)203-0721.

MISSION STATEMENT

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

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

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Volume XXII, Issue 1, and subsequent issues of the *Journal* are also available online by accessing http://connect.michbar.org/businesslaw/newsletter

From the Desk of the Chairperson

By Mark W. Peters

This issue of *The Michigan Business Law Journal* provides me my first chance to introduce myself to many of you as the current Chair of your Business Law Section. Before going further, it is imperative that I take this opportunity, on behalf of the Council and all members of our Section, to thank our immediate past Chair, Judy Calton, for her service. While Judy's most recently completed Section position has been as Chair, she has been an incredibly important and active member of our section for many years, including as a member of Council and Co-Chair of our Debtor/Creditor Rights Committee. The practice of law has benefitted greatly from Judy's service.

We are now several months into a new Section fiscal year, which started on October 1, with a refreshed Executive Committee, Council, Committee Chairs and Program Directorships. New energy has been injected, but not a wholesale change in leadership, and it is an opportune time to review our Section's priorities. Fortunately, we have a great roadmap for this exercise due to the updated *Section Strategic Plan and Directives*, which was adopted by the Section Council in the first quarter of 2017. The committee that prepared the Plan update devoted considerable time and thoughtful consideration to its work, including incorporation of a number of themes from the State Bar's June 2016 21st Century Task Force report. The Plan is available on our Section website, and I join Judy in urging you to give it a read. The Plan not only sets out the goals and objectives of the Business Law Section, but also provides a good overview of the breadth of activities and opportunities available through our Section.

The core of the Business Law Section value proposition to its members is to be a resource for you, and that resource can and should be a priceless value throughout your career as a business lawyer. Here is a quick outline of what I mean:

- One of the early Business Law Section resources that a new lawyer can and should take advantage of is our award winning Business Boot Camp, which provides instruction on basic skills and grounding to attorneys in key areas of business practice through two yearly, two day sessions offered every three years. While originally conceived as a training program for newer attorneys, Business Boot Camp is now a great resource for any attorney interested in a broad overview of business-related topics.
- A fundamental resource for business lawyers that the Business Law Section provides is *The Michigan Business Law Journal*. In a recent survey of Business Law Section members, conducted in coordination with our Strategic Plan update, over 87% of respondents described the Journal as being either "valuable" or "very valuable" to them. Given the high quality of useful information and discussion available in the Journal, it is easy to see why our members hold this publication in such high regard. In the fall 2017 issue, the focus was on corporate law issues, while in this issue it is debtor/creditor rights, and nonprofit corporation matters will be spotlighted in the summer, demonstrating the expansive reach of what fits under the umbrella of "business law."
- A key element of our Section's service to the Michigan business lawyer is our yearly Business Law Institute, held each fall in Grand Rapids. Here we strive to not only bring you exceptional speakers on timely and useful business law topics to enhance your practice, but also a place for in-person, face-to-face communication and collegiality. The tag line we have used for a number of years in publicizing the Institute is "the place to be for business lawyers," and I certainly believe this description is true, as the Business Law Institute provides a natural progression of educational opportunities to our members after the Business Boot Camp and throughout their careers.
- If you are interested in not only learning about, but also giving back to the practice of business law, I urge you to be involved in our various committees, such as business courts, commercial litigation, debtor/creditor rights, corporate laws and regulation of securities, just to name a few. These committees provide opportunities, not only to enhance your knowledge in their substantive topic areas, but also for professional fulfillment by making a meaningful impact on the law. For example, our corporate laws committee routinely proposes, and works with our state legislature to pass, amendments improving the Michigan Business Corporation Act, and the regulation of securities committee has been a terrific resource in working with our state regulators on rules to implement the Michigan Uniform Securities Act. These are only two examples of the important work being done by our numerous Section committees.

This is only a small sampling of the high points. The short of it is—the Business Law Section is here for you. Please participate, please take advantage, and please—let us know how else we can be of service.

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Corporations Online Filing System (COFS) Tips & Tricks

On October 30, 2017, the State of Michigan's Corporations Division launched the new Corporations Online Filing System (COFS). COFS provides many new services and features, and it replaced a system that was nearly 40 years old.

As you are becoming more familiar with the new system, the following is a list of tips and tricks to help you use the system:

Overview

- COFS is a web-based application. You access the desired areas from the Corporations Division's homepage at www.michigan.gov/corporations.
- COFS functions best when using Google Chrome. All major browsers are supported.
- Disable autofill settings. In Chrome, at the top right, click the Settings icon. At the bottom, click Advanced. Under "Passwords and forms," turn off Autofill Settings.
- Do not input spaces before or after entering data into a field or this will cause an error.

Searches

- Tips for Business Entity Search at www.michigan.gov/corpentitysearch.
  - Example name: ABC LLC
    - If "begins with" yields too many results, try "exact match" means punctuation must be exact also. Results are limited to the first 1,000.
    - Next, try to search for each one of these with "begins with".
    - ABC L (this will find LLC, LEC LTD, LP)
    - ABC Limited (this will find Limited Liability Company, Limited, Limited Partnership)
    - ABC Co (this will find CO, Company, Corp, Corporation)
    - ABC INC (this will find INC, Incorporated)
  - An entity name with the ending "Limited Liability Partnership" or "LLP" does not create a name conflict for any other type of business entity. The former system did not display these limited liability partnerships in the search results.
  - In the Rejected Filings Search, if the entity is amending its name with a document submitted online, the rejection can be found under the proposed new name.
  - The Name Availability Search website has been discontinued. To check name availability, use Business Entity Search, the Name Availability Guidelines, and Restricted Words List. Business Entity Search is available at www.michigan.gov/corpentitysearch. The other resources are available through the Forms & Publications section of the Corporations Division homepage at www.michigan.gov/corporations. Also, you can call the Corporations Division at (517) 241-6470 to check a name. However, it is important to note that the final determination of name availability is when the Corporations Division receives a document to review.

Online Forms

- Expedited service can be requested when you submit a document online.
- If your document is rejected, expedited service can be requested or the service level increased when you correct and resubmit the document.
- When submitting a document online, you can establish an "Account on File" so that you do not have to enter your credit card information and billing address each time you use the online filing system.
- When adding additional Articles in the online form, enter or add returns between the Articles so that the text does not run together. Also make sure to label each Article accordingly.
- Be sure to review the document after you have completed entering information into all appropriate fields. You should perform this double-check after selecting the "Review" button and before selecting the "Submit" button. Specifically, make sure that autofill did not insert any unnecessary language or that any text that was copied and pasted is entered in the appropriate area.
- The submitter's contact information should be completed with the person who completed the online form and can be contacted by Corporations Division staff if there are questions regarding the submission.
- An effective date is not required. If an effective date is not entered in the online form, the earliest effective date will be the date that the document is reviewed and filed. The effective date field in the online form should only be completed only if a later effective date other than the date of filing is desired. This date must be no more than 90 days after the document is submitted.

- For each person signing the document, click "Add new entry to this list," accept the signature statement, and then click "Add" to add the signature.
- If you have questions regarding an online form, review the Information and Instructions page in the PDF version of the form through the Forms & Publications section of the Corporations Division homepage.

Certificates and Certified Copies

- Certificates of Good Standing ordered online to be returned by email are sent to the email address provided minutes after the payment is received.
- If you would like to order certified copies of more than one document per entity, you will need to create a separate order or contact the Corporations Division by calling (517) 241-6470.

Email

- Check your email SPAM folder periodically as emails from COFS could be in your SPAM folder.
  - Alternatively, add following email addresses to your email address book or safe sender list:
    - Rejection emails will be sent from LARA-CSCL-CorpInfo@michigan.gov to the submitter's email address.
    - Filed documents will be sent from LARA-CSCL-CorpFiling@michigan.gov to the submitter's email address.
    - If you order certificates or certified copies to be returned to you via email, these items will be sent from LARA-CSCL-CorpOrders@michigan.gov.

CID/PIN

If you have forgotten an entity's CID or PIN, please visit www.michigan.gov/corpPIN. After providing your name, the entity's identification number, your affiliation to the entity, and your email address, an email will be automatically sent with the CID and PIN information to the email address provided.

More information on how to use the new system, including a COFS User Manual is provided on the Corporations Division homepage at www.michigan.gov/corporations.

Over the next several months we will continue to make enhancements to the system and will be sure to keep you apprised. As you know, change under the best circumstances is still difficult. Thank you for your patience with the Corporations Division staff as we are also adjusting to the new system.

Alexis Chadderdon is the Document Review Section Manager in the Corporations Division of the state of Michigan's Corporations, Securities & Commercial Licensing Bureau. In that capacity, she oversees the review and filing of business entity documents for the formation, continuation, and growth of corporations, limited liability companies, limited partnerships, and limited liability partnerships.

Well… 2018 will prove to be a year of major long-term importance for tax and business lawyers. We have sweeping new federal tax legislation that upends the corporate tax regime, and three major United States Supreme Court hearings involving tax issues that could make significant changes in how and what is taxed, or at least collected, over the internet, the tax regulation process, and something new in the criminal tax area.

Just before the end of the year on what amounted to a straight-party vote, the Tax Cuts and Jobs Act became the law of the land. The legislation made sweeping changes to several areas of the tax law and by association business and estate planning. The corporate rate was reduced from 35 percent to 21 percent. The impact on "effective rates" is less clear at this point, but early indications are for a large economic tax cut. Individual taxpayers have a murkier picture. The standard deduction increased significantly, but limitations for state and local tax deductions, the elimination of personal exemptions, new limits on mortgage interest deductibility, the prospective elimination of alimony deduction payments for the newly divorced, and phase-out for deductions in certain pass-through businesses *should* have taxpayers proactive now in projecting their particular tax situation. The media has been filled with various stories about state and local governments trying to either figure out a way to make the state and local taxes deductible (unlikely) or make legislative changes to address potential unintended state income tax increases. Count Michigan in that proverbial pot.

The married couple joint estate and gift tax exemption is now at $22 million. For mere mortals, the estate tax planning is the stuff of lottery tickets but the importance of "estate" (probate) planning remains. The impact in charitable giving and planning has institutional advancement folks in spasmatic overdrive.

The IRS may need upwards of $500 million to implement the new tax law. Thus far Congress has appropriated *nothing*. Dozens of systems and forms will need to be rewritten, scrapped or modified, and quickly. I have written in previous columns about the impact of IRS budget cuts over the last several years on taxpayers and practitioners. The Tax Reform Act of 1986 had significant budgetary vigor when passed for implementation and enforcement of the new system. Time will tell here.

Generally when there is sweeping tax legislation and/or reform, technical issues arise. How could they not with so many tax lawyers and tax accountants scouring the code for the next "big thing" or edge? Generally if there is conflicting language, some unintended consequence or just a blank box, a technical corrections bill is quickly passed. Given the political climate and mid-term elections later this year it is impossible to predict what may happen.

Marinello II v *United States*, __ US__, 138 S Ct 52 (2017). The Supreme Court is weighing whether an omnibus clause in IRC 7212(a), which criminalizes (corrupt of forcible interference) with the administration of the tax laws, requires some type of knowledge of IRS action or proceeding. In other words, is failing just to keep records and paying employees in cash enough for a violation of that statute? Most observers agree that destroying evidence or interfering with witnesses *after* being alerted to IRS involvement is a crime but the question is whether the same holds true where there is no known IRS involvement by the "taxpayer."

The Supreme Court has also agreed to review the Quill physical presence test. This case takes on the internet or "'e'conomy." It is brick and mortar versus the click-click retailer. States are flummoxed in trying to get their sales tax from sales occurring within their jurisdictions of electronic purchases. Some estimates calculate the loss of Sales or Use Tax revenue from internet sales at $13 billion. Practice Point: The buyer is still supposed to pay the tax. Check your Michigan Income Tax Return. Did you buy anything over the internet and not pay sales tax? Michigan Treasury has started doing some due-diligence.

For most of us, some of the things that we buy over the internet are taxed. The general determinative factor is whether the particular company has a physical presence in the state. Say Barnes & Noble versus a small comic book store in Cincinnati that had the hard-to-find collector's edition of Secret Squirrel. While many taxpayers might pay scant attention to a few cents, state governments are paying a lot of attention as the cents add up fast. Sales and Use taxes provide the lion share of state revenue. Internet shops sell everywhere and perhaps don't collect and pay anywhere. The physical presence test in its day perhaps reflected the reality of most retail activity. Sure there were some folks that lived near state borders that may have worked the system. I seem to recall folks driving to North Carolina for furniture and perhaps not remitting the requisite tax to Lansing. While not condoned, those activities were more often in the breach. No more.

South Dakota is itching for the fight. It passed a state law clearly in conflict with Quill. In Alexander Hamilton's day they would have done a staged case. What we have here is pretty close. Anyway, on January 12, 2018, certiorari was granted. See, *South Dakota v Wayfair, Inc*, __US__, 138 S Ct 735 (2018). The outcome of this case has massive repercussions for nearly every type of business.

The IRS scored a major win in their multi-year war with certain types of micro-captive insurance companies. In *Avrahami v Commissioner*, 149 TC No 7 (2017), the U.S. Tax Court found the underlying product was not bona-fide insurance and thus the insurance premiums for federal tax purposes are not deductible under IRC 162.

For several years the IRS has listed certain micro-captives on their annual "Dirty Dozen List of Tax Scams".

New provisions for small insurance companies became effective for taxable years beginning after December 31, 2016. Taxpayers with a micro-captive are advised to seek *independent* review of their arrangement immediately. In other words, don't ask your insurance advisor if what they sold you qualifies as insurance.

Lastly, in a truth is stranger than fiction moment, a now former IRS lawyer at the IRS' Office of Professional Responsibility pled guilty in late 2017 in a methamphetamine drug conspiracy. Previously, the defendant taught a course on tax lawyering and professional responsibility at Georgetown. The activity went down as the person reviewed the conduct of others.

So, 2018 has come in with a proverbial bang. Stay tuned.

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Technology M&A Due Diligence: More to Consider

In prior columns, technology related issues facing the business lawyer in the M&A context have been discussed. One recent article discussed how the buyer can ensure that the target's intellectual property licenses continue.[1] During due diligence, counsel for the buyer (and perhaps for the seller, if a strong, formal legal opinion is being requested) also look at the way the seller meets its compliance obligations. Counsel may need to consider whether the target is compliant in the movement of data across borders, including the application of the US/EU Privacy Shield,[2] in the gathering and usage of consumer information,[3] and in the public company realm,[4] whether proper investor disclosures have been provided, such as the cybersecurity disclosures recommended by the Securities Exchange Commission in 2011.[5]

There is always more to consider, of course, and no due diligence process can be perfect, but consider the following the next time you are involved in the purchase of a company that is public or that maintains an interactive web site that allows visitors to the site to post material. Each of these topics are equally applicable to advising your clients that have these issues whether or not they are in play.

Updated SEC Cybersecurity Guidance

In late February 2018 the SEC published a detailed statement and interpretive guidance[6] enumerating various matters relating to data security. These issues must be addressed by public companies in 1933 Act filings as well as in periodic and current reports, such as 10-K, 10-Q, and 8-K filings. While the SEC did not formally address the topic, corresponding disclosures in private capital raising offering materials should also be seriously considered. Unlike the prior guidance, the SEC's new statement was very specific about the importance of these disclosures:

> Cybersecurity risks pose grave threats to investors, our capital markets, and our country. Whether it is the companies in which investors invest, their accounts with financial services firms, the markets through which they trade, or the infrastructure they count on daily, the investing public and the U.S. economy depend on the security and reliability of information and communications technology, systems, and networks. Companies today rely on digital technology to conduct their business operations and engage with their customers, business partners, and other constituencies. In a digitally connected world, cybersecurity presents ongoing risks and threats to our capital markets and to companies operating in all industries, including public companies regulated by the Commission.
>
> As companies' exposure to and reliance on networked systems and the Internet have increased, the attendant risks and frequency of cybersecurity incidents also have increased.[7]

This is not the lukewarm statements from prior years and follows the strong statement from last year about examination priorities.[8] As emphasized by a speech of SEC Chair Clayton to the Council of Institutional Investors in early March 2018, the SEC is very serious, especially as compliance in the early years after the original guidance was lacking.

Cybersecurity should be addressed in the Risk Factors section and the Management Discussion and Analysis discussion, as well as the Legal Proceedings discussion, if applicable. The SEC's "guidance" should be presumed to have the force of law, at least for those seeking expeditious processing of registrations. Issuers must address both security risks and their implications—e.g. theft of trade secrets such as product formulae or customer lists, or a hack of consumer information—and the nature of their efforts to mitigate such risks, both in technical and operational terms.

Whether your target company has adequately disclosed cybersecurity risks and any incidents that may have occurred will be an important component of your analysis. Acquisition agreement warranties based on the results of your due diligence are also in order.

The Problem With Web Sites That Invite Users to Add Content: OCILLA Safe Harbor for the Innocent Site Operator

This Section could easily have been called "Avoiding inherited liability for copyright infringement." There are unique risks in buying or investing in companies that have these interactive websites. First, some background. If a member of the public posts material on someone else's website that is protected by copyright laws, the website operator and anyone transmitting the material may be liable for the infringement of the copyright under a legal theory known as 'secondary infringement.'

In order to encourage the growth of the internet and development of required infrastructure, in 1998, Congress enacted legislation known as the Digital Millennium Copyright Act[9] which in pertinent part, provides internet service providers and website operators with a defense to such claims if they observe certain procedural requirements discussed below.[10] The due diligence process must encompass review of whether these steps have been taken.

When considering the acquisition of or investment in (or loan to) a business with an interactive website, accepting public submissions of text, music or video, you will want to ensure that your due diligence process and resulting contract includes robust attention to copyright[11] matters. You do not want to make an acquisition or investment and find that you have walked into a hornets' nest of

third party claims.[12] Just as you conduct due diligence to address potential employment, supplier or products liability claims, you must do the same for copyright claims.[13]

One important consideration is whether the company complies with the safe harbor available under a portion of the DMCA called Online Copyright Infringement Liability Limitation Act or OCILLA. Even if you aren't doing an acquisition, compliance with these terms will benefit the operator of an interactive site.

Proper Terms of Use

Before turning to the nuances of OCILLA, an essential step which must be noted is the online posting of warnings that prohibit the submission of infringing material (and that which is obscene, defamatory or inciting violence). The target company must haved in its terms of use or similar area, unambiguously told visitors not to submit or post such material. While this is self -serving, its presence or absence is quite critically important.[14]

Clean Record

In the same vein, the due diligence review and contract process must extend to assurance that internal communications, especially e-mails, but also including paper files, are not inconsistent with such policy. For example, in a famous secondary infringement case known as *Grokster*,[15] e-mails of Grokster's executives documented that they saw 'getting in trouble with the law' as a promotional strategy by allowing (or arguably encouraging) infringing posts. This paper trail was used by the US Supreme Court as a factor in finding the company liable, effectively putting the company out of business.[16]

The OCILLA Elements

The key elements of OCILLA itself, which should serve as the framework for due diligence and corresponding contractual efforts, are loosely described as:[17]

- Designation (and updating as needed) on site and with Copyright Office of agent for receipt of infringement notices;
- Immediate removal of material which is the subject of such notices[18] and barring of 'repeat infringers;'
- Absence of site operator control over content;
- Absence of site operator financial benefit from infringing activity;[19] and
- Absence of actual knowledge of specific infringements.

Application of OCILLA

The application of these requirements to practical situations is complex and will vary greatly. For example, the points about the required contents in the web site terms of use discussed above (prohibitions on infringing posts and designation of copyright agent) are straightforward. Much the same is true of assessment of the business model and pertinent financial motivation. The due diligence process should inherently yield an understanding of how the target conducts operations, sufficient to allow a conclusion of its propriety. Other issues will be more complex.

DMCA Take-Down Notices

When considering the handling of problematic ('takedown') situations, the analysis is more involved. Discussion with relevant staff is necessary. Many operators have humans reviewing ('moderating') posts. A very recent Ninth Circuit case indicates that if this sort of activity goes beyond screening for infringing or unlawful material and extends into efforts to enhance the interest level of the posts, it will amount to site operator control over content and negate availability of OCILLA.[20] It is essential to discuss with relevant staff their understanding of applicable law and approach in practice.

The same is true with respect to handling of repeat infringers, although here, understanding and assessment of relevant technical measures with corresponding warranties, is needed. The very recent decision of the Fourth Circuit in the case of *BMG v. Cox Communications*[21] provides the most guidance which is available. It refers to the uncertainty around the issue of whether a particular policy will suffice, but makes clear that failure to make meaningful efforts to enforce a policy which does exist, will negate the defense.

The consideration of adherence to the 'absence of actual knowledge' standard is the most difficult prong to apply, for high volume sites. There will always be some inappropriate material that makes it to daylight, but the courts have held that this by itself does not constitute actual knowledge and may be considered only general knowledge. Numerous cases have reflected the struggles of the courts to meaningfully define 'actual knowledge', but have left many observers and commentators quite confused.[22] About all that can be said is that the process must result in an understanding of how target management views the process and their tolerance for and reaction time to infringing material. For low volume sites, the analysis should not be complex and management should be able to demonstrate immediate removal when required. There are even some technical tools that scan or screen submissions. These are becoming more common and can be an indication that the operator is making a good faith effort to comply with its obligations.

Benefits of Broadcast Flags

An increasingly important technical consideration that should be addressed in operational due diligence is the use of a system to respond to so-called "broadcast flags" or modules of computer code, which are embedded by a copyright holder to signify their interest. While not conclusive in litigation, use of appropriate scanning devices to screen submissions for such flags is increasingly prevalent and probably at least a presumptive indication of a good faith effort to comply with their obligations.

Conclusion

Due diligence in transactions is becoming more complex, especially as the importance of various types

of technologies permeate the business world. While these examples are important, look for new issues to arise constantly.

NOTES

1. *The Gap Trap and Twisted Pretzels (Ensuring the Continuity of IP License Rights in the Context Of Mergers And Acquisitions)*, MI Bus LJ (Summer 2013).

2. *The New US/EU Privacy Shield is Effective!* MI Bus LJ (Fall 2016).

3. The reference here relates to the need for privacy disclosures, the requirements of state law and FTC guidance related to consumer protection.

4.While the SEC has not spoken directly on the issue, it is optimal for private financing disclosure documents such as private placement memoranda, to contain comparable disclosures.

4. S*EC Issues Guidance on Cybersecurity Risks and Disclosure*, MI Bus LJ (Summer 2012).

5. 17 CFR Parts 229 and 249 [Release Nos. 33-10459; 34-82746], Commission Statement and Guidance on Public Company Cybersecurity Disclosures.

6. *Id.,* Part I.A.

7. *SEC Announces 2017 Examination Priorities* (Jan 12, 2017 Press Release) at https://www.sec.gov/news/pressrelease/2017-7.html

8. Pub. L. No. 105-304 112 Stat 2860.

9. DMCA Sec. 512 (c), known as the Online Copyright Infringement Liability Limitation Act or OCILLA. While it is not clear from the face of the legislation that OCILLA is intended to cover within the key term 'service providers', 'ordinary' website operators as opposed to those who are instrumental in facilitating internet access, in practice, it has been broadly read by the courts to cover both. *Viacom Int'l, Inc v YouTube, Inc,* 676 F3rd 19 (2nd Cir 2012).

10. While the legal analysis is slightly different and largely beyond the scope of this column, business purchasers should also take into account practices associated with keeping off of websites materials which infringe trademarks.

11. While direct exposure exists if the acquisition takes the form of a stock purchase or statutory merger, it is unclear to the authors whether this type of exposure may be mitigated through use of an asset acquisition strategy, assuming the same is consistent with other business and tax objectives of the parties.

12. While technically unrelated to copyright issues, the process must also encompass practices associated with screening out inappropriate content such as incitements to violence, defamatory statements or obscene material.

13. *UMG Recordings Inc v Shelter Capital Partners, LLC, infra* at n. 21.

14. *MGM Studios Inc v Grokster, Ltd,* 545 US 913 (2005).

15. *Id.*

16. The following is qualified by reference to the actual statutory text at 17 USC. 512(c), and to a lesser extent subsection (a) as well.

17. While a counter-notice procedure exists, in practice, it is very rare for it to come into play, and removal of offending material is almost always highly advisable.

18. In the *Grokster* case, *supra*, the Supreme Court focused on the defendant's business model and concluded that because it was supported solely through advertising and the software product was free, that the defendant had an incentive to maximize infringement.

19. *Mavrix Photographs, LLC v LiveJournal Inc*, 873 F3d 1045 (9th Cir 2017).

20. *BMG Rights Mgmt (US) LLC v Cox Commc'ns, Inc,* 881 F3d 293 (4th Cir 2018).

21. Compare the *Viacom Int'l, Inc v YouTube, Inc* discussion, *supra* at n. 9 with the effort of the Ninth Circuit in *UMG Recordings Inc v Shelter Capital Partners, LLC,* 667 F3rd 1022 (9th Cir 2011).

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This column will highlight the Oakland County Business Court's Case Management Protocol ("Protocol") including recent changes to the Protocol[1] and briefly discuss developments in other Business Courts.[1] Unless exempted or modified, the Protocol applies to each Oakland County Business Court case. The changes to the Protocol align with a core purpose of the Business Courts in Michigan—the efficient resolution of business disputes. Summarizing the changes, the Oakland County Business Court stated:

Amendments to the Business Court Case Management Protocol include, but are not limited to, the adoption of the Protocol—subject to any mutually agreeable alternative procedures—as a Court Order for the governance of all business court cases, the expansion of topics to be discussed at the Case Management Conference, notification concerning the preservation of documents and proportionality in discovery, the basis for initial disclosures as well as a broader scope of information and documents qualifying as initial disclosures.[2]

Oakland County Business Court

Case Management Protocol: Generally

The Case Management Protocol will be adopted as a Court Order unless a party files "specific objections" prior to the Case Management Conference. Those objections must show good cause as to why the case should be exempted from the Protocol or why the Protocol should be modified for that case. The Protocol (including modifications, if any) will be incorporated into the Scheduling Order as an Order of the Court.

Case Management Conference

Parties with a case assigned to the Business Court can expect to discuss the Protocol's requirements at the initial Case Management Conference. Lead counsel are required to attend. At the conference, counsel and the Court will discuss the relief requested in the complaint or counterclaim, amendment of pleadings, dispositive or injunctive motions, the need for a protective order and consent to the Court's Model Protective Order, timing issues, early alternative dispute resolution including designation of an agreed facilitator (mediator), modifications of the discovery protocols, anticipated discovery disputes,[3] and discovery of electronically stored information. Prior to the conference, counsel should meet to discuss these issues. Plaintiff's counsel must file a Joint Case Management Plan at least one week before the conference.

Standard Discovery Protocol: Generally

A party disputing its discovery obligations under the Protocol must do so at the Case Management Conference. The Standard Discovery Protocols include a notice to preserve relevant or potentially relevant documents (including electronically stored information). Also, discovery "shall be proportional to the complexity and amount of the damages sought."[4]

The Oakland County Business Court also requires that certain "initial disclosures"[5] be made within 30 days of the Case Management Conference, regardless of whether such information was requested in discovery. Some of these "initial disclosures" include:

- The factual basis of the party's claims and defenses;
- The legal theories on which the party's claims or defenses are based;
- Identification of individuals likely to have discoverable information—along with the subjects of that information—whom the party may use to supports its claims or defenses;
- A copy—or a description by category and location—of all documents, including electronically stored information, in a party's possession, custody, or control that such party may use to support its claims or defenses;
- A description by category and location of all documents that are not in the disclosing party's possession that the party may use to support its claims or defenses;
- A computation of each category of damages claimed by the disclosing party, who must make available for inspection and copying documents on which each computation is based (this includes materials bearing on the "nature and extent of injuries suffered");
- A copy of any relevant insurance, indemnity, or suretyship agreement; and
- The anticipated subject areas of expert testimony.

The discovery protocols also address a common discovery issue—the sequence of discovery. "A party is not excused from making disclosures because the party has not fully investigated the case or because the party challenges the sufficiency of another party's disclosures, or because another party has not made its disclosures." Thus, a party cannot claim timing or the lack of disclosures from the opposing side as a reason not to make its own disclosures.

Written Discovery

Under the Protocol, the Court will entertain motions to modify the discovery limitations below upon good cause, either initially or later in a case. Written discovery must be served sufficiently in advance of the discovery cutoff date, to allow the opposing party to respond prior to the cut-off date. Thus, the typical written request must be served at least 28 days prior to discovery cut-off. Discovery beyond this may be done by written stipulation, but only if it does not affect important deadlines. If the extension on discovery would affect such dates, a written motion demonstrating good cause must be filed as soon as the need becomes apparent.

Parties are encouraged to agree on limitations to discovery, including the number of written discovery requests and the timing and sequence of written discovery that will best serve the "speedy, just and efficient resolution of the matter."[6]

Moreover, objections to discovery requests "shall be clear and concise. Boilerplate or 'general' objections are discouraged." Furthermore, any document withheld based on privilege and generated before the litigation must be logged to allow the opposing party and the Court to assess the prima facie assertion of privilege. Lastly, when filing a motion to compel pursuant to MCR 2.309(C) or 2.310(C)(3), a party must state it "has in good faith conferred or attempted to confer with the party not making the disclosure to secure the disclosure without court action."

Depositions

Under the Protocol, parties are encouraged to place "limitations on the number and length of any depositions, including timing, location and sequencing" that will best serve the "speedy, just and efficient resolution of the matter." "Inordinate breaks during depositions, gamesmanship, objections violative of MCR 2.306(C)(4), or uncivil behavior are inappropriate" and will be subject to sanctions.

Electronic Discovery

Parties should also be prepared to discuss e-discovery at the Case Management Conference. Parties may agree to additional stipulations governing e-discovery, such as the Model Order from the U.S. District Court for the Eastern District of Michigan.[7]

Model Forms and Orders

The Scheduling Order, which is issued to parties after the initial Case Management Conference, now addresses additional issues. The order now requires "initial disclosures" and eliminates the "heard by" date for dispositive motions. In addition, motions in limine must be heard no later than three weeks before trial. The Scheduling Order also adopts the Model Protective Order and incorporates the Case Management Protocol as a Court Order.

The Model Stipulated Protective Order now provides for the maintenance and retention of files containing materials designated as "Confidential" in a secure location, subject to the statute of limitations. In general, this Model Protective Order will continue to be the default in litigation in the Oakland County Business Court.

Developments in Other Business Courts

Kent County

In the recent past, Kent County's Business Court docket had been divided between two judges. That has changed. Judge Christopher P. Yates has resumed being the sole Business Court Judge for Kent County.

Wayne County

The Wayne County Business Court launched a successful and well-attended First Annual Bench Bar Program on October 20, 2017. The Second Wayne County Business Court Bench Bar Conference is currently being planned for April 2018, with the specific date to be determined.

NOTES

1. Judge James M. Alexander and Judge Wendy L. Potts are the Business Court Judges for Oakland County. https://www.oakgov.com/courts/circuit/departments/business-court.

2. Thank you to the Oakland County Business Court, whose announcement about the changes to the various Business Court documents has been helpful for this article.

3. The Oakland County Business Court uses experienced volunteer discovery facilitators, who assist counsel in resolving discovery disputes.

4. Factors relating to proportionality are discussed in further detail in Fed. R. Civ. P. 26(b)(1). These include "the importance of the issues at stake in the action, the amount in controversy, the parties' relative access to relevant information, the parties' resources, the importance of the discovery in resolving the issues, and whether the burden or expense of the proposed discovery outweighs its likely benefit."

5. Counsel should expect other courts (and arbitrators) to consider requiring initial disclosures.

6. This is consistent with how the Michigan Court Rules are to be construed. MCR 1.105. ("These rules are to be construed to secure just, speedy, and economical determination of every action and to avoid the consequences of error that does not affect the substantial rights of the parties.")

7. https://www.mied.uscourts.gov/pdf-files/ParkerEsiOrderChecklist.pdf.

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What It Means to Win for In-House Counsel

When people think about lawyers, people generally credit lawyers with being great debaters or people who "know how to win arguments." For the most part, they are correct! Lawyers generally have strong inductive and deductive reasoning skills, which are attributes of great debaters. Additionally, law schools train lawyers to establish their points with facts and with an appreciation for both sides of the argument. Great debaters can generally thrive in certain legal environments, particularly as litigators. However, successful in-house lawyers hone their strong reasoning skills and factual perspectives to move beyond winning arguments to strengthening business relationships, resolving problems, increasing goodwill and furthering their company goals. Successful in-house counsel know what it means to win in an in-house environment and the importance of strong partnerships.

Business Team Partners

Successful in-house counsel are resourceful legal partners to their business team. They not only understand the law as it applies to the business situation but are also able to provide their business partners with a path to reach their business goals in a way that complies with the law. Successful in-house counsel dedicate themselves to learning the business in order to provide appropriate and practical legal analysis. Additionally, successful in-house counsel are in constant communication with their business partners in order to assess their legal needs and in an effort to reduce requests for urgent legal reviews. They learn to provide advice that goes beyond just communicating legal roadblocks and instead includes alternative ways to reach the business goals in a legal and ethical manner. They also know how to effectively communicate to their business partners when the law or compliance rules prohibit them from taking certain actions. Successful in-house counsel know that winning means that they are resourceful to their business partners and supportive of their company's goals.

Outside Counsel Partners

Successful in-house counsel appreciate the importance of building strong relationships with outside counsel. Knowing that they have an understanding of the law and how it applies to the business, they respect that outside counsel can provide a greater level of expertise as well as a broader knowledge of cases and rulings related to specific legal areas. Successful in-house counsel, therefore, establish and develop their relationships with outside counsel before incidents arise within the company so that the outside counsel has an understanding of the company's business as well as its philosophy. This partnership allows successful in-house counsel to more effectively ensure that their company is adhering to the law. They work together with outside counsel to review policies, conduct audits and provide training. When an issue does arise, they already have a level of trust with outside counsel that allows them to work cooperatively and efficiently to effectively appreciate the facts, critically conduct a legal analysis and appropriately develop a strategy that is consistent with the company's philosophy. Successful in-house counsel do not simply establish relationships with outside counsel to resolve a single issue, but instead develop a partnership with the common interest of ensuring the company complies with the law and insulating the company from liabilities.

Company Business Partners

Successful in-house counsel are respectful to their companies' business partners. Most often it is in-house counsel that lead the contract negotiations with their companies' external business partners. Successful in-house counsel appreciate that it is important for their companies to have productive business relationships with external parties and therefore negotiate with the external business partners with the goal of establishing and maintaining mutually beneficial business relationships. Successful in-house counsel understand the importance of working through an impasse in a contractual negotiation by discussing the goal of the contractual term and reviewing the industry best practice in order to reach an agreement that is fair and reasonable to both parties in the business relationship. In situations in which the parties cannot reach an agreement, successful in-house counsel are respectful of the business decision and continue to promote an amicable relationship with the other party in order to preserve the relationship for future business endeavors.

Employees

Successful in-house counsel are respectful towards their companies' employees. They appreciate that it is their job not just to defend their companies against legal actions, but also to promote a positive company culture of abiding by the law, acting with integrity and treating employees with respect. They understand the employment laws that protect employees and they respect an employee's option to exercise his/her rights pursuant to these laws. In instances in which employees pursue their rights against the company, successful in-house counsel remain objective and act in a manner consistent with a positive company culture. As they gather all the facts, they remain open-minded in order to determine what actions took place. If they determine their companies may have violated the law or did not follow company policies, successful in-house counsel then make every effort to resolve employee issues fairly and efficiently. More importantly, even if the evidence suggests that the company did not discriminate against the employee or treat the employee unfairly, successful in-house counsel respectfully communicate this information treating the employee with

dignity and respect. They appreciate that the manner in which a company treat its employees greatly contributes to the company's culture and can enhance or deteriorate the company's reputation. Successful in-house counsel understand the benefits to their company when they address employee matters with respect and they act with integrity.

Conclusion

Successful in-house counsel have an understanding and appreciation for their companies' business goals and objectives. They, therefore, provide legal counsel in a manner that supports those goals and objectives while ensuring that their companies comply with the law. They develop strong partnerships that strengthen their companies' relationship with others. Successful in-house counsel have the fortitude to solve problems while exhibiting respectful behavior and acting with integrity.

Angelique Strong Marks serves as Director, General Counsel, Corporate Secretary and Compliance Officer for MAHLE Industries, Inc., which is a Tier One Automotive Supplier.

Issue Overview

By Marc N. Swanson, Co-Vice Chair, Debtor/Creditor Rights Committee

The Debtor/Creditor Rights Committee of the Business Law Section is pleased to present a series of articles for this issue of the *Michigan Business Law Journal* on fraudulent transfer law. This is especially timely in light of the recent enactment in Michigan of the Qualified Disposition in Trust Act ("QDTA") and the Uniform Voidable Transaction Act ("UVTA").

This issue explores key changes to Michigan fraudulent transfer law arising from the enactment of the UVTA and the QDTA. The enactment of the QDTA resulted in Michigan becoming the 17th state to approve domestic asset protection trust legislation. The QDTA represents a dramatic change to the law of asset protection planning in Michigan validating a form of self-settled trust that was previously unavailable in Michigan.

In addition to discussing these new laws, the goal of these articles is to help practitioners spot potential fraudulent transfer issues that may be embedded in their practice. Accordingly, we are examining unsettled issues in fraudulent transfer law in Michigan and throughout the country.

The Debtor/Creditor Rights Committee hopes that this issue will assist you in your practice.

How a Bank Can Avoid Paying the Bankruptcy Trustee When Its Customer Commits Fraud

By Marc N. Swanson and Erika L. Giroux

Introduction

Barton Watson masterminded a Ponzi scheme, and his companies' bank ended up paying for some of the damage.[1] After his fraud was discovered, Mr. Watson's companies were forced into bankruptcy. The bankruptcy trustee then sued the companies' bank to recover proceeds from the Ponzi scheme. The bank argued that it should not have to return any of the money the companies paid to it either as deposits or loan repayments because it acted in good faith and had nothing to do with the Ponzi scheme. The Sixth Circuit disagreed, however, because one employee at the bank knew about Mr. Watson's checkered past and an FBI investigation of the companies. The good faith defense was also raised by defendants who were sued in connection with Bernard Madoff's Ponzi scheme. As a result, both the Sixth Circuit and Second Circuit Court of Appeals have recently formulated standards for when a defendant's good faith defeats a trustee's attempt to claw back proceeds from a Ponzi scheme. The cases not only provide new legal standards but are also important reminders to financial organizations to have well established chains of communication within the organization for addressing fraud and other security risks that are known to all employees and periodically evaluated for effectiveness.

The Fraud

In order to obtain loans from equipment financing companies, Watson, as the Chairman and CEO of Cyberco, represented that Cyberco purchased computer equipment from Teleservices.[2] In reality, Teleservices, existed only on paper: it had no separate officers, directors, or employees, and it operated solely through Cyberco's executives, who fabricated invoices from Teleservices for nonexistent purchases of computer equipment.[3] These invoices were then used to obtain loans from the equipment financing companies, which sent the funds directly to Teleservices as "payment" for computer purchases.[4] Watson later transferred the money from Teleservices's account to Cyberco's account at Huntington in order to pay his accomplices' salaries and make payments on Cyberco's prior loans from the financing companies.[5]

Cyberco also borrowed money from Huntington and routinely made payments to Huntington on the outstanding balance of the loan, in addition to making ordinary deposits into its business account.[6] In September 2003, Huntington became suspicious of several large deposits into Cyberco's account, all from Teleservices.[7] This suspicion was compounded by Cyberco's refusal to use a lockbox for its checks, thereby preventing Huntington from monitoring the source of Cyberco's deposits.[8] Moreover, Cyberco repeatedly violated the loan agreement by failing to provide Huntington with audited financial statements.[9]

During a meeting with Huntington, Watson claimed that Teleservices "was a recent addition to Cyberco's holdings, that Teleservices was not yet operational, and yet that Teleservices was already collecting Cyberco's receivables before sending them to Cyberco."[10] This explanation of Teleservices's business directly contradicted Watson's previous representations to Huntington—of which the employees at the meeting were unaware—that Teleservices supplied Cyberco's computer equipment.[11] Nevertheless, one of Cyberco's account managers at Huntington became concerned over "the heightened risk of financial misinformation (as well as fraud)," noting that "the 'red flags' continue," including a number of overdrafts by Cyberco.[12] In response, another manager accessed Cyberco's report of aging and unpaid receivables and discovered that Cyberco's customers included several competitors in the computer services industry.[13] The account managers contacted Huntington's regional head of security, who made two significant discoveries: (1) the FBI was investigating Cyberco

and (2) Watson had previously confessed to and been jailed for fraud.[14] However, he failed to share this information with anyone else at Huntington.[15] Huntington informed Watson that it planned to contact Cyberco's customers to verify their status.[16] To prevent Huntington from doing so, Watson proposed an independent audit of Cyberco by Grant Thornton, to which Huntington agreed.[17] Watson forged responses from Cyberco's alleged customers to Grant Thornton's inquiries, and Grant Thornton ultimately reported that Cyberco's customers were legitimate.[18]

The entire fraud was not exposed until the FBI raided Cyberco's offices late in 2004.[19] Watson committed suicide shortly thereafter.[20] A state court subsequently appointed a receiver for Cyberco and Teleservices, both of which ended up in bankruptcy.[21]

[B]oth the Sixth Circuit and Second Circuit Court of Appeals have recently formulated standards for when a defendant's good faith defeats a trustee's attempt to claw back proceeds from a Ponzi scheme.

Lawsuit filed By the Trustee Against Huntington

The trustee in the Teleservices case sought to recover from Huntington three types of transfers: (i) payments on Cyberco's debt, sent directly from Teleservices to Huntington ("direct loan repayments"); (ii) transfers from Teleservices to Cyberco's deposit account at Huntington, which Cyberco later used to repay its debt to Huntington ("indirect loan repayments"); and (iii) deposits from Teleservices made to Cyberco's Huntington account that were later withdrawn by Cyberco or seized by the government ("excess deposits").[22]

The bankruptcy court held that the Trustee could recover all three types of transfers from Huntington.[23] The district court agreed.[24] Huntington appealed to the Sixth Circuit, arguing that it was not a transferee of the excess deposits and received the loan repayments in good faith, a complete defense to fraudulent transfer liability under 11 USC 548 and 11 USC 550.

Excess Deposits

The Trustee sought to recover the excess deposits as fraudulent transfers under section 548 of the Bankruptcy Code which provides in pertinent part that "the trustee may *avoid* any transfer . . . of an interest of the debtor in property . . . , if the debtor . . . made such transfer . . . with actual intent to hinder, delay, or defraud any entity to which the debtor was . . . indebted . . . ."[25] In such a case, "the trustee may *recover*, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—the *initial transferee* of such transfer or the entity for whose benefit such transfer was made; or any immediate or mediate [i.e., subsequent] *transferee* of such initial transferee."[26]

The Sixth Circuit held that Huntington was not a transferee of Cyberco's excess deposits because Huntington did not gain "dominion and control" over the funds. Specifically, in order to be a transferee, "the minimum requirement . . . is dominion over the money or other asset, the right to put the money to one's own purposes."[27] As a result, the court distinguished "mere possession" from full "ownership": an entity is not an initial transferee if it is "merely an agent who has no legal authority to stop the principal from doing what he or she likes with the funds at issue."[28]

The court found that Huntington's status as Cyberco's bank was insufficient to confer dominion and control over the deposits.[29] Huntington retained no discretion in determining to what uses Huntington's funds should ultimately be put; rather, that decision remained solely with the depositor (Cyberco), and the bank was bound to follow its directives.[30] Any ability of Huntington to use the deposited funds in the interim, e.g., in making loans to other customers, remained subject to Cyberco's right to withdraw the money.[31]

Additionally, the Sixth Circuit rejected the idea that perfecting a security interest in a deposit account alters this analysis; perfection is therefore likewise insufficient to confer dominion and control.[32] In particular, the court identified several problems with this theory. First, the loan agreement clearly stated that Cyberco remained the owner of the deposited funds, which it could "use and dispose of . . . in the ordinary course of business."[33] Second, the court found it implausible that a security interest in a loan worth $16 million could transfer dominion and control over $64 million—the full value of the deposit account—given that recovery upon default is limited to the amount of the underlying debt.[34] Third, the court rejected the Trustee's argument that the bank gained dominion and control over each individual deposit smaller than the outstanding balance of the debt.[35] Finally, the Sixth Circuit determined that the Bankruptcy Code differentiates between the recipient of a transfer and a transferee: receiving a property transfer, including a secu-

rity interest, within the meaning of 11 USC 101(54) does not inevitably impose transferee status under 11 USC 550(a).

Indirect and Direct Loan Repayments

Unlike the excess deposits, Huntington conceded that it was a transferee of the loan repayments.[36] With respect to the direct loan repayments (i.e. payments on Cyberco's debt, sent directly from Teleservices to Huntington) Huntington gained exclusive use and ownership of the money once it (1) received the check from Teleservices with instructions to apply it to Cyberco's debt and (2) applied the funds as ordered.[37] At that point, Teleservices had relinquished all rights to direct the use of its funds, and Huntington became the sole party with dominion and control. Consequently, Huntington was an initial transferee of the direct loan payments.[38]

Likewise, Huntington came into exclusive ownership and control of the indirect loan repayments (i.e. transfers from Teleservices to Cyberco's deposit account at Huntington, which Cyberco later used to repay its debt to Huntington) when it (1) received instructions from Cyberco to use the funds as payment on Cyberco's debt and (2) applied the funds accordingly.[39] Cyberco then retained no ability to use or direct that money, and Huntington became the exclusive owner. Huntington was therefore a subsequent transferee of those indirect repayments (the initial transferee being Cyberco).[40]

To defend against the Trustee's attempt to claw back the loan repayments, Huntington raised affirmative defenses under sections 548(c) and 550(b)(1) of the Bankruptcy Code.[41] Under section 548(c), an initial transferee who took the property (i) in good faith; and (ii) in exchange for value given to the debtor is absolved of liability for the avoided transfer.[42] Similarly, under section 550(b), the Trustee cannot recover the transfer from a subsequent transferee who took the property (i) for value, (ii) in good faith, and (iii) without knowledge of the transfer's voidability.[43]

Good Faith

The Sixth Circuit first found that the bankruptcy court had used an appropriate test to evaluate Huntington's good faith, namely, whether "Huntington ever reach[ed] the point where it could no longer legitimately cling to the belief that the Teleservices transfers were only Cyberco's collected receivables[.]"[44] Using this standard, the court affirmed that Huntington's good faith ended on April 30, 2004, when its head of security discovered the Watson had confessed to at least two prior frauds, served jail time for the crimes, and been permanently banned by the National Association of Securities Dealers, yet failed to share this information with Cyberco's account manager.[45] The court rejected the idea that this omission could absolve Huntington of its liability: "a corporation cannot feign ignorance . . . when it has delegated responsibilities to a group of individuals and an inexcusable breakdown of communication then occurs within the group."[46] Thus, the court determined that the good-faith standard applies on an organization-wide basis. A transferee cannot avoid liability simply by isolating its business units or declining to share pertinent information across company sectors. Therefore, both the direct and indirect loan repayments made after April 30, 2004, were recoverable in full.[47]

Knowledge of Voidability

The Sixth Circuit next held that the appropriate standard to evaluate Huntington's knowledge of the transfers' voidability was whether "the facts [were] such that they would have 'placed a reasonable person on notice that the transfer was illegitimate, and by extension, that it was voidable' given the investigative avenues that existed, the reasonableness of pursuing those investigations, and the findings that those reasonable investigations would have yielded."[48] This test requires a "holistic factual determination" incorporating both objective and subjective elements.[49] The court looked to two of its prior cases in applying this standard.

In *IRS v Nordic Village, Inc*,[50] the Sixth Circuit held that inquiry notice may be sufficient to constitute "knowledge of voidability."[51] In that case, an officer of the debtor company delivered a check to the IRS in payment of his personal tax obligations, owed on his separate business.[52] The practice of one business entity paying taxes for another is sufficiently out of the ordinary "to place a reasonable person on notice that the transfer [i]s illegitimate, and by extension, that it [i]s voidable."[53] Thus, in some circumstances, inquiry notice may equate to knowledge of voidability, and the IRS could not invoke the 550(b)(1) safe harbor.

By contrast, in *In re First Independence*,[54] the Sixth Circuit found that the facts were

A transferee cannot avoid liability simply by isolating its business units or declining to share pertinent information across company sectors.

not such as to put a reasonable person on notice of voidability. There, the owners of the debtor company deposited several checks issued by the debtor into their personal bank accounts.[55] The bank was not liable for those transfers, given the "range of legitimate scenarios" that could justify deposits from the debtor to its owners, such as salaries or shareholder distributions.[56] Moreover, further inquiries into the source of the money would have been futile, as any questions directed to the debtor would have been answered by the owners making the deposits, who would have inevitably condoned the transfers as legitimate.[57] Thus, the bank had no reason for suspicion and no recourse to investigate.[58]

Interestingly, in remanding *Meoli* to the bankruptcy court to conduct this fact-intensive inquiry, the Sixth Circuit went on to equate the requirement that the transferee act without knowledge of the transfer's voidability to good faith.[59] The court indicated that this good faith/without knowledge inquiry is primarily objective (specifically, "whether a reasonable person, given the available information, would have been alerted to a transfer's voidability") but can also incorporate subjective components (for example, whether the transferee engaged in "egregious, vindictive[,] or intentional misconduct" or demonstrated "integrity, trust, and good conduct").[60]

[T]he court found that lack of objective good faith was not sufficient to overcome the 548(c) safe harbor.

Madoff's Willful Blindness Test

Approximately a year before *Meoli* was decided, the Bankruptcy Court for the Southern District of New York articulated a different test for assessing whether a transferee received the debtor's property in good faith. Specifically, the court required actual knowledge or willful blindness in order to hold the transferee liable.[61]

The Facts

Madoff was one of the multitudes of actions arising out of the liquidation of Bernard L. Madoff Investment Securities, LLC ("BLMIS"), the elaborate Ponzi scheme run by notorious fraudster Bernard Madoff. Here, the BLMIS trustee sued two investment vehicles, Legacy Capital and Khronos (collectively, "the Funds"), to recover distributions from BLMIS. The trustee argued that the Funds had known that it was impossible for the BLMIS fund to achieve its stated returns and were aware of other indicia of fraud. Specifically, executives at the Funds had received a report documenting the results of a market experiment designed to replicate BLMIS's trading success; the report concluded that BLMIS's strategy could not possibly produce the returns it claimed.[62] The Funds also knew that (1) BLMIS's reported option trading volume far exceeded plausible market levels; (2) BLMIS's trades never appeared to impact the market; (3) BLMIS had an unusual operational structure and lacked a capable auditor; (4) BLMIS's pricing, returns, and dividends consistently and substantially exceeded normal expectations; (5) account statements were not available in real time and, moreover, displayed trades that the accounts were not authorized to make.[63] Despite the fact that similar investment funds with the same knowledge chose to withdraw from BLMIS, Legacy borrowed money to increase its investment with Madoff.[64] Between profits and return of its principal over the life of its investment, Legacy received more than $212,000,000 in distributions from BLMIS.[65] The trustee sought to recover those funds from Legacy, along with over $6.5 million from Khronos that it had received from Legacy.[66] The Funds raised affirmative defenses under 548(c) and 550(b)(1).

Good Faith

Since the securities laws "do not ordinarily impose any duty on investors to investigate their brokers" and thereby foreclose liability "for a negligent failure to inquire," the court found that lack of objective good faith was not sufficient to overcome the 548(c) safe harbor.[67] A lack of good faith requires that the transferee has "turned a blind eye to facts that suggested a high probability of fraud."[68] The court, therefore, held that the transferee must have either possessed actual knowledge of the fraud or been willfully blind to it.[69] Actual knowledge requires "a high level of certainty and absence of any substantial doubt regarding the existence of a fact."[70] Similarly, to be willfully blind, "(1) the defendant must subjectively believe that there is a high probability that a fact exists and (2) the defendant must take deliberate actions to avoid learning of that fact."[71]

Interestingly, the court construed the scope of the relevant fraud very narrowly—it was not enough that the Funds believed that BLMIS's reports were falsified and Madoff was "gambling that his initial long portfolio would rise in price."[72] Rather, to be liable for the transfers, the Funds must have

known that Madoff was not engaged in the trading of actual securities.[73] The court found it implausible that the Funds would have willingly continued to participate in a Ponzi scheme and therefore upheld their good faith defense.[74] Significantly, although the court rejected the "'red flag' theory" of knowledge because it "amounts to pleading fraud by hindsight," the court also stated that "intentionally choos[ing] to blind [one]self to the 'red flags' that suggest a high probability of fraud" can be "tantamount to a lack of good faith."[75] Thus, red flags and indicia of fraud remain relevant. Ultimately, the court concluded that even if Legacy suspected that the trades were falsified, it conducted a reasonable investigation and did not "turn a blind eye to its suspicions," therefore preserving its 548(c) protection.[76]

Knowledge of Voidability

With respect to the subsequent transfers from Legacy to Khronos, the court, although suggesting that "good faith" and "without knowledge of the voidability" ought to have independent meaning, declined to address the question explicitly.[77] Instead, the court applied a standard equivalent to willful blindness "which, the District Court has held, is synonymous with lack of good faith."[78] Specifically, while 550(b) does not impose an affirmative duty to investigate the chain of transfers, "some facts strongly suggest the presence of others: a recipient that closes its eyes to the remaining facts may not deny knowledge." However, since the trustee did not allege that Khronos willfully blinded itself to any red flags and Khronos in fact "conducted extensive due diligence," the transfers fell within the 550(b)(1) safe harbor.[79]

Comparison

Although the two tests appear facially different, their substance and outcomes will likely be similar. The Sixth Circuit test focuses on the knowledge requirement, whereas the S.D.N.Y. standard imputes knowledge into good faith, but both acknowledge that the two requirements are effectively the same. Both also reject the idea that mere inquiry notice of red flags is sufficient on its own but further indicate that an accumulation of red flags can, at some point, vitiate good faith. Thus, although the S.D.N.Y. test claims to be wholly subjective, it also appears to take into account whether the number of warning signs has reached a level that would be alarming to a reasonable person or organization. Likewise, although the Sixth Circuit framed its test as objective, it analyzes a number of situation-specific factors, i.e., "the investigative avenues that existed, the reasonableness of pursuing those investigations, and the findings that those reasonable investigations would have yielded," more akin to the S.D.N.Y.'s overtly subjective test.

Moreover, while the S.D.N.Y. test expressly declines to impose a duty to investigate, the court emphasized the Funds' efforts to investigate BLMIS and Madoff's purported trading practices. It is significantly because of these efforts that the court found that the Funds did not willfully turn a blind eye to the fraud. Similarly, the Sixth Circuit underscored the importance of Huntington's investigation into Cyberco in its guidance to the lower court on remand. Thus, although not explicitly, both tests effectively impose a duty to investigate—or at least significantly raise the bar for companies that fail to do so.

If the Cyberco case were evaluated under the S.D.N.Y. test, the outcome would likely have been the same. Namely, the security director's April 30, 2004, discovery of Watson's fraudulent past was the missing link that transformed Huntington's suspicions about Cyberco from a collection of red flags into knowledge of actual fraud. The Funds in *Madoff* never uncovered this type of direct connection, and that gap in knowledge was significant to the outcome. Alternatively, through the security director's failure to share the information with Cyberco's account managers, Huntington's inquiry notice became willful blindness to Watson's fraud.

Additionally, *Madoff* seems likely to have been decided the same way under the Sixth Circuit test. In *Meoli*, the Sixth Circuit emphasized the available avenues of investigation and alternative explanations for the suspect transactions. In *Madoff*, the Funds conducted extensive due diligence on BLMIS, including direct questioning of Madoff personally, considerable analysis of BLMIS's performance, and attempted replication of BLMIS's success in the market. The Funds therefore actively pursued their available avenues of investigation. Moreover, much like the *First Independence* case, at least one legitimate alternative explanation existed: namely, that BLMIS was fabricating trades while holding onto its original portfolio (as opposed to the entire portfolio being a sham).

In order to avoid being held liable under 11 USC 548 for transfers received from bankrupt clients, financial organizations should adopt several simple measures.

Recommendations and Conclusions

In order to avoid being held liable under 11 USC 548 for transfers received from bankrupt clients, financial organizations should adopt several simple measures. First, ensure that chains of communication within the organization for addressing fraud and other security risks are well established, known to all employees, and periodically evaluated for effectiveness. The primary cause of Huntington's trouble was its failure to communicate information about Watson's fraud promptly from the security director to the relevant account manager. Thus, fostering communication among the departments responsible for various aspects of a client account can be invaluable in preventing transferee liability. Similarly, while turning a blind eye to evidence indicating fraud or other unscrupulous conduct can cause an organization to be liable under section 550(a), pursuing a reasonable investigation into the transactions can be sufficient to insulate the company. Therefore, organizations should document and preserve the investigative measures of their employees as part of their client files. Finally, the employees assigned to a particular account should document their theory of wrongdoing with specificity and, if they conclude no wrongdoing occurred, articulate the legitimate reason justifying the transactions—both the Sixth Circuit and the *Madoff* court considered potential alternative explanations for the suspicious transactions in evaluating whether the transferee's hands were clean.

Ultimately, whatever test a court uses, the inquiry is heavily fact-dependent and conducted on a case-by-case basis. As Judge Moore noted in her *Meoli* concurrence, there is "no daylight" between "inquiry notice and facts that would alert a reasonable person to voidability," and financial organizations would, therefore, be wise to exercise caution and adopt prophylactic policies encouraging investigation, documentation, and organization-wide reporting and communication.

NOTES

1. *Meoli v The Huntington Nat'l Bank*, 848 F3d 716, 720 (6th Cir 2017).
2. *Meoli v The Huntington Nat'l Bank*, 848 F3d 716, 720 (6th Cir 2017).
3. *Id.*
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.* at 720–21.
8. *Meoli v The Huntington Nat'l Bank*, 848 F3d 716, 720–21 (6th Cir 2017).
9. *Id.* at 721.
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.* at 721–22.
14. *Meoli v The Huntington Nat'l Bank*, 848 F3d 716, 722 (6th Cir, 2017).
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Meoli v The Huntington Nat'l Bank*, 848 F3d 716, 722 (6th Cir 2017).
21. *Id.*
22. *See id.* at 719.
23. *Meoli v The Huntington Nat'l Bank*, 456 BR 318 (Bankr WD Mich 2011).
24. *Meoli v The Huntington Nat'l Bank*, No. 1:12-1113, 2015 WL 5690953 (WD Mich Sept 28, 2015).
25. 11 USC 548(a)(1).
26. 11 USC 550(a) (emphasis added).
27. *Meoli*, 848 F3d at 725 (quoting *Bonded Fin Servs, Inc v European Am Bank*, 838 F2d 890, 893 (7th Cir 1988)).
28. *Id.* at 725 (quoting *Taunt v. Hurtado*, 342 F3d 528, 522 (6th Cir 2003)) (internal quotation marks omitted).
29. *Meoli*, 848 F3d at 725.
30. *Id.* at 725–26.
31. *Id.* (citing *Nordberg v Societe Generale*, 848 F2d 1196, 1200 (11th Cir 1988)).
32. *Meoli*, 848 F3d at 727.
33. *Id.* at 727–28.
34. *Id.*at 727.
35. *Id.* at 728.
36. *Id.* at 729.
37. *Id.*
38. *Meoli v Huntington Nat'l Bank*, 848 F3d 716, 729 (6th Cir 2017).
39. *Id.*
40. *Id.*
41. *Id.* at 730.
42. 11 USC 548(c).
43. 11 USC 550(b)(1).
44. *Meoli v Huntington Nat'l Bank*, 848 F3d 716, 734 (6th Cir 2017).
45. *Id.*
46. *Id.* at 731.
47. *Id.* at 731–32.
48. *Id.* at 733.
49. *Id.*
50. 915 F2d 1049 (6th Cir 1990), *rev'd on other grounds*, *United States v Nordic Village, Inc*, 503 US 30 (1992).
51. *Id.* at 1056.
52. *Meoli*, 848 F3d at 732.
53. *Nordic Village*, 915 F3d at 1056.
54. 181 F App'x 534 (6th Cir 2006).
55. *Id.* at 526.
56. *Meoli*, 848 F3d at 732.
57. *Id.* at 732–33.
58. *Id.*
59. *See id.* at 734.
60. *See id.* at 733–34.
61. *In re Bernard L. Madoff Inv Sec, LLC*, 548 BR 13, 28–29 (Bankr SDNY 2016).

62. *Id.* at 18–19.
63. *Id.* at 19–24.
64. *Id.* at 24
65. *Id.*
66. *Id.*
67. *Madoff*, 548 BR at 28 (internal quotation marks omitted).
68. *Id.*
69. *Id.*
70. *Id.* at 29 (internal quotation marks omitted).
71. *Id.* (internal quotation marks omitted).
72. *Id.* at 29–30.
73. *Madoff*, 548 BR at 28–30.
74. *Id.* at 30–32.
75. *Id.* at 29, 33–34.
76. *Id.* at 35.
77. *Id.* at 38–39.
78. *Id.* at 38.
79. *Madoff*, 548 BR at 39.

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The New Michigan Domestic Asset Protection Trust Statute and Its Impact on Fraudulent Transfer Law

By Judith Greenstone Miller and Paul R. Hage

Michigan recently became the seventeenth state to approve domestic asset protection trust ("DAPT") legislation by enacting the Michigan Qualified Disposition in Trust Act (the "Act").[1] The Act was signed into law by Governor Snyder on December 8, 2016 and became effective on March 8, 2017. While a DAPT may provide certain tax and estate planning benefits,[2] the primary benefit of a DAPT, as compared to other types of trusts, is that a DAPT allows a settlor to retain a beneficial interest in the trust while limiting the ability of his or her creditors to reach the assets transferred to the trust. The Act was enacted because, at common law in Michigan and elsewhere, if a person created a trust and retained a beneficial interest in the trust, known as a "self-settled trust," then the trust's assets were subject to the claims of that person's creditors.[3]

DAPTs are, perhaps, most beneficial for individuals who have a high net worth and who in the future may be subject to claims from creditors due to reversals in the economy or being subjected to malpractice or D&O claims not covered by insurance (i.e., real estate developers, doctors, corporate executives and professionals). As discussed below, the Act represents a dramatic change to the law of asset protection planning in Michigan by validating a form of self-settled trust that, prior to the enactment of the Act, was invalid from an asset protection perspective.[4]

DAPTs Under the Act

If properly drafted, a DAPT can be funded with a settlor's assets, provide the settler with access to those assets as a beneficiary, and give the settlor the right to make certain fiduciary and administrative decisions regarding the DAPT and the assets placed therein, while at the same time, protect the assets from the settlor's creditors.

The Act establishes several statutory requirements that need to be satisfied for a self-settled trust to qualify as a DAPT, including: (i) the trust must be irrevocable;[5] (ii) the trustee of the trust must be a corporate trustee or an individual, other than the transferor, that resides in Michigan;[6] (iii) the settlor must execute an affidavit stating, among other things, that: (a) the transfer won't render the settlor insolvent (i.e., the settlor must leave sufficient assets out of the trust to satisfy known or anticipated liabilities), (b) the transfer is not being completed with intent to defraud a creditor, the settlor is not aware of any pending or threatened litigation, other than that which is disclosed in the affidavit;[7] and (iv) the settlor's rights are limited as set forth in the Act, most notably, that a settlor cannot demand that the trustee make a distribution to the settlor.[8]

The Act expressly allows the settlor to retain certain rights, powers and interests including: (i) the power to direct investments; (ii) the power to veto distributions; (iii) the power to remove and appoint trustees and advisors; (iv) the right to receive income; (v) the right to receive principal under a discretionary trust provision or support provision, or under the direction of an advisor with respect to either; (vi) the right to receive income or principal to pay income taxes on trust income; and (viii) after the settlor's death, the trustee has the power to pay the settlor's debts, the expenses of administering the settlor's estate, or any estate or inheritance tax imposed on or with respect to the estate.[9]

Creditors' Rights Under the Act

The primary reason for creating a DAPT is to protect an individual's assets from claims of creditors, and the Act provides a number of protections to help effectuate this result. Notably, a creditor's sole remedy with respect to assets transferred into a DAPT is to bring a cause of action to avoid a transfer to the DAPT (referred to in the Act as a "qualified disposition") as a fraudulent transfer under the Uniform Voidable Transactions Act ("UVTA")[10] by showing either actual fraud or constructive fraud.[11] Other traditional remedies, such as seeking to declare

the trust void, an alter ego of the settlor and garnishment, are precluded if the DAPT is created in compliance with the Act.[12]

Under the UVTA, in order to prove that a "qualified disposition" constituted actual fraud, the creditor of the settlor must show that the transfer was made with "actual intent to hinder, delay or defraud creditors."[13] Actual fraud is generally established by proving the existence of several "badges of fraud," which were originally established in the common law, and which were later codified in the statute.[14] These "[b]adges of fraud are not conclusive, but are more or less strong or weak according to their nature and the number occurring in the same case, and may be overcome by evidence establishing the bona fides of the transaction."[15] There is no bright line rule as to how many badges are required to be proven, but Michigan courts generally require the presence of at least a few of the badges before making a finding of actual fraud.[16]

Alternatively, a transfer can be avoided under the UVTA's constructive fraud provisions found in MCL 566.34(1)(b) and MCL 566.35(1). Constructive fraud under MCL 566.34(1)(b) requires that: (1) the debtor did not receive reasonably equivalent value in exchange for the transfer; and (2) (a) the debtor was engaged in a transaction for which its remaining assets were unreasonably small or (b) the debtor intended to incur, or believed, or reasonably should have believed that it would incur debts beyond its ability to pay as they became due.[17] Similarly, constructive fraud under MCL 566.35(1) requires that: (1) the creditor's claim arose before the transfer, (2) the debtor was insolvent or became insolvent as a result of the transfer, and (3) the debtor did not receive reasonably equivalent value in exchange for the transfer.[18]

Put simply, in order to prove constructive fraud under the UVTA, an existing creditor must prove that the transfer was made for less than a reasonably equivalent value and while the transferor was insolvent.[19] Because transfers to a self-settled trust will generally be for no value or consideration, the only element that need be proven by such a creditor for constructive fraud is that the transfer was made while the settlor was insolvent, or that such transfer rendered the settlor insolvent. The UVTA contemplates a balance sheet test for insolvency, providing that "a debtor is insolvent if, at a fair valuation, the sum of the debtor's debts is greater than the sum of the debtor's assets."[20]

A plaintiff's burden of proof with respect to a fraudulent transfer is heightened in the Act. Generally, the burden of proof to avoid a transfer as a fraudulent transfer under the UVTA is "preponderance of evidence."[21] The Act establishes a higher "clear and convincing" standard for setting aside a "qualified disposition" made under the Act.[22]

The statute of limitations for avoiding a "qualified disposition" as a fraudulent transfer is also shortened. Unlike the six-year statute of limitations typically applicable under the UVTA,[23] section 5(3) of the Act generally provides that the statute of limitations for bringing a fraudulent transfer claim under the UVTA expires two years after the "qualified disposition" was made.[24] However, if the creditor's claim arose before the "qualified disposition" was made, the Act provides that the two-year limitations period can be extended to:

> . . . one year after the qualified disposition … was or could reasonably have been discovered by the claimant, if the person who is or may be liable for any claim *fraudulently concealed* the existence of the claim or the identity of any person who is liable for the claim from the knowledge of the person entitled to sue on the claim.[25]

This language begs the question: how has the term "fraudulently concealed" been interpreted in the caselaw. Although there is no caselaw interpreting the term "fraudulently concealed" in the context of the Act, fraudulent concealment is a recognized exception to the general statute of limitations in Michigan under the Revised Judicature Act.[26] The elements of fraudulent concealment under Michigan law are:

1) a material representation which is false;
2) known by defendant to be false, or made recklessly without knowledge of its truth or falsity;
3) that defendant intended plaintiff to rely upon the representation;
4) that, in fact, plaintiff acted in reliance upon it; and
5) thereby suffered injury.[27]

As explained by the Michigan courts, "[f]raudulent concealment means employment of artifice, planned to prevent inquiry or escape investigation, and mislead or hinder acquirement of information disclosing a

DAPTs are, perhaps, most beneficial for individuals who have a high net worth and who in the future may be subject to claims from creditors due to reversals in the economy or being subjected to malpractice or D&O claims not covered by insurance[.]

right of action. The acts relied on must be of an affirmative character and fraudulent."[28] It is the burden of a plaintiff seeking to extend a statute of limitations to show "some arrangement or contrivance on the part of the defendant, of an affirmative character, designed to prevent subsequent discovery."[29] Thus, courts have held that tolling of a statute of limitations only occurs when a defendant commits *affirmative acts or misrepresentations* designed to prevent a plaintiff from discovering its potential claim.[30] Moreover, the Sixth Circuit Court of Appeals has stated that the application of fraudulent concealment should be premised on a defendant's improper conduct, as well as a plaintiff's actual and reasonable reliance thereon.[31]

[I]n order to prove constructive fraud under the UVTA, an existing creditor must prove that the transfer was made for less than a reasonably equivalent value and while the transferor was insolvent.

Applying this caselaw to the language of the Act, in order for the two-year statute of limitations for avoiding a "qualified disposition" to be tolled pursuant to MCL 700.1045(3)(a)(ii), a settlor or a beneficiary of the DAPT must knowingly or recklessly make a material misrepresentation regarding the existence of the DAPT or of a transfer to the DAPT to an existing creditor. Moreover, such creditor must rely on that misrepresentation to its detriment.

In order to avoid a tolling of the statute of limitations set forth in the Act, a settlor should not conceal the creation of the DAPT or any transfers of property into the DAPT. Personal financial statements and other disclosures regarding the settlor's assets should disclose the existence of the DAPT and any property transferred to the trust. Moreover, once the asset is transferred into a DAPT, it should not be shown as an asset of the settlor.[32]

Once the statute of limitations has expired, a creditor appears to have very little recourse with respect to assets placed in a DAPT. A notable exception to this rule is that, in the event that a bankruptcy of the settlor is initiated, either voluntarily by the settler or involuntarily by one or more creditors, section 548(e) of the United States Bankruptcy Code establishes a ten-year look-back period for avoiding actual fraudulent transfers to a self-settled trust.[33] Accordingly, an otherwise time-barred creditor of a settlor who believes that the settlor made a "qualified disposition" to a DAPT under the Act with "actual intent to hinder, delay or defraud creditors" may want to consider commencing an involuntary bankruptcy case against the settlor under section 303 of the Bankruptcy Code.[34]

Recovery of an Avoided Qualified Disposition

Even if a "qualified disposition" is avoided under the UVTA, the Act limits a creditor's remedies with respect to such avoided transfer. First, section 7(1) of the Act provides that "a qualified distribution may be avoided only to the extent necessary to satisfy or provide for the present value, taking into consideration any uncertainty of the transferor's debt to the creditor at whose instance the disposition had been avoided."[35] Thus, the avoidance of a qualified distribution does not result in the avoidance of the entire transfer. Rather, the transfer is only avoided to the extent necessary to satisfy the creditor/plaintiff's present claim.[36]

Moreover, so long as the trustee has not acted in bad faith in accepting or administering the property that is the subject of the "qualified disposition," the trustee has a lien "against the property that is the subject of the qualified disposition" in an amount equal to the entire cost, including attorney's fees, incurred by the trustee" in defending the fraudulent transfer action.[37] Further, where the trustee has not acted in bad faith,[38] the statute provides that the qualified distribution "is avoided subject to the fees, costs, preexisting rights, claims, and interests of the trustee."[39]

> Section 7(7) of the Act provides:
> on avoidance of a qualified disposition to the extent permitted under subsection (1), the *sole remedy* available to the creditor is an order directing the trustee to transfer to the transferor the amount necessary to satisfy the transferor's debt to the creditor at whose instance the disposition has been avoided.[40]

This remarkable provision seemingly provides that if a creditor is able to establish that a transfer to a DAPT is avoidable under the UVTA, the transfer itself is not actually avoided or returned.[41] Rather, the sole remedy is an order directing the trustee to transfer cash in the "amount necessary to satisfy the transferor's debt" to the settlor.

Putting these provisions together, let's assume that the settlor transfers $1 million in artwork to a DAPT and that a creditor successfully proves by clear and convincing evidence (within the shortened statute of limitations) that such transfer was a fraudulent transfer. If the creditor had a contingent claim in the amount of $200,000, the court would first need to determine the likelihood

of the creditor prevailing on such contingent claim. Let's assume that the court assigns the creditor a 50% chance of prevailing on his claim. In that case, only $100,000 of the $1 million transfer is avoidable. If the trustee acted in good faith, she has a lien on the amount of the transfer that is avoidable and can pay any fees and expenses incurred in defending the fraudulent transfer action out of such amount. So, if the trustee incurs $75,000 in fees in defense of the fraudulent transfer action, she would only have to pay $25,000 to the settlor, not the creditor. The artwork stays in the trust. The creditor would then have to try to collect the $25,000 from the settlor using the traditional collection remedies available under Michigan law.

Finally, it is worth noting that section 9(2) of the Act protects the interests of a *trust beneficiary* who, in many cases, will be the same party as the settlor. That section provides that the interest of a beneficiary in a DAPT "is not subject to a process of attachment issued against the beneficiary, and may not be taken in execution under any form of legal process directed against the beneficiary, trustee or trust estate."[42] The "whole of the trust estate and the income of the trust estate must go to and be applied by the trustee solely for the benefit of the beneficiary, free, clear, and discharged of and from all obligations of the beneficiary."[43] So a judgment creditor of the beneficiary cannot reach the beneficiary's interest in the trust until after a distribution is made, and the trustee cannot be compelled to make a distribution.

These asset protection provisions of the Act are powerful, and they go a long way towards vitiating any creditor collection action that might be taken to collect on the assets of the settlor or the beneficiary when a "qualified disposition" under the Act has been made.

Creditor Protections Under the Act

The Act does contain a few creditor protections, but creditors must act diligently to protect themselves. First, while it may go without saying, the Act expressly clarifies that a valid lien that attaches to property before it is transferred to a DAPT survives the disposition and the trustee takes the property subject to the lien.[44]

Additionally, the Act provides that a written agreement between a settlor and a creditor may provide for any of the following: (a) the transferor will have a continuing or periodic obligation to disclose any "qualified dispositions" to the creditor, (b) a "qualified disposition" will require the prior written approval of the creditor, or (c) that the transferor is under those other obligations as the creditor may require with respect to a "qualified disposition."[45] The Act provides that if a transfer that would otherwise qualify as a "qualified disposition" violates such an agreement with a creditor, then "with respect to the creditor only, the transfer is not a qualified disposition" and the Act does not affect the rights of the creditor.[46]

Given the foregoing, one would expect lenders to start incorporating provisions regarding DAPTs in their loan and guarantee documents and require additional representations, warranties and limitations on a continuing basis. In the absence of such provisions, an added emphasis should be placed on post-loan due diligence by creditors. Personal financial statements, for instance, must be carefully scrutinized to ensure that transfers to a DAPT are discovered before it is too late.

The Act does contain a few creditor protections, but creditors must act diligently to protect themselves.

Entireties Property

While entireties property is protected from attack in Michigan by a creditor whose claim arises against only one of the two spouses, the Act provides that if entireties property is transferred into a DAPT, the property retains its entireties character despite what would otherwise appear to be a transfer that would destroy or negate it.[47]

Even though entireties property outside a DAPT may provide protection for a married couple from debts of either spouse, there may be other reasons to transfer entireties property into a DAPT. For example, entireties property is only protected to the extent that both spouses are alive and married. If a spouse were to die after the entireties property was transferred into a DAPT, such property will still be immune from the claims of creditors of the surviving spouse.[48]

Professional Protections Under the Act

Finally, the Act provides express protection and immunity for claims against professionals who serve as trustee of a DAPT, or who assist in establishing or executing a DAPT. Specifically, the Act provides:

> (7) With respect to a qualified disposition, a creditor does not have a claim or cause of action against any of the

following:

> (a) The trustee of a trust that is the subject of a qualified disposition.
>
> (b) An advisor of a trust that is the subject of a qualified disposition.
>
> (c) A person involved in the counseling, drafting, preparation, execution, or funding of a trust that is the subject of a qualified disposition.[49]

This provision is a welcome protection for professionals who consult with clients about the creation of a DAPT as there is some case-law over the years in the non-DAPT setting suggesting that an attorney may be liable for aiding and abetting his or her client in the execution of a fraudulent transfer that was made in conjunction with asset protection planning.

Conclusion

While the public policy with respect to DAPTs can and should be debated, the Act is now the law in Michigan. The Act is a remarkable statute that dramatically changes the law in Michigan with respect to asset protection planning. As noted, a DAPT created in compliance with the Act can provide a substantial benefit to wealthy individuals desiring to protect their assets from creditors. A few things should be noted in closing however.

First, before creating a DAPT, clients need to understand that a DAPT means giving up control over the assets subject to the "qualified disposition." Although the Act does permit a settlor/beneficiary of the trust to retain some control by allowing him or her to replace the trustee, with many clients, the inability to compel distributions from the trust may be the end of the discussion.

Second, even a properly created DAPT is not bulletproof. Provided that a "qualified disposition" is timely discovered, fraudulent transfer law may be a powerful remedy for creditors harmed by such a transfer, especially when the transfer renders the settlor insolvent. It should be noted, however, that choice of law issues may complicate the analysis when a settlor or its assets are "located" outside of Michigan. Such issues require careful analysis by experienced counsel.[50]

Third, the Act will likely provide limited protection for a settlor who ends up in bankruptcy because of the ten-year look back period set forth in section 548(e) of the Bankruptcy Code for actual fraudulent transfers made to self-settled trusts. Given the chance to bring assets transferred by way of a "qualified disposition" back into the bankruptcy estate, a bankruptcy judge is perhaps more likely to avoid a transfer to a DAPT where possible.

Fourth, creating a DAPT that will pass muster under the Act is likely to involve significant fees and costs. Moreover, because of the intricacies associated with complying with the Act, as well as the need to evaluate a client's assets and liabilities, and tax and estate implications from the creation of a DAPT, an individual who is considering the establishment of a DAPT will need to confer with counsel experienced in trusts and estates, tax and creditors' rights law, as well as financial advisors who can assess the financial condition and solvency of the individual (both before and after the making of a qualified disposition) and valuation of the assets to determine whether the creation of a DAPT is advisable and in the client's best interest.

Finally, despite growing approval of DAPTs by state legislatures, there are few published court opinions validating or enforcing DAPTs. When the courts are involved, despite what may appear to be clear statutory language, there is always some uncertainty. Since none of the provisions of the Act have yet been tested in court, and because the Act is new and complex and changes existing law dramatically, some of the conclusions set forth in this article must be somewhat preliminary and clients should be so advised.

NOTES

1. MCL 700.1041 *et seq.*

2. Most DAPTs are treated as grantor trusts with the tax benefits flowing through to the settlor. Recognize, while the Act requires a DAPT to be irrevocable, by retaining rights to receive principal and income from a DAPT, a settlor will not be able to exclude the assets placed in the DAPT from its estate upon death.

3. *See In re Hertsberg Inter Vivos Trust*, 457 Mich 430, 578 NW2d 289 (1998).

4. *See Fornell v Fornell Equip, Inc,* 390 Mich 540, 213 NW2d 172 (1973); *see also In re Edgar Estate,* 425 Mich 364, 389 NW2d 696 (1986).

5. MCL 700.1042(aa)(ii).

6. MCL 700.1042(r).

7. MCL 700.1046.

8. MCL 700.1042(p).

9. MCL 700.1044.

10. The UVTA revised the Uniform Fraudulent Transfer Act, MCL 566.31 *et seq.* ("UFTA"), and became effective in Michigan on April 10, 2017. For a thorough discussion of the changes brought about by the UVTA, see "*MUFTA Becomes MUVTA: Recent Changes to Michigan Voidable Transactions Law"* written by Thomas R. Morris and published in this edition of the Michigan

Business Law Journal.

11. Pursuant to MCL 700.1045(2)(b), "For a creditor whose claim arose after a qualified disposition, the action must involve a qualified disposition that was made with actual intent to defraud the creditor."

12. *See* MCL 700.1045(1) ("Notwithstanding any other provisions of this act, with respect to any qualified disposition, a creditor has only the rights provided in this section and section 7"); MCL 700.1045(2)(a) ("For an action brought by a creditor for an attachment or other provisional remedy against property that is the subject of a qualified disposition or for avoidance of a qualified disposition … the action may only be brought under sections 4 and 5 of the uniform fraudulent transfer action…."); MCL 700.1047(4) ("With respect to a qualified disposition, a levy, attachment, garnishment, notice of lien, sequestration, or other legal or equitable process is permitted only in those circumstances permitted by this act.").

13. MCL 544.34(1)(a).

14. The UVTA identifies the following badges of fraud:

> (a) The transfer or obligation was to an insider.
> (b) The debtor retained possession or control of the property transferred after the transfer.
> (c) The transfer or obligation was disclosed or concealed.
> (d) Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit.
> (e) The transfer was of substantially all of the debtor's assets.
> (f) The debtor absconded.
> (g) The debtor removed or concealed assets.
> (h) The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred.
> (i) The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.
> (j) The transfer occurred shortly before or shortly after a substantial debt was incurred.
> (k) The debtor transferred the essential assets of the business to a lienor that transferred the assets to an insider of the debtor.

MCL 566.34(2).

15. *Timmer v Pietrzyk,* 272 Mich 238, 242 (1935).

16. *See, e.g., In re Select One, Inc*, 556 BR 826 (Bankr ED Mich 2013) (four badges not enough**)**; *Warner Norcross & Judd, LLP v Police & Fire Ret Sys of Detroit*, 2014 WL 2600554 (Mich Ct App 2014) (two badges not enough).

17. MCL 566.34(1)(b).

18. MCL 566.35(1).

19. MCL 566.35.

20. MCL 566.32.

21. MCL 566.34(3); MCL 566.35(3).

22. *See,* MCL 700.1045(2)(c). While the UFTA was recently amended to make this standard clear with respect to setting aside a "qualified disposition," the UVTA does not contain a similar provision. While it probably would have been clearer if the UVTA so provided, the failure to do so may not be critical since the Act (a more specific statute) expressly provides the standard for setting aside a "qualified disposition."

23. MCL 566.39(a) (referencing MCL 600.5813).

24. MCL 700.1045(3).

25. MCL 700.1045(3)(a)(ii) (emphasis added).

26. *See* MCL 600.5855 which provides, in pertinent part:

> If a person who is or may be liable for any claim fraudulently conceals the existence of the claim ... from the knowledge of the person entitled to sue on the claim, the action may be commenced at any time within 2 years after the person who is entitled to bring the action discovers, or should have discovered, the existence of the claim....

27. See e.g., *B&P Process Equip & Sys, LLC v Applied Indus Techs, Inc,* 2016 WL 67580, at *3 (ED Mich Jan. 1, 2016) (citing R*omeo Inv Ltd v Michigan Consolidated Gas Co,* 2007 WL 1264008, at *3 (Mich Ct App May 1, 2007); *McMullen v Joldersma*, 174 Mich App 207, 212, 435 NW2d 428 (1988)).

28. *Tonegatto v Budak,* 112 Mich App 575, 583, 316 NW2d 262 (1982); *see also Witherspoon v Guilford,* 203 Mich App 240, 248, 511 NW2d 720 (1994) ("[T]he fraud must be manifested by an affirmative act or misrepresentation.").

29. *Id.*

30. *Phinney v Perlmutter,* 222 Mich App 513, 562–63, 564 NW2d 532 (1997).

31. *See Egerer v Woodland Realty, Inc,* 556 F3d 415, 425 (6th Cir 2009).

32. Moreover, if an individual fraudulently conceals property and the creditor materially relies upon such misrepresentation to its detriment, it may give rise to a determination that the creditor's claim is non-dischargeable under section 523(a)(2) of the United States Bankruptcy Code.

33. 11 USC 548(e)(1) provides:

> In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—
> (A) such transfer was made to a self-settled trust or similar device;
> (B) such transfer was by the debtor;
> (C) the debtor is a beneficiary of such trust or similar device; and
> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

34. *See generally* 11 USC 303, which sets forth the requirements for filing an involuntary bankruptcy petition against a debtor.

35. MCL 700.1047(1).

36. This language raises important limitations on the creditor's recovery, specifically: (i) if the creditor's claim is contingent or unliquidated, then the likelihood of the creditor prevailing on liability or amount is considered, and (ii) the plaintiff can obtain only the present value of his claim, although the factors for making that determination are not provided.

37. MCL 700.1047(2)(a).

38. A creditor has the burden of proving by clear and convincing evidence that a trustee acted in bad faith. MCL 700.1047(3).

39. *Id.* The Act also provides that if a trust beneficiary has not acted in bad faith, the beneficiary is entitled to retain any distributions received from the trust prior to the creditor's commencement of the fraudulent transfer action. MCL 700.1047(2)(b).

40. MCL 700.1047(7) (emphasis added).

41. The use of the term "amount" in MCL 700.1047(7) suggests that a trustee cannot be compelled

to turn over tangible property to the transferor, even if the transfer involved tangible property. If the trust has no money such that the trustee is unable to return an "amount" to the transferor, the creditor/plaintiff is arguably left with no remedy whatsoever. It is unclear whether under such circumstances a creditor/plaintiff can force the trustee to liquidate property held in the trust in a sufficient amount to deal with the claim, in other words, to make a transfer to the settlor to provide for payment of the claim. The Act is silent on this point and, ultimately, the courts are likely to be asked to make this determination.

42. MCL 700.1049.

43. *Id.*

44. MCL 700.1045(10).

45. MCL 700.1045(11).

46. MCL 700.1045(12).

47. MCL 700.1047(7).

48. *See also*, MCL 700.1045(4). The Act provides that property transferred into a DAPT at least thirty days prior to a trust beneficiary's marriage is excluded from marital property. Thus, a DAPT can serve as a form of a prenuptial agreement.

49. MCL 700.1045(7).

50. Which state law governs a fraudulent transfer action may differ depending upon what law governs. The UFTA does not contain a choice of law provision. The caselaw generally looks to the *situs* of the property transferred or the law of the State having the most significant relationship to the occurrence and the parties. *See e.g.,* Kettering, Kenneth C., *Codifying a Choice of Law Rule for Fraudulent Transfer: A Memorandum to the Uniform Law Commission,* 19 Am. Bankr. L.Rev. 319, 341-342 (2011). Conversely, the UVTA specifically provides that a claim for relief thereunder is governed by the local law of the jurisdiction in which the debtor is located when the transfer is made or the obligation is incurred. In the case of an individual, the individual is located in the State of his or her principal residence. Whereas, an organization that has only one place of business is located at its place of business, if the organization has more than one place of business, it is located in the State of its chief executive office.

The Act and the amendments to the UFTA were adopted in Michigan before the UVTA was passed. As a result, neither the Act, nor the UVTA, address choice of law in the case of a DAPT. A potential amendment to the UVTA is being considered that would provide, in the case of a qualified disposition to a DAPT, the location of the trustee of the DAPT, as opposed to where the individual making the qualified disposition is located, governs choice of law.

The following States have adopted the UVTA: California, Idaho, New Mexico, North Dakota, Minnesota, Iowa, Michigan, Kentucky, Georgia and North Carolina. The UVTA has been introduced and is pending in the following States: Washington, Indiana, South Carolina and New York.

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MUFTA Becomes MUVTA: Recent Changes to the Michigan Voidable Transactions Law

By Thomas R. Morris

Introduction

Michigan's version of the statute formerly known as the Uniform Fraudulent Transfer Act (UFTA) was amended, effective April 10, 2017. The UFTA is now the Uniform Voidable Transactions Act, or UVTA. This article discusses the background of the UVTA and the changes it brings to Michigan law, and it touches briefly on two other Michigan statutes, the Qualified Dispositions in Trust Act (QDITA)[1] and the "judgment-creditor remedy" contained in the Judicature Act.[2] Those two other statutes specify different rules for challenges to transfers of property prejudicial to creditors. The QDITA is discussed in more detail in the accompanying article by Judith Greenstone Miller and Paul R. Hage.[3]

A Brief Linguistic History of the UVTA

In Roman law, *in fraudem creditorum* did not mean necessarily to defraud a creditor. It meant "conduct to the prejudice of creditors." Such conduct could be challenged by a creditor. Under Roman law, a voidable transaction was not necessarily fraudulent in the usual sense of the term.[4]

One of the roots of our modern law is the Fraudulent Conveyances Act 1571 (13 Eliz 1, c 5), also known as the Statute of 13 Elizabeth, which prohibited certain conduct with the "intent to delay, hinder or defraud creditors and others of their just and lawful actions." That is the source of the phrase "hinder, delay or defraud" which is still at the core of current law. The Statute of 13 Elizabeth became part of American common law.

The Uniform Fraudulent Conveyance Act (UFCA), adopted in 1918, codified the common law. The specific meaning of "conveyance" is a transfer of real property, but the UFCA was not limited to transfers of real property. This helps to explain the change in terminology which resulted from the adoption of the Uniform Fraudulent Transfer Act (UFTA) in 1984, and its enactment by Michigan in 1998. The term "fraudulent conveyance" thus became "fraudulent transfer." The UFTA also addresses more issues than did the UFCA.

The latest amendments to the UFTA are contained in the UVTA, which was adopted by the Uniform Law Commission in 2014. If we follow the linguistic line of reasoning, the explanation for the UVTA is that it takes the fraud out of fraudulent transfers.

Background of the UVTA and Michigan's Version

The UVTA is technically a set of amendments to the UFTA. Public Act 2016, No 552 amended the Michigan Uniform Fraudulent Transfer Act (MUFTA) by enacting the UVTA with minor adaptations. it is codified at MCL 566.31 to MCL 566.45. The courts have not yet had the opportunity to update the acronym, but the former MUFTA, as amended, is referred to herein as "MUVTA."

Effective Date

The new provisions of MUVTA do not apply to a transfer made or obligation incurred prior to the effective date of the amendments.[5] Note that Lexis and the Michigan Legislature Web site show the "current" language of MUVTA. If you are advising a client regarding a transfer made or obligation incurred prior to April 10, 2017, you should keep a copy of the former MUFTA available. On Lexis, MUFTA is available as an "archived code version" of the particular section.

Changes to MUFTA Made by MUVTA

The changes are listed in order of importance.

1. Change the name of the UFTA to the "Uniform Voidable Transactions Act."[6]
2. Add a choice-of-law provision.[7]
   a. The UFTA contained no choice-of-law provision. Therefore, under the UFTA, courts typically apply the choice-of-law analy-

sis that would be applicable in a tort case.[8] When a transfer of real property is at issue, the law of the situs of the real property will presumably apply. That was the rule in *Palmer v Mason*,[9] a case which predates the UFCA.

b. The UVTA adopts the basic "place of business" definition from UCC 9-307 to determine a debtor's location, and provides that a claim for relief under the UVTA "is governed by the local law of the jurisdiction in which the debtor is located when the transfer is made or the obligation is incurred."[10] The UVTA does not employ the Article 9 rule that a "registered organization" is located in its state of organization.

3. Clarify that the burden of proof is by a preponderance of the evidence.[11] The "clear and convincing" standard had arguably applied to the issue of the existence of fraud.[12] That higher standard, rejected by the UVTA, was adopted in 2016 with respect to a "qualified disposition" governed by the QDITA.[13]
4. Remove strict foreclosure under Article 9 from the "safe harbor" provisions applicable to the enforcement of a security interest.[14]
5. Delete the special definition of "insolvent" that applies to partnerships.[15]
6. Specify that the value given by a good-faith transferee of a transfer made without "actual intent" must be "given the debtor" if the transferee is to have a complete defense.[16]
7. Add protections to transactions entered into by "series organizations."[17] Michigan law does not provide for the establishment of "series organizations", but they are provided for under Delaware law, for example. This provision essentially prevents a Michigan court from disregarding the separate identities of series organizations.
8. Tie-in with the QDITA. The QDITA takes precedence over the MUVTA in the narrow circumstances of its application. MCL 566.31(k) adopts the definition of "qualified disposition" from the QDITA. MCL 566.34(4) shelters a "qualified disposition" from avoidance by a creditor whose claim arose after the qualified disposition except "if the qualified disposition was made with actual intent to hinder, delay, or defraud any creditor of the debtor." MCL 566.39(c) makes the two-year limitations period provided in the QDITA applicable to qualified dispositions.

The latest amendments to the UFTA are contained in the UVTA, which was adopted by the Uniform Law Commission in 2014. If we follow the linguistic line of reasoning, the explanation for the UVTA is that it takes the fraud out of fraudulent transfers.

How MUVTA Deviates From the UVTA

1. Style. Almost all of the differences between the MUVTA and the UVTA are stylistic. The state Legislative Service Bureau is responsible for these stylistic choices. They carry over from MUFTA. The section headings from the UFTA and now the UVTA are (unfortunately) not included.
2. Definition of "Transfer". Approximately 20 lines dealing with the definition of "transfer" were added to MUFTA at the request of estate-planners in 2009 to create trust-related exceptions to the definition of "transfer." This language is retained by MUVTA.[18]
3. The Statute of Limitations and the "Discovery" Exception. Like other uniform acts, the UVTA loses its uniformity as it becomes law, because each state that chooses to enact the UVTA is free modify it. When the choice of law applicable to a situation is arguable, consider the implications.

The most significant way in which MUVTA differs from UVTA (and from the law of other states), is the limitations period. The limitations period may therefore be the most important or most common choice-of-law consequence for Michigan practitioners. The enactment of MUVTA did not change this. Michigan's deviation from the uniform version remains the same. MUVTA retains the limitations period applicable to MUFTA: Six years for the avoidance of fraudulent transfers, and one year for the avoidance of insider preferential payments. The UVTA retains the limitations periods of the UFTA: One year for insider preferential payments, four years for any other voidable transaction, and a discovery rule applicable to cases of "actual

intent to hinder, delay or defraud" which allows suit to be filed "within one year after the transfer or obligation was or could reasonably have been discovered by the claimant."

The "discovery rule" of the UVTA strengthens the remedy for creditors but creates uncertainty. Michigan law[19] partially addresses the issue by allowing a fraudulently concealed claim to be brought within two years of its discovery.

Continuing Application of MCL 600.6131, the Judgment-Creditor Remedy

A judgment creditor seeking to reach assets that it contends have been conveyed in a fraudulent manner may proceed under either MUFTA/MUVTA or Chapter 61 of the Revised Judicature Act of 1961.[20] Under a nameless provision,[21] which we will call the "judgment-creditor remedy", the burden of proof is on the defendant instead of the plaintiff. Once the plaintiff makes a *prima facie* case by "introducing into evidence the judgment . . . and proof of the conveyance complained of" the burden of proof shifts to the "judgment debtor, the person claiming through him, or the person who it is claimed holds the property in trust for him to show that the transaction is in all respects bona fide or that the person is not holding as trustee of the judgment debtor."[22] It is not clear that a transferee-defendant's proof that the transaction is either bona fide, *or* that the transferee does not hold the property as trustee of the judgment debtor, would be sufficient. It seems likely that a court that entered a judgment in favor of the plaintiff would require a transferee-defendant to disprove both theories.

The judgment-creditor remedy can only be used by a judgment creditor. Others must rely upon the other remedies available (now MUFTA/MUVTA).[23] The judgment-creditor remedy, which dates from 1897,[24] has continuing vitality. Its use was recently upheld.[25]

Nationwide Status of the UVTA

Fifteen states including Michigan have adopted the UVTA, and another seven have it under consideration.

Cases Construing the UVTA

As of July 28, 2017, no Michigan state or federal court opinion available on Lexis had cited the MUVTA.

NOTES

1. MCL 700.1041 to MCL 700.1050.
2. MCL 600.6128 to MCL 600.6134.
3. *The New Michigan Domestic Asset Protection Trust Statute and Its Impact on Fraudulent Transfer Law,* pages 24-30 of this edition of the Michigan Business Law Journal.
4. Kettering, Kenneth C., *The Uniform Voidable Transactions Act; or, the 2014 Amendments to the Uniform Fraudulent Transfer Act,* 70 Business Lawyer 777, 807 (Summer 2015). But cf. Phillimore, John G., *Private Law Among the Romans* 188 (1863); Berger, Adolf, 43 *Encyclopedic Dictionary of Roman Law* 477 (1952) (giving the traditional translation).
5. MCL 566.45(2).
6. MCL 566.45(1).
7. MCL 566.40.
8. Kettering, Kenneth C., *Codifying a Choice of Law Rule for Fraudulent Transfer: A Memorandum to the Uniform Law Commission,* 19 Am Bankr Inst L Rev 319, 341-342 (2011).
9. 42 Mich 146, 153, 3 NW 945 (1879).
10. MCL 566.40(2).
11. MCL 566.35(3).
12. *Foodland Distribs v Al-Naimi*, 220 Mich App 453, 481, 559 NW2d 379 (1996) (concurring opinion).
13. MCL 700.1045(2)(c).
14. MCL 566.38(5)(b).
15. MCL 566.32.
16. MCL 566.38(1).
17. MCL 566.41.
18. MCL 566.31(p).
19. MCL 600.5855.
20. MCL 600.6101 to MCL 600.6143.
21. MCL 600.6131.
22. MCL 600.6131(1).
23. *Mason v Mason*, 296 Mich 622, 296 NW 703 (1941).
24. 1897 PA 99.
25. *Burke v Maurer,* No. 329839, 2017 Mich App LEXIS 271 (Feb 21, 2017) (unpublished).

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The most significant way in which MUVTA differs from UVTA (and from the law of other states), is the limitations period.

Understanding Standing of a Receiver to Bring Claims Under Michigan's UVTA

By Laura J. Eisele*

Introduction

Does a Michigan court-appointed receiver have standing as a creditor, under the newly enacted Michigan Uniform Voidable Transfers Act ("UVTA"),[1] to recover voidable transfers previously made in the name of the person or entity in whose shoes the receiver stands? The answer is unclear.

Guidance can be found from existing Michigan statutory and caselaw, and caselaw from other states that have analyzed the issue. Those states have found, in limited circumstances, that a receiver for an entity that made a voidable transfer has standing, as a creditor, to bring a fraudulent transfer claim to recover that voidable transfer when the individual responsible for the wrongful transfer is removed from either control of, or a beneficial interest in, the entity. It is unclear, however, if Michigan would follow this rule given the recent enactment of the Uniform Commercial Real Estate Receivership Act[2] (the "Receivership Act") and existing caselaw with its unique interpretations of doctrines such as *in pari delicto* and imputed wrongdoing.

Practically, the best way to ensure that a receiver has standing to bring voidable transfer actions in Michigan, is to have the pleadings and order appointing the receiver: (i) authorize the receiver to bring UVTA claims on behalf of creditors, (ii) address which creditors will receive the benefit of any recoveries from voidable transfer actions, and (iii) make it clear that the individual responsible for the wrongful transfer will not benefit from any recoveries.

The Michigan UVTA

In General

The UVTA replaced the Michigan Uniform Fraudulent Transfer Act ("UFTA")[3] effective on April 10, 2017. The UVTA allows creditors to recover voidable transfers for both actual and constructive "fraud," although the term "fraud" is rarely used in the UVTA. UVTA, pursuant to MCL 566.34(1), provides that a transfer made by a debtor is voidable as to a creditor if it is made with actual or constructive "fraud", stating:

a. With actual intent to hinder, delay, or defraud any creditor of the debtor.
b. Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor did either of the following:
   (i) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction.
   (ii) Intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.

The UVTA was adopted, among other reasons, to clarify ambiguities in the UFTA,[4] and to more closely align the UVTA with other relevant statutes such as the United States Bankruptcy Code (the "Bankruptcy Code").[5]

One of the most significant changes from UFTA to UVTA is the use of the term "voidable" rather than "fraudulent" to describe transfers subject to avoidance. UFTA's use of the term fraud led some courts to set aside transfers only in situations of actual fraud but not constructive fraud. Previously, some Michigan courts had applied the "clear and convincing evidence" standard to prove a fraudulent transfer under UFTA.[6] The UVTA has now codified the lesser standard of "preponderance of the evidence,"[7] which seems consistent with its use of the word "voidable" in place of the word "fraudulent."

UVTA does not, however, make any changes that would affect the question of whether a receiver has standing to bring an action under UVTA.

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Overview of Who May Bring Claims Under the UVTA

Under the Michigan UVTA and its predecessor statutes, only "creditors" have the right to bring a claim to void a transfer, and each of them defines the term "creditor" broadly.[8] Giving the right to void transfers to creditors is also consistent with the original purposes of fraudulent transfer law, when it was first enacted by Parliament in 1571, to allow creditors to void transfers made by insolvent debtors to impede the creditors' collection efforts.[9] This raises the question of who or what constitutes a creditor?

MCL 566.31(1)(d) defines a creditor as "a person that has a claim." A claim is defined in MCL 566.31(1)(c):

> "Claim", except as used in "claim for relief", means a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.

A "person" is defined in MCL 566.31(1)(k):

> "Person" means an individual, estate, partnership, association, trust, business or nonprofit entity, public corporation, government or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.

The language of the UVTA regarding *who* may bring a claim is similar to the language under the UFTA, so cases construing the UFTA on this issue remain relevant.[10] Where a receiver stands in the shoes of a creditor, it has standing to pursue claims under the UVTA.[11] *The more difficult question arises when the receiver stands in the shoes of the entity or individual that made the voidable transfer.*

The UVTA does not specifically grant a receiver standing to bring a fraudulent transfer action. This is distinct from the Bankruptcy Code[12], which makes clear that a bankruptcy trustee has standing to pursue fraudulent transfer actions by stepping into the shoes of a creditor.[13] It is also distinct from the Michigan Assignments for the Benefit of Creditors statute[14] which provides that assignees "may recover all property or rights or equities in property which might be recovered by a creditor."[15] While various Michigan statutes allow for the appointment of a receiver, none specifically grant standing to a receiver to pursue claims of creditors.[16] In fact, as will be discussed further, the recently enacted Receivership Act suggests that this issue was specifically contemplated by its drafters who decided not to grant receivers standing to pursue avoidance actions.

Michigan Receiverships

Receiverships are an equitable device that began in the medieval courts of England, where they developed over time and were adopted in the American colonies.[17] Receiverships' usage generally increases in times of economic crisis—such as the Panic of 1893, the Great Depression of the 1930's, and the recent financial crisis of 2008.[18]

A receiver is typically appointed in litigation brought by a creditor. Many mortgage and loan documents permit the appointment of a receiver as a remedy for a default. Thus, a receiver may be appointed in any resulting foreclosure action.

Numerous statutes and court rules also provide for the appointment of a receiver as a specific remedy. For example, MCR 2.621 allows a court to appoint a receiver to assist a judgment creditor in the collection of a debt, and the UVTA allows a creditor to have a receiver "take charge of the asset transferred or of other property of the transferee."[19]

Under MCR 2.622(A), an appointed receiver "is a fiduciary for the benefit of all persons appearing in the action or proceeding." The Michigan Supreme Court has defined a receiver as "the arm of the court, appointed to receive and preserve the property of the parties to litigation and in some cases to control and manage it for the persons or party who may be ultimately entitled thereto. A receivership is primarily to preserve the property and not to dissipate or dispose of it."[20]

Under MCR 2.622(E), the powers of an appointed receiver are:

> (1) Except as otherwise provided by law or by the order of appointment, a receiver has general power to sue for and collect all debts, demands, and rents of the receivership estate, and to compromise or settle claims;
>
> (2) A receiver may liquidate the personal property of the receivership estate into money. By separate order of the court, a receiver may sell real property of the receivership estate;
>
> (3) A receiver may pay the ordinary expenses of the receivership but may not distribute the funds in

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the receivership estate to a party to the action without an order of the court; and

(4) A receiver may only be discharged on order of the court.

Therefore, MCR 2.622(E) permits the receiver to sue for and collect debts of the "receivership estate" which is defined as "the entity, person, or property subject to the receivership."[21] The rule does not specifically allow the receiver to pursue claims of creditors of the receivership estate.

On February 26, 2018, the Michigan Legislature enacted the Receivership Act, which is effective as of May 7, 2018. The Receivership Act was modeled on the Uniform Commercial Real Estate Receivership Act drafted by the National Conference of Commissioners on Uniform State Laws (the "Uniform Act"). The Receivership Act, which applies to commercial real estate transactions, might suggest that a receiver has standing to bring claims under UVTA because under section 9, receivers are specifically designated as lien creditors under Article 9 of the Uniform Commercial Code.[22] However, a closer review of the Receivership Act and the history of its enactment suggests that the drafters specifically considered and rejected giving receivers avoidance powers similar to those enjoyed by bankruptcy trustees.

The language of the UVTA regarding *who* may bring a claim is similar to the language under the UFTA, so cases construing the UFTA on this issue remain relevant.

Section 9 of the Receivership Act provides that a receiver has the status of a lien creditor under both:

(a) Article 9 of the uniform commercial code, … as to receivership property that is personal property or fixtures.

(b) The recording statutes of this state as to receivership property that is real property.

However, the comments to the Uniform Act state that the intent of section 9 is to enable the receiver to establish priority over unperfected secured parties and subsequent creditors.[23] The comments also specifically state that this section "does not create (and is not intended to create) an 'avoiding power' in the receiver analogous to the strong-arm power exercisable by a bankruptcy trustee under Bankruptcy Code § 544(a)."[24] Finally, section 12(d) of the Receivership Act specifically grants a receiver power to "[a]ssert a right, claim, cause of action, or defense of the owner that relates to receivership property." That section does not, however, specifically grant a receiver standing to pursue any claims belonging to creditors.

Therefore, a strong argument can be made that the Receivership Act did not intend to give a receiver standing under UVTA to pursue voidable transfers made by the receivership estate.

Analysis of Caselaw

Introduction

No Michigan case has specifically considered whether a receiver under the Receivership Act or otherwise has standing to pursue voidable transfer claims under UVTA belonging to creditors of the receivership entity.

Several other states have held that a receiver for an entity that made a voidable transfer has standing, as a creditor, to bring a fraudulent transfer claim to recover that voidable transfer when the individual responsible for the wrongful transfer is removed from either control of or a beneficial interest in the entity. Those cases held that a receiver representing an entity that made a voidable transfer may recover the voidable transfer because the entity, which is a separate legal entity from the individual, was harmed by the individual's wrongful actions and such wrongful actions would not be imputed to the entity making the transfer.[25] It is not clear whether Michigan courts would reach the same conclusion, given the complexity and uniqueness of Michigan laws that effectively impute the individual's wrongdoing to the corporation and the recent enactment of the Receivership Act.

Note that, as will be discussed further, under the wrongful conduct or *in pari delicto* doctrines, a receiver standing in the shoes of an *individual* who made a wrongful transfer would likely never be deemed a creditor with standing to bring a fraudulent transfer action to undo the individual's wrongful act. This is because the individual who caused the "voidable transaction" is the actual wrongful *transferor*, and *a transferor* can never both make a wrongful transfer and then benefit from the wrongful transfer by bringing a fraudulent transfer cause of action to void or otherwise nullify the transfer.[26]

Caselaw Outside Michigan—The Scholes Analysis

Scholes v. Lehmann

The leading case outside of Michigan on whether a receiver has standing to bring a fraudulent transfer action standing in the

shoes of the transferor comes from the Seventh Circuit Court of Appeals in *Scholes v Lehmann*.[27] *Scholes* held that the receiver for corporate entities that made wrongful transfers, had standing under UFTA to bring suit to recover the transfers for the benefit of the entities' customers—investors that were defrauded by a Ponzi scheme.[28]

In *Scholes*, Michael Douglas masterminded a Ponzi scheme by creating three corporations where he was the sole shareholder in each of them. After the appointed receiver sued Douglas on the behalf of the corporations, Douglas argued that the receiver did not have standing to bring such a claim.[29] Douglas argued that since both he and the corporations caused the "transfers" to be made it was not possible for the corporations to have been harmed by the transfers, and that the receiver was really trying to bring claims on behalf of other creditors—which is impermissible under the doctrine of *in pari delicto*.[30]

Judge Posner rejected Douglas' argument, finding that the receiver represented the corporations, separate legal entities, not the individual wrongdoers who instigated the transfers at issue. Because Douglas had been ousted from control of and a beneficial interest in, the corporations, those entities were no longer "evil zombies" under Douglas' "spell", and therefore each had been injured in their own right, as separate legal entities.[31] The appointment of the receiver, as requested by the SEC, had removed the wrongdoer from the scene.[32]

Judge Posner also rejected the *in pari delicto* argument, stating that "the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated."[33] Judge Posner stated the practical reasons for his decision:

> Now that the corporations created and initially controlled by Douglas are controlled by a receiver whose only object is to maximize the value of the corporations for the benefit of their investors and any creditors, we cannot see an objection to the receiver's bringing suit to recover corporate assets unlawfully dissipated by Douglas. We cannot see any legal objection and we particularly cannot see any practical objection. The conceivable alternatives to these suits for getting the money back into the pockets of its rightful owners are a series of individual suits by the investors, which, even if successful, would multiply litigation; a class action by the investors-and class actions are clumsy devices; or, most plausibly, an adversary action, in bankruptcy, brought by the trustee in bankruptcy of the corporations if they were forced into bankruptcy.[34]

Judge Posner's analysis has been widely followed by courts in other jurisdictions.[35] Judge Posner allowed standing to the receiver despite that Douglas was essentially the "sole actor" for the receivership entities.

Eberhard v. Marcu

Following the reasoning set forth by the Seventh Circuit in *Scholes*, the Second Circuit, in *Eberhard v Marcu*, found that a "receiver's standing to bring a fraudulent conveyance claim will turn on whether he represents the transferor only or also represents a creditor of the transferor."[36]

In *Eberhard*, Todd Eberhard, the sole shareholder of several corporations ("Mr. Eberhard"), made unlawful transfers in violation of federal securities laws.[37] In making its ruling, the court noted that the receiver was only appointed to represent Mr. Eberhard's personal assets since the corporation's assets were removed from the receivership estate.

Following *Scholes* and an analysis of whether Mr. Eberhard could be considered a "creditor" under New York law, the court held the receiver did not have standing to set aside the purported conveyance of a company which Mr. Eberhard once controlled as its sole shareholder, because the receiver only held Mr. Eberhard's individual claims, and not those of his companies. The court made it clear that if the receiver stood in the shoes of the company, following the rationale of *Scholes*, the court would have allowed the receiver to pursue the fraudulent transfer action.[38]

Analysis of Michigan Caselaw

***In Pari Delicto* and Wrongful Conduct Doctrines**

While Michigan has not decided the precise issue raised in *Scholes*, Michigan has significant and distinct caselaw construing the *in pari delicto* defense and the "wrongful conduct" doctrine in the context of other claims that could impact a Michigan court's analysis of whether a receiver on behalf of the entity making the fraudulent transfer has standing under the UVTA. While *Scholes* consid-

No Michigan case has specifically considered whether a receiver under the Receivership Act or otherwise has standing to pursue voidable transfer claims under UVTA belonging to creditors of the receivership entity.

ered the doctrine of *in pari delicto*, it did not discuss in detail the wrongful conduct doctrine, imputed knowledge or other equitable doctrines—such as the sole actor rule—that could be raised to support a conclusion that the receiver did not have standing as a creditor.

The doctrine of *in pari delicto,* with respect to a corporation, is based upon the laws of agency which imputes a corporate agent's conduct to the corporation. Thus, a corporation may be charged with its agent's wrongful conduct, which would bar it from recovering from another wrongdoer under the *in pari delicto* doctrine.[39] However, if the agent's wrongful conduct was completely adverse to the corporation's interest, the agent's wrongful conduct cannot be imputed to the corporate principal. In this case, *the in pari delicto* doctrine would not apply. This is known as the "adverse interest exception" to the *in pari delicto* doctrine.[40]

Under UVTA, a receiver for a *creditor* clearly has standing to bring actions to recover voidable transfers.

But, there is an exception to this exception called the "sole actor rule." It provides that where a corporate agent/wrongdoer is the corporation's sole actor, the corporate agent and the corporation are essentially one and the same and the adverse interest exception does not apply (essentially reinstating the *in pari delicto* doctrine).[41]

To confuse matters further, some courts recognize an innocent decisionmaker exception to the "sole actor rule," articulated in *In re Sharp International Corp*.[42] The "innocent decision maker" exception states that even if the wrongdoer was the sole actor, if at least one decision maker existed (such as a board member or creditor's committee) who would have stopped the wrongdoing if alerted to the wrongdoing, the wrongdoing will not be imputed to the corporation.[43]

NM Holdings

In *NM Holdings*, a Michigan bankruptcy court construing UFTA, held that a trustee for an entity that made a voidable transfer could not be a creditor under UFTA (other than as authorized under the Bankruptcy Code, which did not apply in this case) and thus, could not pursue claims under the UFTA.[44]

In *In re NM Holdings*, the chapter 7 trustee for Venture Holdings Company and related entities ("Venture") brought a professional negligence action against Deloitte & Touche, LLP ("Deloitte"), as well as other claims including claims for fraudulent transfers. *NM Holdings* held that the chapter 7 trustee had missed the statute of limitations to bring a fraudulent conveyance action under the provision of the Bankruptcy Code that allows the chapter 7 trustee to stand in the shoes of a creditor to pursue fraudulent transfers, and thus could only pursue state law claims under UFTA.[45]

Next, *NM Holdings* considered whether the chapter 7 trustee could bring a claim for a fraudulent transfer as a successor to Venture under 11 USC § 544 pursuant to UFTA. The court noted that "[t]he Uniform Fraudulent Transfer Act was designed to protect unsecured creditors against debtors who make transfers out of, or make obligations against, the debtor's estate in a manner adverse to the creditors' rights."[46] Relying on the UFTA's language, NM Holdings held that only a creditor that has been harmed by a transfer has standing under UFTA, and therefore, because Venture, as the transferor, could not be a creditor, the bankruptcy trustee could not bring a fraudulent transfer action as a successor to Venture.[47]

NM Holdings did not explicitly consider the wrongful conduct of Larry Winget, Venture's sole shareholder, ("Mr. Winget"), when ruling on standing to pursue a fraudulent transfer action under UFTA. However, in the course of dismissing the malpractice claims against Deloitte, *NM Holdings* held Mr. Winget's wrongful actions would be imputed to Venture.[48] *NM Holdings* ultimately held that even though Mr. Winget was acting on his own behalf and not on Venture's, because Mr. Winget was Venture's sole actor, his wrongful conduct would be imputed to Venture.[49]

MCA Financial

MCA Financial v. Grant Thornton,[50] held that a liquidating agent for MCA Mortgage Corporation ("MCA") could not recover damages from MCA's auditors for certification of false financial statements, because the wrongful conduct of the individuals who made the false financial statements was imputed to MCA.[51] *MCA Financial* was not persuaded by the fact that monies collected by the liquidating agent would be used to reimburse investors, and the individuals making the false statements would not benefit, holding:

> While an innocent company that is harmed by others' wrongdoing may be able to recover damages and recoup its investors' losses, we see no basis for guaranteeing the recoupment of losses

> by investors whose company engaged in wrongdoing. Ultimately, by making an investment in a company, an investor is casting a vote of confidence in the management of that company.[52]

Both *NM Holdings* and *MCA Financial* discussed whether and when a corporate representative's wrongful conduct should be imputed to the corporation. Both courts explained various theories--including the doctrine of *in pari delicto*, wrongful conduct theory and generally agency laws—that may impute the wrongful conduct of a corporation's officers the corporation.[53]

Neither *NM Holdings* nor *MCA Financial* decided whether these exceptions exist in Michigan. *MCA Financial* distinguished *Scholes* by pointing out that *Scholes* was decided under Illinois law and involved a fraudulent conveyance action rather than a tort action. *MCA Financial* also noted that defendants in a fraudulent transfer action, while not wrongdoers, directly profited from the fraud.[54] Thus, depending upon the type of claims being brought under the UVTA, a Michigan court could reach a different conclusion from *MCA Financial* and *NM Holdings*.

Coppola v. Manning

Whether a receiver has standing to bring suit on behalf of the receivership estate was also recently addressed by the Michigan Court of Appeals in *Coppola v. Manning*.[55] In *Manning,* the receiver ("*Mr. Coppola*") sought to bring an action for breach of fiduciary duties by the former officers and directors of the receivership estate.[56]

Manning found that Mr. Coppola "had both the authority and obligation to initiate lawsuits for the protection and preservation of ReCellular's assets, including any cause of action it may hold against its former directors and officers."[57] These findings were premised on the proposition that the breach of fiduciary duty claims belonged to the receivership entity because, under state law, either a shareholder on behalf of a corporation or the corporation itself may bring the fiduciary duty action.[58] The Court emphasized that while a receiver is appointed as an arm of the court to protect and benefit parties in interest, the receiver may only bring claims of the entity under receivership.[59] The court also noted that the receivership order gave the receiver general authority to initiate lawsuits it deemed necessary to carry out his duties.

Manning supports the proposition that a receiver has broad powers to pursue litigation on behalf of a receivership entity. However, *Manning* did not have to find that the receivership entity was a "creditor" in order to find standing to pursue breach of fiduciary duty claims, because those claims belong to the corporation. Therefore, *Manning* supports a conclusion that a receiver has standing to pursue a fraudulent transfer made by the receivership entity, but only if the court can also conclude, as *Scholes did*, that the receivership entity is separate from the wrongdoer and harmed by the wrongdoing, and thus a creditor.

Conclusion

Under UVTA, a receiver for a *creditor* clearly has standing to bring actions to recover voidable transfers.

Otherwise, the issue of whether a receiver for a party making a voidable transfer has standing to pursue UVTA claims is less clear. For example, if the receiver is standing in the shoes of an *individual* who made a wrongful transfer, a Michigan Court would probably deny the receiver standing under UVTA because the *in pari dilecto* doctrine bars individuals from profiting from their own wrongdoing.

In contrast, where a receiver is standing in the shoes of an *entity* who made a wrongful transfer, some courts outside of Michigan have held that the wrongdoer who made the fraudulent transfer can be treated separately from the receivership entity, if the receivership entity is harmed by the wrongdoing, the *in pari dilecto* doctrine does not apply and the receiver has standing to recover voidable transfers.

Scholes and its progeny allows the practical result of granting standing to a receiver under the UVTA to permit the receiver to maximize the value of the receivership estate for the benefit of all creditors. But, *Scholes* and their progeny limit such standing to situations where the entity subject to the receivership is no longer an "evil zombie" subject to the spell of agents who have wrongfully transferred the entity's assets in the first place. Rather, the receivership is in control of the entity, and recoveries will benefit creditors or other investors and not the wrongdoer.

It is unclear if Michigan courts would follow *Scholes'* reasoning. First, the newly enacted Receivership Act which is applicable

It is unclear if Michigan courts would follow *Scholes'* reasoning.

to commercial real estate transactions suggests that a receiver would not have standing under UVTA to pursue claims of creditors of the Receivership estate. Similarly, if *NM Holdings* is followed, an entity making a wrongful transfer could not be a "creditor" under UVTA in any circumstance, and the receiver would not have standing.

If *NM Holdings* is not followed, and the Receivership Act does not preclude standing, Michigan courts might follow *Scholes* if they recognize the adverse interest exception to the *in pari dilecto* doctrine and the sole actor theory is not applicable; e.g. the wrongdoer was acting on his own behalf and was not the sole actor for the corporation.

However, where the wrongdoer is the "sole actor" for the entity making the wrongful transfer, under *MCA Financial*, Michigan courts may reject *Sholes'* analysis. Even where the person making the wrongful transfer is the "sole actor," a Michigan court could distinguish *MCA Financial* because it involved a tort action, where the defendant did not directly benefit from the wrongdoing. Further, a Michigan court could adopt the "innocent decisionmaker" exception to the "sole actor" rule and follow *Scholes* to allow a receiver to have standing under UVTA.

Given the uncertainty in the caselaw and the recent enactment of the Receivership Act, creditors who wish to appoint receivers for entities that made fraudulent transfers should carefully consider the likelihood of a Michigan court granting standing to the receiver to seek to recover the fraudulent transfer. To maximize that possibility, the request for standing should be explicitly stated in the pleadings with an analysis as to why the receivership entity is a "creditor" entitled to pursue recovery of the voidable transfer. The proposed order appointing the receiver should also specifically state that the receiver has standing and provide that the wrongdoer will not benefit from any recoveries.

NOTES

1. MCL 566.31-.43.

2. MCL 554.1011 et. seq.

3. MCL 566.31-.43.

4. According to a Bill Analysis of Senate Bill 982-985, Michigan Senate Fiscal Agency, February 2, 2017, the changes were reportedly made "to address ambiguities in the previous version of the law and to bring the Act up to date with current practices and technology." http://www.legislature.mi.gov/documents/2015-2016/billanalysis/Senate/pdf/2015-SFA-0982-N.pdf (accessed on August 30, 2017.)

5. Gary A. Foster & Eric C. Boughman, *The Uniform Transactions Act: An Overview of Refinements to the Uniform Fraudulent Transfer Act*, ABA Probate & Property Magazine, https://www.americanbar.org/publications/probate_property_magazine_2012/2015/july_august_2015/2015_aba_rpte_pp_v.29_3_article_foster_boughman_uniform_voidable_transactions_act.html (accessed on September 29, 2017).

6. *See, e.g. Foodland Distributors v. Al-Naimi*, 220 Mich App 453, 481 (1996)(concurring opinion).

7. MCL 566.38(8).

8. MCL 566.37. *See also*, *In re NM Holdings, LLC*, 405 BR 830 (Bankr ED Mich, 2008), *affirmed,* 622 F3d 613 (6th Cir 2010).

9. Fraudulent Conveyances Act 1571 (13 Eliz 1, c 5).

10. *See* Act 34 of 1998, sect. 566.31, repealed by the UVTA.

11. *See Barber v Kolowich,* 262 Mich 589 (1933) (receiver for bank was clearly a creditor for purposes of bring a claim for fraudulent transfer). *See also, Jarrett v Kassel*, 972 F2d 1415, 1426 (6th Cir 1992) ("[The receiver's] authority was limited to preserving the property of the… receivership for [the receivership entity's] customers. In this regard, he had authority to sue on behalf of the receivership itself but had no authority to bring a cause of action on behalf of the individual customers.").

12. 11 USC 101*, et seq*. Specifically, 11 USC 548 addresses fraudulent transfers.

13. 11 USC 544 allows the trustee to stand in the shoes of creditors for purpose of avoidance actions.

14. MCL 600.5201, et. seq.

15. MCL 600.5205.

16. *See, e.g.* MCL 600.2926 (granting courts equitable powers to appoint receivers in connection with litigation); The Uniform Commercial Real Estate Receivership Act, MCL 554.1011 *et. seq*.

17. *See, e.g.,* Patrick E. Mears & Dustin Daniels, Sales of Receivership Assets Free and Clear of Liens and Interests, 38 Mich Real Prop Rev 112, 112-113 (2011).

18. *See* Patrick E. Mears, Hon. John T. Gregg, Daniel J. Yeomans, Michael David Almassian, *Receiverships in Michigan* (Michigan ICLE, Sept. 29, 2017).

19. MCL 566.37(1)(c)(ii). One argument against giving a receiver standing to bring UVTA causes of action is even though receivers are mentioned in this section, they are not specifically referenced in the definition of creditor, or otherwise specifically given standing to pursue creditor's claims.

20. *Westgate v Westgate,* 294 Mich 88, 91, 292 NW 569 (1940).

21. MCR 2.622(A).

22. MCL 554.1019.

23. Uniform Commercial Real Estate Receivership Act §9, with prefatory note and comments, (Uniform Law Commission 2015) http://www.uniformlaws.org/shared/docs/appointment%20and%20powers%20of%20real%20estate%20receivers/UCRERA_Final%20Act_2015.pdf.

24. Id.

25. *See e.g. Scholes v Lehmann* 56 F3d 750 (7th Cir 1995) (applying Illinois's Uniform Fraudulent Transfer Act).

26. *Orzel v Scott Drug Co*., 449 Mich. 550, 537 NW2d 208 (1995)(the wrongful-conduct rule precludes a plaintiff from recovering on a claim that is based on the plaintiff's own wrongdoing); *See also, MCA Fin Corp v Grant Thorton*, 263 Mich App 152, 687 NW2d 850 (2004).

27. *Scholes v Lehmann* 56 F3d 750 (7th Cir 1995) (applying Illinois's Uniform Fraudulent Transfer Act).

28. For a comprehensive discussion on Ponzi schemes, the law pertinent to Ponzi schemes, and the

role of the receiver of a corporation which has perpetuated a Ponzi scheme, please read *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes* by Kathy Bazoian Phelps and Hon. Steven W. Rhodes (Ret.)(LexisNexis 2012).

29. *Scholes.* at 753.

30. *Id.*

31. *Id.* at 754.

32. *Id.*

33. *Scholes* at 754 (internal citations omitted).

34. *Id.* at 755.

35. *See e.g.*, *Wiand v Lee*, 753 F3d 1194, 1202 (11th Cir 2014)(adopting *Scholes* and stating that "the Receiver has standing to sue on behalf of the receivership entities because they were harmed by [their principal] when he transferred profits to investors … from the principal investments of others for the unauthorized purpose of continuing the Ponzi scheme"); *Donnell v Kowell*, 533 F3d 762, 777 (9th Cir 2008) ("The receiver has standing to bring this suit because, although the losing investors will ultimately benefit from the asset recovery, the receiver is in fact suing to redress injuries that [the company] suffered"); *Janvey v Democratic Senatorial Campaign Comm, Inc*, 712 F3d 185, 189-92 (5th Cir 2013) (receiver of assets of Ponzi scheme had standing under Texas UFTA); *Wuliger v Mfr's Life Ins Co*, 567 F3d 787 (6th Cir 2009)(construing Ohio law and determining a receiver had standing to sue based on injury suffered by the entity as a result of transfers traceable to such entity).

36. *Eberhard v Marcu*, 530 F3d 122, 133 (2nd Cir 2008) (applying New York Debtor & Creditor Law).

37. *Id.*

38. *Id.* at 134. While the receiver in *Eberhard* was appointed under federal law, this did not change the court's analysis.

39. *MCA Fin* at 159.

40. *Id.* at 164. *NM Holdings* at 860-861.

41. NM Holdings at 860. MCA Financial at 169.

42. *In re Sharp International Corp*, 278 BR 28, 39 (Bankr EDNY, 2002).

43. *See, e.g. MCA Fin Corp v Grant Thorton*, *LLP*, 263 Mich App 152 (2004) (stating that the court "need not consider whether to apply the Sharp exception to the sole actor rule."); *but see Hagan v. Baird*, 591 Fed App'x 434 (6th Cir 2015)(unpublished) (Michigan law is clear that the imputation rule has an exception as well: "A corporate officer's fraud will not be imputed to the corporation ... where there exists at least one innocent decision maker who, if he had been alerted to the fraud, could have stopped it."), citing *MCA*, *supra*, at 860.

44. *In re NM Holdings, LLC*, 405 BR 830 (Bankr ED Mich, 2008), *affirmed,* 622 F3d 613 (6th Cir 2010).

45. *Id.* at 853.

46. *Id.* at 854, citing *Wells v Sleep (In re Michigan Mach Tool Control Corp),* 381 BR 657, 667 (Bankr ED Mich, 2008) (emphasis added).

47. *Id.* at 854.

48. *Id.* at 862.

49. *Id.*

50. *See e.g., MCA Fin Corp v Grant Thornton, LLP,* 263 Mich App 152; 687 NW2d 850 (2004) (liquidating officer in tort action lacked standing to bring claim based on the wrongful conduct rule, where the wrongful conduct of some officers and directors was imputed to the corporation represented by the liquidating agent; rejecting the "adverse interest" exception to that rule and explaining that since this situation did not involve a single shareholder in sole control, the "sole actor rule" did not apply and neither did the exception to that rule in the case of an innocent decision maker).

51. *MCA Fin, supra.*

52. *Id.* at 161.

53. *Id.* at 156. *NM Holdings* at 859-863.

54. *Id.* at 167.

55. *Coppola v. Manning*, 2015 Mich App LEXIS 2152 (Nov 17, 2015) (unpublished).

56. *Manning*, at *1.

57. *Id.* at 13, citing 75 C.J.S. Receivers § 384.

58. *Coppola, supra.* MCL 450.1541a.

59. *Coppola*, supra, at *10-11.

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Unpaid FICA in Chapter 11: Navigating the Minefield

By John J. Stockdale, Jr. and Michael E. Baum

Business clients consult bankruptcy counsel for a variety of reasons. Frequently, they have been robbing Peter to pay Paul and taking the easy-to-get, high-interest "loan" from the Internal Revenue Service ("IRS")—choosing not to pay the Federal Insurance Contributions Act tax ("FICA"), and using the money to pay other creditors to keep the business afloat.

It takes a little time for the IRS to discover these "loans." But when the IRS does, it responds with tax liens[1] and levies. By the time the IRS swoops in, the amount of FICA due has usually ballooned with penalties and interest, and can easily force a business into bankruptcy.

So businesses in bankruptcy often have FICA problems. Managing unpaid FICA in chapter 11, however, is not easy—it presents unique challenges. This article is about how to work through those challenges.

FICA Overview

FICA is a tax levied on employees and employers to fund Social Security and Medicare benefits. FICA is made up of two components. First, 6.2% of the employee's first $118,500 of gross compensation for social security and an additional 1.45% of the employee's total compensation for Medicare are withheld from the employee's pay.[2] This is the "withholding tax" or the "Trust Portion." Next, the employer-taxpayer matches the Trust Portion, which is the "Employer Portion."[3]

The Trust Portion and the Employer Portion are each due quarterly,[4] and the employer must file a quarterly form 941 return reporting the FICA.[5] Penalties are assessed for, among other things, failure to file as well as failure to pay.[6] Interest accrues on any unpaid FICA and penalties.[7]

Except with respect to voluntarily payments, which may be directed by the taxpayer, the IRS may apply payments in its best interest.[8] As a result, the IRS ordinarily applies the payments to the oldest assessed period first and then in the following order in that assessment: (1) the Employer Portion, (2) the Trust Portion, (3) interest and (4) penalties.[9] The IRS makes this allocation because, among other things, the IRS may also assess the taxpayer's responsible person[10] with the so-called 100% penalty for any unpaid Trust Portion.[11] Thus, by satisfying the Employer Portion first, the IRS preserves it option to later prosecute any other parties responsible for the Trust Portion.

Bankruptcy Court Jurisdiction

Bankruptcy courts have broad jurisdiction to hear and determine tax matters. The Bankruptcy Code provides that "[t]he Court may determine the amount or legality of any tax, any fine or penalty relating to any tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction."[12] Moreover, once the IRS files its proof of claim, it has waived sovereign immunity as to those tax periods reported in the proof of claim.[13] This may allow the debtor to dispense with the IRS's administrative requirement of filing a claim of refund when a refund or credit is sought as an offset or counterclaim to a proof of claim[14] so long as the applicable statute of limitations on seeking the refund has not lapsed.[15]

The IRS's Claim

The business debtor who files chapter 11 is required to report its unpaid FICA liability on Schedule D (secured claims), Schedule E (priority claims), or Schedule F (unsecured claims) as warranted. The amount reported on the business debtor's schedules is presumed correct unless and until the IRS files its proof of claim[16] (and the IRS will file a proof of claim).[17] Once the proof of claim is filed, it is presumed correct until the business debtor (or another party in interest) contests it.[18] Where the IRS's proof of claim asserts claims for multiple tax periods, each tax period (comprised of separately reported tax, interest, and penalties) is a separate claim.[19]

Analyzing the Proof of Claim

A bankruptcy analysis[20] of the priority position of the IRS's secured claim starts with an analysis of the claim in relation to other secured claims and the value of the underlying collateral.[21] Despite the face value of the IRS's secured claim as reported on the proof of claim, the IRS's secured claim is limited to the value of its interest[22] in its collateral.[23]

For example, assume the IRS is the first priority secured creditor, and has asserted a $652,500 secured FICA claim for a single tax period, comprised of $500,000 in FICA tax, $20,000 in interest, and $132,500 in penalties. Assume further that the debtor's assets consist solely of equipment and goods having a value of $500,000. The IRS's secured claim is limited to $500,000. The remaining $152,500 is either a priority unsecured or general unsecured claim.

Where there are multiple tax periods reported in the proof of claim, the priority of the tax liens is determined by the filing date of the notice of tax lien.[24] Earlier tax periods have priority over later periods. Within each tax period, the secured claim is allocated first to tax, interest[25] and then penalty until the full value of the secured claim is exhausted.[26]

Once the claim is bifurcated between secured and unsecured, section 507 of the Bankruptcy Code determines what priority will be given to the unsecured portion of the claim.[27] Section 507(a)(8)(C) gives priority treatment to the Trust Portion of FICA.[28] However, in partially paid tax periods, the Trust Portion is likely to be a greater amount than the comparable Employer Portion because the IRS will have applied prepetition payments to the Employer Portion first.[29]

By contrast, the Employer Portion is given limited priority treatment under section 507(a)(8)(D) of the Bankruptcy Code. Specifically, section 507(a)(8)(D) of the Bankruptcy Code gives priority treatment to "an employment tax on a wage, salary or commission described in paragraph 4 of this subsection earned from the debtor before the date of filing of the petition, whether or not actually paid before such date, for which a return is last due, under applicable law or under any extension, after three years before the date of filing the petition."[30] Thus, if the Employer Portion reported on the proof of claim is older than three years, then it may be a general unsecured claim as opposed to a priority tax claim.

Importantly, interest on the tax is given the same treatment as the underlying tax.[31] However, prepetition penalties[32] associated with the tax, to the extent that they are not secured, are treated as general unsecured claims regardless of whether the tax claim itself is entitled to priority treatment."[33] General unsecured claims, in a bankruptcy, are rarely paid in full.

Objecting to the Proof of Claim

If the business debtor determines that the IRS's proof of claim is incorrect, it must object to the IRS's proof of claim. Since the IRS will frequently have filed a tax lien, encumbering all of the debtor's property, the objection should be brought as an adversary proceeding because it involves "a proceeding to determine the validity, priority, or extent of a lien or other interest in property, other than a proceeding under Rule 4003(d)."[34] However, timing the filing of a tax claim objection is important since an adversary proceeding (or contested matter) objecting to the proof of claim is unlikely to be resolved before the business debtor's plan of reorganization must be filed or by confirmation of that plan of reorganization.[35]

Bankruptcy courts have broad jurisdiction to hear and determine tax matters.

Once the objection to the IRS's proof of claim is filed, the debtor will bear the ultimate burden of proof. Ordinarily, once the debtor rebuts the presumption of validity accorded a proof of claim, the claimant bears the burden of proof to establish that its claim is correct;[36] however, the burden does not shift where applicable substantive law provides otherwise.[37] Thus, unlike typical creditor claims, the burden of proof is on the debtor to prove that the claim of the IRS is invalid.

The burden is on the debtor because in tax litigation outside of the bankruptcy context, "[t]ax assessments by the Internal Revenue Service are presumed by to be correct. Once the IRS shows that the taxes were assessed, introducing certified records of assessments, the burden shifts to the taxpayer to show that the assessments were incorrect. The taxpayer cannot carry this burden by showing that the assessments are erroneous in some respects. The taxpayer must prove the correct amount of his tax liability."[38] The allocation of the burden of proof under tax law also governs tax litigation in bankruptcy court.[39]

Chapter 11 Considerations

In addition to the claim objection considerations discussed above, there are several

additional considerations related to FICA taxes which should be considered when filing a bankruptcy case and formulating a plan of reorganization. The first issue that arises is when to address any IRS claims.

Typically, at the outset of the case, counsel is more concerned with the Debtor's ability to continue its operations in the ordinary course. Engaging in protracted litigation when a case is first filed is a tactic that should be carefully decided. Issues affecting the extent, validity and priority of the IRS' secured claim are often best deferred for consideration to a later time in the chapter 11 process as a result. No matter what the recommended course of action, however, counsel must be cognizant of the need not to waive any future objections which may impact how the IRS' proof of claim is treated in connection with a plan of reorganization.

Where there are multiple tax periods reported in the proof of claim, the priority of the tax liens is determined by the filing date of the notice of tax lien.

Before filing the case, counsel should analyze cash collateral issues. A debtor is required to provide adequate protection for the right to use cash collateral.[40] If the debtor is making periodic payments[41] under a prepetition offer and compromise or other settlement mechanism, the adequate protection payment should mirror the prepetition monthly payments. If periodic payments are offered as adequate protection for the right to use cash collateral, then counsel should reserve, if possible, the right to direct an allocation to either the Employer or the Trust Portion (the better option) of the FICA claim at some future date. If granting a replacement lien[42] as adequate protection, it should be limited to a lien with the same validity and priority in those assets as to which the IRS had a lien immediately prior to the filing of the bankruptcy case.

The debtor's principals often want the plan payments on FICA taxes allocated first to the Trust Portion and then to the Employer Portion. The IRS will resist any plan requirement to apply plan payments to the IRS to the Trust Portion first. Absent such a provision, the plan payments are involuntary payments and the IRS may apply them in its best interest.[43]

In approving this type of plan provision, the court must determine that application of the plan payments is "necessary for reorganization success."[44] While what is "necessary for reorganization success" is undefined, several courts consider "whether 'the allocation of the tax payments puts in jeopardy the government's tax claim and increases the risk the government will not be able to collect the total tax due … and whether such risk is acceptable by offsetting the likelihood that the allocation would increase the possibility for successful reorganization."[45]

Third, the debtor might attempt to enjoin the IRS from collecting against the responsible person using 11 USC 105(a). There is a circuit split regarding whether 11 USC 105(a) supersedes the Anti-Injunction Act, 26 USC 7421, which bars courts from restraining tax collection or assessment.[46] The Sixth Circuit has not decided this issue. Enjoining the IRS is difficult, but the argument 11 USC 105(a) permits this relief and that it is appropriate in order to allow the debtor's principle to effectively assist in the reorganization of the debtor remains viable.[47]

Last, the IRS's secured and priority claim must be paid over a five-year period beginning on the date that the debtor filed its bankruptcy petition—not the date of confirmation of the plan of reorganization.[48] The IRS has some flexibility on extending the five-year period and may consent to allow payments on the secured and priority claim beyond five years.[49] However, if a five year amortization of the full amount of the secured and priority tax claim (plus interest) is unworkable, then a plan treatment providing for workable regular payments followed by a balloon at the end of the five year period may be appropriate.[50] However, a balloon payment option may draw a plan feasibility objection that will require expert testimony to resolve at confirmation.[51]

Conclusion

A Proof of Claim filed by the IRS requires careful attention by a bankruptcy practitioner who is very knowledgeable of the law and who has a clear understanding of the various regulations that govern the practices of the IRS. The challenges facing a practitioner can be overcome if one patiently takes the time to understand the rules which direct the IRS's decisions.

NOTES

1. *See Gran v IRS (In re Gran)*, 964 F2d 822, 828 (8th Cir 1992) ("The [26 USC 6321 tax lien 'reaches every interest in property that a taxpayer might have'"), *quoting United States v National Bank of Commerce*, 472 US 713, 720 (1985).

2. 26 USC 3101(a)-(b).

3. 26 USC 3111(a)-(b).

4. https://www.irs.gov/businesses/small-businesses-self-employed/employment-tax-due-dates.

5. 26 CFR 31-6071(a)-4(a)(1).

6. 26 USC 6651.

7. 26 USC 6621. *See also* Rev. Rul. 2017-6 (establishing interest rates).

8. *See* Rev. Proc. 2002-26. *See also In re Edgington*, 2000 Bankr LEXIS 1902 (Bankr ND Cal Apr 21, 2000) ("if the taxpayer failed to target the funds to a specific liability, the IRS may apply the payment as its sees fit."), *citing Davis v United States*, 961 F2d 867, 878 (9th Cir 1992).

9. *See* Rev. Proc. 2002-26(3.02). *See also In re Greenberg*, 105 BR 691, 693 (Bankr MD Fla 1989) (discussing allocation of payments between Employer Portion and Trust Portion).

10. *See* Internal Revenue Manual, 5.17.7.1 (describing characteristic of the responsible person), available at https://www.irs.gov/irm/part5/irm_05-017-007.html.

11. *See* 26 USC 6672. However, and beyond the scope of this article, the 100% penalty for unpaid Trust Portion assessed against the Responsible Person [is/may be] nondischargeable under 11 USC 523(a)(1)(A). *See, e.g., Fernandez v. United States (In re Fernandez)*, 130 BR 757 (Bankr WD Mich 1991)(holding 100% penalty nondischargeable under 11 USC 523(a)(1)(A)).

12. 11 USC 505(a)(1).

13. *See* 11 USC 106(b) ("A governmental unit that has filed a proof of claim in case is deemed to have waived sovereign immunity with respect to a claim against such governmental unit that is property of the estate and that arose out of the same transaction or occurrence out of which the claim of such governmental unit arose."). *See also Jefferson v Arkansas Dep't of Fin & Admin (In re Jefferson)*, 2014 Bankr LEXIS 5039, *13-*14 (Bankr ED Ark Dec 11, 2014)(overruling state sovereign immunity claims under 11 USC 106 and 11 USC 505); *In re United States v Bond*, 762 F3d 255 (2d Cir 2014)(limiting the waiver of sovereign immunity under 11 USC 505(a) to trustee in bankruptcy and enforcing sovereign immunity against a post-confirmation liquidating trustee established under a plan). *Compare Tennessee Student Assistance Corp v Hood*, 541 US 440 (2004) (holding that a bankruptcy court's discharge of a state student debt did not implicate Eleventh Amendment sovereign immunity because the bankruptcy court's jurisdiction is in rem over the estate and not the creditors).

14. See In re Dunhill Med, Inc, 1996 Bankr LEXIS 435, *14; see also Jefferson v Arkansas Dep't of Fin & Admin (In re Jefferson), 2014 Bankr LEXIS 5039, *17-*18. But see Graham v. United States (In re Graham), 981 F2d 1135, 1138 (10th Cir 1992).

15. 26 USC 6511(a) ("A claim for a refund or credit is timely if it is filed within three years from the date the return in question was filed or two years from the date the claimed tax was paid, which is later."). *See also* 26 USC § 6532 (requiring commencing of refund suit within two years from IRS's notice of disallowance of refund claim), *discussed by In re Symthe*, 306 BR 218 (Bankr SD Ohio 2004) (denying refund claim where 26 USC 6511 was satisfied but 26 USC 6532 was not). To ensure there is no statute of limitations problem, consult with a tax professional.

16. Fed. R. Bankr. P. 3003(c)(4).

17. In Chapters 7, 12 and 13, the deadline to file proofs of claim for governmental authority is longer than that for general creditors. *See* Fed. R. Bankr. P. 3002(c)(1). In a Chapter 11 or Chapter 9 case, the court has discretion to set deadlines. *See* Fed. R. Bankr. P. 3003(c)(3).

18. 11 USC 502(a)–(b). *See also* Fed. R. Bankr. P. 3001(f).

19. *See In re Matter of Unroe*, 937 F2d 346, 349 (7th Cir 1991) ("Separate years imply separate tax claims …."). *See also In re Gran*, 964 F2d 822, 828 (8th Cir 1992) ("When the taxpayer introduces evidence that refutes the government's proof of claim in a bankruptcy proceeding, any burden shifting to the government of coming forward with evidence involves only those elements that the taxpayer has challenged" (citing cases)).

20. A tax analysis should also be performed. Possible tax law defenses to IRS claims are beyond the scope of this article.

21. In making this analysis, bear in mind 26 USC 6323's 45-day rule, which allows the IRS to jump ahead of preexisting secured creditors on after-acquired inventory and accounts receivable.

22. 11 USC 506(a). *See also Gran v IRS (In re Gran)*, 964 F2d at 82 (noting allocation between priority and general unsecured claims comes only after IRS's secured claim is determined).

23. A complete valuation discussion is beyond the scope of this article. However, a brief summary is appropriate. "[T]he value of the secured creditor's interest under [11 USC]§ 506(a) is measured by what the debtor would incur to obtain like property for the same proposed use (the "Replacement-value Standard") *In re Nat'l Book Warehouse, Inc*, 2007 Bankr LEXIS 4643, *14 (Bankr MD Tenn May 23, 2007), *discussing Associated Commercial Corp v Rash*, 520 US 953 (1997). Further, "A thorough reading of *Rash* indicates that the phrase "replacement value" is a term of art, and what courts are supposed to determine under section 506(a) is the fair market value of the collateral securing the claim." Id. at *15, *citing In re Richards*, 243 BR 15 (Bankr ND Ohio 1999). In asserting a value, bear in mind that the party with the burden of proof of is unclear.

"Neither the Code nor the Federal Rules of Bankruptcy Procedure assign the burden of proof for a motion to determine the value of a creditor's interest in its collateral. Rather, the circumstances will dictate the assignment of the burden of proof of the question." *In re Dunston*, 515 BR 387, 390 (Bankr ND Ga 2008); *In re Heritage Highgate, Inc*, 679 F3d 132 (3d Cir 2012). As a result, courts have utilized three different approaches: (i) placing the burden on the creditor, (ii) placing the burden on the debtor, and (iii) a burden shifting approach which places the initial burden on the debtor to establish that the creditor's proof of claim overvalues a creditor's secured claim, with the ultimate burden on the creditor to prove the extent of its lien and value of the collateral securing its claim. *See In re Heritage Highgate, Inc*, 679 F3d at 139-140 (applying shifting burden); *but see In re Dunston*, 515 BR at 390 (placing burden on debtor), and *In re Sneijder*, 407 BR 46 (Bankr SD NY 2009) (placing burden on creditor).

24. *See In re Senise*, 202 BR 403, 407 (Bankr D SC 1996) ("The general rule with respect to priority against secured federal tax liens under nonbankruptcy law is 'first in time, first in right" (citing cases)).

25. For the calculation of secured or priority claims, interest on tax is given the same treatment as the underlying tax. IRS Manual 5.17.8.18(1), found at http://www.irs.gov/irm/part5/irm_05-017-008.html#d0e754.

26. *See* Rev. Proc. 2002-26. *See also* Internal Revenue Manual, 5.9.13.19.2(8), available at https://www.irs.gov/irm/part5/irm_05-009-013r.html. However, the IRS may take the position that it has discretion to allocate the secured claim in its best interest and may allocate the secured claim to penalty first.

27. *In re Senise*, 202 BR at 407.

28. *Id. See also* 26 USC 3102.

29. *See*, *supra*, fn. 10.

30. 11 USC 507(a)(8)(D).

31. IRS Manual 5.17.8.18(1) (prepetition interest has the same status as a claim for the underlying tax (citing cases)), available at http://www.irs.gov/irm/part5/irm_05-017-008.html#d0e754.

32. While section 507(a)(8)(G) of the Bankruptcy Code permits compensatory penalties to be accorded

In approving this type of plan provision, the court must determine that application of the plan payments is "necessary for reorganization success."

priority status, generally failure to file or pay penalties are punitive in nature and are not compensatory. *See, e.g., In re Southeast Waffles, LLC*, 460 BR 132, 142-143 (6th Cir BAP 2011) (considering penalties arising from the failure to pay withholding taxes), *affirmed by* 2012 US App LEXIS 24991 (6th Cir 2012).

33. IRS Manual 5.17.8.19(2), available at http://www.irs.gov/irm/part5/irm_05-017-008.html#d0e754.

34. Fed. R. Bankr. P. 7001(2); *but see Harmon v United States Farmers Home Admin*, 101 F3d 574, 585 (8th Cir 1996) (holding "where a creditor files a proof of claim and initiates a valuation process [under Fed. R. Bankr. P. 3012], the debtor is not required to bring an adversary proceeding to strip down the creditor's lien). Additionally, if a refund or offset is sought by the debtor in connection with the objection, then Fed. R. Bankr. P. 7001(1) may also be applicable.

35. *See* 11 USC 1121 (according the debtor exclusivity for 120 days to file the plan and 180 days to confirm the plan). If the tax claim objection is filed before plan confirmation, the business-debtor and its professionals should consider whether to file a motion in the main bankruptcy case to estimate the IRS's claim for confirmation purposes under 11 USC 502(c) and FRBP 9011. Ordinarily, this motion is set for a hearing contemporaneously with confirmation of the plan of reorganization. If so, the plan of reorganization should be carefully crafted to insure its feasibility and ability to be confirmed.

36. *In re Pruden*, 2007 Bankr LEXIS 4385, *28-*30 (Bankr ND Ohio).

37. *In re Refco Pub Commodity Pool, LP*, 554 BR 436, 741 (Bankr D Del 2016) (Placing burden of proving failure to file penalties were improper on taxpayer), *citing Raleigh v Illinois Dep't of Revenue*, 530 US 15, 17 (2000).

38. *Giacchi v United States (In re Giacchi)*, 553 BR 36, 41-42 (Bankr ED Pa 2015) (Internal citations omitted) (allocating burden of proof of proof to taxpayer).

39. *Id.* at 42, *citing Raleigh v Illinois Dep't of Revenue*, 530 US 15, 26 (2000). *See also Rahndee Indus Servs v United States (In re Rahndee Indus Servs)*, 2015 Bankr LEXIS 3158, *30-*32 (Bankr ND Ok 2015).

40. *See* 11 USC 363(c)(2).

41. *See* 11 USC 361(1) (providing for periodic payments as a form of adequate protection).

42. *See* 11 USC 361(2).

43. *See In re Senise*, 202 BR 403, 408 fn. 4 (1996). ("To best ensure that all corporate employment tax liabilities (which include trust fund and non-trust fund components) will be collected, the IRS applies corporate payments first to the non-trust fund portion of the employment tax liability, leaving open the liability of the responsible persons as an alternative source of collection of trust funds."). Additionally, the IRS's Internal Revenue Manual ("IRM") states "[a]s a policy matter, the IRS does not assess the IRC 6672 penalty against a responsible officer as long as the debtor corporation is current on its bankruptcy plan payments." IRM 5.17.7.1.12 (http://www/irs.gov/irm/part5/irm_05-017-007.html); *see also* IRM 5.9.10.7 (http://www/irs.gov/irm/part5/irm_05-009-008r.html#d0e1625).

44. *United States v Energy Res Co, Inc*, 495 US 545 (1990) (applying to reorganizing chapter 11). *See also United States v Flo-Lizer, Inc (In re Flo-Lizer, Inc)*, 1994 US Dist LEXIS 1919 (Bankr SD Ohio Feb 7, 1994)(applying *Energy Res* to liquidating chapter 11).

45. *In re FG Metals, Inc*, 2008 Bankr US Dist 111451, *9-*10 (MD Fla 2008) (affirming lower court's denial of allocation of plan payments first to Employer Portion), *quoting In re Oyster Bat of Pensacola, Inc*, 201 BR 567, 569 (Bankr ND Fla 1996) (same).

46. *See In re Condado Rest Grp, Inc*, No 17-00050-BKT (Bankr D PR June 7, 2017) (discussing circuit split and holding that the Anti-Injunction Act trumps 11 USC 105).

47. *See In re Interstate Motor Freight Sys*, 62 BR 805, 811 fn 4 (Bankr WD Mich 1986) (recognizing in dicta a bankruptcy court's authority under 11 USC 105(a) to issue injunctions barring collection of tax against responsible persons where the trustee could show that the IRS's actions were interfering with the orderly administration of the bankruptcy estate). *See also Wright v Butz (In re Buildwright Homes)*, 179 BR 765 (Bankr SD Ohio 1994) (dismissing case where no showing that injunction against the IRS was necessary for a successful reorganization).

48. *See* 11 USC 1129(a)(9)(C) (requiring "regular" payments over a five-year period). However, "regular" payments does not necessarily mean equal payments. *See*, *infra*, fn 53.

49. *See In re Associated Cmty Servs, Inc*, No 14-44095-pjs (Bankr ED Mich), [DN 258, ¶ 12] (allowing for significant monthly payments beyond the five-year period and continuing until the entire secured and priority tax debt is fully paid with interest).

50. *See In re FG Metals, Inc.*, 390 BR 467, 474 (Bankr MD Fla 2008) (granting confirmation, over the IRS's objection, to a plan of reorganization that paid taxes with regular payments and final balloon payment); *In re Jerath Hospitality, LLC*, 484 BR 245 (Bankr SD Ga 2012) (holding that regular payment does not mean equal payments and authorizing payment of taxing authorities claim over time with a final balloon payment).

51. *See* 11 USC 1129(a)(11). *See also In re Sula Store, LLC*, 2005 Bankr LEXIS 3129 (Bankr D Mont July 28, 2005)("Debtor must prove feasibility by more than mere assertions, it must bring forth evidence, including necessary expert testimony, of the likely success of debtor's plan." (citing cases)); *In re Sagewood Manor Assocs Ltd P'shp*, 223 BR 756, 763 (Bankr D Nev 1998) ("Feasibility is established through expert testimony and those knowledgeable of the future prospects of the reorganized debtor.")

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Can You Spot a Potential Fraudulent Transfer?[1]

By Ronald A. Spinner

Your client works for a real estate leasing company. His company leases out office space to various retailers. Your client calls you because he is concerned about one retailer in particular which appears to be in dire financial straits. It consistently pays late; and, although the retailer has repeatedly promised that "things will get better," nothing he has seen suggests that this is the case. In fact, your client is worried that the retailer won't survive the year.

Your client is tired of arguing with this lessee, giving allowances on the rent, and otherwise accommodating it. He knows there are more profitable customers out there. Your client wants its leases with this customer terminated so that it can lease the properties to more financially stable enterprises. You contact the lessee's attorney and get to work. Ultimately, you negotiate a voluntary termination of all leases between the parties. Your client thanks you and goes on his way.

Almost two years later, your client calls you again, and he is not happy. He tells you that his company was just served with a complaint by the former lessee's bankruptcy estate. The complaint alleges that the lease terminations you negotiated for him were constructively fraudulent transfers. The trustee is demanding that your client's real estate company return the "value of the terminated leases," whatever that means. Your client demands to know if there is any basis to this claim and, if there is, he wants to know why he was not informed about this risk. A follow up call to discuss the complaint is set for a few days from now. You sigh and begin reading through the numbered paragraphs to prepare.

Most lawyers believe they understand the basic components of a constructively fraudulent transfer. Typically, a debtor transfers property to another entity when it is insolvent (or likely to become so as a result of the transfer) and does not receive "reasonably equivalent value" in return.[2] But, what *exactly* is a "transfer" and what constitutes "property?" Caselaw tells us that many everyday transactions, including the lease termination situation above, may qualify. Indeed, the concern regarding many transactions is that the very reason your client wishes to undertake the transaction may be that the client has lost confidence in its counterparty's ability to perform. Put another way, the concerns over a counterparty's financial health that motivate a transaction may be the same ones that later give rise to fraudulent transfer litigation.

The goal of this article is to help you spot some potential fraudulent transfers that may be lurking within your practice so that you can guard against them where possible. At the very least, the hope is that you will be able to alert your clients to the possibility that today's good deal may be unwound tomorrow. Although the legal theories applied in the cases cited in this article are not new, courts seem increasingly willing to entertain and employ them. (Indeed, although some cases cited in this article are over 30 years old, eight of the decisions referenced here were issued in 2016 or later.) Because courts are showing an increased interest in applying fraudulent transfer law to what otherwise may appear to be innocuous transactions, attorneys need to be equally interested in educating themselves concerning the circumstances in which fraudulent transfer law can apply.

Lease and Contract Terminations as Fraudulent Transfers

The example at the start of this article is drawn from the recent Seventh Circuit Court of Appeals decision in the *In re Great Lakes Quick Lube LP* bankruptcy case.[3] Debtor Great Lakes Quick Lube had negotiated terminations of several of its leases with T.D. Investments I, LLP ("TD") 52 days before it filed for bankruptcy protection.[4] Some of those leased stores were profitable.[5] The Creditors Committee sued TD for the value of those leases, asserting that their termination constituted fraudulent transfers.[6] TD argued that termination of a lease is not a transfer of an interest in property, much less a fraudulent one.[7] The Seventh Circuit disagreed, ruling that a lease termination qualified as a transfer of an inter-

est in property and remanding the case to the bankruptcy court to determine the value transferred and to evaluate any defenses TD might have to the Committee's claim.[8]

In re Great Lakes Quick Lube is neither an aberration nor a novelty. Other courts have reached similar conclusions.[9] To be sure, not every court agrees with this premise,[10] but enough courts do to warrant caution. Lessors whose lessees may be considering filing for bankruptcy protection face an unenviable choice: try to terminate the lease now (and risk a later avoidance action for the "value" of the terminated lease, whatever that might turn out to be) or stick it out and risk getting stuck in the retailer's bankruptcy case.[11] Either way, it makes sense to discuss with clients the risk that a lease termination could eventually give rise to a law suit should the debtor later file for bankruptcy.

It is not just lease terminations that can give rise to fraudulent transfer actions; ordinary contract terminations can have the same result.[12] Even renegotiation of a contract can be considered a fraudulent transfer if valuable rights are given up by the debtor.[13] Because a party often seeks to terminate a lease or contract (or renegotiate its terms) precisely because it has become leery of its counterparty's financial stability, it is important to be aware of cases such as these and plan accordingly.

Asset Sales and Foreclosures

The list of potentially surprising fraudulent transfer actions is hardly limited to lease and contract terminations. Recall that a transfer may be constructively fraudulent if insufficient value is received in return for the transfer at a time when the transferor is insolvent. It is not necessary to show that no value was received at all. Thus, the sale of an asset can qualify as a constructively fraudulent transfer if it is shown that the sale price was below the asset's minimum value.

In a recent example, Kudzu Marine, a shipping company that pushed tank barges loaded with fuel, found itself in financial difficulty.[14] The company had never made a profit.[15] Thus, when it came time for Kudzu Marine to renew its Certificate of Inspection (COT) with the Coast Guard (necessary for continued operations), there simply were not sufficient funds to make the repairs the Coast Guard required.[16] Kudzu Marine began to wind up its operations.[17]

Of particular concern to Kudzu Marine's shareholders, each had personally guaranteed the company's bank loan, and thus would bear personal liability if the loan were not repaid.[18] The company had assets that it could sell, though, to help repay the bank. These assets included tank barge "KDZ 1801," which appraised at various amounts from a low of $590,000 to over $1,000,000.[19] After much effort and negotiations, Kudzu Marine was able to effect a sale of its assets that included a release of its shareholders' guaranties.[20] In particular, sale of the KDZ 1801 was completed on May 30, 2013, fetching a price of $493,126.61, which was below the lowest prior appraisal.[21] On August 23, 2013, Kudzu Marine filed a voluntary chapter 7 petition in the Bankruptcy Court for the Southern District of Alabama.[22]

The trustee appointed in Kudzu Marine's bankruptcy case filed a complaint in 2015, seeking to recover an actual or constructive fraudulent transfer of the KDZ 1801.[23] The court analyzed the case and found that indeed, a constructively fraudulent transfer had occurred, because the evidence showed that Kudzu Marine had never made a profit (thus demonstrating insolvency) and that the KDZ 1801 had been sold for less than any appraisal amount admitted into evidence.[24] In other words, if a deal seems too good to be true, it very well may be unwound later.

This example is of particular concern because insiders often guaranty the debts of small corporations. Even if these guaranties may not provide significant recoveries to a bank, they often ensure insider cooperation in winding up a dissolving corporation's affairs. If the guaranties cause the insiders to sell assets too cheaply, however, that "clean windup" may be disturbed by avoidance actions years later.

There is some good news. Although one might be concerned that a similar rationale could be used to unravel a state foreclosure action if reasonably equivalent value for the foreclosed property is not obtained, the Supreme Court put that question to rest in 1994 in *BFP v Resolution Trust Corp*.[25] There, the Court held that as long as state law requirements are met, a mortgage foreclosure, by definition, provides reasonably equivalent value for the property foreclosed.[26] Thus, mortgage foreclosures are safe from being reversed in an avoidance law suit. (Of course, if any state law requirements are *not* met, the safe harbor may be lost.[27])

It is not just lease terminations that can give rise to fraudulent transfer actions; ordinary contract terminations can have the same result.

The certainty afforded to properly conducted mortgage foreclosures does not carry over to all similar property transfers. For example, tax sales often use bidding systems designed more to recover the amount of delinquent taxes than the value of property sold, and thus may be subject to a fraudulent transfer[28] or other avoidance action.[29] Likewise, compliance with strict foreclosure laws, where nothing would "prevent a foreclosing mortgagee with a debt of $2,000 from foreclosing on property worth $100,000 and retaining the property," will not necessarily insulate a foreclosure from being later unwound.[30] Thus, the seeming protection provided by *BFP* is not a blanket guaranty that all foreclosure actions are sacrosanct.

The obvious solution for protecting asset sales and foreclosures is likely adequate documentation, where it is available. If an appraisal shows that reasonably equivalent value has been obtained, trustees will be less likely to attempt to recover a perceived windfall to a creditor.

There are many transactions that a corporation might undertake which could later be challenged as constructively fraudulent, especially if undertaken at a time of financial stress.

Guaranties and Other Obligations

When considering what might be avoided as a fraudulent transfer, it helps to remember that, in addition to transfers, obligations also may be avoided.[31] This can make guaranties avoidable as well if they are obtained when the guarantor is experiencing financial difficulties.[32] Intercompany guaranties can be especially problematic. As one court noted, when intercompany guaranties are involved, there is "an obvious danger" that "creditors of the guarantor, who normally are unaware of the contingent liability and may not even be aware of their debtor's affiliation with other corporations, will find themselves, without warning, dealing with a suddenly less solvent…debtor."[33] The concern that guaranties can invoke in courts may lead to some interesting outcomes. For example, more than one court has held that, even if a guaranty was issued beyond the look-back period of the fraudulent transfer law used to challenge it, the individual transfers made pursuant to the guaranty still may be considered individually and thus be avoidable.[34] This may seem counterintuitive, in that most cases tend to hold that an obligation arises when it becomes legally enforceable, not when a transfer is made pursuant to that obligation,[35] but perhaps it shows just how far courts will go in trying to deliver equitable outcomes.

What Counts as "Reasonably Equivalent" Consideration

Of course, almost any obligation or transfer can be attacked as a fraudulent transfer if it is undertaken for insufficient consideration. For example, obligations for "consulting fees" may be avoided if it can be shown that little or no value was provided for the fees paid.[36] Likewise, fees paid to obtain a guaranty can be avoided if the debtor that paid the fee had no liability on the underlying obligation and thus had no reason to obtain the guaranty in the first place.[37] Finally, a loan made for the benefit of the debtor's owner, rather than for the benefit of the debtor, cannot provide reasonably equivalent value to the debtor and thus may be avoidable.[38]

The type of value received, however, has little bearing on whether value was received at all. The main question courts seem to ask is whether the benefit received would suffice as consideration for a contract. If so, it generally will be recognized. Thus, "[a]transfer for love and affection does not constitute reasonably equivalent value,"[39] nor will "spiritual fulfillment" suffice.[40] On the other hand, one court held that charges for calls made to a "900" number for "psychic guidance" were not avoidable because "these transactions occurred at arm's length between a willing buyer and a willing seller."[41] And transfers made to place wagers in a casino have been determined not to be voidable so long as the underlying gambling itself is lawful.[42] In short, courts do not try to rule on the morality or advisability of the value sought and received for a transfer; instead, they focus on its legality.

Dividends, Stock Repurchases, and Other Corporate Payments

There are many transactions that a corporation might undertake which could later be challenged as constructively fraudulent, especially if undertaken at a time of financial stress.[43] For example, payments of dividends can be successfully challenged as fraudulent transfers.[44] Likewise, stock repurchases will also qualify as constructively fraudulent under the proper circumstances.[45] In addition, leveraged buyouts are often questioned[46] and intercompany transfers may be subjected to scrutiny.[47]

Additionally, payments from a company to its insiders will often be challenged. An executive's "golden parachute" could generate a clawback suit if the executive was an

insider of the debtor and the grant of the "parachute" was not made in the ordinary course of the debtor's business.[48] Severance payments granted outside of a debtor's ordinary course of business may be similarly attacked.[49] So might "bonuses or other perquisites," if they occur outside the usual scope of business.[50] Thus, if a business is suffering financially, its owner should be aware of the risks involved before he or she attempts to draw additional cash from it.

Self-Settled Trust Deposits as Fraudulent Transfer

Of particular interest to Michigan practitioners, on March 8, 2017, Michigan's Domestic Asset Protection Trust ("DAPT") Act became effective.[51] The Bankruptcy Code fraudulent transfer statute has a special provision for dealing with such trusts. That provision states

> In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if--
>
> (A) such transfer was made to a self-settled trust or similar device;
>
> (B) such transfer was by the debtor;
>
> (C) the debtor is a beneficiary of such trust or similar device; and
>
> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

11 USC 548(e)(1). Thus, transfers made to self-settled trusts with actual intent to hinder creditors are subject to a ten-year look-back period for avoidance.

Even though this part of section 548 was added in 2005,[52] caselaw remains relatively sparse. The caselaw that *does* exist is informative, however. For one thing, even though this statute requires a bankruptcy filing in order to be useful, nothing prohibits creditors from filing an involuntary bankruptcy petition against a debtor in order to bring the statute into play.[53] For another, the caselaw indicates that, to determine actual fraud under section 548(e)(1)(D), courts look to see whether established "badges of fraud" exist.[54] This brings a degree of certainty to what otherwise might feel like a novel analysis. That said, only federal badges of fraud may be relevant. A state statute that says that "a settlor's expressed intention to protect trust assets from a beneficiary's potential future creditors is not evidence of an intent to defraud" may not be given any effect in an analysis under the Bankruptcy Code.[55]

For a DAPT to be effective, it is vital that all state law procedures regarding its creation are followed. Otherwise, the assets of the would-be DAPT may simply flow into the bankruptcy estate.[56]

Divorce Settlements and Interspousal Transfers

For the most part, judgments of divorce are respected by bankruptcy courts, even if the division of assets appears unequal, so long as there are no signs of fraud, collusion, or violations of state law.[57] That said, the Sixth Circuit has held that a state court marital dissolution decree is not always entitled to claim preclusive effect on property dissolution questions and thus property divisions may be challenged as fraudulent transfers.[58] Other circuits, such as the Ninth, have noted that the laws of their states subject marital property agreements to fraudulent transfer law and thus have upheld decisions finding particular agreements as constituting fraudulent transfers.[59]

Of course, where questionable signs are present, courts are likely to undertake a more rigorous analysis of state court property divisions. For example, if one spouse transfers substantially all marital assets to the other on the eve of filing bankruptcy, not only will that transfer be avoided, the transferring spouse may also be denied a discharge.[60] This is especially true if the spouse attempts to hide or disguise the transfer(s) in any way.[61]

Conclusion

The purpose of this article is not to have lawyers looking for the "boogeyman" hiding in every transaction. Just because a particular type of transaction is discussed here does not necessarily make it avoidable. A trustee still needs to prove insolvency or other elements in order to avoid any particular transaction. That said, if you find yourself dealing with a party who does not appear financially healthy, it may pay to keep in mind that transactions with that debtor may be subject to future challenges. Simply being aware of the possibility can help a lawyer design the transaction to minimize risk, or, at the very least, ensure that clients fully understand the risks involved.

[I]f you find yourself dealing with a party who does not appear financially healthy, it may pay to keep in mind that transactions with that debtor may be subject to future challenges.

NOTES

1. Although this article discusses "fraudulent transfers" (and occasionally, "fraudulent conveyances"), it should be noted that Michigan has enacted Public Act 2016, No. 552, amending MCL 566.31 *et. seq.* and implementing the Michigan Uniform Voidable Transactions Act ("MUVTA"), effective as of April 10, 2017. Although there are slight differences between MUVTA and its predecessors, the Michigan Uniform Fraudulent Transfers Act and the Michigan Uniform Fraudulent Conveyances Act, the Acts are similar enough that the concepts discussed in this article are essentially the same under each of them.

2. *See, e.g.*, 11 USC 548(a)(1)(B).

3. *Official Comm. of Unsecured Creditors of Great Lakes Quick Lube LP v. T.D. Inv. I, LLP (In re Great Lakes Quick Lube LP)*, 816 F.3d 482 (7th Cir. 2016); *see also* Vincent E. Lazar & Angela M. Allen, *LESSORS BEWARE: Lease Termination Might Give Rise to Fraudulent Transfer or Preference Claims*, Am. Bankr. Inst. J., May 2017, at 32 for a summary of *Great Lakes Quick Lube LP*.

4. *Id.* at 483.

5. *Id.* at 484-85.

6. *Id.*

7. *Id.* at 483.

8. *Id.* at 486.

9. *E.g.*, *Pettie v Ringo (In re White)*, 559 BR 787 (Bankr ND Ga 2016) (citing *Great Lakes Quick Lube LP*); *Eder v Queen City Grain, Inc (In re Queen City Grain, Inc)*, 51 BR 722 (Bankr SD Ohio 1985); *In re Indri*, 126 BR 443 (Bankr DNJ 1991).

10. *Haines v Regina C Dixon Trust (In re Haines)*, 178 BR 571 (Bankr WD Mo 1991); *Creditors' Comm for Jermoo's Inc v Jermoos Inc (In re Jermoos Inc)*, 38 BR 197 (Bankr WD Wisc 1984); *In re Egyptian Bros Donut, Inc*, 190 BR 26 (Bankr DNJ 1995).

11. Lazar & Allen, *supra* note 2, at 74 (discussing the choices faced by lessors).

12. *E.g.*, *id.* at 33 (discussing Fifth Circuit *Prime Income* case); *EBC I, Inc v America Online, Inc (In re EBC I, Inc)*, 356 BR 631 (Bankr D Del 2006).

13. *Wallach v Nowak (In re Sherlock Homes of WNY, Inc)*, 246 BR 19 (Bankr WDNY 2000).

14. *Littleton v Lanac Invs, LLC (In re Kudzu Marine, Inc)*, 569 BR 192, 197-99 (Bankr SD Ala 2017).

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.* at 198.

19. *Id.* at 196, 207-08.

20. *Id.* at 199-200.

21. *Id.* at 200.

22. Bankruptcy Case No 13-02935, Doc No 1 (Bankr SD Ala Aug. 23, 2013).

23. *Kudzu Marine*, 569 BR at 196.

24. *Id.* at 206-08.

25. 511 US 531 (1994).

26. *Id.* at 544.

27. *Id.* at 545-46; *see also Thorien v Baro Enters, LLC (In re Thorien)*, 349 BR 59 (Bankr D Idaho 2006).

28. *E.g.*, *Smith v SIPI, LLC (In re Smith)*, 811 F3d 228 (7th Cir 2016); *GGI Props, LLC v City of Millville (In re GGI Props, LLC)*, 568 BR 231 (Bankr DNJ 2017).

29. The Bankruptcy Court for the District of New Jersey recently held that a transfer of property valued at $335,000 as part of a tax sale to satisfy a $45,000 lien was a preferential transfer. *Hackler v Arianna Holdings Co (In re Hackler),* No 16-01881, 2017 WL 3701469 (Bankr DNJ Aug. 28, 2017). The court thus did not need to consider whether the transfer also constituted a fraudulent conveyance. *Id.* at *1.

30. *Sensenich v Molleur (In re Chase)*, 328 BR 675 (Bankr D Vt 2005); *see also Chorches v Fleet Mortg Corp. (In re Fitzgerald)*, 255 BR 807 (Bankr D Conn. 2000).

31. 11 USC 548(a)(1) ("The trustee may avoid any transfer . . . of an interest of the debtor in property, **o***r any obligation* . . . incurred by the debtor . . . ."); MCL 566.34(1) ("[A] transfer made *or obligation incurred* by a debtor is voidable as to a creditor . . . ."); *see also* 5 Collier on Bankruptcy ¶ 548.03[4].

32. *Leibowitz v Parkway Bank & Trust Co (In re Image Worldwide, Ltd)*, 139 F3d 574 (7th Cir 1998).

33. *In re Xonics Photochemical, Inc*, 841 F2d 198, 201 (7th Cir 1988).

34. *Belfance v Buonpane (In re Omega Door Co)*, 399 BR 295 (BAP 6th Cir 2009); *Gold v Winget (In re NM Holdings Co, LLC)*, 407 BR 232 (Bankr ED Mich 2009).

35. *Advanced Telecomm Network, Inc v Allen (In re Advanced Telecomm Network, Inc)*, 490 F3d 1325, 1331-32 (11th Cir 2007).

36. *McKloskey v Galva Foundry Co (In re Art Unlimited, LLC)*, 356 BR 700 (Bankr ED Wisc 2006).

37. *Official Comm of Unsecured Creditors of Toy King Distribs, Inc v Liberty Sav Bank, FSB (In re Toy King Distribs, Inc)*, 256 BR 1, 138 (Bankr MD Fla 2000).

38. *Angell v Endcom, Inc (In re Tanglewood Farms, Inc of Elizabeth City)*, 487 BR 705 (Bankr EDNC 2013).

39. *Tavenner v Smoot*, 257 F3d 401, 408-09 (4th Cir 2001).

40. *Zahra Spiritual Trust v United States*, 910 F2d 240, 248-49 (5th Cir 1990).

41. *Samson v US West Comm'cns, Inc (In re Grigonis)*, 208 BR 950 (Bankr D Mont 1997).

42. *Allard v Flamingo Hilton (In re Chomakos)*, 69 F3d 769 (6th Cir1995).

43. *See* 5 Collier ¶ 548.05[2][c].

44. *Pryor v Tiffen (In re TC Liquidations, LLC)*, 463 BR 257 (Bankr EDNY 2011) (finding dividends to be avoidable transfers.

45. *Consove v Cohen (In re Roco Corp)*, 701 F2d 978 (1st Cir 1983).

46. *Boyer v Crown Stock Distrib, Inc*, 587 F3d 787 (7th Cir 2009) (ordering recovery of nearly $4 million from shareholders); *Citicorp N Am, Inc v Official Comm of Unsecured Creditors (In re TOUSA, Inc)*, 680 F3d 1298 (11th Cir 2012); *United States v Tabor Court Realty Corp*, 803 F2d 1288 (3d Cir 1986).

47. 5 Collier ¶ 548.05[2][c] (citing *TOUSA*, 680 F3d 1298 in n.47a).

48. 5 Collier ¶ 548.05[4].

49. *TSIC, Inc v Thalheimer (In re TSIC, Inc)*, 428 BR 103 (Bankr D Del 2010).

50. 5 Collier ¶ 548.05[4].

51. The act is named the "Qualified Dispositions in Trust Act, MCL 700.1041, *et seq.*,

52. 5 Collier ¶ 548.07[1].

53. *Rigby v Mastro (In re Mastro)*, 465 BR 576, 583-84 (Bankr WD Wash 2011) (noting how several banks worked together to put Mastro into an involuntary bankruptcy, enabling the trustee to file an adversary proceeding that leveraged section 548(e)).

54. *Waldron v Huber (In re Huber)*, 493 BR 798, 811-14 (Bankr WD Wash 2013) (looking to Ninth Circuit caselaw articulating badges of fraud); *see also* 5 Collier ¶ 548.07[3][d].

55. *Battley v Mortensen (In re Mortensen)*, No A09-90036-DMD, 2011 WL 5025249, 2011 Bankr LEXIS 5560 (Bankr D Alaska May 26, 2011) (noting that federal law preempts state law and declining to give any effect to Alaska statute).

56. *In re Erskine*, 550 BR 362, 367-68 (Bankr WD Tenn 2016).

57. *Ingalls v Erlewine (In re Erlewine)*, 349 F3d 205, 211-12 (5th Cir 2003); *Batlan v Bledsoe (In re Bledsoe)*, 569 F3d 1106 (9th Cir 2009) (following *Erlewine* and agreeing that, absent signs of "fraud, collusion, or violation of state law," the property division set by a divorce court is conclusively not a fraudulent transfer); *Meoli v Cooper (In re Allen)*, 521 BR 613 (Bankr WD Mich 2014) (following *Bledsoe* and *Erlewine*).

58. *Corzin v Fordu (In re Fordu)*, 201 F3d 693 (6th Cir 1999) (finding that property settlement that divided up lottery proceeds might qualify as a fraudulent transfer and remanding for further proceedings); *see also Suhar v Bruno (In re Neal)*, 541 Fed Appx 609 (6th Cir 2013) (finding that marital law on joint debt controls as to who is liable on a debt and must be taken into account in determining whether a transfer is fraudulent).

59. *Beverly v Wolkowitz (In re Beverly)*, 551 F3d 1092 (9th Cir 2008) (adopting holding and reasoning of *Wolkowitz v Beverly (In re Beverly)*, 374 BR 221 (BAP 9th Cir 2007).

60. *Citibank, NA v Williams (In re Williams)*, 159 BR 648 (Bankr DRI 1993).

61. *Dobin v Hill (In re Hill)*, 342 BR 183, 200 (Bankr DNJ 2006).

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Can Michigan Creditors Find the Green? The Impact of Janvey v Golf Channel *on Fraudulent Transfers in Ponzi Schemes*

By Adam L. Kochenderfer and Thomas J. Kelly

Introduction

In recent years, Ponzi schemes have gripped the nation. From Bernie Madoff in New York to Dante DeMiro in Michigan, con men have taken advantage of tens of thousands of investors for their own benefit and left creditors footing the bill.

But what happens when they get caught? In addition to criminal proceedings, the individual perpetrating the fraud and, if applicable, the entities through which the individual operated, will typically enter insolvency proceedings. A trustee or receiver is then appointed to seek to recover assets for the benefit of the defrauder's unsecured creditors, which largely consist of swindled investors. Many of these assets will come from the prosecution of fraudulent transfer claims under the Bankruptcy Code and state law.

Courts routinely struggle with balancing the interests of defrauded investors against innocent third-parties who unwittingly received payments from the criminal enterprise. That struggle has only intensified in the past decade as Ponzi schemes have become more prevalent and larger in scope. The Fifth Circuit Court of Appeals recently introduced greater uncertainty in this area by arguably broadening a receiver's power to claw back payments from vendors unknowingly doing business with Ponzi scheme operators. Specifically, the court held that the court-appointed receiver of a failed Ponzi scheme could recover nearly $6 million that the scheme spent advertising on a major cable network because the network failed to provide "reasonably equivalent value" in exchange for the transfers. The court found that the services provided by the cable network only served to diminish, rather than enhance, the defrauder's estate from the creditors' point of view and, therefore, "reasonably equivalent value" did not exist.

While the Fifth Circuit ultimately reversed its decision after certifying the issue to the Texas Supreme Court, practitioners should be wary of the decision's impact on fraudulent transfer law. No Michigan court has specifically addressed this issue, leaving open the possibility that the Fifth Circuit's rationale could appear in this state's jurisprudence. This article will further explore the Fifth Circuit's decision and its potential impact on fraudulent transfers resulting from a Ponzi scheme.

Two Types of Fraudulent Transfer Claims—Actual and Constructive

Both the Bankruptcy Code and state law provide a means for bringing fraudulent transfer claims. Under section 548 of the Bankruptcy Code, a trustee may avoid, among other things, any transfer of an interest of a debtor in property if (A) the debtor made such transfer with actual intent to hinder, delay, or defraud; or (B) the debtor received less than a reasonably equivalent value in exchange and was insolvent.[1] Likewise, under state law, a creditor may generally assert nearly identical claims under sections 4 and 5 of the Uniform Fraudulent Transfer Act ("UFTA") or its successor, the Uniform Voidable Transactions Act ("UVTA"). Transfers involving a transferor's actual intent to hinder, delay, or defraud are commonly referred to as actual fraudulent transfers, while transfers involving reasonably equivalent value and insolvency are referred to as constructive fraudulent transfers.

The Ponzi Scheme Presumption and Defenses

Courts have developed a number of peculiar rules regarding fraudulent transfers arising from Ponzi schemes. The most notable is the "Ponzi scheme presumption," which is the presumption that, as a matter of law, a Ponzi

scheme transferor is presumed to have actually intended to "hinder, delay, or defraud" creditors with respect to any transfer made during the scheme.[2] For instance, the Sixth Circuit Court of Appeals has stated that "the question of intent to defraud [in a Ponzi scheme] is not debatable."[3] This is because "[o]ne can infer an intent to defraud future undertakers from the mere fact that a debtor was running a Ponzi scheme."[4] Indeed, "no other reasonable inference is possible. A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors."[5] The Ponzi scheme presumption creates a *prima facia* case that a trustee or receiver may recover 100% of any transfer (including principal returned to investors) effectuated during the time an individual or entity operated a Ponzi scheme, absent applicable defenses.[6]

However, that presumption does not guarantee victory to a trustee or receiver asserting a fraudulent transfer claim in a Ponzi scheme context. The Bankruptcy Code and the UFTA/UVTA provide that even if the Ponzi scheme operator makes a transfer with actual intent to defraud, the transfer is not voidable if the transferee took the transfer in "good faith" and in exchange for reasonably equivalent value. Specifically, 11 USC 548(c) states that a transferee of a transfer that "takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred . . . to the extent that such transferee . . . gave value to the debtor in exchange for such transfer." Similarly, section 8(a) of the UFTA/UVTA states that an actual fraudulent transfer is not voidable against a person who "took in good faith and for a reasonably equivalent value." Courts have construed "for value" in section 548(c) and "reasonably equivalent value" in section 8(a) to have the same fundamental meaning.[7]

These affirmative defenses set the stage for a difficult question: should an "innocent" transferee who has no reason to suspect illegal activity be entitled to keep proceeds from an illegal enterprise? Several court opinions address this issue in the context of an unwitting broker working for a Ponzi scheme's perpetrator. The majority of case law permits an innocent broker to retain the transfers. For example, the Southern District of New York has held that a transferor "received 'value' in exchange for the commissions paid to the Brokers for performing in good faith a facially lawful and customary service for which they were retained by the Debtors."[8] The court indicated that the appropriate focus is "the value of the goods and services provided rather than . . . the impact that the goods and services had on the bankruptcy enterprise."[9]

Yet, there is significant case law holding that such brokers can never provide reasonably equivalent value. For example, the Bankruptcy Court for the Northern District of Illinois has held that enforcing any broker agreement "would only exacerbate the harm to the debtor's creditors" and that the solicitation "could not give any 'value' to the estate for promoting a Ponzi scheme."[10] That court went on to hold that the transferees' failure to provide value for services mooted any inquiry into whether the transferees could demonstrate good faith under section 548(c).[11]

The Fifth Circuit's Recent Opinion

This question regarding "reasonably equivalent value" becomes even more difficult when the transferee is a third-party unknowingly selling goods or services to the Ponzi scheme operator in an arms-length transaction. The Fifth Circuit Court of Appeals recently addressed this situation in *Janvey v Golf Channel, Inc*, 780 F3d 641 (5th Cir 2015). The case stemmed from a multi-billion dollar Ponzi scheme operated by Stanford International Bank, Ltd. ("Stanford"). For nearly two decades, Stanford promised investors "exceptionally high rates of return on certificates of deposits (CD), and sold these investments through advisors employed at . . . affiliated entities."[12] Some early investors "received the promised returns, but, as was later discovered, these returns were merely other investors' principal. Before collapsing, Stanford had raised over $7 billion selling these fraudulent CDs."[13]

In furtherance of the Ponzi scheme, Stanford marketed its services to sports audiences by purchasing advertising on The Golf Channel, Inc. ("Golf Channel"). This marketing included year-long commercial airtime and live coverage of the Stanford St. Jude's Championship, which was sponsored by Stanford. By 2011, Stanford had paid Golf Channel at least $5.9 million for advertisements.

Courts routinely struggle with balancing the interests of defrauded investors against innocent third-parties who unwittingly received payments from the criminal enterprise.

In February 2009, the Securities and Exchange Commission uncovered Stanford's Ponzi scheme and filed a lawsuit against the company in a Texas federal district court, after which a receiver was appointed. The receiver discovered the payments to Golf Channel and filed suit against the company alleging that the transfers were fraudulent under Texas's version of UFTA ("TUFTA"). The parties subsequently filed cross-motions for summary judgment, which the district court granted in favor of Golf Channel "Despite the fact that Golf Channel offered no evidence to show how its services benefitted Stanford's creditors."[14] The district court determined that although Stanford's payments to Golf Channel were fraudulent, the company was "entitled to judgment as a matter of law on its affirmative defense that it received the payments in good faith and in exchange for reasonably equivalent value."[15] Importantly, the district court measured "reasonably equivalent value" as the market value of advertising on Golf Channel.

In reviewing the district court's opinion, the Fifth Circuit held that the only issue for the court to decide was whether "the property or service exchanged categorically had any value under TUFTA."[16] The court then began its analysis by reviewing the definition of "value" under TUFTA, which includes "property transferred or an antecedent debt secured or satisfied, but . . . does not include an unperformed promise made otherwise than in the ordinary course of the promisor's business to furnish support to the debtor or another person."[17] The Fifth Circuit took an "*Erie* guess" as to how Texas would interpret the definition because the issue had not been previously addressed by a Texas court.

In reviewing the district court's opinion, the Fifth Circuit held that the only issue for the court to decide was whether "the property or service exchanged categorically had any value under TUFTA."

The Fifth Circuit noted that TUFTA expressly instructs courts to "apply and construe its provisions so as to effectuate UFTA's general purpose to make uniform the law with respect to the subject of UFTA among states enacting it."[18] To that end, the Fifth Circuit considered the comments to UFTA, authorities interpreting other states' UFTA provisions, and interpretations of section 548 of the Bankruptcy Code. In UFTA, the comment to the definition of value states that "[t]he definition is not exclusive and is to be determined in light of the purpose of the Act and to protect a debtor's estate from being depleted to the prejudice of the debtor's unsecured creditors. *Consideration having no utility from a creditor's viewpoint does not satisfy the statutory definition*."[19] Thus, "courts are left to define the contours of 'value' and the primary consideration is the degree to which the transferor's net worth is preserved."[20] Unlike the district court, the Fifth Circuit held that "value" is to be measured from the standpoint of the creditors, not from that of a buyer in the marketplace.

The Fifth Circuit then noted that Golf Channel failed to put forward any evidence "that its services preserved the value of Stanford's estate or had any utility from the creditors' perspective."[21] Rather, Golf Channel only put forward evidence showing the market value of its services. Such evidence, the Fifth Circuit held, was insufficient to satisfy Golf Channel's burden under TUFTA of proving value to Stanford's creditors.

While the lack of evidence alone required reversal, the Fifth Circuit went on to hold that Golf Channel's services "did not, as a matter of law, provide any value to Stanford's creditors" because "[w]hile Golf Channel's services may have been quite valuable to the creditors of a legitimate business, they ha[d] no value to the creditors of a Ponzi scheme."[22] This is so because Ponzi schemes, by definition, create greater liabilities than assets with each subsequent transaction. "Each new investment in the Stanford Ponzi scheme *decreased* the value of the estate by creating a new liability that the insolvent business could never legitimately repay. Services rendered to encourage investment in such a scheme do not provide value to the creditors."[23] Accordingly, the Fifth Circuit reversed the district court and rendered judgment in favor of the receiver.

The Texas Supreme Court Disagrees with the Fifth Circuit

After the Fifth Circuit rendered its opinion, Golf Channel filed a petition for a panel rehearing, which the Fifth Circuit granted.[24] The Fifth Circuit then vacated its previous opinion and certified the issue to the Texas Supreme Court.

Construing the relevant statutory provisions, the Texas Supreme Court held that TUFTA's "reasonably equivalent value" requirement "can be satisfied with evidence that the transferee (1) fully performed under a lawful, arm's-length contract for fair market value, (2) provided consideration that had objective value at the time of the transaction, and (3) made the exchange in the ordinary course of the transferee's business."[25]

Central to the court's decision was its conclusion that "TUFTA is unique among uniform fraudulent-transfer laws because it provides a specific market-value definition of 'reasonably equivalent value.'"[26] TUFTA's definition of "reasonably equivalent value" states: "'Reasonably equivalent value' includes without limitation, a transfer or obligation that is within the range of values for which the transferor would have sold the assets in an arm's length transaction."[27] The definition provides an illustration of an exchange by the transferor that occurred for fair market value in an arm's-length transaction, with the reasonably equivalent value of the exchange evaluated objectively at the time of the transfer.

The court also noted that the definition of "value" does not require consideration "that can be sold to satisfy the debtor's creditors' claims."[28] Its meaning is expansive and nonexclusive. The court concluded:

> Whether a debtor obtained reasonably equivalent value in a particular transaction is determined from a reasonable creditor's perspective at the time of the exchange, without regard to the subjective needs or perspectives of the debtor or transferee and without the wisdom hindsight often brings. Considering TUFTA's definitions of "value" and "reasonably equivalent value" as applied to the circumstances of this case, we conclude the reasonably equivalent value requirement in section 24.009(a) of TUFTA is satisfied when the transferee fully performed in an arm's-length transaction in the ordinary course of its business at market rates.[29]

After the Texas Supreme Court issued its opinion, the Fifth Circuit affirmed the district court's opinion in favor of Golf Channel.[30] The Fifth Circuit did note, however, that "The Supreme Court of Texas's answer interprets the concept of 'value' under TUFTA differently than we have understood 'value' under other states' fraudulent transfer laws and under section 548(c) of the Bankruptcy Code."[31] Therefore, the binding effect of the Fifth Circuit's decisions interpreting other states' UFTA statutes and section 548(c) of the Bankruptcy Code remains.

The Aftermath

The full impact of the Fifth Circuit's rationale in *Golf Channel* is unknown. If it is adopted in other courts across the country, a trustee or receiver's ability to recover transfers from third-party vendors in a Ponzi scheme context could dramatically expand. While swindled investors may welcome that shift, it would also introduce greater uncertainty in the marketplace. The costs of unwittingly providing goods or services to a Ponzi scheme operator must be borne by someone. It is uncertain if and how parties would attempt to shift those costs onto others.

That uncertainty is especially present under Michigan law. No Michigan court has opined on how "reasonably equivalent value" should be viewed within the context of a Ponzi scheme. How Michigan courts will rule on these issues is, at best, an educated guess.

The Michigan Court of Appeals has provided guidance in a fact pattern unrelated to any Ponzi scheme. In *Dillard v Schlussel*, the court stated that"'[r]easonably equivalent value' is a commercial concept. The touchstone is whether the transaction conferred realizable commercial value on the debtor reasonably equivalent to the realizable commercial value of the assets transferred."[32] That statement suggests that a Michigan court may take a view similar to the Texas Supreme Court when addressing a Ponzi scheme, finding that "reasonably equivalent value" should be evaluated from a creditor's point of view in the marketplace, as Michigan's UVTA contains nearly identical provisions to TUFTA.

However, that result is anything but certain. TUFTA specifically defines "reasonably equivalent value," whereas Michigan's UVTA does not. Moreover, Michigan courts have previously looked to federal law in construing its own UFTA, and will presumably do so with UVTA.[33] It is entirely possible that a Michigan court could adopt the Fifth Circuit's rationale within the context of a Ponzi scheme and, therefore, arguably strengthen a trustee's or receiver's ability to claw back transfers made to innocent third-party vendors.

It is entirely possible that a Michigan court could adopt the Fifth Circuit's rationale within the context of a Ponzi scheme and, therefore, arguably strengthen a trustee's or receiver's ability to claw back transfers made to innocent third-party vendors.

Conclusion

As demonstrated by *Golf Channel*, how a court views "reasonably equivalent value" results in drastically different outcomes for a Ponzi schemer's unsecured creditors. If viewed from the standpoint of the defrauder's creditors, i.e., whether the transfer serves to diminish or enhance the estate, creditors

providing intangible goods such as Golf Channel will likely lack a defense to fraudulent transfer claims. But if these transfers are viewed from the marketplace, those same creditors will likely have a complete defense to these same claims.

Practitioners should be aware that a Michigan court may take either approach and plan accordingly when prosecuting or defending fraudulent transfer claims in a Ponzi scheme context.

NOTES

1. 11 USC 548(a).

2. *See, e.g.*, *Donell v Kowell*, 533 F3d 762, 770 (9th Cir 2008); *Klein v Cornelius*, 786 F3d 1310, 1320 (10th Cir 2015); *Wiand v Lee*, 753 F3d 1194, 1201 (11th Cir 2014); *Zazzali v 1031 Exch Grp LLC (In re DBSI, Inc)*, 476 BR 413, 422 (Bankr D Del 2012); *Bear, Sterns SEC Corp v Gredd (In re Manhattan Inv Fund Ltd)*, 397 BR 1, 13 (SDNY 2007); *but see Finn v All Bank*, 860 NW2d 638, 653 (Minn 2015).

3. *Conroy v Shott*, 363 F2d 90, 92 (6th Cir 1966); *see also Sturrus v Department of Treasury*, 292 Mich App 639, 647, 809 NW2d 208, 213 (2011) ("And in any event, it is well established that in the absence of a defense under 11 USC 548(c) a bankruptcy trustee may recover the full amount paid to Ponzi scheme investors under [section] 548(a)(1)(A), because the question of intent to defraud is not debatable.").

4. *Emerson v Maples (In re Mark Benskin & Co)*, Nos 94-5421/94-5422, 1995 US App LEXIS 16053, at *12 (6th Cir June 26, 1995) (citation omitted).

5. *Id.* at *12-13 (citation omitted).

6. *See, e.g.*, *Donell*, 533 F3d at 771 n4 ("Under the actual fraud theory, the good faith losing investor is technically still liable even if his net transactions are negative, because even payments that total less than the amount of that investor's initial outlay were made 'with actual intent to hinder, delay, or defraud a creditor of the debtor.'" (citation and alterations omitted)).

7. *See Rieser v Hayslip (In re Canyon Sys Corp)*, 343 BR 615, 651 (Bankr SD Ohio 2006).

8. *Balaber-Strauss v Lawrence*, 264 BR 303, 308 (SDNY 2001).

9. *Id.* at 307.

10. *Martino v Edison Worldwide Capital (In re Randy)*, 189 BR 425, 441 (Bankr ND Ill 1995)

11. *Id.* at 442.

12. *Janvey v Golf Channel, Inc*, 780 F3d 641, 642 (5th Cir 2015).

13. *Id.*

14. *Id.* at 643.

15. *Id.*

16. *Id.* at 644.

17. *Id.* (alterations omitted).

18. *Id.* at 645 (citation and alterations omitted).

19. *Id.* (citation and alterations omitted) (emphasis in original).

20. *Id.* (citation and alterations omitted).

21. *Id.* at 646.

22. *Id.*

23. *Id.* (citations omitted) (emphasis in original).

24. *See Janvey v Golf Channel, Inc*, 792 F3d 539 (5th Cir 2015).

25. *Janvey v Golf Channel, Inc*, 487 SW3d 560, 564 (Tex 2016).

26. *Id.* at 563.

27. *Id.* at 569 (citation omitted).

28. *Id.* at 575.

29. *Id.* at 582.

30. *Janvey v Golf Channel, Inc*, 834 F3d 570, 573 (5th Cir 2016).

31. *Id.*

32. *Dillard v Schlussel*, 308 Mich App 429, 459, 865 NW2d 648, 663 (2014) (citation omitted).

33. *See, e.g.*, *Steinberg v Young*, No 09-11836, 2010 US Dist Lexis 31996, at *11 (ED Mich Mar 31, 2010) ("Though the Michigan Uniform Fraudulent Transfer Act does not define 'reasonably equivalent value,' Michigan Courts have imported the analysis used in the Federal Bankruptcy Code, which assists Bankruptcy Courts in evaluating similar issues."); *Gold v Marquette Univ (In re Leonard)*, 454 BR 444, 447 n9 (Bankr ED Mich 2011) (holding that Michigan's fraudulent transfer statute is similar to 11 USC 548(a)(1)(A)).

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What is the Value of Education?

By Elliot Crowder

"A fundamental aspect of the American Dream has been the expectation that the next generation should do better than the previous generation."[1]

Introduction

In order to fulfill their expectations and dreams for their children, many parents pay private or parochial school tuition for their children and assist their children with the payment of tuition at post-secondary institutions. However, when the parents find themselves as debtors in a bankruptcy case or post-judgment collection proceeding, these payments are subject to scrutiny.

In either proceedings supplementary to a judgment or when a debtor files a bankruptcy petition under 11 USC 101 et seq. (the "Bankruptcy Code"), the tuition payments may be avoided or "clawed back" by a judgment creditor in supplementary proceedings or a trustee in a bankruptcy case. Generally speaking, this is not a new phenomenon; however, with surging tuition costs, parties have undertaken a new approach to collect on their judgments. These avoidance actions can be troubling not just because of the ever-increasing cost of education but also because of the potential for the impact on the student. When an institution must turn over tuition payments it received to a judgment creditor or bankruptcy trustee, the student may be left with unfulfilled obligations to his or her school; the school, in turn, will often seek to be repaid any amounts it had to turn over and place a freeze on the student's education and transcripts. Arguing that the debtor did not receive "reasonably equivalent value" in exchange for the tuition payments, some trustees have been successful in recovering these transfers while other trustees have failed in their pursuits.

Fraudulent Transfer Law, Generally

Under Bankruptcy Code sections 548 and 550, a trustee can file suit to avoid and recover fraudulent transfers made by a debtor within two years of the filing of the petition. Generally speaking, the trustee must establish that either (a) the debtor made the transfer with actual intent to hider, delay, or defraud his creditors; or (b) that the transfer was "constructively fraudulent."[2] To establish that a transfer was constructively fraudulent, the trustee must establish that the debtor received less than reasonably equivalent value in exchange for the transfer and (i) was insolvent on the date the transfer was made or became insolvent as a result, (ii) was engaged in a business or transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital, (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured, or (iv) made the transfer to or for the benefit of an insider.[3] Furthermore, under section 544 of the Bankruptcy Code, a trustee has the authority to "step into the shoes of a creditor and avoid the debtor's transfers of property or property interests that could have been avoided by the creditor outside of bankruptcy."[4]

Under the Michigan Uniform Voidable Transactions Act ("MUVTA"), formerly the Michigan Uniform Fraudulent Transfer Act, MCL 566.34 *et seq.*, a judgment creditor may avoid transfers made (a) With actual intent to hinder, delay, or defraud any creditor of the debtor; or (b) Without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor did either of the following: (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or (ii) intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.[5] Under MCL 566.35, a judgment creditor may avoid a transfer made without receiving a reasonably equivalent value in exchange for the transfer or obligation at the time when the debtor was insolvent or became insolvent as a result of the transfer or obligation.[6]

Using both the Bankruptcy Code and state law fraudulent transfer statutes, bankruptcy trustees across the country have endeavored to recover transfers made by debtors and

encounter a consistent defense – reasonably equivalent value.

Tuition Clawback Lawsuits

One such case that addressed the ability of a party to clawback payments to educational institutions is the case of *Gold v Marquette Univ (In re Leonard)*, 454 BR 444 (Bankr ED Mich 2011). In *Leonard*, Judge Thomas J. Tucker of the United States Bankruptcy Court for the Eastern District of Michigan was tasked with the dispute between a Chapter 7 Trustee who sought to recover transfers totaling slightly more than $21,500 made within seven months of the bankrupt debtors having filed a petition for relief under the Bankruptcy Code. At the time of the transfers, the debtors' son was 18 years old and a student at Marquette University, the recipient of the transfers.[7]

Under Bankruptcy Code sections 548 and 550, a trustee can file suit to avoid and recover fraudulent transfers made by a debtor within two years of the filing of the petition.

The Trustee sought to avoid the transfers from Marquette University under Michigan's fraudulent transfer statute, specifically, MCL 566.35(1), and 11 USC 548(a)(1)(B), which provides:

> The Trustee may avoid any transfer ... of an interest of the debtor in property, ... that was made ... on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
>
> (B)(i) received less than a reasonably equivalent value in exchange for such transfer ...; and
>
> (ii)(I) was insolvent on the date that such transfer was made ... or became insolvent as a result of such transfer ...; and
>
> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; [or]
>
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured...[8]

The *Leonard* court noted in its decision that MCL 566.35(1) is virtually identical to 11 USC 548(a)(1)(B)(i) and (ii)(I).[9]

The parties each moved for summary judgment and did not dispute that the transfers were made and that they were made while the debtors were insolvent; however, the question before the court was whether the debtors received reasonably equivalent value in exchange for the transfers.[10] The Trustee argued that the value received in exchange for the tuition payments was received by the debtors' son and not the debtors.[11] On the other hand, the university argued that the debtors received reasonably equivalent value for the transfers, because the transfers enabled their son to receive a college education.[12] Further, the university argued that the debtors also received reasonably equivalent value in the form of intangible benefits.[13] Namely, (1) the debtors' son received an education which "bestowed peace of mind" on the debtors that their son "will be afforded opportunities in life that would not have come but for the education; and (2) that the debtors "anticipate that they will not remain financially responsible for [their son]."[14]

With the issue of reasonably equivalent value squarely before the Court, Judge Tucker began his analysis by noting that neither the Bankruptcy Code nor the Michigan fraudulent transfer statutes define the phrase "reasonably equivalent value;" however, both define "value."[15] The Bankruptcy Code defines value, for purposes of § 548, as "property or satisfaction or securing of a present or antecedent debt of the debtor, but [it] does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."[16] Similarly, MCL 566.33(1) provides that "value is given for a transfer or an obligation if, in exchange for the transfer of obligation, property is transferred or an antecedent debt is secured or satisfied. Value does not include an unperformed promise made otherwise than in the ordinary course of the promisor's business to furnish support to the debtor or another person."[17] Both definitions of the word "value" are virtually identical between the MUVTA and the Bankruptcy Code's fraudulent transfer provisions.

The *Leonard* court next turned to the so-called "indirect benefit rule" with respect to reasonably equivalent value. In the case of *Lisle v John Wiley & Sons, Inc (In re Wilkinson),* 196 Fed Appx 337 (6th Cir 2006), the Sixth Circuit held that "[i]t is well settled that reasonably equivalent value can come from one other than the recipient of the payments, a rule which has become known as the indirect benefit rule."[18] Indeed, in the case of *Rubin v Manufacturers Hanover Trust Co,* 661 F2d 979 (2nd Cir 1981), the court held "[t]he transaction's benefit to the debtor need not be direct; it may come indirectly through benefit to a

third person… If the consideration given to the third person has ultimately landed in the debtor's hands, or if the giving of the consideration to the third person otherwise confers an economic benefit upon the debtor, then the debtor's net worth has been preserved, and [the statute] has been satisfied-provided, of course, that the value of the benefit received by the debtor approximates the value of the property or obligation he has given up."[19]

In *Leonard*, the value provided was in the form of a benefit that was given by Marquette University to the debtors' son in exchange for the tuition payments received from the debtors.[20] Accordingly, there was no direct benefit to the debtors. Turning to the indirect benefit rule recognized in *Lisle*, the *Leonard* court found that in order for an indirect benefit to be considered in the analysis of reasonably equivalent value, an economic benefit must be received by the debtors.[21] Moreover, the economic benefit must be both concrete and quantifiable.[22] The only potential economic benefit received by the debtors was the potential that the debtors' son could be financially independent in the future.[23] The Court observed that there were plenty of reasons that may have led to the debtors paying their son's tuition; however, "peace of mind" "love and affection" and "moral obligations" do not equate to reasonably equivalent value when confronted with a complaint for fraudulent transfer.[24] As a result, Marquette University's motion for summary judgment was denied.[25]

Perhaps as a precursor to what the court thought may be coming down the pike, it made a point to note that Marquette did not claim that the debtors had any *legal* duty under Michigan law to pay for their adult son's education.[26] However, that distinction was important to Judge Phillip Shefferly in a decision that was issued two years later in the case of *McClarty v University Liggett Sch (In re Karolak)*, No 12-61378, 2013 WL 4786861 (Bankr ED Mich Sept 6, 2013), again in the United States Bankruptcy Court for the Eastern District of Michigan.

In *Karolak* the Chapter 7 Trustee sought to recover transfers totaling almost $17,000 made by a Chapter 7 debtor to University Liggett School over a three-year period for tuition for her minor children.[27] University Liggett is a private school that provides education for children from kindergarten through 12th grade.[28] The debtor was a teacher at University Liggett and, as an employment benefit and through regular deductions from her paychecks, paid a reduced amount for her children's tuition.[29]

These facts were not in dispute and, again, the Court heard motions for summary judgment that dealt largely with the question of whether reasonably equivalent value was received by the debtor in exchange for the tuition payments made.[30] The Chapter 7 Trustee argued that the debtor did not receive reasonably equivalent value while University Liggett argued that the reasonably equivalent value was that of the grammar school education provided to the debtor's minor children.[31]

Although the bankruptcy court did look to the indirect benefit rule, it found that the debtor received a direct and reasonably equivalent value in exchange for the tuition payments, stating "[t]his is not a case where the value comes from someone other than the recipient of the transfer."[32] Rather, the court held that the debtor received a direct benefit by satisfying her legal obligation to provide schooling to her children pursuant to MCL 380.156(1), which requires that parents and guardians provide education to their minor children.[33] The *Karolak* court noted that the fact that the debtor could have provided an education to her children for far less than $17,000 (or even for free at a public institution) did not preclude her from receiving reasonably equivalent value in exchange for the tuition paid.[34]

By paying the tuition and providing schooling for her children, the debtor satisfied her statutory requirements to the state of Michigan and, accordingly, she received a direct benefit which was reasonably equivalent to the value of the tuition payments.[35] The *Karolak* court was not persuaded by the previous decision in *Leonard* and specifically distinguished the decisions as the tuition payments in *Karolak* were for minor children and, accordingly, satisfied the debtor's statutory obligations to educate her children, whereas there is no such statutory requirement under Michigan law to provide education for adult-aged children as was the case in *Leonard*.[36]

Other courts, however, have not been as straight-forward in their analysis of tuition clawback lawsuits. In the case of *Banner v Lindsay (In re Lindsay),* the court permitted a chapter 7 trustee to recover transfers; however, in *Lindsay* the court required the debtor to repay the trustee, not the educational insti-

A debtor/parent's payment for their child's tuition, regardless of intent, can create substantial risk and unknown consequences within the context of a fraudulent transfer lawsuit.

tution.[37] Three months before filing his bankruptcy, the debtor sold various vehicles and used the sales proceeds to pay his son's tuition at the University of St. Andrews.[38] The trustee's complaint alleged that the transfers to St. Andrews were fraudulent because the debtor received no "fair consideration" in return.[39] The debtor argued that he had a "moral obligation" to pay for his son's college education.[40]

The *Lindsay* court rejected the debtor's argument, first noting that it was not aware of any legal requirement for the debtor to pay for his son's college tuition.[41] The court went on to also rebuff the debtor's "moral" arguments and recognized that in another proceeding, the court had rejected an argument that paying for a child's college education was a debtor's "responsibility."[42] In the end, the *Lindsay* court required the debtor to pay in excess of $35,000 to the trustee in order to "recover" the funds used to pay the son's college tuition.[43]

On the other hand, there have been cases where courts have rejected attempts to recoup tuition payments as fraudulent transfers. Recently, the case of *DeGiacomo v Sacred Heart Univ, Inc (In re Palladino)* was decided in the United States Bankruptcy Court for the District of Massachusetts.[44] In this case, the parents of a student enrolled at Sacred Heart University paid almost $65,000 in the two years before filing Chapter 7 bankruptcy.[45] Unlike the *Leonard* court, the *Palladino* court found that "a financially self-sufficient daughter offered [the debtors] an economic benefit and that a college degree would directly contribute to financial self-sufficiency…. A parent can reasonably assume that paying for a child to obtain an undergraduate degree will enhance the financial well-being of the child which in turn will confer an economic benefit on the parent. This, it seems to me, constitutes a *quid pro quo* that is reasonable and reasonable equivalence is all that is required."[46] By finding that the debtors' tuition payments were both concrete and quantifiable, the court held that the transfers were unavoidable by the Chapter 7 trustee.[47]

In another case, *In re Cohen*, the trustee sought to avoid transfers under both the Bankruptcy Code and Pennsylvania fraudulent transfer law.[48] The transfers in question were made by the debtors and were in excess of $45,000 for their son's college education, $7,500 for their daughter's college education, and $39,000 for their daughter's graduate education.[49] Notably, the trustee in *Cohen* argued that "because Pennsylvania law does not require parents to pay for their children's post-secondary education, such education is not a necessity", and, therefore, the transfers would be avoidable.[50] The court, however, rejected the Trustee's arguments and found that despite the lack of a statutory requirement for Pennsylvanians to provide for post-secondary education for their children, the transfers for the children's college education were "reasonable and necessary for the maintenance of the debtors' family."

In another case similar to *Cohen*, the United States Bankruptcy Court for the Western District of Pennsylvania denied a trustee's attempt to clawback tuition payments.[51] The debtor in the case of *In re Oberdick* filed a Chapter 7 bankruptcy after making over $82,000 in college tuition payments for his children.[52] The Chapter 7 trustee, citing the lack of statutory authority in Pennsylvania requiring parents to provide education for their children beyond the age of 18, filed a complaint against the debtors in an attempt to recover those transfers pursuant to claims of fraudulent transfer under the Pennsylvania Uniform Fraudulent Transfer Act.[53] The court denied the trustee's claims, stating that the debtors viewed the tuition payments as a "family obligation" and noting that both children, save for small unsubsidized student loans, were denied student aid by both the state and federal governments.[54] Agreeing with *Cohen*, the court stated:

> What is a necessity for purposes of family obligation law is not necessarily congruent with what should be considered a necessity for purposes of an action under PaUFTA. Even though there may not strictly speaking be a legal obligation for parents to assist in financing their children's undergraduate college education, in following [*Cohen*], this Court has little hesitation in recognizing that there is something of a societal expectation that parents will assist with such expense if they are able to do so.[55]

Conclusion

A debtor/parent's payment for their child's tuition, regardless of intent, can create substantial risk and unknown consequences within the context of a fraudulent transfer lawsuit. The lack of a statutory definition of "reasonably equivalent value" in either the

Bankruptcy Code or the MUVTA (or UFTA) has further complicated an already tenuous issue for courts. Some courts take the position that without a legal requirement for parents to provide post-secondary education for their children, tuition payments are avoidable fraudulent transfers. Conversely, other courts have found that the transfers provide either moral equivalencies or concrete economic benefits to the debtor. With an ongoing split in authorities, no clear delineation of rationale, and rising costs of tuition, it is likely that this grey area of fraudulent transfer law is likely to remain a hotly contested matter for years to come. All the while, the American Dream will continue to be pursued.

NOTES

1. Mark Robert Rank, PhD, Thomas A. Hirschl, PhD, and Kirk A. Foster, PhD, *Chasing the American Dream: Understanding What Shapes Our Fortunes* (2014).
2. 11 USC 548.
3. 11 USC 548(a)(1)(B).
4. 11 USC 544.
5. MCL 566.34.
6. MCL 566.35.
7. *Id.* at 446.
8. *Id.* (citing 11 USC 548(a)(1)(B)).
9. *Id.* at 455 (citing *Steinberg v Young*, No 09–11836, 2010 WL 1286606, at *3–4 (ED Mich Mar 31, 2010) ("Michigan Courts have imported the analysis used in the Federal Bankruptcy Code" in determining "reasonably equivalent value" under the Michigan Uniform Fraudulent Transfer Act).
10. *Id.* at 454.
11. *Id.*
12. *Id.* at 454-55.
13. *Id.*
14. *Id.* at 455.
15. *Id.* at 455-56.
16. *Id.*
17. *Id.*
18. *In re Wilkinson,* 196 Fed Appx 337, 342 (6th Cir 2006).
19. *Rubin v Manufacturers Hanover Trust Co,* 661 F2d 979, 991-92 (2nd Cir 1981).
20. *In re Leonard*, 454 BR at 456.
21. *Id.*
22. *Id.*
23. *Id.* at 457.
24. *Id.*
25. *Id.* at 459.
26. *Id.* at 457.
27. *In re Karolak*, 2013 WL 4786861 at *1.
28. *Id.*
29. *Id.*
30. *Id.* at *3.
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.* at *4.
37. *In re Lindsay*, No 06-36352 (CGM), 2010 WL 1780065 (Bankr SDNY May 4, 2010).
38. *Id.* at *2.
39. *Id.* at *5.
40. *Id.* at *9.
41. *Id.*
42. *Id.*
43. *Id.*
44. *In re Palladino*, 556 BR 10 (Bankr D Mass 2016)
45. *Id.* at 12.
46. *Id.* at 16.
47. *Id.*
48. *In re Cohen*, No ADV 07-02517-JAD, 2012 WL 5360956, at *1 (Bankr WD Pa Oc. 31, 2012), aff'd in part, vacated in part, remanded sub nom. on other grounds, *Cohen v Sikirica*, 487 BR 615 (WD Pa 2013).
49. *Id.* at *9.
50. *Id.* at *10.
51. *In re Oberdick*, 490 BR 687, 696 (Bankr WD Pa 2013)
52. *Id.*
53. *Id.*
54. *Id.* at 711-12.
55. *Id.* at 712.

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Fiduciary Duties of Officers and Managers: Some Open Questions Under Michigan Law

By Michael K. Molitor

The Michigan Business Corporation Act (BCA) provides in part that a corporation's business is "managed by or under the direction of its board."[1] But power brings responsibility: directors owe strict duties of care and loyalty. BCA Section 541a provides that directors must act in good faith, with the care that "an ordinarily prudent person in a like position would exercise under similar circumstances," and as they reasonably believe to be in the corporation's best interests.[2] Although this article focuses on the duty of care, the duty of loyalty includes avoiding interested-director transactions, unless they were approved by the disinterested directors or disinterested shareholders or were fair to the corporation,[3] and refraining from usurping corporate opportunities.[4]

This risk of liability for breaches of the duty of care, however, is substantially tempered by two other legal doctrines, not to mention the possible presence of "D&O" insurance and indemnification. First, the business judgment rule (BJR) presumes that directors acted in good faith and on a reasonably informed basis. If a plaintiff does not rebut the BJR's presumptions, directors will be deemed to have satisfied their duty of care.[5] Second, BCA Section 209(c) allows corporations to include exculpation provisions in their articles that shield directors from monetary liability for any actions or inaction, with some exceptions.[6]

Things are similar in manager-managed limited liability companies (LLCs).[7] Section 404 of the Michigan Limited Liability Company Act (LLCA) imposes on LLC managers (or members, if the LLC is member-managed[8]) the same duty of care as for corporate directors: the duty to act "in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances …." Also, LLCA Section 407 allows exculpation provisions for managers that are similar to BCA Section 209(c) and the BJR may[9] protect LLC managers.

What about corporate officers? In many corporations, directors are responsible only for major policy decisions; most operational decisions are made by officers. In practice, this means that officers are "the most pervasively influential business actors in any company."[10] Because officers have great power, BCA Section 541a imposes the same duties on officers as it does on directors. However, the law is not as protective of officers. First, Michigan case law may not apply the BJR to officers. Second, BCA Section 209(c) does not permit exculpation provisions for officers. Thus, corporate officers are the odd persons out: they have the same fiduciary duties as corporate directors and LLC managers but not the same protections.

Officers' Fiduciary Duties

Although the BCA prescribes the same duty of care for officers as for directors,[11] there are some unresolved issues under Michigan law. First, officers (however that term is defined[12]) are agents of the corporation, unlike directors.[13] This means that officers have additional, or perhaps different, fiduciary duties depending on whether a court applies the BCA or agency law. For example, Section 8.08 of the *Restatement (Third) of Agency* provides in part that an agent "has a duty to act with the care … normally exercised by agents in similar circumstances." In Delaware, applying an agency-law standard of liability to officers would make a difference; as discussed below, because of the BJR, in Delaware directors are not normally liable unless they were grossly negligent. In Michigan, this may not matter a great deal, as the BCA standard of ordinary negligence applies to officers and directors.[14]

But even if the BCA standard of care is not materially different from agency law, agents have several other duties not specifically found in the BCA or "general" corporate case law, such as duties of obedience, competence, and diligence.[15] Other states have struggled with whether to use agency law in evaluat-

ing officers' actions. For example, a Delaware court recently observed that: "A vibrant debate exists over the extent to which the full agency law regime should apply to officers. One of the principal disputes appears to be whether officers should be liable for simple negligence, like agents generally, or whether some form of more deferential standard of review, such as the [BJR], should apply to their decisions."[16] This brings us to another open question in Michigan.

Does the Business Judgment Rule Apply to Corporate Officers and LLC Managers?

The BJR is a judicial presumption that, when making a decision, directors "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[17] To rebut this presumption, Delaware law generally requires that the plaintiff show that the defendant directors had a conflict of interest (a loyalty breach) or that they were grossly negligent in their decision-making process.[18] The BJR thus acts to increase the standard of liability for directors: "[W]hen an agent causes loss to the principal … the agent is subject to liability for simple negligence. But Delaware gears directors' liability for breaches of the duty of care to the less exacting standard of gross negligence."[19]

Despite some important authorities stating that the BJR protects officers as well as directors,[20] case law is surprisingly unsettled on this issue. In 2005, Professor Lyman Johnson reviewed cases in many jurisdictions and concluded that "[c]ase law support for extending broad [BJR] protection to officers is far weaker than commentators and courts acknowledge or appreciate."[21] Professor Johnson found few cases that actually applied the BJR to officers *in their capacities as officers*. Instead, courts' statements that the BJR protects officers often turned out to be dicta or to involve cases where officers were sued in their capacities as directors. In 2017, he found that little had changed: "Delaware has yet to provide an answer to … whether and how the [BJR] applies to officers …."[22]

Michigan cases do not provide a clear answer, either. There are many Michigan cases that hold that the BJR applies to corporate directors.[23] But does it apply to officers? In the 1937 case of *Barrows v JN Fauver Co*, the Michigan Supreme Court suggested that it did, writing that "[i]t is not the function of the court to … substitute its own judgment for the officers [of the corporation]. It is only when the officers are guilty of willful abuse of their discretionary powers … that the court will interfere."[24] However, the business in *Barrows* was managed by the defendant "in an informal manner, with few stockholders' or directors' meetings"[25] and some of the issues in dispute in the case were decisions normally made by directors, so it is difficult to conclude that the court specifically meant to apply the BJR to the actions of an officer *as an officer*. The *Barrows* court cited *Dodge v Ford Motor Corp*[26] for the rule that courts will not ordinarily interfere with the discretion of officers, but *Dodge* primarily concerned the payment of dividends, which is a board decision.[27] Similarly, the *Barrows* court cited *Morehead Mfg Co v Washtenaw Circuit Judge* for the proposition that a court normally "will not infringe upon the discretion vested in corporate officers,"[28] but *Morehead* mainly concerned a court's power to appoint a temporary receiver after the plaintiff complained about (among other things) the non-payment of dividends.

In *Wojcik v McNish*,[29] a 2006 unreported decision, the Michigan Court of Appeals said that the BJR makes courts "reluctant to interfere with the discretion vested in the directors and officers of the corporation to manage its affairs."[30] However, that case mainly concerned a board decision (the appointment of the defendant's son as an officer) and also involved a cause of action for oppression.[31] In sum, Michigan courts do not appear explicitly to have addressed whether the BJR should apply to actions that officers took as officers.[32]

Recent cases in other jurisdictions have declined to apply the BJR to officers. For example, in *Palmer v Reali*,[33] the court said that "Defendants have cited to no cases where a Delaware court has held that the business judgment rule applies to corporate officers; therefore, the court will not address the business judgment rule …."[34] Further, the FDIC has had some success in recent years arguing that the BJR does not apply to bank officers.[35] On the other hand, some recent opinions have found that the BJR applies to officers as well as directors,[36] and at least two state statutes do so.[37]

There are some explanations for this dearth of case law. First, most lawsuits by shareholders against officers are brought as derivative lawsuits.[38] This means that the

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plaintiff would be subject to the pre-suit demand requirement and likely would not be able to file the lawsuit if a majority of the directors were not personally interested in the challenged transaction.[39] Thus, there may be a small possibility of bringing a lawsuit against a non-director officer if the board does not consent to it. Somewhat similarly, in cases involving closely held corporations, shareholders aggrieved by officers' actions often sue for oppression under BCA Section 489. This means these cases are decided under different legal standards. Moreover, boards have tools to discipline errant officers short of litigation, such as firing or demoting them or recovering past compensation. Further, it wasn't until 2004 that Delaware courts had personal jurisdiction over officers of Delaware corporations.[40] For these reasons, and perhaps others, the application of the BJR to corporate officers remains unsettled, even in Delaware.

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Does the BJR apply to LLC managers? First, assuming there are policy reasons to apply the BJR to corporate directors but not officers (discussed below), a threshold question might be whether to characterize LLC managers as more similar to directors or to officers. Given the flexibility of the LLC form, it's difficult to give a general answer; much will depend on the specific LLC. For example, one LLC may have a "board of managers" as well as non-manager officers that have only limited authority, whereas a different LLC may have managers that make only some decisions, leaving the members to decide most issues.[41] In the former LLC, the managers seem like directors but in the latter they appear more like officers. On the other hand, the LLCA provides that managers are an LLC's agents,[42] suggesting that managers should be treated more like officers (who are agents) than directors (who are not). In any event, Michigan case law is nonexistent: "No Michigan appellate court has specifically addressed whether the [BJR's] protections apply to managers or members of an LLC, although trial courts do apply it in the LLC context."[43] However, commentators argue that "it seems logical that the [BJR] should apply to LLC managers, at least for an LLC that has adopted centralized management."[44]

Other states present a mixed bag. Until 2011, Section 409 of the Uniform Limited Liability Company Act (ULLCA) provided that "[s]ubject to the business judgment rule, the duty of care of a member of a member-managed [LLC] … is to act with the care that a person in a like position would reasonably exercise under similar circumstances …." (Under subsection (g), this same standard applied to managers of manager-managed LLCs.) Currently, however, Section 409(c) provides that members of member-managed LLCs and managers of manager-managed LLCs must refrain from gross negligence (or worse). In other words, the ULLCA changed from an ordinary negligence/BJR standard to a gross negligence standard. The prefatory note to the 2011 amendments to the ULLCA indicate that this change was part of the efforts of the National Conference of Commissioners on Uniform State Laws to "harmonize" the ULLCA with other model acts relating to unincorporated business organizations, such as the Revised Uniform Partnership Act. Nonetheless, at least a few state statutes apply the BJR to managers.[45]

The Delaware LLC statute was recently amended to suggest that managers owe default fiduciary duties akin to those of directors,[46] and recent Delaware court decisions have applied the BJR to LLC managers. For example, in the 2015 case of *Corwin v KKR Fin Holdings, LLC*,[47] the Delaware Supreme Court applied the BJR to the managers of an LLC, but that was in part because the "parties have acted as if this case was no different from one [involving] corporations whose internal affairs are governed by the Delaware General Corporation Law and related case law."[48] Similarly, in *Minnesota Invco of RSA No 7, Inc v Midwest Wireless Holdings LLC*,[49] the Delaware Court of Chancery applied the BJR to an LLC's "board of managers."[50] But a more recent case applied the BJR in analyzing the actions of a single manager.[51]

With respect to other states, two commentators observed in 2005 that "the law is schizophrenic on the question of whether and how the [BJR] applies in the context of unincorporated business organizations."[52] More recently, another commentator observed that "[t]here is no consensus on whether to apply the [BJR] to nontraditional business forms, such as the LLC …."[53] Nonetheless, the trend of recent authority appears to be in favor of applying the BJR to LLC managers.[54]

No Exculpation for You!

Even if officers are protected by the BJR, they do not enjoy the even greater protection of exculpation provisions in Michigan. This means they are treated differently than cor-

porate directors and LLC managers, which seems to be the norm in other states. For example, Section 102(b)(7) of the Delaware statute permits exculpation provisions for directors—but not officers—to be included in a corporation's certificate of incorporation. In *Chen v Howard-Anderson*,[55] the court held that directors who also were officers could not rely on an exculpatory provision with respect to actions that they took in their capacities as officers. Similarly, Section 2.02(b)(4) of the Model Business Corporation Act only pertains to directors, not officers. In fact, only a few states permit exculpation provisions for officers.[56]

Policy Considerations

As for applying the BJR to corporate officers and LLC managers in Michigan, it seems inappropriate *not* to do so, given that the statutory standard of care for corporate officers and LLC managers is the same as for corporate directors. In other words, if the legislature has not specified differing standards of care for them, it would seem puzzling for courts to treat corporate officers and LLC managers differently.

In Delaware—which does not have a statute that addresses the duty of care of officers and directors—this issue has been extensively debated by commentators.[57] Others have weighed in,[58] but the two sides of this issue have been most visibly taken by Lyman P. Q. Johnson, who argues that the BJR should not apply to officers, and Lawrence Hamermesh and A. Gilchrist Sparks III, who argue that it should. Although both sides have written several articles on this issue,[59] they went "head to head" in the *Business Lawyer* in 2005.[60] Their arguments are too numerous and subtle to fully explore in this short article, but Professor Johnson argues that two of the commonly stated policy reasons for the BJR—encouraging directors to take risks and respecting directors' statutory authority to manage the business—do not apply with the same force to the officers' actions. For example, many officers are already properly incentivized to take risks because their compensation is often performance-based or otherwise tied to the company's success, unlike many directors. Also, not applying the BJR to officer decisions that are challenged by the board would better seem to respect the hierarchy of decision-making authority. In other words, if "directors make a considered business judgment to pursue a breach of fiduciary duty claim against an officer, the rationale of honoring *director* discretion means that *officer* conduct should not be deferred to under the auspices of the [BJR] but, instead, should be scrutinized in accordance with the underlying standard of ordinary care …."[61]

Hamermesh and Sparks disagree with many of Professor Johnson's arguments. They point out that subjecting officers to an ordinary negligence standard unprotected by the BJR could expose them to liability that is enormous compared to their compensation, thereby discouraging risk-taking.[62] Also, refusing to apply the BJR to officers might "encourage officers to place more decisions in the hands of the board," which would substantially impair the board's ability to delegate decision-making authority to officers and make the corporation's management processes "top heavy."[63] In addition, they argue that another commonly stated rationale for the BJR, avoiding judicial second guessing of business decisions, supports applying the BJR to officers: "If concerns about hindsight bias and institutional competence warrant application of [BJR] deference to director action, they equally justify such deference to the action of corporate officers."[64]

In Delaware (but perhaps not Michigan[65]) the outcome of this debate matters a lot: officers would be subject to a gross negligence standard of liability if the BJR applies but an ordinary negligence standard if not. Largely taking Johnson's side in the debate, Professor Deborah DeMott argues that officers should be subject to an ordinary-negligence standard, evaluated in an agency-law framework. Among other reasons, she points out that officers' duties under agency law are much more specific than directors' duties under general corporate law, and questions whether it makes sense to "apply a less demanding standard—gross negligence—to corporate officers as a particular cohort of agents."[66] This is particularly so when an officer has specialized skills, such as a company's chief legal officer: why should a CLO be subject to a gross negligence standard when an outside attorney would be subject to an ordinary negligence standard?[67] Further, if a gross negligence standard applied, directors may be reluctant to rely on officers, knowing that they would worry only about being grossly negligent.[68] She also points out that any concerns over officers being subject to an ordinary negligence standard and not protected by the BJR and exculpation provi-

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sions can be addressed in officers' employment contracts "that define in advance the applicable standard of performance."[69] On the other hand, if an ordinary negligence standard applies, officers might try to shift more decision-making responsibility to the board, a concern shared by Hamermesh and Sparks.[70]

Others have argued that the BJR should apply to corporate officers when they are sued in derivative lawsuits or class actions filed by shareholders, but not in lawsuits brought by the corporation's board.[71] And at least one commentator has argued for a different approach: emphasizing that, because officers are agents of the corporation, they owe a duty of obedience to the corporation's board of directors, which "addresses what the proper balance of power in corporate management should be."[72] This debate will likely continue, but hopefully the Delaware courts will have the opportunity to address these issues soon.

Many of the same arguments can be made as to whether to apply the BJR to LLC managers. On one hand, managers are agents of an LLC and perhaps should be treated as such, that is, subject to an ordinary negligence standard with no BJR protection. On other hand, in many LLCs managers are the highest level of decision-making authority and perhaps should be treated in similarly to corporate directors. Moreover, as noted above, the BCA standard of liability for directors (and officers) is the same as that for LLC managers, suggesting that they should be treated equivalently. In any event, although Michigan courts have yet to decisively answer this question, the trend of case law in other jurisdictions is apply the BJR to LLC managers.[73] It would not be surprising to see Michigan courts follow suit.

Allowing exculpation provisions for officers would require an amendment to BCA Section 209(c), and whether the legislature should do so is debatable. As noted above, only a handful of states allow exculpation provisions for officers, so there might be "safety in numbers." But one argument in favor of doing so is that, if the statute were amended, the application of exculpation provisions to officers of a given corporation would require an amendment to its articles—which would require shareholder approval. Perhaps corporations should be free to choose whether exculpation provisions are appropriate for their officers. In the last issue of the *Michigan Business Law Journal*, Justin Klimko discussed recent amendments to the BCA that originated with the work of the Corporate Laws Committee of the Business Law Section of the State Bar.[74] One amendment the committee considered, but decided not to pursue at this time, was whether to amend BCA Section 209(c) to include officers. Since the drafting of Mr. Klimko's article, 2018 PA 88 was signed by Governor Snyder.

Conclusion

Several important issues remain unresolved under Michigan law: Are corporate officers protected by the BJR? Are LLC managers? Should corporate officers be able to be protected by exculpation provisions? Even in the corporate law flagship state of Delaware, the answers to some of these questions are murky. Good arguments can be made on both sides of these issues, and time will tell how Michigan courts resolve them.

NOTES

1. MCL 450.1501. *But see* MCL 450.1488(1)(a) (shareholder agreement can restrict the board's powers or eliminate the board). Because Section 488 agreements require unanimous shareholder approval, they typically are found in closely held corporations, which are not the focus of this article.
2. MCL 450.1541a.
3. MCL 450.1545a.
4. *See, e.g., Production Finishing Corp v Shields,* 158 Mich App 479; 405 NW2d 171 (1987).
5. Stephen C. Schulman, Michigan Corporation Law & Practice § 5.9 at p. 5-27 (2015 Supp.).
6. MCL 450.1209(c).
7. An LLC is managed by its members unless its articles state that it is managed by one or more managers. MCL 450.4401.
8. *See id.*
9. *See infra* notes 41 to 54 and accompanying text.
10. Lyman P. Q Johnson, *Dominance by Inaction: Delaware's Long Silence on Corporate Officers*, Washington & Lee Public Legal Studies Research Paper Series, May 5, 2017, p 2, *available at:* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2964033. *See also* Megan W. Shaner, *Restoring the Balance of Power in Corporate Management: Enforcing an Officer's Duty of Obedience*, 66 Bus Law 27, 28 (2010) ("officers have replaced directors as the individuals occupying the central role in corporate decision making.").
11. This is similar to the Model Business Corporation Act, section 8.42 of which ("Standards of Conduct for Officers") uses identical language to section 8.30 ("Standards of Conduct for Directors"). In 2009, the Delaware Supreme Court held that officers have the same fiduciary duties as directors. *Gantler v Stephens*, 965 A2d 695, 708-09 (Del 2009). This had been an open question because Delaware does not have a statute on point.

12. The BCA does not define "officers." BCA Section 531(1) merely provides that the officers consist of a "president, secretary, treasurer, and … *such other officers as may be prescribed by the bylaws or determined by the board*." (Emphasis added.) In *Aleynikov v Goldman Sachs Grp, Inc*, 765 F3d 350 (3d Cir 2014), the bylaws designated all "vice presidents" as officers entitled to indemnification. The court found this language ambiguous, given the corporation's many "vice presidents."

13. *See* Schulman, *supra* note 5, § 5.8 at p 5-22. *See also Restatement (Third) of Agency* 1.01 cmt b ("The elements of common-law agency are present in the relationships between … corporation and officer ….") and cmt. f ("[T]he directors are neither the shareholders' nor the corporation's agents ….").

14. *See, e.g., Martin v Hardy*, 251 Mich 413, 416; 232 NW 197 (1930). *See also Dykema v Muskegon Piston Ring Co,* 348 Mich 129, 136; 82 NW2d 467 (1957). On the other hand, commentators have noted that the Delaware and Michigan standards are difficult to distinguish in practice. Schulman, *supra* note 5, at p. 5-32.

15. *Restatement (Third) of Agency* 8.08, 8.09.

16. *Amalgamated Bank v Yahoo! Inc.*, 132 A3d 752, 780 n24 (Del Ct Ch 2016). *See generally* Deborah A. DeMott, *Corporate Officers as Agents*, 74 Wash & Lee L Rev 847 (2017).

17. *Aronson v Lewis*, 132 A3d 805, 812 (Del 1984) (citations omitted). For a discussion of the BJR in Michigan, see Schulman, *supra* note 5, at 5-26 to 5-34.

18. *Smith v Van Gorkom*, 488 A2d 858, 873 (Del 1984).

19. DeMott, *supra* note 16, at 862 (footnotes omitted).

20. The official comment to section 8.42 of the Model Business Corporation Act states that the BJR "will normally apply to decisions within an officer's discretionary authority …." *See also* American Law Institute, *Principles of Corporate Governance* 4.01(c) (1994).

21. Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus Law 439, 469 (2005). *See also* Gregory S. Crespi, *Should the Business Judgment Rule Apply to Corporate Officers, and Does it Matter?*, 31 Okla City U L Rev 237 (2006).

22. Johnson, *supra* note 10, at 3 (footnote omitted). *See also* Megan W. Shaner, *The (Un)enforcement of Corporate Officers' Duties*, 48 UC Davis L Rev 271 (2014) (reviewing cases from 2004 to 2014).

23. *See, e.g., In re Estateof Butterfield*, 418 Mich 241, 255; 341 NW2d 453 (1983); *Good v Modern Globe, Inc*, 346 Mich 602, 609-10; 78 NW2d 199 (1956); *Reed v Burton*, 344 Mich 126, 130-31; 73 NW2d 333 (1955); *Wagner Elec Corp v Hydraulic Brake Co,* 269 Mich 560, 566-67; 257 NW 884 (1934); *Churella v Pioneer State Mut Ins Co*, 258 Mich App 260, 270; 671 NW2d 125 (2003). *See also Simon Prop Group, Inc v Taubman Ctrs, Inc*, 261 F Supp 2d 919, 937 (ED Mich 2003); *Gray v Zondervan Corp.*, 712 F Supp 1275, 1280-81 (WD Mich 1988); *Priddy v Edelman*, 679 F Supp 1425, 1434 (ED Mich 1988).

24. 280 Mich 553, 558-59; 274 NW 325 (1937) (citation omitted).

25. *Id* at 556.

26. 204 Mich 459; 170 NW 668 (1919).

27. MCL 450.1345.

28. 254 Mich 697, 698; 236 NW 911 (1937). *See also Olsen v National Memorial Gardens, Inc*, 366 Mich 492, 496, 115 NW2d 312 (1962) (BJR does not shield officers' actions when there is fraud, misconduct, or abuse of discretion).

29. 2006 WL 2061499 (Mich App 2006).

30 *Id.* at *3. One supporting authority the court cited was *Estate of Butterfield*, *supra* note 23. However, *Butterfield* did not explicitly state that the BJR applies to officers.

31. *See* MCL 450.1489.

32. One federal court applying Michigan law suggested that the BJR applies to officers, but that case involved a suit against directors. *Resolution Trust Corp. v Rahn*, 854 F Supp 480, 489-90 (WD Mich 1994). *See also Estate of Detwiler v Offenbecher*, 728 F Supp 103, 148 (SDNY 1989).

33. 211 F Supp3d 655 (D Del 2016).

34. *Id* at 666 n8.

35. Ryan Scarborough & Richard Olderman, *Why Does the FDIC Sue Bank Officers? Exploring the Boundaries of the Business Judgment Rule in the Wake of the Great Recession*, 20 Fordham J Corp & Fin L 367, 367 (2015). *Compare FDIC v Florescue,* 2013 WL 2477246 (MD Fla 2013); *FDIC v Perry*, 2012 WL 589569 (CD Cal 2012); and *FDIC v Loudermilk,* 761 SE2d 332 (Ga 2014).

36. *Sneed v Webre*, 465 SW3d 169 (Tex 2015); *Fried v Gordon*, 2011 WL 1157891 (D Mass 2011).

37. Nev Rev Stat 78.138(3) ("[d]irectors and officers, in deciding upon matters of business, are presumed to act in good faith, on an informed basis and with a view to the interests of the corporation."); Ohio Rev Code Ann § 1701.641(C)(1).

38. *See* MCL 450.1491a(a).

39. In Michigan, a demand is always required before a shareholder may file a derivative lawsuit. MCL 450.1493a. *See also* MCL 450.1495 (court shall dismiss a derivative action if it finds that a majority of the disinterested directors determined in good faith, after a reasonable investigation, that the lawsuit is not in the corporation's best interests).

40. *See* Shaner, *supra* note 10, at 33.

41. *See generally* James R. Cambridge & George J. Christopolous, *Michigan Limited Liability Companies* § 7.10 at p 331 (Feb 2015 update).

42. MCL 450.4406.

43. Gerard V. Mantese & Ian M. Williamson, *Fiduciary Duty in Business Litigation*, Mich Bar J, Aug 2014, 30, 32. However, the case that the authors cite, *Savas v Yaker*, 2010 WL 1565534 (Mich App 2010), involved a Delaware LLC. In the unpublished opinion of *Morris v Bales*, 2017 WL 5759787 (Mich App 2017), the court cited the BJR in deciding that the "general manager" of an LLC (who was also on the LLC's board of directors) had done a reasonable investigation of whether a derivative lawsuit was in the LLC's best interests under MCL 450.4512.

44. Cambridge & Christopolous, *supra* note 41, at 344.

45. *See, e.g.,* Okla Stat 18-2016(4) ("A manager is not liable for any action [or inaction] … if the manager performed the duties of the office in compliance with the business judgment rule as applied to directors and officers of a corporation"); Va Code Ann 13.1-1024.1(A) ("A manager shall discharge his or its duties as a manager in accordance with the manager's good faith business judgment of the best interests of the [LLC].").

46. In 2013, the following italicized words were added to Section 18-1104 of the Delaware LLC statute: "In any case not provided for in this chapter, the rules of law and equity, including *the rules of law and equity relating to fiduciary duties and* the law merchant, shall govern." 6 Del Code Ann 18-1104 (emphasis added). The synopsis of the bill that made this amendment stated in part that "a manager of a manager-managed [LLC] would ordinarily have fiduciary duties even in the absence of a provision in the [LLC] agreement establishing such duties." *See also Feely v NHAOCG, LLC*, 62 A3d 649 (Del Ch 2012).

47. 125 A3d 304 (Del 2015).

48. *Id* at 306, n3.

49. 903 A2d 786, 797 (Del Ct Ch 2006).

50. *See also In re ALH Holdings LLC,* 675 F Supp2d 462 (D Del 2009); *Blackmore Partners, LP v Link Energy, LLC*, 2005 WL 2709639 (Del Ch 2005); *In re BH*

S&B Holdings LLC, 420 BR 112 (Bankr SDNY 2009); *In re Ultimate Escapes Holdings, LLC*, 2015 WL 1590132 (Bankr D Del 2015).

51. *Cancan Dev, LLC v Manno*, 2015 WL 3400789 (Del Ch 2015), *aff'd*, 132 A3d 750 (Del 2016). *See also VGS, Inc v Castiel*, 2000 WL 1277372 (Del Ch 2000) at *5 ("the actions of … [the] managers constituted a breach of their duty of loyalty and … those actions do not, therefore, entitle them to the benefit or protection of the [BJR]").

52. Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Associations?*, 30 Del J Corp L 343, 344 (2005).

53. Lael D. Weinberger, *The Business Judgment Rule and Sphere Sovereignty*, 27 TM Cooley L Rev 279, 218 (2010).

54. *See* J. William Callison & Maureen A. Sullivan, *Limited Liability Companies: A State-by-State Guide to Law and Practice* § 8:7 (July 2017 update). The authors cite numerous cases that applied the BJR to LLC managers. *See id* at nn 18, 60. *See also* Larry E. Ribstein & Robert R. Keatinge, *Ribstein & Keatinge on Limited Liability Companies* § 9:2 (June 2017 update).

55. 87 A3d 648 (Del Ct Ch 2014).

56. *See* La Rev Stat 12:1-832; Md Code Ann, Cts & Jud Proc 5-418(a); Nev Rev Stat 78.138(7); NH Rev Stat Ann 293-A:2.02(b)(4); NJ Stat Ann 14A:2-7(3); Va Code Ann § 13.1-692.1.

57. For a summary of this debate, see Aaron D. Jones, *Corporate Officer Wrongdoing and the Fiduciary Duties of Corporate Officers Under Delaware Law*, 44 Am Bus L J 475, 480-83 (2007).

58. *E.g.,* Paul Graf, *A Realistic Approach to Officer Liability*, 66 Bus Law 315 (2011).

59. *E.g.,* Lyman Johnson & Robert Ricca, *Reality Check on Officer Liability*, 67 Bus Law 75 (2011); Lyman Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 Wm & Mary L Rev 1597 (2005); A. Gilchrist Sparks III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 Bus Law 215 (1992).

60. Johnson, *supra* note 21; Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus Law 865 (2005).

61. Johnson, *supra* note 21, at 464.

62. Hamermesh & Sparks, *supra* note 60, at 870-73.

63. *Id* at 875.

64. *Id* at 874.

65. As noted above, the Michigan Supreme Court has specified an ordinary negligence standard for directors. *See supra* note 14 and accompanying text.

66. DeMott, *supra* note 16, at 868.

67. *Id.*

68. *Id* at 870.

69. *Id.* at 869.

70. *Id.* at 870.

71. *See* Crespi, *supra* note 21, at 246-53.

72. *See* Shaner, *supra* note 10, at 54.

73. *See supra* note 54 and accompanying text.

74. Justin G. Klimko, *2017 Amendments to Michigan's Business Corporation Act,* MI Bus LJ, Fall 2017, at 6.

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Case Digests

AuSable River Trading Post, LLC v Dovetail Solutions, Inc, 874 F3d 271 (6th Cir 2017)

Tawas, Michigan hosts an annual winter festival called "Perchville." Dovetail is a for-profit corporation that oversees the Chamber, a non-profit dedicated to promoting local business. In 2002, the Chamber applied for a federal trademark registration for the term "Perchville," which was subsequently registered in 2003. The trademark was cancelled for a year-period in 2013 due to a failure to renew the application.

The Trading Post, a wholesale provider of miscellaneous products, had an order to sell or was actively selling merchandise with the term "Perchville." In January 2016, the Chamber filed suit against Agnello, an employee of the Trading Post, seeking an injunction against his unauthorized use of "Perchville" on T-shirts. The Chamber failed to include the Trading Post as a party in their lawsuit and was initially unaware that the employee was selling the shirts on behalf of the Trading Post. The court granted the injunctive order, binding upon the parties to the action. The Trading Post challenged the Chamber's trademark of "Perchville." The district court granted the Chamber's motion as to the challenge to the trademark's validity on the grounds of res judicata, finding the Trading Post's claims were barred by the prior litigation between the Chamber and the employee, Agnello. In reaching its conclusion, the district court determined that Plaintiff was in privity with an hourly employee who had previously consented to a permanent injunction barring his use of the "Perchville" mark. Plaintiff challenges the district court's finding that it is in privity with its employee for purposes of res judicata.

The Sixth Circuit reversed the district court, concluding that summary judgment on the basis of res judicata was inappropriate because the two actions did not involve the same parties or their privies. Not only was the Trading Post not a party in the initial lawsuit filed by the Chamber, no one appeared at the hearing on behalf of the company. Therefore, the Chamber failed to meet its burden of showing that Agnello and the Trading Post were in privitiy such that the doctrine of res judicata would bar the Trading Post's claims.

Simms Buick-GMC Truck, Inc v General Motors, LLC, 876 F3d 182 (6th Cir 2017)

Sims Buick- GM sells GM cars and trucks in Warren, Ohio. It participates in the Vehicle Purchase Program, which gives sales incentives to dealers who sell cars to GM employees, retirees, and their family members at a discounted rate. Each sale under this program entitles the dealer to a financial incentive payment. In order to receive the incentives, the dealer must collect a signed agreement that proves the purchaser's eligibility for the program. In 2012, GM imposed a timing requirement for dealers to collect the signed agreements. In 2014, GM audited Sims Buick-GMC Truck and discovered a number of transactions where the agreement was not collected within the timeline set by GM. GM debited plaintiff's account over $47,000 for the improper incentive payments.

Sims filed a complaint against GM alleging breach of contract and violations of the Ohio Dealer Act. The district court granted summary judgment for General Motors.

The Sixth Circuit affirmed the lower court. The parties' dealership arrangement permitted the debit and a timely filed agreement is considered "material documentation" under section 4517.59(A)(20)(a) of the Ohio Dealer Act.

Hall v Edgewood Partners Ins Ctr, Inc, 878 F3d 524 (6th Cir 2017)

Brian Hall and Michael Thompson owned an equipment rental insurance company. Hall and Thompson decided to bring some of their clients to a specialty division they formed at Hylant Group. They ultimately divided their business and sold its clients to USI Insurance Services. USI agreed to pay a substantial sum for the division's assets and keep Hall and Thompson as employees. Hall and Thompson gave up any ownership interest in their clients and promised that if they were terminated, they would refrain from soliciting those clients for two years. They also agreed that USI could assign their employment contracts to a subsequent purchaser.

After some time, Edgewood Partners Insurance Center bought out USI's equipment rental insurance business, including all of Hall and Thompson's old clients. Due to some issues with Edgewood, USI terminated Hall and Thompson. After they were terminated, they began to reach out to their old clients. They also requested the court to permit them to do so through a declaratory judgment. Edgewood sought a preliminary injunction to halt Hall and Thompson from breaching the non-solicitation agreements. The district court issued the injunction and the plaintiffs appealed.

The plaintiffs argued that the employment contracts could not be properly assigned to Edgewood without both of their written consent. Hall did not consent in writing to USI's sale to Edgewood. Therefore, it should invalidate USI's assignment of their employment contracts, which would include the Asset Purchase Agreement. However, Edgewood is not a party to the Asset Purchase Agreement. Therefore, USI would have breached the Asset Purchase Agreement by executing the sale to Edgewood and assigning Hall and Thompson's employment contracts without Hall's consent. Even if the court made a finding the USI breached the agreement, the plaintiffs would have to show that the assignment provision in the Asset Purchase Agreement superseded the assignment provision in their employment contracts.

The Sixth Circuit remanded to determine which clients were recruited and developed by only Thompson, and which clients Hylant and USI use their resources in recruiting and developing. The court found that Edgewood has no legitimate interest in barring Thompson from soliciting

clients who came to Hylant and USI because of Thompson's services and only as a result of his own independent recruitment efforts.

In re Nicole Gas Prod, Ltd, 581 BR 843 (6th Cir 2018)

Nicole Gas Productions, Ltd. is a Chapter 7 debtor, and now deceased Freddie Fulson was its indirect equity owner. Nicole Gas had business relationships with various branches of Columbia Gas. Throughout the years, litigation between Nicole Gas and various Columbia Gas entities occurred. Eventually, Nicole Gas filed for bankruptcy and the estate obtained its causes of actions against the Columbia Gas entities. During the pendency of the bankruptcy, Fulson filed a complaint against Columbia Gas entities under the Ohio Corrupt Practices Act ("OCPA"), alleging that the companies caused him indirect injury by harming Nicole Gas. In the complaint, Fulson only pled to the injuries suffered by Nicole Gas and did not claim any individual damages. Frederick Ransier, the Chapter 7 Trustee of Nicole Gas, argued that Fulson had a derivative claim completely based the Debtor's injury and for damages that duplicated Nicole Gas' damages. Ransier further argued that the estate had the exclusive right to prosecute the causes of action against Columbia Gas entities. He concluded that by filing a state court complaint, Fulson's estate violated the automatic stay by appropriating estate property without the Bankruptcy Court's permission. Fulson's estate responded that his claim was one for indirect injury that fell within the OCPA. The Bankruptcy Court rejected this argument and the estate's request. The Court opined that the "directly or indirectly injured" language under the OCPA did not abrogate the principal that an injured shareholder has only a derivative claim deriving from the corporation and not a separate, individual claim. The court held the estate in contempt and awarded Ransier $91,068.00.

The Ohio Supreme Court declined to answer the question of whether a shareholder of a corporation has standing to bring an individual claim under OCPA. The Bankruptcy Appellate Judge ultimately affirmed the contempt order and sanction award, holding that OCPA did not provide Fulson an individual claim against Columbia Gas entities.

Index of Articles

(vol 30 and succeeding issues)*

**For cumulative index from volume 16, go to http://connect.michbar.org/businesslaw/newsletter.*

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SECTION CALENDAR

Council Meetings

DATE	TIME	LOCATION
June 5, 2018	3:30 p.m.	Bloomfield Hills, MI