# The Michigan Business Law Journal

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The editorial staff of the *Michigan Business Law Journal* welcomes suggested topics of general interest to the Section members, which may be the subject of future articles. Proposed topics may be submitted through the Publications Director, Robert T. Wilson, The Michigan Business Law Journal, 150 W. Jefferson, Suite 900, Detroit, Michigan 48226-4430, (248) 258-1616, or through Daniel D. Kopka, Senior Publications Attorney, the Institute of Continuing Legal Education, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432.

## MISSION STATEMENT

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

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

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# From the Desk of the Chairperson

*By Michael S. Khoury*

## Make the Most of Your BLS Membership

For the majority of you that receive and read the Business Law Section's E-Newsletter, you will have noticed the recurring theme of opportunities for participation and the coordination of our efforts with other sections of the State Bar of Michigan.

Business Section participation is an option for each of you, but less than 10 percent of the Section's membership takes the opportunity to work with a committee, participate in legislative initiatives, or attend the Business Law Institute. For the other 90+ percent, the recent member survey results indicate that the Section is delivering sufficient value for you to continue to pay your dues and maintain your membership simply through the publication of the *Michigan Business Law Journal* and the attendance at periodic Section activities.

Despite the ever-increasing demands on our time, and the increasing complexity and challenges of law practice, I hope you will consider taking some time to participate in a Section committee. Our current committees are as follows:

Commercial Litigation

Corporate Laws

Debtor/Creditor Rights

Financial Institutions

In-House Counsel

Nonprofit Corporations

Regulation of Securities

Uniform Commercial Code

Unincorporated Enterprises

The committee leadership is listed near the front of each issue of the *Michigan Business Law Journal*, and you are encouraged to contact the committee chairs directly.

One of our activities that has generated significant interest are the periodic Small Business Forums that take place in southeast and western Michigan. The purpose of our Small Business Forums is to bring together attorneys, consultants, other service providers and business representatives to discuss and network on common themes of interest. Check out the calendar for upcoming events.

## Michigan Business Law Institute

The 20th Annual Michigan Business Law Institute will take place on June 13-14, 2008. As a result of feedback from participants, the program chairs have decided to move the Institute from its typical resort location to the historic and classic Dearborn Inn in Dearborn, Michigan. This will make it easier and more accessible to people in southeastern Michigan but still provide an interesting venue and opportunity for lawyers from around the state to attend.

The program itself promises to be an interesting mix of updates and trends in the law, as well as business and financial topics that will make you a better counselor to your clients. I hope to see many of you there.

## Coordination with Other Sections

The Business Law Section E-Newsletter was launched in September 2007 and was discussed with other SBM section leaders during a conference in Lansing in October. As a result, several other sections are looking at launching a similar newsletter. We are making a concerted effort to tell you about interesting events being sponsored by these and other groups. In exchange, of course, those groups will highlight our events. We hope that by informing you of activities concerning business lawyers, you will see it as an additional value you receive from your Section membership.

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### Business Corporation Act Amendments

Rep. Huizenga introduced HB 5356 in October that contains amendments to the Business Corporation Act drafted by the Corporate Laws Committee of the Business Law Section. The amendments permit the use of abbreviations, such as inc., co., corp., and ltd., with or without periods; permit appointment of a limited liability company as resident agent; and permit conversion of a corporation to a business organization and conversion of a business organization to a corporation, if permitted by the law that will govern after the conversion.

An amendment to section 545a clarifies that an interested director transaction that satisfies section 545a(1) could still be subject to attack for other defects. Amendments to sections 564a and 564b clarify language regarding indemnification and permit general authorization of advances in connection with a single proceeding. The amendments also include repeal of Chapter 7B, commonly referred to as the control share act.

### Legislation to Address *Miller v Allstate*

HB 5356 is tie barred to HB 5357 and HB 5358, introduced by Rep. Meisner and Rep. Clemente, respectively, which amend the Professional Service Corporation Act and Michigan Limited Liability Company Act. The bills contain amendments to address issues raised by *Miller v Allstate*,[1] which held that a corporation providing professional services must form under the Professional Service Corporation Act rather than the Business Corporation Act. Prior to *Miller* the Corporation Division followed Attorney General Opinion No. 6592, which states that only corporations providing services of lawyers, physicians, surgeons, dentists, and psychologists were required to organize as professional service corporations. The intent of the bills is to preserve the status quo as it existed before the *Miller* decision.

HB 5356 amends the Business Corporation Act to clarify that a corporation may form under the Business Corporation Act to provide professional services, other than services in a learned profession. It also adds a definition for "service in a learned profession" and has a savings clause for existing corporations. HB 5357 amends the Professional Service Corporation Act to clarify that only corporations providing "services in a learned profession" are required to organize as professional service corporations. It adds a definition for "services in a learned profession," simplifies the definition of "professional service," and adds a savings clause for existing corporations. HB 5358 amends the Michigan Limited Liability Company Act to simplify the definition of "professional service."

HB 5356 and HB 5357 were amended in committee to add chiropractors and optometrists to the definition of "services in a learned profession," restricting them to only incorporating as professional service corporations. The house passed HB 5356-5358 on December 6, 2007, with further amendments to HB 5356 and HB 5337 to add physical therapists to the definition of "services in a learned profession" and restrict them to only incorporating as professional service corporations. The bills have been referred to the Senate Committee on Economic Development and Regulatory Reform.

Section 4(3) of the Professional Service Corporation Act, MCL 450.224(3), provides that when a professional service corporation renders a professional service included within the Public Health Code "all the shareholders of the corporation shall be licensed or legally authorized in this state to render the same professional service." The bills as amended would limit chiropractors, optometrists, and physical therapists to organizing as professional service corporations and, therefore, would limit ownership to shareholders licensed to provide the same professional service. The impact of the amended bills on existing corporations and existing professional service corporations that offer the services of chiropractors, optometrists, or physical therapists is unclear.

On November 21, 2007, the Michigan Supreme Court granted the applications for leave to appeal in *Miller v Allstate.* The court invited the Attorney General, the Prosecuting Attorneys Association of Michigan, the Michigan Association for Justice, the Insurance Institute of Michigan, and the Business Law and Health Care Law Sections of the State Bar to file briefs amicus curiae. The issues to be briefed include whether PT Works must be incorporated under the Professional Service Corporation Act and, if so, whether the failure to do so means that the physical therapy provided was not lawfully rendered. The parties are invited to consider the possible application of sections 9 and 13 of the Professional Service Corporation Act, MCL 450.229 and 450.233, and section 271(c) of the Business Corporation Act, MCL 450.1271(c). The Corporation Division has requested that the Attorney General file a brief.

### Reference to Michigan Business Tax Added to BCA

SB 942, introduced November 29, 2007, amends sections 911 and 1062 of the Business Corporation Act, MCL 450.1911 and 450.2062. The amendment to section 911 adds the Michigan Business Tax apportionment percentage to the information to be reported on foreign corporation annual reports. The amendment to section 1062 provides for the Michigan Business Tax apportionment percentage to be used to determine the foreign corporation's shares attributable to Michigan to be used to ascertain the required fee to be paid for an increase in shares attributable to Michigan.

Governor Granholm signed the bill on December 27, 2007. It became Public Act 182 of 2007 and has immediate effect.

### 2008 Annual Reports and Statements

Michigan corporations and domestic and foreign limited liability companies in good standing can file their 2008 and prior year annual reports

and statements online. Previously filed reports can be viewed and printed from Business Entity Search at www.michigan.gov/entitysearch. If a prior year report for 2006 or 2007 has not been filed, FileOnline provides a reminder message and advises the customer of the date when the prior report or statement must be filed to remain in good standing.

The 2008 limited liability company and professional limited liability company annual statements and reports are due on February 15, 2008. Professional limited liability companies are liable for late penalty fees. FileOnline will indicate what fee is due, and both current and prior year annual statements and reports may be filed online if the company is in good standing.

The 2008 profit corporation reports are due May 15, 2008. Policy C-67, signed May 10, 2007 (http://www.dleg.state.mi.us/bcsc/forms/corp/pol/c-67.pdf), provides for assessment of statutory late penalty fees of $10 for each month or part of a month that a profit corporation report is late, not to exceed $50 in addition to the $25 annual fee.

The late penalty fee schedule is as follows:

$10 May 16-31

$20 June 1-30

$30 July 1-31

$40 August 1-31

$50 September 1 or later

Michigan profit corporations in good standing may file their 2008 report and prior year reports for 2006 and 2007 online. It is expected that online filing will be available in spring 2008 for foreign profit corporations in good standing, which have 60,000 or fewer shares attributable to Michigan or which have previously reported all shares attributable to Michigan.

When filing annual statements and reports online, fees are paid by credit card. A receipt can be printed before exiting the application, and the filed statement or report can be viewed online immediately after filing. To file online go to www.michigan.gov/fileonline.

## Scams Targeting Businesses Reported in Other Jurisdictions

Businesses in North Carolina recently received documents entitled "Important Final Notice" from a company called the National Companies Register Corporation that imply that the businesses are required to nationally register under the Patriot Act of 2001. The notice contains a seal similar to the state seal of North Carolina and a Web site that is capable of redirecting the person to the North Carolina Secretary of State's Web site. The notice warns businesses to pay $487 to avoid dissolution. North Carolina posted an alert on their Web site (http://www.secretary.state.nc.us/corporations/) in late December 2007 alerting businesses to the fraud. In Canada, recipients received invoices for $749 for a directory they supposedly ordered from the federal government of Canada. A press release from March 2007 is on the Industry Canada Web site, http://www.corporationscanada.ic.gc.ca/epic/site/cd-dgc.nsf/en/cs03451e.html.

In Oregon, businesses received mailings from "Assumed Business Name Renewal Service" that appeared to be from the secretary of state. The solicitation offers to prepare and file all necessary documents with the secretary of state for $100. Notice regarding the solicitation is on the Oregon Secretary of State's Web site at http://www.sos.state.or.us/corporation/business/suspicious_solicitations.htm.

In Florida, California, Texas, Georgia, and New York, businesses have reported various scams using communications that imply the notice is from a government agency. "Texas Corporate Compliance" used an icon similar to the state seal of Texas when it notified businesses they were required to complete a form listing officers and directors and submit it with a $125 fee within 10 days or risk loss of the corporation's limited liability status. "Georgia Corporate Compliance" sent notices to Georgia companies regarding completion of "corporation meeting minutes" and provided forms that appeared to be from the Georgia Secretary of State.

In 2007, California businesses received notices from "California Corporate Compliance" to complete an "Annual Minutes Disclosure Statement" and return it with $125 to retain their corporate status. The envelope and form contained a seal similar to the state seal of California. In 2006, California businesses received similar notices from the "Compliance Annual Minutes Board" with a request to pay $150 to remain in good standing. "New York State Corporation Compliance" sent compliance registrations forms to businesses asking them to return the completed form with $125. In Florida, businesses received similar notices from "Corporate Compliance Center". In Oregon, official looking correspondence was sent to nonprofit corporations by "Corporate Compliance Recorder" regarding an annual minutes requirement around the same time that annual reports were due.

Generally, these mailings have been sent out about the same time that annual filings are required to be made with the state's corporate filing office. The Department of Labor & Economic Growth issued a press release on January 2, 2008, to alert Michigan businesses to the possibility of receiving a misleading mailing.

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**NOTES**

1. *Miller v Allstate*, 275 Mich App 649, 739 NW2d 675 (2007).

*G. Ann Baker is the director of the Corporation Division of the Michigan Bureau of Commercial Services, Lansing. Ms. Baker routinely works with the department, legislature, and State Bar of Michigan's Business Law Section to review legislation. Ms. Baker is a member of the International Association of Commercial Administrators, and of the State Bar's Committee on Libraries, Legal Research and Legal Publications. Ms. Baker has been a frequent speaker at ICLE courses.*

 By Paul L.B. McKenney

# *Far Tougher Tax Preparer Rules? Not Me, I'm a Business Lawyer*

If you do not sign client tax returns, why should you be concerned with the pernicious new federal tax "return preparer" rules? A simple example answers your question. You write a memo, an e-mail, or send a letter recommending that a given transaction be entered into, or that a transaction or a piece of it be structured in a certain way. The advice can even be oral. On the tax return, which you never saw, it was reported accordingly. It was later determined that was not the correct treatment as a result of one of the increasing number of IRS audits. You are a "non-signing preparer" subject to the new amendments to IRC §6694 and Circular 230. Before the 2007 amendments, these return preparer rules only applied to preparers of income tax returns. Now they also regulate signing and non-signing preparers of income, gift, estate, employment, and excise tax returns.

The rules apply if an item that is the subject of your advice is "substantial" on a return. There is a trap here as a non-signing preparer of an item on a pass-through entity return, such as an S corporation, an LLC taxed as a partnership, estate or trust, is also deemed, as to that item, a preparer of all returns to which that flows. Whether an item is substantial or not is measured on each return. For example, an issue may not be substantial on a Form 1040 of a deep-pocket majority shareholder, but could be substantial to a small shareholder. Therefore, in a pass-through situation, you could be subject to exposure for a tax return that you never saw, for a taxpayer about which you know absolutely nothing.

The 2007 IRC §6694 and Circular 230 amendments essentially apply FIN 48 GAAP accounting to the front end of tax compliance by now generally requiring that every item on a tax return satisfy the more demanding "more likely than not" (i.e., over 50 percent) standard. Prior law had only mandated a 30 percent or higher likelihood of success on the merits. Alternatively, penalties can be avoided by a combination of the position having both a) a 20 percent or greater possibility of being sustained on the merits (the previous standard was "not frivolous," i.e., 5 percent to 10 percent or better chance), plus b) full and adequate disclosure on IRS Form 8275. The filing of such disclosure statements, however, has long been viewed by the tax bar as an open invitation to an IRS audit.

What are the consequences of running afoul of these new rules? The old $250 penalty days are now history. Revenue agents were simply not interested in doing considerable work for a mere $250 penalty. You and your firm are now liable for penalties under IRC §6694 and Circular 230 totaling up to 150 percent of the "fees." The fees are not just for your work on your piece of the larger puzzle, but can include the entire fees for a transaction, such as an acquisition, sale of business, restructuring, or sophisticated estate plan. Additionally, you can be suspended from practice before the IRS under Circular 230. Today, tax malpractice complaints routinely assert violations of a known federal tax standard of care, Circular 230, as determinative of liability.

On December 31, 2007, the IRS issued twenty-seven pages of guidance on these new standards in general and penalty defenses in particular. See Notice 2008-13. The new regime is generally applicable to signing preparers for returns filed on or after January 1, 2008, such as 2007 Forms 1040, 1065, 1120, and 1120S. For non-signing preparers, the effective date is generally written or oral "advice" given on or after January 1, 2008. At least on some returns, virtually every business lawyer is now a statutory non-signing preparer subject to the new regime.

Why did Congress adopt these rules, imposing such large potential liabilities on lawyers, among others? Congress is like your parents when you were teenagers—it either over-reacts or does nothing. The over-reactive legislation was in direct response to the tax shelter scandals that have become public through senate hearings and elsewhere. Accountants were historically viewed as the gatekeepers. After the tax shelter scandals, Enron and other prominent examples of corporate fraud, the old gatekeeper system was viewed as broken. You may view this as the tax version of Sarbanes Oxley, or the parental version of being grounded for "the rest of your life!"

At the recent American Bar Association Taxation Section meetings, these new preparer standards were both the number one topic and the leading concern. There were numerous presentations. The biggest fear within the tax community was not for those in the tax departments of their respective firms, as they are sensitized to the issues. The largest concern was that attorneys who tangentially touch on tax matters in corporate, litigation, estate, labor, and other practice groups would unwittingly stumble into traps for the unwary. There is considerable value in having a practitioner in your firm with a tax background who is familiar with these rules present an in-house program for those whose practices touch tax, or seek an outside tax professional to make the presentation.

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## Technology Corner By Michael S. Khoury and Scott M. Goemmel

# *Business Continuity Planning*

This column has its roots in a lunchtime conversation between the authors several months ago. The weaknesses in current models of business continuity planning came up in our discussion, and we recall that both of us said, almost simultaneously, "People!" This column is an adaptation of an article previously published by Scott Goemmel.

Businesses are exposed to some form of potential disaster and interruption on a daily basis. Each year, the volume and impact of these events increase, while most companies make little or no effort to be truly prepared. As lawyers, we teach our clients the importance of proactive planning through contracts, estate planning, wills, and trusts, but lawyers should also counsel businesses about the importance of business continuity planning. Business continuity planning is a process that will provide a competitive edge to firms who emphasize the importance of the plan, apply a degree of proactivity by implementing the plan, and continuously monitor and improve the plan's effectiveness.

The approach to business continuity planning introduced in this article is very different from plans present in the marketplace today. While this column is about technology, the primary difference is that true continuity plans start with people and not the underlying technology. Many firms have a basic level of recovery capability for key system resources, but even in some of the best technical plans, the importance of humans is understated and the overall recovery objectives often unattainable. This is the primary reason that such an approach to continuity planning is needed, regardless of the maturity of the existing plan.

### Step One: People—The Critical Resource

The key premise of this approach is the assumption that it takes extraordinary human interaction and focus to continue critical business functions during and after a disaster. With the absence of people and a high degree of energized focus incorporated into the culture, customer service, reputation, and potentially the company's survival are in jeopardy. An organization's most important assets affected by a disaster are the employees and customers. In a service business, people must come first in the plan.

Consider the case of New Orleans. During and immediately after Hurricane Katrina struck the city, the evacuation and safety of the community were the first priorities. However, once the storm settled and customers began to come back home, many businesses had no idea where their employees were located. The very people necessary to a firm's recovery plan were scattered across several states. Without the most vital of the resources, experienced employees, many recovery plans fell behind even though "technically" their systems could have been operational.

### Employees and family always come first!

The safety of employees will usually be paramount in the minds of business owners, but the business needs attention too. How should you plan?

- Know where your employees would go if they needed to leave the general area in the event of an emergency.
- Have contact information for their primary and alternative locations that includes the homeowner, phone, email, and mobile access.
- Provide an emergency number for your employees to be able to contact the firm. Recorded messages can let people know what is going on.

It is simple to begin a process for gathering this information and initiating an easy family planning process that includes sharing some key information with the firm. The bottom line is simple: know where you and your employees will go; know what they will do if they need to leave the area; know how to find them, pay them, and enable them to work remotely if needed.

### Linkage to the Company

A key benefit of starting with employee planning is that it begins to instill a real connection between the individual and the firm in terms of working together and building continuity planning into the culture. More importantly, a realistic plan recognizes that it takes extraordinary human focus to work in difficult situations, and if there is any question about the welfare of family, then those issues have to be addressed first. Linking this employee communication process to the company's plan results in a foundation that is better aligned with the business continuity requirements.

### Step Two: Keep Yourself and Your Customers in Business

If you can keep your customers in business, then your firm has a much better chance of survival. Regardless of the severity of the situation, there is a positive impact on the firm's reputation for having planned for continuity.

Once a communication process for employees and a level of knowledge regarding their family's safety has been established, you can truly begin ensuring that the company "continues" the critical business processes needed to support its customers. Even the smallest of firms have many key business processes that are required for deliverables and to maintain operations. Many of these processes are enabled by one or more technology applications and their related infrastructure. In order to prioritize efforts in both disaster recovery and process continuity, there must be an established priority for each of the required activities. The business continuity plan should clearly indicate how the critical pro-

cesses will be maintained regardless of the current physical environment.

## Priorities

Determine the most critical business processes (in order of importance) and document a simple process for how the operation will continue while the underlying components are returned to their pre-disaster conditions. To assist in prioritizing the processes, a simple matrix can be developed that matches the key business processes against their operational impact. Some example operational impacts often are:

- Impact on customer service
- Loss of customers
- Loss of revenue
- Exposure to penalty clauses
- Exposure to possible litigation
- Loss of key information
- Negative financial impact
- Impairment of firm reputation

Avoid over-complicating the number of critical processes from the onset of the plan. Start with one or two critical processes, determining how they will operate and their priority during recovery. Maintaining simplicity from the start and building details and scope over time is a practice that most firms can use to ensure the quality of the plan is maintained. Thus, the plan's linkage to the firm's culture is achieved.

## Linkage to the Leadership

Success starts at the top, so begin with bringing top management into the approach. The champion of the plan must have authority supporting the common goal to ensure that consistent progress is made and incorporated into the firm's culture over time. This is a way of life in today's world, no longer a binder sitting on a shelf that we hope to never utilize.

## Summary

Business continuity planning and disaster recovery are very important components of any business plan. There is no question, however, that the overall level of detail can be overwhelming and is often the reason why many of the best intentions never get the level of priority needed for success. With the ever-increasing level of risk and related reliance on information technology, we must begin to realize that our responsibilities go much further than our corporate needs. Business continuity planning is about the interrelationships within our families, communities, and businesses. Getting started and ensuring that we incorporate a human element to our continuity plans is an essential responsibility as we engage in business planning and implementation.

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# *Trust Fund Statutes and the Discharge of "Trustee" Debts Under Bankruptcy Code Section 523(a)(4)*

By Thomas R. Morris*

## Introduction

Pursuant to 11 USC 523(a)(4), a debt owing by an individual "for fraud or defalcation while acting in a fiduciary capacity" is not dischargeable in bankruptcy. Two United States Supreme Court cases, one from 1844 and one from 1934, establish a definition of "fiduciary" for purposes of section 523(a)(4).[1] However, the enactment by Congress and the state legislatures of "statutory trust" laws has created a new type of fiduciary duty not specifically addressed by the Supreme Court cases. The lower courts are not in agreement as to whether a statutory trust creates a "fiduciary capacity" for purposes of section 523(a)(4). As a result, there are a number of unanswered questions which arise under section 523(a)(4). Of particular interest to Michigan attorneys are questions relating to the dischargeability of liability under the Michigan Building Contract Fund Act (MBCFA) or "Builders Trust Fund."

This article addresses the historical development of the "fiduciary capacity" exception to discharge and the issues raised by the enactment of "statutory trust" laws, specifically the MBCFA, the most frequent source of dischargeability litigation under section 523(a)(4) in Michigan.

## The development of the original exceptions to discharge

For several millennia there has been a concept in law and religion that debtors should be forgiven their debts.[2] Nevertheless, bankruptcy was long punishable by imprisonment, and fraudulent financial dealings by mutilation or death.[3] Prior to 1705, when the British Parliament enacted a law that allowed a discharge to qualifying debtors of "all debts," the concept of a discharge of a debtor meant a release from prison.[4]

It was not until 1800 that Congress acted upon its grant of constitutional authority "[t]o establish…uniform laws on the subject of bankruptcies."[5] The Bankruptcy Act of 1800 was limited to merchants.[6] Proceedings were commenced only by involuntary petition (although it was not uncommon for a debtor to arrange for creditors to file a petition).[7] A debtor whose creditors did not vote down a discharge, and who satisfied the requirements intended to punish dishonest and uncooperative debtors, was "discharged from all debts by him or her due or owing at the time he or she became bankrupt."[8] The 1800 Act was repealed in 1803.[9]

The Bankruptcy Act of 1841, enacted following the Panic of 1837, made federal bankruptcy relief available again.[10] With the 1841 act, provision was made for a voluntary bankruptcy petition.[11] The 1841 act also for the first time created a category of non-governmental debt that was not dischargeable.[12] Under the Bankruptcy Act of 1841, all debts "which shall not have been created in consequence of a defalcation as a public officer, or as executor, administrator, guardian, or trustee, or while acting in any other fiduciary capacity" were dischargeable.[13] An exception to discharge very similar to this original exception is now found in 11 USC 523(a)(4).

## The Supreme Court defines the term "Fiduciary Capacity"

In *Chapman v Forsyth*,[14] Mr. Forsyth had been a partner in a firm which acted as a "commercial factor" and "commission merchant," and which owed a debt to its customer for the proceeds of sale of 150 bales of cotton sold by it, as agent, and received on the owner's account. The Supreme Court addressed the question whether this debt (for which Forsyth was liable as a partner) constituted a debt for "defalcation…while acting in [a] fiduciary capacity." The Supreme Court interpreted the term "fiduciary capacity" narrowly and held as follows:

> The…point is, whether a factor, who retains the money of his principal, is a fiduciary debtor within the act.

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> If the act embrace such a debt, it will be difficult to limit its application. It must include all debts arising from agencies; and indeed all cases where the law implies an obligation from the trust reposed in the debtor. Such a construction would have left but few debts on which the law could operate. In almost all the commercial transactions of the country, confidence is reposed in the punctuality and integrity of the debtor, and the violation of these is, in a commercial sense, a disregard of a trust. But this is not the relation spoken of in the first section of the act.
>
> The cases enumerated, 'the defalcation of a public officer,' 'executor,' 'administrator,' 'guardian,' or 'trustee,' are not cases of implied but special trusts, and the 'other fiduciary capacity' mentioned, must mean the same class of trusts. The act speaks of technical trusts and not those which the law implies from the contract. A factor is not, therefore, within the act.[15]

[F]rom 1800 to 1900 there was a federal bankruptcy act in effect for a total of less than 20 years.

Bankruptcy law in the nineteenth century was sometimes controversial and sometimes met with indifference.[16] The result was that from 1800 to 1900 there was a federal bankruptcy act in effect for a total of less than 20 years.[17] By the time that *Chapman v Forsyth* was decided in 1844, the Bankruptcy Act of 1841 had already been repealed.

The next federal bankruptcy legislation, which followed the Panic of 1857, was the Bankruptcy Act of 1867.[18] The 1867 Act, viewed in the context of Reconstruction legislation, afforded relief to many southerners put in financial straits as a result of the Civil War.[19]

The Supreme Court narrowly construed the provision of the 1867 Act that excepted from discharge "debt created…while acting in any fiduciary character," choosing to follow *Chapman v Forsyth*'s strict, technical definition rather than broadening the exception to discharge based upon the different wording of the 1867 Act. After examining English law on the topic, the court concluded that the "English courts regard many transactions as frauds or breaches of trust under their statutes of common knowledge."[20] The court distinguished American law, concluding that perhaps the "liberal construction made in favor of the certificate of discharge in this country is due to the peculiar modes and habits of business prevailing among our people…. At all events, we think that [cases such as *Chapman v Forsyth*] accord with the true spirit and meaning of the act of congress, and with the necessities of our business conditions and arrangements".[21]

After the repeal in 1878 of the 1867 Act, the next federal bankruptcy law was not enacted until after the Panic of 1893. This was the Bankruptcy Act of 1898, which continued in effect (with amendments) for eighty years until passage of the present Bankruptcy Code in 1978. Under the 1898 Act, the exceptions to discharge came to resemble those of the current Bankruptcy Code. For example, section 17(a)(2) excluded from discharge "liabilities for…willful and malicious injuries to the person or property of another." Similar language is now found in 11 USC 523(a)(6). Section 17(a)(4) (carried over from the 1841 and 1867 acts and the source of the current section 523(a)(4)), excluded from discharge the liabilities of a bankrupt "created by his fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity."

The landmark case involving section 17(a)(4) of the 1898 Act was *Davis v Aetna Acceptance Co*,[22] in which the United States Supreme Court brought the logic and holding of *Chapman v Forsyth* into the twentieth century. In *Davis*, an automobile dealer who sold an Auburn sedan and failed to remit the proceeds to the finance company, Aetna Acceptance, was found to be entitled to a discharge of the resulting debt despite his written agreement to "hold [the automobile] as the property of [Aetna Acceptance] for the purpose of storage, and not to sell, pledge or otherwise dispose of it except upon consent in writing."[23]

The Supreme Court found that the meaning of the term "fraud or misappropriation while acting in a fiduciary capacity" to have been "fixed by judicial construction for very nearly a century."[24] The *Davis* court elaborated as follows:

> The statute 'speaks of technical trusts, and not those which the law implies from the contract'…. It is not enough that, by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee *ex maleficio.* He must have been a trustee before the wrong and without reference thereto. In

> the words of Blatchford, J.: 'The language would seem to apply only to a debt created by a person who was already a fiduciary when the debt was created.' [citations omitted.] Was petitioner a trustee in that strict and narrow sense?
>
> We think plainly he was not, though multiplicity of documents may have obscured his relation if the probe is superficial.[25]

## The application of *Davis* under the Bankruptcy Code

*Davis* is still good law under the current Bankruptcy Code. But the confidence with which both it and *Chapman v Forsyth* had determined that specific commercial debts were not of a true fiduciary nature has not been of sufficient guidance to the courts. Recent decisions under section 523(a)(4) have given inconsistent results. "It is an understatement to say that the courts are divided on the meaning of 'fiduciary capacity' for purposes…of 523(a)(4)."[26]

The reason for these inconsistent results is that legislation enacted during and since the New Deal era in which *Davis* was decided has layered many types of commercial relationships with special treatment. Often that legislation uses terms adopted from the law of trusts to impose special duties on participants in commercial relationships. These laws have created a new species of implied trust, usually referred to as a "statutory trust" and aptly referred to by one court as an "occupational trust."[27] "In nineteenth century jurisprudence, the concept of 'trust' generally fell into two categories: (1) a voluntary trust, created by contract, often referred to as an 'express' trust, and (2) a trust created by operation of law…. The difficulty arose with the advent of statutorily-created 'trusts'."[28]

## Federal statutory trusts and dischargeability

At the federal level, the Perishable Agricultural Commodities Act of 1930 (PACA),[29] the Packers and Stockyards Act (PSA),[30] and the Employee Retirement Income Security Act of 1974 (ERISA),[31] impose "fiduciary" duties on purchasers/resellers of meat and farm produce, and employers.[32]

The cases that have applied the *Davis* express-trust standards to these statutes have yielded divergent results. The Sixth Circuit, in the recent case of *In re Bucci*,[33] followed an Eighth Circuit case, which held that ERISA does not create an express trust of which a corporate officer is the trustee.[34] However, at least one court has found ERISA to satisfy the requirements for nondischargeability with respect to a corporate officer.[35] The cases go both ways with respect to PACA.[36] Although there is no controlling Sixth Circuit case on PACA, *Bucci* gives a good indication that the Sixth Circuit would rule in favor of the debtor.

## State statutory trusts

Numerous state laws enacted during or since the New Deal era have likewise engrafted the language of trust law onto commercial relationships. The result is to alter, in specified industries and occupations, the general rule of debtor-creditor law that, absent the grant of a lien on a particular item of property, a creditor has no claim to a particular asset and is not entitled to be paid out of particular funds. Various state "trust fund" statutes are applicable to construction contractors, insurance agents,[37] lottery sales agents, partners,[38] and bankers.[39]

## "Builders' trust fund" laws and dischargeability

The type of law most often involved in dischargeability litigation under section 523(a)(4) is the "builders' trust fund" law. At least 21 states have laws of this type.[40] New York's law was the source of the MBCFA. The MBCFA, enacted in 1931, provides, in relevant part, as follows:

> In the building construction industry, the building contract fund paid by any person to a contractor, or by such person or contractor to a subcontractor, shall be considered by this act to be a trust fund, for the benefit of the person making the payment, contractors, laborers, subcontractors or materialmen, and the contractor or subcontractor shall be considered the trustee of all funds so paid to him for building construction purposes.[41]

It was not until 1982 that the Sixth Circuit addressed the issue of whether the MBCFA creates an "express trust,"[42] the violation of which could give rise to a debt that was not dischargeable under former section 17(a)(4), the predecessor to section 523(a)(4). In *In re Johnson*,[43] the Sixth Circuit determined that a debt owing by a building contractor for his

Numerous state laws enacted during or since the New Deal era have likewise engrafted the language of trust law onto commercial relationships.

failure to pay money out of a "building contract fund" to a supplier was not dischargeable. The court first determined that "[t]he question of who is a fiduciary for purposes of section 17(a)(4) is one of federal law, although state law is important in determining when a trust relationship exists."[44] The court went on to find that the MBCFA did establish an express or technical trust with respect to a contractor or subcontractor receiving the payments:

> The term "fiduciary" applies only to express or technical trusts and does not extend to implied trusts, which are imposed on transactions by operation of law as a matter of equity. *Davis v Aetna Acceptance Co*, 293 US 328, 333, 55 S Ct 151, 153, 79 L Ed 393 (1934); *Chapman v Forsyth*, 43 US (2 HO) 202, 207, 11 L Ed 236 (1884). Moreover, the requisite trust relationship must exist prior to the act creating the debt and without reference to it. *Davis, supra* at 333-34, 55 S Ct, at 153-54. State statutes which impose a trust *ex-maleficio* are not within the scope of section 17(a)(4) since such trusts only arise upon an act of misappropriation. *Id.* [additional citations omitted].
>
> The Michigan Building Contract Fund Act imposes a "trust" upon the building contract fund paid by any person to a contractor or subcontractor for the benefit of the person making the payment, contractors, laborers, subcontractors and materialmen. Mich Comp Laws Ann section 570.151. The contractor or subcontractor receiving the payments is the "trustee". *Id*.
>
> * * *
>
> The Building Contract Fund Act satisfies the express or technical trust requirements of section 17(a)(4). The trust relationship is unambiguously imposed on a contractor or subcontractor by the language of the statute.
>
> * * *
>
> A fiduciary relationship established by the Building Contract Fund Act arises at the time any monies are paid to the contractor or subcontractor whether or not there are any beneficiaries of the trust at that time and continues until all of the trust beneficiaries have been paid. [Citations omitted.][45]

A true trust, many courts have held, requires that the trust funds be segregated in some manner.

## Is *Johnson* the final word on the topic?

There are at least two fundamental legal questions posed by a claim of nondischargeability under the MBCFA and 523(a)(4) for "defalcation while acting in a fiduciary capacity."[46]

The first is: Does the MBCFA establish an "express trust" that meets the requirements to impose a "fiduciary duty" on the trustee such that a defalcation of that fiduciary duty will render the resulting debt nondischargeable for purposes of section 523(a)(4)? With *In re Johnson*, the question of whether the MBCFA imposes an express trust is settled in this circuit. But the question may not be forever settled. Holdings of other courts provide a basis for a challenge to that holding. "[T]he cases are divided over the question whether a statute that…deems a debtor a fiduciary in order to enlarge the remedies for default makes the debtor a 'fiduciary' for purposes of section 523(a)(4)."[47] A definite position on this issue is taken by *In re Heilman*,[48] which concluded that a statute on its own simply cannot create an express trust: "A statutory trust cannot be a technical trust—as express trusts are sometimes referred to—in the absence of the execution of a formal trust agreement between the parties."[49] In contrast, *Johnson* found the MBCFA to satisfy the "express trust" requirement of *Davis* because the MBCFA is in writing. Whether or not the Sixth Circuit reached the correct result, this is not what most courts have taken the term "express trust" to mean.[50]

A more narrow but related challenge is that the MBCFA, unlike its New York counterpart for example, does not require segregation of the so-called "trust funds."[51] Rather than requiring segregation or separate accounting for "builders trust funds", the MBCFA punishes a building contractor who, "with intent to defraud," misuses building contract funds.[52] A true trust, many courts have held, requires that the trust funds be segregated in some manner. The Supreme Court, in the 1890 case of *Upshur v Briscoe*,[53] noted the lack of a segregation requirement as support for its conclusion that no trust existed.[54] In *Davis*, there was likewise no segregation requirement.[55] The Court of Appeals for the Fifth Circuit, in *In re Tran*,[56] found the lack of a segregation requirement in the

Texas Lottery Act to render it insufficient to create nondischargeability under 523(a)(4). In *In re Boyle*,[57] the Fifth Circuit held that the Texas construction fund law likewise did not create an express trust since it did not require segregation of funds. In *In re McCue*,[58] a PACA case, the court concluded that for a statutory trust to satisfy the express-trust requirements of section 523(a)(4), the statute must require a segregation of trust funds.

## Is officer liability under the MBCFA dischargeable?

The second question, which was not addressed in *Johnson*, is: Who is the trustee? Specifically, is an officer/director/manager/employee of a contractor organized as a corporation or LLC (hereinafter, "officer") the trustee when the MBCFA does not specifically impose duties on the particular officer? Are the other elements of an "express trust" present with respect to an officer who was not personally a party to the transaction, who did not personally agree to serve as trustee, and who personally was not given title to property (the "building contract funds")? Does a position of responsibility in a business that is subject to a statutory trust result in nondischargeable personal liability of the officer when the business fails to pay its creditors? What elements must be established for there to be nondischargeable officer liability?

In *Johnson*, the Sixth Circuit distinguished other state statutes that "impose only criminal or other penalties on a general contractor."[59] Citing a number of cases from other jurisdictions, the court of appeals concluded that "[t]here the statutory trust arises only upon the active misappropriation and cannot be said to exist prior to the law and without reference to it even though a technical or express trust may exist at that time."[60] This statement seems to describe the situation when an officer who is not technically the "contractor" is held to be the "trustee." It therefore seems to portend that the Sixth Circuit would find officer liability under the MBCFA to be dischargeable.

In *Johnson*, the debtor, Mr. Johnson, was the actual contractor. Mr. Johnson, a sole proprietor,[61] personally entered into contracts for the construction of pole barns and personally received payment pursuant to those contracts. Mr. Johnson failed to pay fully a supplier, Carlisle Cashway, Inc., for materials used in the construction of the buildings.

Unlike Mr. Johnson, many if not most people in the building-construction business work for or own a corporation or LLC that conducts the business. Michigan case law holds that an officer or other agent of a corporate contractor who causes the corporation to violate the MBCFA can face both criminal and civil liability for the violation.[62] The Sixth Circuit, in an unpublished decision in *In re Kriegish*,[63] upheld the bankruptcy court and district court decisions that found the corporate officer's liability nondischargeable under 523(a)(4). However, there was no discussion of the issue arising from the fact that Mr. Kriegish was an officer of a contractor, but was not himself a contractor. Nor was there a finding that he was the "contractor" under the MBCFA. A number of lower courts have also considered the question of officer liability for violations of the MBCFA, but none of the reported decisions has discussed whether a corporate officer or other corporate agent qualifies as the "contractor," and therefore the trustee, under the MBCFA for purposes of section 523(a)(4).[64]

In recent unpublished decisions, bankruptcy judges Phillip J. Shefferly and Thomas J. Tucker, of the Eastern District of Michigan, have reached different conclusions as to whether the MBCFA satisfies the "express trust" requirement of section 523(a)(4) with respect to a corporate officer who did not, individually, enter into a construction contract. Judge Tucker granted a motion for dismissal of "defalcation while acting in a fiduciary capacity" claims under section 523(a)(4) for the reason that the MBCFA did not make the corporate officer the trustee of building contract funds.[65]

Judge Shefferly denied a similar motion, holding that because the courts have treated corporate officers found guilty of the misuse of building contract funds as though they were the "contractor," the application of the MBCFA to a corporate officer satisfies the express-trust requirement.[66] This holding is consistent with the unpublished opinion in *In re Kriegish*. But *Kriegish*, as noted above, contains no discussion of the issue.

Is the definition of "contractor" in the MBCFA broad enough to encompass not only a person who enters into a contract, but also a corporate officer? If so, which corporate officer or other corporate agent will be liable? Is the liability limited to the corporate officer who exercises sufficient (and inappropriate) control over the funds such that he or

Michigan case law holds that an officer or other agent of a corporate contractor who causes the corporation to violate the MBCFA can face both criminal and civil liability for the violation.

she can be said to have personally caused a misappropriation of the funds? Is this merely a broad definition of "contractor" under the MBCFA, or is it *ex maleficio* liability? If it is *ex maleficio* liability, *Davis* holds this to be insufficient to constitute a breach of a fiduciary duty for purposes of section 523(a)(4).

## Conclusion

In *Johnson*, the MBCFA was held to impose an express trust, so unless and until *Johnson* is overturned, the liability of a sole-proprietor contractor for a breach of trust under the MBCFA is not dischargeable. The question that remains to be explicitly addressed by the Sixth Circuit is whether a corporate officer of a corporate contractor is himself or herself the "contractor" and the trustee under an express trust.

Remaining issues for the U.S. Supreme Court are (1) whether a statute can impose "fiduciary capacity" obligations; and, if so, (2) what are the requirements for a statute to do so. Until those issues are considered, dischargeability of debts under the MBCFA and other federal and state "statutory trust" laws will be neither certain nor uniform.

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### NOTES

1. The cases are identified below. *See* notes 12 and 16. For a definition of "fraud" under 523(a)(4), see *In re Chavez*, 140 BR 413, 423 (Bankr WD Tex 1992). For a definition of "defalcation", see *In re Garver*, 116 F3d 176, 179 (6th Cir 1997) and *In re Millikan*, 188 Fed Appx 699, 701-702 (10th Cir 2006). Because defalcation under 523(a)(4) is a lesser standard, there is not a lot of discussion in the cases of the elements of fraud under 523(a)(4).
2. DeMarco, Robert T., *History of Bankruptcy,* http://www.bankruptcytx.com/bankruptcy-history.htm.
3. *Id. See also* Pomykala, Joseph, *Bankruptcy's Origins in Debtor Perpetrated Crime,* http://pages.townson.edu/jpomy/origins.pdf. The most thorough and useful works on 19th-century American bankruptcy are: Warren, Charles, *Bankruptcy in United States History* (Harvard Univ. Press, 1935) and Mann, Bruce H., *Republic of Debtors: Bankruptcy in the Age of American Independence* (Harvard Univ. Press, 2003).
4. *Central Va Comm College v Katz*, 546 US 356, 364 (2006).
5. US Const, Art. I, § 8. Bankruptcy Act of 1800, section 1, Ch 19, 2 Stat 19 (repealed 1803). The text of the 1800 Act is available on the Library of Congress Web site, http://memory.loc.gov/ammem/amlaw/lwsl.html. Search *Statutes at Large*, for Vol 2 (6th Congress, 1st Session).
6. 1800 Act, § 34.
7. *Pomykala, supra*, note 7.
8. 1800 Act, § 36. However, section 62 provided that nothing contained in the act impaired obligations for "money due to the United States or to any of them". Such obligations were outside of the category of dischargeable "debt". Thus, the original exception to discharge was actually for debts owing to the government.
9. Act of Dec 19, 1803, ch 6, 2 Stat 248.
10. Although states can enact bankruptcy laws, a state law cannot provide for a discharge of an obligation owing (as of the date of enactment) to a citizen of another state. *Brown v Smart*, 145 US 454, 457 (1892).
11. 1841 Act, 5 Stat 440, § 1, repealed by Act of March 3, 1843, Ch 82, 5 Stat 614.
12. The discharge under the 1841 Act was of all debts that were provable under the act. 1841 Act, § 4. Presumably, this did not include tax obligations. *US v Herron*, 87 US 251 (1873). *See also* Tabb, Charles J, "The Top Twenty Issues in the History of Consumer Bankruptcy", 2007 U Ill L R 9, 21-22 (2007). Section 2 provided that "nothing in this act shall be construed to annul, destroy, or impair any lawful rights of married women, or minors…which are not inconsistent with (other) provisions…of this act." In other words, support obligations were not discharged. Thus, the defalcation exception was actually one of the first three exceptions to discharge.
13. 1841 Act, § 1. This wording is not clear because it is phrased in the form of eligibility to be a bankrupt under the act, not an exception to discharge. But the courts construed it as an exception to discharge. See note 14.
14. 43 US 202 (1844).
15. *Id.* at 208.
16. *DeMarco, supra* at 8.
17. *US v Kras*, 409 US 434, 446-448 (1973).
18. Act of Mar 2, 1867, Ch 176, 14 Stat 517, *amended by* Act of June 22, 1874, Ch 390, 18 Stat 178, *repealed by* Act of June 7, 1878, Ch 170, 20 Stat 99.
19. Flaherty, Jane, review of *The Reconstruction of Southern Debt: Bankruptcy After the Civil War* by Elizabeth Lee Thompson. www.h-net.org.
20. *Hennequin v Clews*, 111 US 676 (1884).
21. *Id.* at 683-684.
22. 293 US 328 (1934).
23. *Id.* at 330.
24. *Id.* at 333.
25. *Id.* at 333-34.
26. *In re Heilman*, 241 BR 137, 152 (Bankr ED Md 1999).
27. *In re Turner*, 134 BR 646, 655 (Bankr ND Okla 1991) (contains insightful analysis of the 19th century cases and legislation).
28. *Quaif v Johnson*, 4 F3d 950, 953 (11th Cir 1993).
29. 7 USC 499 *et seq*.
30. 7 USC 181 *et seq*.
31. USC 1001 *et seq*.
32. *Heilman, supra* at 153 (cataloging cases). Federal income taxes withheld from employee wages are also held in trust by the employer. 26 USC 7501. However, the imposition and the discharge of "responsible personal liability" is governed by specific provisions of the Internal Revenue Code and Bankruptcy Code. *See* 26 USC 6672 and 11 USC 523(a)(1). Therefore, 523(a)(4) is not called into play with respect to personal liability for withheld taxes.
33. 493 F3d 635 (6th Cir 2007) (discussing only employer contributions; the issue of "withheld" employee contributions was not examined on appeal).
34. *Hunter v Philpott*, 373 F3d 873 (8th Cir 2004).
35. *In re Duncan*, 331 BR 70 (Bankr EDNY 2005).
36. Compare *In re Nix*, 1992 WL 119143 (MD Ga 1992) (PACA liability of corporate officer non-dischargeable) with *In re McCue*, 324 BR 389 (Bankr

MD Fla 2005). *See also Nuchief Sales, Inc v Harper*, 150 BR 416, 418-19 (Bankr ED Tenn 1993); *In re Stout*, 123 BR 412 (Bankr WD Okla 1990); *In re Snyder*, 171 BR 532 (Bankr D Md 1994).

37. *See In re Blasczak*, 397 F3d 386 (6th Cir 2005).

38. *See Heilman*, 241 BR at 155, n 14 (comprehensive listing) and 15 ALR Fed 337 (outlining issue by industry). As to partners, see *In re Kraus*, 37 BR 126 (Bankr ED Mich 1984) (holding that Michigan Uniform Partnership Act, MCL 449.21, creates an express trust).

39. *See In re Millikan, supra*.

40. An overview of this type of legislation can be found in 3 Bruner & O'Connor, Construction Law § 8:41.

41. MCL 570.151. Note that proposed revisions to the MBCFA are under discussion.

42. *Davis* used the term "technical trust" instead of the term "express trust", but the terms are synonymous.

43. 691 F2d 249 (6th Cir 1982).

44. *Id.* at 251.

45. *Id.* at 252-253. Query whether the MBCFA "unambiguously" imposes a trustee-beneficiary relationship. The definition of "building construction" and "building contract" is subject to varying interpretations. *See, e.g., In re Skilled Trades*, 1 BR 396 (Bankr WD Mich 1979) and *In re Yacos*, 370 BR 131 (Bankr ED Mich 2007). As discussed below, there is room for disagreement as to who is the "contractor" in a case not involving a sole proprietor. *See also In re Hunt*, 352 BR 579 (Bankr WD Mich 2006) (manufacturer of modular homes not engaged in "building construction").

46. Dischargeability claims based upon the MBCFA might also be brought under 523(a)(2) (false pretenses, fraud), 523(a)(4) (embezzlement, larceny), 523(a)(6) (willful and malicious injury), or 523(a)(7) (state criminal restitution). Those other theories are beyond the scope of this article.

47. *In re Marchiando*, 13 F3d 1111, 1115 (7th Cir 1994).

48. 241 BR 137 (Bankr D Md 1999).

49. *Id.* at 161 (citing § 159, Trusts, 76 Am Jur 2d 191 (1992)). *Accord, In re Marchiando*, 13 F3d 1111 (7th Cir 1994) (state lottery sales agent law determined not to create 523(a)(4) fiduciary duty; decision based on analysis of the "knowledge" and "power" of the parties to the transaction).

50. *In re Turner*, 134 BR 646, 654 (Bankr ND Okla. 1991); *In re Holmes*, 117 BR 848 (Bankr D Md 1990); *In re Angelle*, 610 F2d 1335, 1340 (5th Cir 1980). But many courts have not drawn a distinction between statutory trusts and express or technical trusts. *In re Ardolino,* 298 BR 541, 546 (Bankr WD Pa 2003); *In re Librandi*, 183 BR 379, 382 (MD Pa 1995). *Johnson* is an example of cases which hold or assume that a statute can impose an express trust.

51. *In re Morris Ketchum, Jr. and Assoc*, 409 F Supp 743, 746 (SDNY 1975); McKinney's Lien Law § 75.

52. MCL 570.152.

53. 138 US 365 (1890).

54. *Id.* at 375.

55. "The only writing at all suggestive of a trust is the one characterized as a trust receipt." *Davis* at 334. Note that the trust receipt was a device replaced with the security agreement upon the adoption of the Uniform Commercial Code.

56. 151 F3d 339 (5th Cir 1998).

57. 819 F2d 583, 588-89 (5th Cir 1987).

58. 324 BR 389 (Bankr MD Fla 2005).

59. 691 F2d at 253.

60. *Id.* (citations omitted).

61. *Id.* at 258 (discussion in dissent of bankruptcy judge's findings).

62. *See, e.g., People v Brown*, 239 Mich App 735, 610 NW2d 234, 239 (2000); *Joy Mgt Co v Detroit,* 138 Mich App 334, 340, 455 NW2d 55 (1990).

63. 97 Fed Appx 4 (2004).

64. In cases such as *In re Englund*, 20 BR 957 (Bankr ED Mich 1982); *In re Little*, 163 BR 497 (Bankr ED Mich 1994); and *In re Collins*, 266 BR 123 (ND Ohio 2000), the issue was not reached because the debtor was a sole proprietor, personally entered into the contract, and personally received payment. In other cases such as *In re Crane*, 154 BR 60 (Bankr ED Mich 1993); *In re Hickey*, 1999 WL 33313133 (ED Mich 1999); and *In re Kriegish*, 275 BR 839 (ED Mich 2002), there was no distinction made between the debtor and the business entity which had entered into the contract. In the first group of cases, the question was not reached. In the second group of cases, it was not addressed.

65. *Franzone v Ernst*, 06-4803 (unpublished bench opinion, Bankr ED Mich, Sept 25, 2006).

66. *Conquest Construction Co v Cicero*, 06-4852 (Opinion Denying Defendant's Motion for Reconsideration, etc., unpublished, Bankr ED Mich, Nov 30, 2006).

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# *503(b)(9) Claimants – The New Constituent, A.K.A. "the 500 Pound Gorilla," At the Table*[1]

By Judith Greenstone Miller and Jay L. Welford*

## Introduction

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)[2] established a new administrative priority claim under Section 503(b)(9) of the Bankruptcy Code,[3] (Code) for those creditors that provide goods to a debtor in the ordinary course of business within 20 days prior to the commencement of the case. The legislative history surrounding this section is scant, but presumably, Congress was concerned about providing a vehicle to enhance payment to creditors that shipped goods to a debtor in the ordinary course of business on the eve of bankruptcy. According to *Collier on Bankruptcy*:

> The ostensible reason for according administrative priority to such obligations was to prevent debtors from acquiring goods at a time where the debtor knew that bankruptcy was imminent and that the debtor would not be able to pay for such goods.[4]

Collier goes on to state that the provision, while well intentioned, provides unequal treatment to similarly situated creditors:

> The addition of this provision represents a dramatic departure from bankruptcy precedent. It is also likely to lead to disparate treatment of otherwise similarly situated creditors since vendors of goods will be treated differently than other creditors providing value to the debtor during the 20-day period preceding the filing of the case.[5]

Apart from this dichotomy in treatment, in enacting this provision, Congress failed to take into consideration other ramifications that this section would have on the bankruptcy process.

The adoption of this provision, in essence, has created a new constituent at the bargaining table—the Section 503(b)(9) claimants. The first days of a Chapter 11 case were already difficult and complicated enough for a debtor, in terms of obtaining financing and approval to use cash collateral and maintaining the flow of goods and services. Now, that process has been further complicated and exacerbated by the creation of this new class of creditor. Issues such as (1) who is entitled to assert a 503(b)(9) claim; (2) how and when is the claim asserted; (3) may 503(b)(9) claimants compel immediate payment of their claims; (4) what defenses may be asserted against payment of such claims; (5) whether an unsecured creditors' committee should align itself with the interests of the 503(b)(9) claimants; and (6) whether the U.S. Trustee can be compelled to form a 503(b)(9) committee, are but a few of the many questions that are now being raised, addressed, and analyzed in Chapter 11 cases.

## What Is a 503(b)(9) Claim?

The time for making a reclamation demand under Section 546(c) of the Code has been expanded under BAPCPA from 10 days to 45 days *if* the debtor received goods from a creditor while insolvent. A written request must be made to the debtor identifying the goods subject to reclamation within 45 days after the date of receipt of such goods. Alternatively, if such time period expires after the petition is filed, then the request must be made no later than 20 days after the petition date. Notwithstanding a creditor's failure to make a written demand for reclamation, Section 546(c)(2) nonetheless entitles the creditor to seek allowance of an administrative expense claim for a portion of goods delivered to a debtor during the 20 days preceding the filing of the debtor's bankruptcy petition under Section 503(b)(9).

Section 503(b)(9) provides:

> (b) After notice and a hearing, there shall be allowed administrative expense, other than claims allowed

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> under section 502(f) of this title, including –
>
> > (9) the value of any goods received by the debtor within 20 days before the date of mencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.[6]

By its express terms, Section 503(b)(9) only applies to "goods" (not "services") provided to a debtor within 20 days prior to the commencement of the case. "Goods" is not defined in Section 503(b)(9) and, thus, what is ultimately determined to be "goods" may be subject to litigation. For example: is a part or tooling that has been significantly altered by a creditor a "good" or "service" when it is provided to the debtor? Courts may look to the definition of "goods" contained in Article 9 of the Uniform Commercial Code (UCC) for purposes of defining what falls within the scope of Section 503(b)(9).[7] Query, whether the manner in which the invoice refers to what was shipped to the debtor impacts whether the item for which 503(b)(9) treatment is being sought will be accorded that classification? While the writing on the invoice may be a starting point for the analysis and evidence of the parties' intent, nevertheless, it is likely to be subject to rebuttal and contested by other parties-in-interest.

Section 503(b)(9) does not specifically provide that the goods shipped by the creditor must remain unpaid to qualify for treatment under Section 503(b)(9); to hold otherwise would create a windfall for the creditor. This section also does not delineate how the claim is to be calculated. Presumably, the invoice price of the goods (exclusive of interest, freight, or other charges) would be the applicable amount in valuing the claim, so long as it represents the price that was ordinarily used between the parties.

Moreover, early case law interpreting Section 503(b)(9) has held that all claims, whether secured or unsecured, arising from 20 day sales are entitled to administrative priority based upon the plain language of Section 503(b)(9).[8]

## How and When Does One Assert a 503(b)(9) Claim?

Early in bankruptcy cases, the courts establish a bar date for the filing of unsecured claims. These notices, however, typically do not establish bar dates for the filing of administrative claims. Moreover, it is well settled that an administrative claimant, if it feels its claim is going unpaid, must file a motion with the court for allowance and payment of its claim. There is no current Code or Bankruptcy Rule that provides for the assertion of administrative claims through the proof of claim process.

Most debtors are fully aware of their traditional administrative obligations, as those obligations are incurred voluntarily by a debtor post-petition. Section 503(b)(9) claims are different, in that they are a subset of a debtor's pre-petition unsecured debt and must be asserted in order to be elevated to be accorded administrative priority. If a debtor does not know the extent and nature of such claims, it makes it very difficult for a debtor to propose a plan that satisfies the confirmation requirement that administrative claims be paid in full.[9]

To address these concerns, some courts are enacting local rules to create bar dates for the filing of Section 503(b)(9) administrative claims. For example, Local Bankruptcy Rule 3002-1, United States Bankruptcy Court for the District of Massachusetts, requires that creditors asserting administrative expense claims pursuant to Section 503(b)(9) must file them in writing with the court within 60 days of the first date set for the meeting of creditors pursuant to Section 341, unless the court orders otherwise. If a creditor fails to file such a request within this specified period, the creditor will lose the right to assert administrative expense treatment for such claim. Other courts are establishing bar dates for the submission of administrative expense claims as part of the initial scheduling order in a case.[10] Another option is for a debtor to seek to establish a bar date by motion or, alternatively, to provide a bar date and mechanism for asserting such claims as part of a plan. Creditors having such claims must carefully read the notices they receive to ensure that they timely and properly follow the procedures for asserting 503(b)(9) claims. Otherwise, they risk losing the right to assert such claims.[11]

## Can a 503(b)(9) Claimant Compel Immediate Payment?

As stated above, generally, an administrative claim is asserted by the filing of a motion seeking allowance and, sometimes, immediate payment of the claim unless the local rules or a scheduling order provide other-

By its express terms, Section 503(b)(9) only applies to "goods" (not "services") provided to a debtor within 20 days prior to the commencement of the case.

[I]n some recent cases, 503(b)(9) claimants have filed motions early in the case, well before any plan has been filed, seeking immediate payment of their claims.

wise. While Section 503(b) provides that an administrative creditor may request payment of its claim, it does not provide any specific mechanism regarding when such a claim must be paid. Prior to the adoption of Section 503(b)(9), the courts generally held that the timing for payment of an administrative expense claim was left to the sound discretion of the court.[12] However, Section 1129(a)(9)(A) of the Code sets an outside date for payment of administrative expense claims, requiring that they be paid in cash, in an amount equal to the allowed amount of such claim, on the effective date of any plan of reorganization, unless creditors agree to different treatment.

Nevertheless, in some recent cases, 503(b)(9) claimants have filed motions early in the case, well before any plan has been filed, seeking immediate payment of their claims.[13] In all of these cases, the claimants expressed concern that if they were not paid immediately, in *pari passu* with the other ordinary course post-petition expenses, there might not be sufficient funds at the end of the case to pay them in full. Claimants have also argued that immediate payment is required because: (1) the goods they provided were being used by the debtor and were necessary and essential to the debtor's ability to continue its business operations; (2) by paying other post-petition trade creditors, the debtor was treating similar claims differently, i.e., an "equal protection" argument; and (3) the debtor had sufficient cash to pay such claims. Despite these concerns, in each of the recent cases, the courts denied requests for immediate payment of the 503(b)(9) claims because: (1) there was no statutory requirement that compelled immediate payment; and (2) payment of such claims would interfere with the debtor's cash flow and business operations. In neither of these cases, however, did the court make a finding of administrative insolvency.

According to Judge Frank in the *Bookbinders' Restaurant* case:

> There is nothing in the language of § 503(b)(9) to support Blue Crab's suggestion that it is entitled to immediate payment of its allowed expense in derogation of the accepted principle that the timing of payment of an allowed administrative expense is within the court's discretion. Section 503(b)(9) does nothing more than define a type of liability, previously treated as a prepetition claim, which is now accorded administrative expense status. The text of § 503(b)(9) neither states nor even implies that allowance of the expense encompasses an unqualified right to immediate payment. Nor does the text of the provision suggest that an administrative expense allowed under § 503(b)(9) is to be treated in a more favorable manner than any other allowed § 503(b) administrative expense.[14]

Moreover, the court indicated that it was not aware of the existence of any legislative history that supported the claimant's argument for immediate payment.[15] The court did recognize, however, that "there may be circumstances in which it would be inequitable or inappropriate to permit a debtor to pay certain administrative expenses but not others."[16]

While not yet fully articulated in these cases, there seems to be a difference between requiring a debtor to promptly pay for post-petition goods and services it receives post-petition and requiring immediate payment for goods provided pre-petition for which the Code has now created an administrative priority. The court in the *Bookbinders' Restaurant* case suggests that part of the statutory basis justifying the disparate treatment accorded creditors that supply goods post-petition, versus those entitled to Section 503(b)(9) priority, is Section 363(c)(1). The court noted that those creditors that are providing goods post-petition are being paid for such goods pursuant to Section 363(c)(1), not Section 503(b)(1), and thus, "the expenses are being paid without the formality of court allowance under § 503(b)."[17]

Finally, the court in *Bookbinders' Restaurant* rejected the notion that 503(b)(9) claimants be paid immediately on the basis of landlords having such a right under Section 365(d)(3). Neither the text of the various statutory provisions nor the legislative history supported immediate payment on this basis. According to the court: "…[H]ad Congress intended to provide § 503(b)(9) claimants with some type of enhanced right to payment after allowance of the expense, I am convinced that it would have made its intent express in the statute and it has not done so."[18] Moreover, legislative policy associated with the enactment of this provision would not trump the otherwise clear and unambiguous language on the basis of rules of statutory construction.

The court in *In re Global Home Prods., LLC*[19] was equally unpersuaded that 503(b)(9) claimants receive immediate payment of their claims. In denying the requested relief, the court indicated that the primary factor considered by the court is an orderly and equal distribution among creditors and preventing a race to the debtor's assets. As such, according to the court:

> Distributions to administrative creditors are generally disallowed prior to confirmation if there is a showing that the bankruptcy estate may not be able to pay all of the administrative expenses in full. Courts will also consider the particular needs of each administrative claimant and the length and expense of the case's administration.[20]

Moreover, the court indicated that absent demonstrating a necessity to pay, as opposed to the ability of the debtor to pay, an administrative claimant is not entitled to the exceptional remedy of immediate payment.[21]

Ultimately, in denying immediate payment to the 503(b)(9) claimant, the *Global Home Products* Court relied on the 3-prong test articulated in *In re Garden Ridge Corp.*,[22] to wit: (i) the prejudice to the debtors; (ii) hardship to the claimant; and (iii) potential detriment to other creditors. In applying each of these factors, Judge Gross denied the relief sought. First, the claimant had not submitted any evidence of hardship other than its self-serving conclusory statements. Moreover, according to the debtors, there was no evidence that failure to pay this claim would put the claimant out of business—thus, in essence, attempting to analogize the 503(b)(9) claimant to a critical vendor. Second, the debtors presented testimony that they would suffer substantial hardship in their reorganization effort if immediate payment was required. In balancing the relative hardships to the parties, the Court had little difficulty in finding that the balance tipped in favor of the debtors. Clearly, the bar for 503(b)(9) claimants establishing a right to immediate payment has been set very high.

In *In re Fashion Shop of Kentucky*, a 503(b)(9) creditor objected to the payment to the debtor's financial advisors prior to the payment of its own 503(b)(9) administrative expense claim. The court approved the financial advisor's fee application over the creditor's objection based upon Section 331. It found that because Section 331 permits a professional employed under Section 327 to apply for interim compensation every 120 days, a right not afforded to Section 503(b)(9) claimants, the debtor's financial advisor was entitled to interim compensation pursuant to Section 331.

While Section 503(b)(9) appears to enhance the position of the creditor that has provided goods to the debtor within the 20 days prior to the commencement of the case, the actual benefit to be derived by the creditor may be illusory, at best. If the creditor is unable to compel immediate payment of its 503(b)(9) claim and the case is subsequently rendered administratively insolvent, it is unlikely that the creditor will receive payment on its claim. Moreover, there is no requirement that the lender fund the payment of such claims. If the administrative claimants are unwilling to accept less than full payment on their claims at confirmation, the debtor will not be able to propose and confirm a plan.

When faced with an administratively insolvent case, 503(b)(9) claimants may have as their only viable option to trigger payment of their administrative claims the filing of a motion to dismiss or convert the case under Section 1112 of the Code. Nevertheless, obtaining dismissal or conversion is not likely to result in payment of such claims *unless* there is some benefit to be achieved by liquidating the case through Chapter 11. If such circumstances exist, then dismissal or conversion may provide 503(b)(9) claimants with the ability to leverage their position to compel payment of their claims in the early stages of the case.

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## Is the Return of All Preferential Payments a Prerequisite to Allowance and Payment of a 503(b)(9) Claim?

Questions have been raised whether allowance and payment of an administrative expense claim asserted under Section 503(b)(9) of the Code may be defeated based on the creditor having received and failed to return preferential payments made by a debtor within the 90 days prior to the filing of the petition. Section 502(d) of the Code generally requires the return of all preferential transfers as a prerequisite to claim allowance. It provides:

> (d) Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of an entity from which property is recoverable under

> Section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under Section 522(f), 522(h), 544, 545, 547, 548, 549 or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity, or transferee is liable under Section 522(i), 542, 543, 550 or 553 of this title.[23]

According to Collier's:

> Section 502(d) of the Bankruptcy Code requires disallowance of a claim of a transferee of a voidable transfer *in toto* if the transferee has not paid the amount or turned over the property received as required under the sections under which the transferee's liability arises. . . . Once the liability of the transferee has been determined, the claim interposed by the transferee will be disallowed unless such transferee gives effect to the judgment flowing from the exercise of the powers described above.[24]

Moreover, "[t]he legislative history and policy behind Section 502(d) illustrates that the section is intended to have the coercive effect of ensuring compliance with judicial orders."[25] Thus, creditors who have received a voidable transfer, irrespective of whether they have filed a proof of claim, will not be able to participate in a distribution from the estate until the improperly transferred property is surrendered to the estate.[26]

However, there is a split of authority in the cases over whether an administrative claim (as opposed to an unsecured claim) is subject to Section 502(d). No court, however, has considered the issue to date in the context of a Section 503(b)(9) claim.[27]

Moreover, in some cases it has been argued that if a creditor is granted and paid an allowed administrative expense claim, the amount paid should not be able to be used as "new value" in defending a subsequent preference action. To allow otherwise would, in essence, be giving the creditor a windfall.[28]

## Does the Committee Represent the Interests of § 503(b)(9) Claimants As Part of Its Constituency and Fiduciary Obligations?

### *In General*

Prior to the enactment of BAPCPA, a committee was generally homogeneous and was comprised only of creditors holding unsecured claims. As such, their goal of maximizing the value of the assets and securing the greatest return for the unsecured creditors as a whole was relatively easy to address and achieve among the members of the committee. However, with the adoption of Section 503(b)(9), a committee is often comprised of two types of creditors—those solely with unsecured claims and those with both unsecured and Section 503(b)(9) claims. Moreover, oftentimes, the 503(b)(9) claimants constitute a significant majority of the committee. As a result, the goals of the various members are not necessarily consistent and aligned. This has often prompted questions regarding whom the committee represents and what responsibilities and actions the committee must take to fulfill and satisfy its fiduciary duties. For example, should a committee actively seek to limit the amount of 503(b)(9) claims, as it would with any type of administrative claim, to maximize the possible return to unsecured creditors? The issue becomes particularly focused when, as often is the case, there are insufficient assets to pay both groups of creditors in full.

Section 1102(b)(1) of the Code directs the U.S. Trustee to appoint a committee of creditors consisting of persons willing to serve, holding the seven largest claims against the debtor, and who are representative of the different kinds of claims to be presented. The duties of the committee are set forth in Section 1103 of the Code and include, among other things, consulting with the debtor about the administration of the case, investigating the acts, conduct, assets, liabilities and financial condition of the debtor and its operations, and the desirability of continuing such business and participating in the formulation of a plan.[29] Overlaying these specific statutory duties is the general duty of the committee to maximize the value of the assets for the benefit of the unsecured creditors of the estate.

However, with the adoption of Section 503(b)(9), a committee is often comprised of two types of creditors—those solely with unsecured claims and those with both unsecured and Section 503(b)(9) claims.

***To Whom Does a Committee Owe a Fiduciary Duty?***

Generally, the case law requires a committee to act in the best interest of its constituency – i.e., the unsecured creditors—and to pursue that fiduciary duty. The clearest statement of the rule is:

> In general, the purpose of such committees is to represent the interests of unsecured creditors and to strive to maximize the bankruptcy dividend paid to the class of creditors.[30]

The duty is to maximize the return to the entire class, not for particular segments of that class. According to the Court in *In re Tucker Freight Lines, Inc*:

> The Bankruptcy Code contemplates a significant and central role for committees in the scheme of a business reorganization. Official committees appointed under § 1102 are empowered under § 1003(c)(3) to participate in the formulation of a plan, [and] advise those represented by such committee of such committee's determinations as to any plan formulated…. While there is "implied in this grant of authority….a fiduciary duty" to committee constituents, there is at the same time "an implicit grant of limited immunity."[31]

The duty extends to the class as a whole, not to individual members. As the court indicated:

> Counsel for the…committee do not represent any individual creditor's interest in [a] case; they were retained to represent the entire….class. Therefore, counsel for the creditors' committee do not owe a duty to [one creditor] to maximize its interest at the expense of the remaining creditors in the represented class.[32]

The principle that a committee owes a duty to all and only all of the general unsecured creditors is implicitly recognized in varying contexts. Thus, a committee member will be removed if his efforts to establish his own individual rights may result in a lesser distribution to the unsecured creditor class as a whole.

> Members of the Committee also have another duty – a fiduciary duty to all creditors represented by the committee…. If [the committee member] is successful in the trust fund litigation it would have a substantial negative impact on the prospects of a distribution to unsecured creditors in these bankruptcy cases…. [Its] aggressive efforts to establish its secured status could seriously undermine the Committee's effort on behalf of the unsecured creditors…. [33]

Moreover, the courts assume that the committee's duty is to maximize the recovery for the class as a whole and not to any individual members, or group of members, of the class.

> In the case of reorganization committees, these fiduciary duties are crucial because of the importance of committees. Reorganization committees are the primary negotiating bodies for the plan of reorganization. They represent those classes of creditors from which they are selected. They also provide supervision of the debtor and execute an oversight function in protecting their constituent's interests.[34]

Based on the foregoing, one can certainly make the argument that a committee's duties extend to its unsecured constituents only. Thus, any support for allowance or payment of higher priority administrative claims would be in direct conflict with the committee's fiduciary duties, even if a subset of its constituents may benefit from such claim allowance and payment. The analysis is similar to a committee's stance on allowance and payment of reclamation claims that would diminish the overall return to unsecured creditors.

***If Section 503(b)(9) Claimants' Interests Are Not Represented By the Unsecured Creditors' Committee, Do the Section 503(b)(9) Claimants Have the Right to Form Their Own Committee?***

Recognizing that 503(b)(9) claimants are required to generally act individually and not as part of an organized group in seeking allowance and payment of their claims: should 503(b)(9) claimants be entitled to their own committee to pursue payment of their claims on a collective basis? In some instances, 503(b)(9) claimants are attempting to formally organize, requesting the U.S. Trustee to appoint a 503(b)(9) committee.[35]

While 503(b)(9) committees are not specifically provided for under the Code, the U.S. Trustee has discretion to appoint such a com-

[T]he courts assume that the committee's duty is to maximize the recovery for the class as a whole and not to any individual members, or group of members, of the class.

mittee. Section 1102(a)(1) of the Code permits appointment of "such additional committees of creditors…as the United States trustee deems appropriate."[36] Having a formal committee of 503(b)(9) claimants may make it easier to negotiate and resolve the allowance and immediate payment claims of such creditors. On the other hand, authorizing such a committee will increase the administrative fees and costs of a Chapter 11—a committee formed under the auspices of Section 1102 has the right to hire counsel and other professionals whose fees are paid by the estate. Absent formation of a committee, the costs and expenses for pursuing payment of such claims would fall on each of the individual 503(b)(9) claimants. In most cases, resources available to debtors to fund such expenses are scarce at best. Moreover, lenders are reluctant or unwilling to carve out additional funds for payment of another layer of professional fees. Furthermore, these claimants are more likely to be able to protect themselves without the necessity of a committee. Thus, it is unlikely that the U.S. Trustee will appoint a committee solely for 503(b)(9) claimants.

[I]t is unlikely that the U.S. Trustee will appoint a committee solely for 503(b)(9) claimants.

***Does a Committee Violate Its Fiduciary Duties By Negotiating for a Carve Out for Payment of General Unsecured Claims, or Does It Have a Duty to Ensure That the Bankruptcy Code's "Waterfall Priority Scheme" Is Fully Respected?***

It is becoming more common for committees to seek to carve-out from the secured creditors' collateral an assigned dividend for the benefit of unsecured creditors. By utilizing the carve-out mechanism, a committee is necessarily seeking to bypass other higher priority creditor classes who would otherwise take first from a debtor's assets under the waterfall priority scheme set forth in the Code. Because 503(b)(9) claimants are usually present on a committee in their dual creditor status role, such creditors are privy to discussions by a committee regarding carve-out strategies. Whether such committee members must recuse themselves or be excused from such discussions is certainly not well settled, let alone addressed in the case law.

The 503(b)(9) claimants often suggest that the committee is required to get the best deal that it can for the creditors as a whole. On the other hand, each dollar that goes to pay a 503(b)(9)-allowed claim takes funds away from the general unsecured creditor pool. Is the committee required to negotiate a carve-out for the benefit of the estate as a whole (at least inclusive of 503(b)(9) claims) or merely for the payment of unsecured claims? Put another way, is the committee required to ensure that the Chapter 11 process is being used for the purposes consistent with the Code?

First, it would appear that a committee would not be deemed to have violated its fiduciary duties if it adopts a position supportive of the Code's requirements generally. In *In re Cent Med. Ctr, Inc*,[37] the committee objected to certain provisions of a plan. In addition, an opposing party argued that since the objection did not run directly to the benefit of the unsecured creditors, but instead addressed other plan terms that violated the Bankruptcy Code, the committee should be deemed to have overstepped its bounds, and its objection should be ignored. The court disagreed and permitted the committee to pursue its objections, stating:

> Finally, this Court believes that as part of upholding its fiduciary responsibilities to its constituents, a committee has both a duty and an obligation to raise objections to any provision of a plan it deems violative of Section 1129(a) [of the Code]. For example, an individual class constituent may ratify the economic treatment it receives under a given plan of reorganization. However, the plan may violate one of the subsections of Section 1129(a). This Court believes that in such a case, a committee has a duty to object to the Plan. Thus, for these three reasons this Court concludes that the Committee has standing to raise its objections to Proponents' Plan pursuant to Section 1129(a).[38]

Alternatively, at least one court has held that a committee would not be deemed to have violated its fiduciary duties if it negotiates for a carve-out solely for the benefit of the general unsecured creditors. The question of carve outs and "gifting" by a secured creditor was addressed by the court in *Official Unsecured Creditors' Committee v Stern*.[39] In that case, the court held generally that an under-secured lender with a conclusively determined and uncontested "perfected, first security interest" in all of a debtor's assets may through a settlement, "share" or "gift" some of those proceeds to junior, general unsecured creditors, even though priority unsecured creditors (i.e., taxing authorities) will

go unpaid. In response to the argument by certain priority unsecured creditors that the committee breached its fiduciary duties by carving out a distribution only for the general unsecured creditors, the court stated:

> The Code expressly authorizes a committee to "perform such other services as are in the interest of those represented." 11 USC 1103(c)(5). Appellees also concede that the Committee's appointment, pursuant to 11 USC 1102(a) charged it only with representation of the general, unsecured creditors (not with representation of the I.R.S. or other priority creditors). Nevertheless, they contend, any agreement negotiated by the Committee should have been negotiated to benefit the estate as a whole and thus any contractual right to receive payment from Citizens rightfully belongs to them….
>
> We do not accept this contention, as it seems based on the erroneous assumption that the Official Unsecured Creditors' Committee is a fiduciary for the estate as a whole. While a creditors' committee and its members must act in accordance with the provisions of the Bankruptcy Code and with proper regard for the bankruptcy court; the committee is a fiduciary for those whom it represents, not for the debtor or the estate generally. *In re Microboard Processing, Inc.*, 95 BR 283, 285 (Bankr D Conn 1989). Thus the committee's fiduciary duty, as such, runs to the parties or class it represents. *Markey v. Orr*, 1990 WL 483808 at *4 (WD Mich 1990). *It is charged with pursuing whatever lawful course best serves the interests of the class of creditors represented. In this case, the Committee reasonably determined that entering into the Agreement with Citizens was in the best interests of the class it represented.*[40]

The *SPM* decision, while known for its groundbreaking approval of "gifting" by secured creditors to lower class creditors, is equally groundbreaking in its approval of a committee's actions, which were expressly detrimental to an assumed subset of its constituency, priority unsecured creditors, in favor of another subset of its constituency, general unsecured creditors. While the *SPM* decision appears to be one of the few decisions, to date, to ratify this departure from a general fiduciary duty concept, the holding in *SPM* seems equally applicable to a committee's efforts to extract a benefit for general unsecured creditors to the detriment of 503(b)(9) claimants. Whether that analogy will hold true in other courts has yet to be seen.

## Conclusion

It is unlikely that Congress envisioned that all of these ancillary issues would arise from the creation of a new administrative class of creditors. Unfortunately, because BAPCPA is relatively new, there is little case law to provide guidance on how to deal with these issues. Hopefully, over time, as more of these issues reach the courts, creditors will be provided with more guidance and better benchmarks for addressing and dealing with the 503(b)(9) claimants—the new constituent, a.k.a. the "500 Pound Gorilla," at the table.

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**NOTES**

1. Previously published at 5 *DePaul Bus & Com Law Journal* 487 (Spring 2007).
2. Pub L No 109-8 (2005) (effective in cases commenced on or after Oct. 17, 2005).
3. 11 USC 101, *et seq*.
4. King, *Collier's on Bankruptcy* ¶ 503.16[1] at 503-79 (15th ed rev).
5. *Id.* at 503-79 and 503-80.
6. 11 USC 503(b)(9).
7. Collier's on Bankruptcy ¶ 503.16[1] at 503-79-80. *See also* UCC 9-102(44). Section 9-102(44) defines "goods" as:

   . . . all things that are movable when a security interest attaches. The term includes (i) fixtures, (ii) standing timber that is to be cut and removed under a conveyance or contract for sale, (iii) the unborn young of animals, (iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and (v) manufactured homes. The term also includes a computer program embedded in goods and any supporting information provided in connection with a transaction relating to the program if (i) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or (ii) by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods. The term does not include a computer program embedded in goods that consists solely of the medium in which the program is embedded. The term also does not include accounts, chattel paper, commercial tort claims, deposit accounts, documents, general intangibles, instruments, investment property, letter-of-credit rights, letters of credit, money, or oil, gas, or other minerals before extraction.
8. *Brown & Cole Stores, LLC v Associated Grocers, Inc (In re Brown & Cole Stores, LLC)*, 2007 WL 2701283 (CA 9, August 17, 2007).
9. *See, e.g.*, 11 USC 1129(a)(9)(A).

10. *See In re Ward Prod, LLC*, Case No. 06-50527 (TJT) (Bankr ED Mich 2006) (in this scheduling order, in addition to setting a bar date, the Court clarified that the filing of a proof of claim, as opposed to a motion, would be sufficient for asserting an administrative claim).

11. For example, in *In re Dana Corp*, the Court denied a creditor's request for enlargement of time pursuant to Federal Rule of Bankruptcy Procedure 9006(b) to file claims for the sale of goods delivered during the 20-day period immediately preceding the bankruptcy filing after it missed the expiration of a bar date that was set in the Court's procedures order. The Court held that the strict bar date was intended to facilitate the equitable and orderly intake of claims and to enable the Debtors to understand the universe of liabilities in connection with plan negotiations and formation. *In re Dana Corp*, 2007 WL 1577763 (Bankr SDNY May 30, 2007).

12. *In re Photo Promotion Assocs, Inc*, 881 F2d 6, 9 (CA 2, 1989).

13. *See, e.g.*, *In re Bookbinders' Rest, Inc*, 2006 WL 3858020 (Bankr ED Pa 2006); *In re Global Homes, Inc,* 2006 Bankr LEXIS 3608 (Bankr D Del 2006); and *In re Fashion Shop of Kentucky, Inc*, 265 BR 283 (Bankr WD Ky March 14, 2007). In each of these cases, the courts denied the creditors' requests for immediate payment.

14. *In re Bookbinders' Rest, Inc*, 2006 WL 3858020 at *4.

15. *Id.* at *4 n 14.

16. *Id.* at *5.

17. *Id.*

18. *Id.* at *6.

19. 2006 Bankr LEXIS 3608 (Bankr D Del 2006).

20. *Id.* at *11 (citing *In re HQ Global Holdings, Inc*, 282 BR 169 (Bankr D Del 2002) (citations omitted).

21. *Id.* (citing *In re Cont'l Airlines, Inc.*, 146 BR 520, 531 (Bankr D Del 1992), *In re Ionosphere Clubs, Inc.*, 98 BR, 174, 179 (Bankr SDNY 1989); Resnick, The Future of Chapter 11: A Symposium Cosponsored by the American College of Bankruptcy: The Future of the Doctrine of Necessity and Critical Vendor Payments in Chapter 11 Cases, 47 BCL Rev 183, 205 (2005) ("Section 503(b)(9) 'is a rule of priority, rather than payment.' The new section does not specify when payment will be made. 'Arguably, prepetition vendor claims are never payable in the ordinary course of business because of the intervening bankruptcy and the automatic stay, even if afforded administrative expense priority.'")).

22. 323 BR 136, 143 (Bankr D Del 2005)

23. 11 USC 502(d).

24. Collier's on Bankruptcy ¶ 502.05[1] at 502-56 and 502-57.

25. *In re Davis*, 889 F2d 658, 661 (5th Cir 1989), cert. denied, 495 US 933 (1990).

26. Collier's on Bankruptcy ¶ 502.05[2] at 502-57.

27. *See In re Triple Star Welding, Inc,* 324 BR 778 (BAP CA 9, 2005) (Section 502(d) applies to administrative expense claims); *MicroAge, Inc v. Viewsonic Corp (In re MicroAge, Inc),* 291 BR 503, 508 (BAP CA 9, 2002) (Section 502(d)) may be raised in response to the allowance of an administrative expense claim; the definition of a "claim" in Section 101(5) is broad enough to include administrative expenses and Section 502(d) does not include any language to qualify such definition; policy behind Section 502(d), to encourage transferees to return avoidable transfers to estate, supports result); *In re Georgia Steel, Inc,* 38 BR 829, 839-40 (Bankr MD Ga 1984) (holding that Section 502(d) applies to prevent payment of any part of administrative expenses due a creditor until preferential property transferred is recovered). *Contra In re Lids Corp,* 260 BR 680, 683 (Bankr D Del 2001) ("administrative expense claims are accorded special treatment under the Bankruptcy Code and thus, are not subject to Section 502(d)"); *Camelot Music, Inc v MHW Adver & Public Relations, Inc (In re CM Holdings, Inc),* 264 BR 141, 158 (Bankr D Del 2000) (because administrative claim did not arise prepetition, it is not a claim under §101(10), and thus, Section 502(d) does not apply).

28. *Contra, Boyd v The Water Doctor (In re Check Reporting Servs), Inc,* 140 BR 425 (Bankr WD Mich 1992) (transfer does not have to remain unpaid to qualify for new value).

29. 11 USC 1103(c).

30. *In re Nationwide Sports Distribs, Inc,* 227 BR 455, 463 (Bankr ED Pa 1998) (referring to *In re Haskell-Dawes, Inc,* 188 BR 515, 519 (Bankr ED Pa 1995).

31. 62 BR 213, 216 (Bankr WD Mich 1986) (citations omitted).

32. *In re Drexel Burnham Lambert Group, Inc,* 138 BR 717 (Bankr SDNY 1992); *see also, In re Levy,* 54 BR 805, 807 (Bankr SDNY 1985).

33. *In re Fas Mart Convenience Stores, Inc,* 265 BR 427, 432 (Bankr ED VA 2001).

34. *In re Johns-Manville Corp,* 26 BR 919, 925 (Bankr SDNY 1983) (referring to HR Rep No 95-595, 95th Cong, 1st Sess 401 (1977), US Code Cong & Admin News, 5787.

35. *See,, e.g., In re Pine River Plastics, Inc,* Case No. 07-42010-PJS (Bankr ED Mich 2007) (503(b)(9) claimants resigned from the Committee and were unsuccessful in their unofficial attempt to cause the U.S. Trustee to appoint a 503(b)(9) committee).

36. *Id.*

37. 122 BR 568 (Bankr ED Mo 1990).

38. *Id.* at 571.

39. *In re SPM Mfg Corp,* 984 F2d 1305 (CA 1 1993).

40. *In re SPM Mfg Corp,* 984 F2d at 1316 (emphasis added*). See also In re World Health Alternatives, Inc,* 344 BR 291 (Bankr D Del 2006) (court approved settlement of committee's objections to sale and financing motions that provided, among other things, for a carve-out of the lender's collateral to the unsecured creditors under which priority unsecured creditors would not be paid as not violating the absolute priority rule; because the proposed settlement was being made outside the context of a plan, the absolute priority rule was not applicable); *contra, Motorola, Inc v. Official Comm of Unsecured Creditors, et al (In re Armstrong World Indus, Inc)*, 432 F3d 507 (CA 3 2005) (court refused to confirm a plan that provided for issuance and distribution of warrants to equity over the objection of the unsecured creditors where the plan provided that the subject warrants would be transferred by class 7 creditors to equity if class 6 creditors objected to the plan as violating the absolute priority rule because equity would be receiving or retaining property when all senior classes were not being paid in full under the plan); *In re Iridium, Operating LLC,* 478 F3d 452 (CA 2 2007) (court refused to approve settlement whereby secured creditor proposed to "gift" proceeds of its claim to unsecured creditors because it violated the absolute priority rule that requires administrative and priority creditors to be paid in full before unsecured creditors are paid on their claims and suggested that (i) the committee owes a duty to all the creditors of the estate, and (ii) the absolute priority rule and its application needs to be considered even in the context of a Rule 9019 settlement being proffered outside confirmation of a plan).

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# *Second Generation Proceeds: The Conflict Between After-acquired Property and Proceeds in Bankruptcy*

By Michelle Epstein Taigman

## Introduction

It is generally understood and accepted, without debate, that the filing of a bankruptcy petition cuts off the operation of so-called after-acquired property security clauses. This results in the debtor or trustee having rights in assets acquired postpetition that they would not have had without the bankruptcy filing. However, in a series of decisions from outside the Sixth Circuit Court led by *In re Bumper Sales, Inc*[1] courts have found that the lien of a prepetition lender can extend to property typically thought of as after-acquired collateral. This is not because of the existence of an after-acquired property clause but because the postpetition collateral is found to be proceeds of the prepetition lender's prepetition collateral. These "second generation proceeds" cases blur the line between after-acquired property and proceeds and can lead to outcomes that initially appear inconsistent with the general principles of the Bankruptcy Code. However, the cases may not be as far-reaching as they at first appear.

## After-acquired Property Clauses and Proceeds in Bankruptcy

The after-acquired collateral clause is a reality of modern commercial financing. Typical secured financing will provide the lender with a security interest not only in a borrower's current assets but also in similar assets acquired by the borrower in the future. By encumbering not only present but also future assets, after-acquired collateral clauses effectively prevent a borrower from obtaining cash or financing from any other source based on the value of these future assets without the consent of the existing lender. They would appear to leave a borrower with no financing alternative in bankruptcy.

The Bankruptcy Code, however, aims to assist the debtor's reorganization by allowing it to use property acquired after the bankruptcy petition as a source of funding its ongoing operations.[2] 11 USC § 552(a) provides:

> Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

Nevertheless, the Bankruptcy Code recognizes that prepetition lenders must be allowed some protection for their prepetition interests. *See Arkison v Frontier Asset Mgmt., LLC (In re Skagit Pac Corp).*[3] Section 552(b)(1) therefore provides an exception governing proceeds:

> Except as [otherwise] provided…if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankrutpcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

Generally speaking, the "applicable non-bankruptcy law" that determines the extent of a security interest is the Uniform Commercial Code (UCC).[4]

The UCC defines proceeds as:

> …(A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral; (B) whatev-

> er is collected on, or distributed on account of, collateral; (C) rights arising out of collateral; (D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or (E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

UCC § 9-102(64). Also relevant is UCC § 9-315(c), which provides that "[a] security interest in proceeds is a perfected security interest if the security interest in the original collateral was perfected."[5]

Although an initial reading of the relevant UCC provisions suggests that "proceeds" is what is actually received in direct exchange for collateral, as well as rights to damages and insurance proceeds where value is lost, the concept of "proceeds" has expanded over time with each revision of the UCC.[6] In a bankruptcy, this expanded concept of "proceeds" may conflict with section 552(a). This conflict has led to a series of cases in which prepetition lenders advanced a "second generation" proceeds theory to argue that their liens in prepetition proceeds extend to and cover postpetition inventory, accounts, and other collateral that their after-acquired property clauses could not reach.

## Second Generation Proceeds and *Bumper Sales*

*Bumper Sales* appears to be the most widely cited case supporting the theory of second generation proceeds. *Bumper Sales* arose out of the bankruptcy of a company seeking to increase its inventory of car and truck bumpers through a lending relationship with a small asset-based lender. This prepetition lender held an uncontested, perfected security interest in substantially all of the debtor's prepetition assets. Although no formal cash collateral order was ever entered, the debtor and the prepetition lender had an agreement pursuant to which the debtor could use cash collateral in exchange for making current loan payments and remaining in compliance with the terms of the prepetition loan documents, and the prepetition lender was intended to receive a postpetition lien.[7] All parties additionally stipulated that the debtor's postpetition operations, including the purchase of new inventory, were funded exclusively by the proceeds of the prepetition lender's cash collateral.[8]

Eight months into the debtor's bankruptcy proceedings, the prepetition lender filed a motion seeking to condition the use of cash collateral and seeking adequate protection for its security interest in all of the debtor's assets.[9] The bankruptcy court found that the lender's valid interest in prepetition assets and proceeds continued postpetition to the extent of the lender's unpaid claim and granted the lender a lien on pre- and postpetition collateral. The district court affirmed, and the creditors' committee appealed. [10]

On appeal, the Fourth Circuit Court believed that a four-part analysis would determine whether the debtor's postpetition accounts receivable and inventory were after-acquired property or proceeds of prepetition collateral: (1) does a prepetition security agreement cover prepetition accounts and inventory; (2) postpetition, did the debtor receive proceeds of prepetition accounts and inventory; (3) is postpetition inventory second generation proceeds of prepetition inventory and accounts, and are postpetition accounts proceeds of postpetition inventory; and (4) did the lender's consent to the use of proceeds end its security interest? [11]

In *Bumper Sales*, an affirmative answer to the first and second requirements was not disputed by the parties.[12] In evaluating the third requirement, the court applied the UCC's definition and treatment of proceeds and found that the parties' stipulation that debtor's postpetition operations were financed exclusively by the prepetition lender's cash proceeds meant that the proceeds remained identifiable postpetition.[13] The debtor then used the cash proceeds to purchase new inventory. While postpetition inventory is typically considered after-acquired property, the court concluded that treating it as after-acquired property in the *Bumper Sales* case:

> …could completely deprive the secured party of his pre-petition perfected security interest. Therefore, the term "proceeds"[14] should be read broadly…to include after-acquired property, at least where inventory and accounts are concerned and there is no improvement in position. This is nothing more than a postpetition substitution of collateral.[15]

[T]he Bankruptcy Code recognizes that prepetition lenders must be allowed some protection for their prepetition interests.

Ultimately, the Fourth Circuit Court "agree[d] that Section 552(b) covers second generation proceeds, even if they are in the form of inventory, because such proceeds are clearly contemplated by the UCC…The only requirement is that the second generation proceeds be traceable to the original collateral…" [a fact to which, again, the court found the parties had stipulated].[16] The court went on to find that the lender's consent to the use of cash collateral did not affect its security interest in the proceeds of cash collateral.[17] With the four-part test met, the Fourth Circuit Court upheld the lower courts' decisions extending the prepetition lender's liens.

## Subsequent Interpretations of Second Generation Proceeds

When tracing of proceeds is required, courts look to equitable state-law tracing methods.

Rather than interpreting it as creating a broad general rule, many subsequent cases have emphasized the fact-specific nature of the *Bumper Sales* holding and applied its rule narrowly. In *In re Package Design & Supply Co, Inc*,[18] the prepetition lender to debtor, a packaging supply manufacturer and distributor, permitted the use of cash collateral without court order for six months before seeking (jointly with the debtor) court approval of a cash collateral agreement. The trustee and an unsecured creditor objected, arguing that by failing to act promptly the lender had "rolled out" of its secured position due to the operation of section 552(a).[19]

The court found that the popular belief that prepetition creditors can roll out of a secured position postpetition "…must be reconciled with the undeniable fact that under the [UCC], second generation proceeds of liened proceeds are merely 'proceeds of proceeds' and are subject to the initial lien without regard to any 'after-acquired property' clause, where such second generation assets are identifiable as such."[20] A prepetition lien may extend to assets typically considered after-acquired collateral not through operation of an after-acquired property clause but by virtue of a prepetition perfected security interest in proceeds. Similar to *Bumper Sales*, the court found that the debtor had no unencumbered assets on the petition date and that all postpetition needs had been funded through the use of cash collateral.[21] The court additionally found that the definition of proceeds was meant to be flexible, particularly given the equitable component of 11 U.S.C. § 552(b).[22]

The *Package Design* court, however, believed that such equitable considerations, as well as 11 U.S.C. § 506(c),[23] would prevent a prepetition secured creditor from using a proceeds claim to benefit from value added by others.[24] When value is added from other sources, commingling of prepetition and postpetition cash and assets is likely, particularly with the passage of time, and the secured creditor must establish a link between its prepetition proceeds and postpetition assets, making for a more demanding analysis.[25] Although the *Package Design* court believed its fact pattern to be similar to *Bumper Sales*, it remanded for further evidence to be certain that none of the debtor's postpetition assets were "enhanced" by the use of unencumbered cash or equity that would otherwise have been available to unsecured creditors.[26]

The *Skagit* court expanded the concept of postpetition value by looking not just at new sources of funding but at the value of the debtor's efforts in the operation of its business. In *Skagit*, the debtor was a manufacturer of modular trailers. Shortly after its bankruptcy petition, it was awarded a contract to build four trailers, leading to a postpetition account receivable paid subsequent to conversion of the bankruptcy to Chapter 7.[27] As in *Bumper Sales*, the use of the prepetition lender's cash collateral proceeded postpetition without the benefit of a cash collateral order or a replacement lien, and the prepetition lender[28] subsequently sought to foreclose on the postpetition payment. [29]

The lender alleged that the payment received for the postpetition receivable was proceeds of its prepetition collateral, offering the debtor's declaration that the collection of prepetition accounts and proceeds from the sale of prepetition inventory funded the postpetition construction of the four trailers.[30] The court, however, indicated its belief that "revenue generated by the operation of a debtor's business, post-petition, is not considered proceeds if such revenue represents compensation for goods and services rendered by the debtor in its everyday business performance…Thus, any portion of the [postpetition account receivable] attributable to the Debtor's services as part of the manufacturing or production of the modules would not be considered proceeds under § 552(b)."[31] The court continued, "[c]ase law supports the proposition that where it is only post-petition acts which generate an account receiv-

able, those post-petition receivables will not be considered proceeds because there is no interest in, or connection to, the right in the account receivable created pre-petition."[32] The account arising postpetition from the sale of the modular trailers could only be proceeds of the lender's prepetition collateral if evidence linked the money collected from prepetition accounts to those postpetition accounts.

The *Skagit* court's desire to ensure that the debtor benefited from its postpetition efforts differed from the *Bumper Sales* approach and led to a tracing analysis. Once cash proceeds are deposited into an account and commingled with other funds, they are no longer considered to be identifiable as proceeds unless the secured creditor establishes a link.[33] The burden of proof of tracing proceeds, both under *Skagit* and generally, falls on the secured party claiming the interest.[34]

When tracing of proceeds is required, courts look to equitable state-law tracing methods, the most widely used of which is the "lowest intermediate balance rule" (LIBR).[35] The LIBR is used to trace commingled proceeds and assumes that the alleged proceeds are the last amounts withdrawn from an account. Where the amount on deposit in the account falls below the amount of the alleged proceeds, the maximum amount that the secured creditor can trace is the lowest balance of the account between the time the proceeds are commingled and the time respective rights in the account are determined.[36] In *Skagit*, the secured creditor had used neither the LIBR nor another tracing method to identify its proceeds; the bankruptcy appellate panel therefore held that the bankruptcy court abused its discretion in finding the postpetition account arising from the sale of the modules to be proceeds of the lender's prepetition collateral.[37] The court emphasized that the facts were not as clear as in *Bumper Sales*, where all parties stipulated to the link between prepetition and postpetition assets.[38]

Another case evidencing the movement away from the broad tracing permitted in *Bumper Sales* (and relied upon by the *Skagit* court) is *In re Cafeteria Operators, LP*.[39] *Cafeteria Operators* relied on the equitable exception provided by 11 U.S.C. § 552(b)(1) to find that postpetition restaurant revenues are largely attributable to the efforts of the debtor and should not fully inure to the benefit of prepetition secured creditors despite the fact that their cash collateral or proceeds may have purchased the unprepared food and beverages served by the restaurant.[40] Per the *Cafeteria Operators* court, the full value of the postpetition receivables could not constitute proceeds of prepetition collateral because "[f]rom a plain reading of § 552, revenues generated post-petition solely as a result of the debtor's labor are not subject to a pre-petition lender's security interest."[41]

*Cafeteria Operators* limited the prepetition secured creditors' proceeds claim to the value of their prepetition inventory that was used to generate postpetition revenue.[42] Ultimately, the court concluded that the debtor's use of cash collateral could be conditioned on the prepetition lenders receiving a replacement lien in postpetition inventory, plus, to the extent inventory levels decreased postpetition, a replacement lien of the highest possible priority in additional assets to maintain the lenders' prepetition secured position.[43] The recently decided appeal in *Qmect, Inc v Burlingame Capital Partners II, LP (In re Qmect, Inc)*,[44] however, affirmed a prior decision holding that where a prepetition proceeds lien was traced to postpetition collateral, any postpetition increase in value is also part of the proceeds of the prepetition lender's collateral. The *Qmect* court distinguished *Skagit*, stating that there the prepetition lender lacked a blanket lien.[45] While *Qmect* does not specifically cite *Bumper Sales*, its holding seems to be a return to *Bumper Sales'* expansive approach.

## Reconciling Second Generation Proceeds Cases with the Bankruptcy Code

It is difficult to understand how the second generation proceeds theory supported by *Bumper Sales*, *Package Design*, and, albeit to a lesser degree, *Skagit* and *Cafeteria Operators*, as well as the expansive proceeds concept endorsed by *Qmect*, can be consistent with the policy behind 11 U.S.C. § 552. Nevertheless, these cases remain good law, and *Bumper Sales* in particular is widely cited and not heavily criticized. However, a common theme between certain of these cases may explain their origins and suggest their limitations.

Each of *Bumper Sales*, *Package Design*, and *Skagit* involve Chapter 11 proceedings where the prepetition lender permitted the debtor to use cash collateral but did not require court approval of a cash collateral order ei-

The analysis of these cases would not seem to protect a prepetition lender in bankruptcy proceedings involving a postpetition lender or other new financing or value.

ther at all or until several months after the petition date. In *Cafeteria Operators*, while the prepetition lender and debtor agreed to an initial, limited use of cash collateral, they were never able to come to agreement on a final order; the case arose out of the debtor's motion to allow continued use of cash collateral without the consent of the lender. Cash collateral orders typically afford a number of protections to prepetition secured parties, including a replacement lien in postpetition assets and/or a lien in unencumbered prepetition and postpetition assets to protect the secured creditor for any diminution in value of its prepetition collateral during the bankruptcy proceedings. With these liens, a lender likely would not need to resort to second generation proceeds arguments to protect its interests.

In *Bumper Sales*, *Package Design*, *Skagit,* and *Cafeteria Operators*, the lenders were allowing the debtor to use cash collateral to continue its operations but failed to protect their own interests, either at all or in a timely manner. Although the holdings are not expressly limited, perhaps, ultimately, stretching the concept of second-generation proceeds is the court's way of trying to help these creditors, without whose cash collateral the debtors evidently would not have been able to operate postpetition and attempt to reorganize.[46] The analysis of these cases would not seem to protect a prepetition lender in bankruptcy proceedings involving a postpetition lender or other new financing or value, as it could not easily be said that postpetition assets were attributable solely or largely to prepetition proceeds or cash collateral.

Notwithstanding *Bumper Sales* and the second-generation proceeds theory, the prudent lender will still protect its interests by pursuing the protection of a cash collateral order and replacement lien at the earliest appropriate opportunity.

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## NOTES

1. 907 F2d 1430 (4th Cir 1990).

2. See Collier on Bankruptcy, 15th ed. ¶ 552.01[1] (citations omitted); *In re Bumper Sales*, 907 F2d at 1436 (citation omitted).

3. 316 BR 330, 3365 n.4 (9th Cir BAP 2004) (hereafter, *Skagit*).

4. Collier, ¶ 552.02[1]. Most courts use the already expansive definition of proceeds under the UCC, although some others have found that the Bankruptcy Code did not intend the Uniform Commercial Code's definition to be an absolute limitation. See Collier ¶ 552.02[2] (citations omitted). The basis for an alternative definition of proceeds comes from a statement in the legislative history indicating that the meaning of "proceeds" is not limited to the UCC definition but also covers "property into which property subject to the security interest is converted." *In re Bumper Sales*, 907 F2d at 1437. The *Bumper Sales* court noted, however, that many courts reviewing this question have found the statutory reference to "applicable nonbankruptcy law" to be more compelling than legislative history and have applied the UCC definition. Id. (citations omitted).

5. The prior version of UCC Article 9, which both defined proceeds and discussed perfection in proceeds in § 9-306, included a subsection which specifically addressed proceeds in insolvency proceedings. Prior § 9-306(4) provided that in an insolvency proceeding a secured creditor with a perfected security interest in proceeds had a perfected security interest only in identifiable non-cash proceeds, separate deposit accounts containing only proceeds, identifiable cash proceeds in the form of money or checks not commingled with other money or deposited into a deposit account prior to the insolvency proceedings, and cash and deposit accounts in which proceeds have been commingled but the perfected security interest is subject to a right of setoff and limited to a calculation based on the debtor's cash receipts in the ten days prior to the insolvency proceeding. Neither old § 9-306(4) nor any provisions specifically addressing perfected security interests in proceeds in insolvency proceedings were incorporated into revised Article 9. There is no specific discussion of the rationale for its exclusion, only the indication that "[e]xcept as otherwise provided by the Bankruptcy Code, the debtor's entering into bankruptcy does not affect a secured party's right to proceeds." UCC Official Comment to § 9-315, #8.

6. White & Summers, Uniform Commercial Code, § 31-17(a) (5th ed. 2002).

7. *In re Bumper Sales*, 907 F2d at 1432, 1433.

8. *Id.* at 1433.

9. *Id.*

10. *Id.*

11. *Id.* at 1436-1437.

12. *Id.* at 1437.

13. *Id.*

14. *Bumper Sales*, as well as *Package Design* (discussed below), were decided under old Article 9, including § 9-306 (which is largely but not entirely enacted in current § 9-315).

15. *Id.* at 1439 (quoting Clark, The Law of Secured Transactions under the Uniform Commercial Code, ¶ 6.6[3] at 6-47 (1980)).

16. *Id.*

17. *Id.* at 1441.

18. 217 BR 422 (Bankr WDNY 1998).

19. *Id.* at 423.

20. *Id.* (citing, among other authority, *Bumper Sales*).

21. *Id.*

22. *Id.* at 424.

23. 11 U.S.C. § 506(c) provides in part "The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim…"

24. *Id.* at 425.

25. *Id.* at 427.

26. *Id.*

27. 316 B.R. 333-334.

28. At this point in the case the lender was no longer the third-party prepetition lender but rather an LLC formed by the debtors' principals to manage the interests of the prepetition lender, which they had acquired by assignment in connection with the settlement of litiga-

tion instituted against them by the prepetition lender based on their guarantee of the underlying debt.

29. *Id.* at 333, 334.

30. *Id.* at 334.

31. *Id.* at 336 (citations omitted).

32. *Id.*

33. *Id.* at 338.

34. *Id.* (citations omitted). *See also First Bank v. North Country Bank & Trust (In re Superior Used Cars, Inc),* 258 BR 680, 686 (Bankr WD Mich. 2001) (finding that, under Michigan law, the secured creditor bears the burden of tracing and identifying proceeds). At least one court has suggested that the burden of proof can be shifted from the secured creditor to the debtor where the debtor wrongfully commingles funds. That court, however, didn't need to fully address the issue as it found that the debtor had not in fact acted wrongfully. *See In re Qmect, Inc,* No. 04-41044T, 2006 Bankr LEXIS 1489, at *13-14 (Bankr ND Cal. June 26, 2006).

35. *See In re Skagit*, 316 BR at 338 (citations omitted); UCC, Official Comment to § 9-315 No. 3.

36. *In re Skagit*, 316 B.R. at 338.

37. *Id.* at 340.

38. *Id.* at 339-340.

39. 299 B.R. 400 (Bankr. N.D. Tex. 2003).

40. *Id.* at 408-409.

41. *Id*. at 405.

42. *Id*. at 409.

43. *Id*. at 410.

44. 373 BR 100 (Bankr ND Cal 2007).

45. In fact the prepetition lender in *Skagit* had a very comprehensive lien, covering equipment, inventory, accounts receivable, chattel paper, general intangibles and all proceeds.

46. The *Package Design* court believed that its fact pattern, where all postpetition needs are funded exclusively through the use of cash collateral, is quite common in smaller bankruptcies.

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# *A Road Map for Bankruptcy Litigation*

By Scott A. Wolfson

## Introduction

A litigator's fundamental skill set is portable from state and federal district courts to the bankruptcy court. However, successfully litigating bankruptcy-related matters also requires knowledge of the jurisdictional and procedural nuances unique to bankruptcy litigation. The consequences of being unfamiliar with concepts like "bankruptcy counting" can be severe—from inadvertent waiver of jury trial rights to missing a response deadline. The goal of this article is to provide practitioners with an overview of important bankruptcy litigation statutes and rules and to highlight potential pitfalls.

## Bankruptcy Court Jurisdiction

The jurisdictional scheme governing bankruptcy courts is complicated by the fact that bankruptcy judges are not Article III judges, but Article I judges. As a result of the U.S. Supreme Court's decision in *Northern Pipeline Constr Co v Marathon Pipe Line Co*,[1] which struck down a broad grant of jurisdiction to the bankruptcy courts, bankruptcy courts are courts of limited jurisdiction that derive their jurisdiction from the district courts.[2]

District courts are granted "original and exclusive jurisdiction of all *cases* under title 11" by 28 USC § 1334(a).[3] A "case" under title 11 means a bankruptcy action commenced with the filing of a bankruptcy petition.[4] Additionally, district courts are vested with "original but not exclusive jurisdiction of all civil proceedings *arising under* title 11, or *arising in* or *related to* cases under title 11" by 28 USC § 1334(b).[5]

Whether a bankruptcy court can enter final orders with respect to a particular proceeding depends upon the jurisdictional category into which the proceeding falls and whether the proceeding is "core" under 28 USC § 157.[6]

### *Arising in or Under Title 11 – "Core" Proceedings*

Proceedings that *arise in* a case under title 11 are those that, by their very nature, could arise only in a bankruptcy case.[7] For example, an action to appoint a trustee under section 1104 to investigate the financial condition of a debtor could only arise in a bankruptcy case.

The phrase "arising under title 11" describes those proceedings that involve a cause of action created or determined by a statutory provision of title 11.[8] A common example of a cause of action created by title 11 would be an action under section 547 to avoid a preferential transfer.

Bankruptcy judges may hear and determine all cases *under* title 11 and all "core proceedings" *arising under* title 11 or *arising in* a case under title 11.[9] Courts in the Sixth Circuit appear to consider all proceedings that *arise under* or *arise in* a case under title 11 to be core proceedings.[10]

### *Related to a Case Under Title 11 – "Non-Core" Proceedings*

The standard for determining whether a case is related to a bankruptcy case is very liberal. A case is generally held to be related to a case under title 11 if its outcome could "conceivably" have any effect on the debtor's estate.[11] A proceeding does not even have to be against the debtor or the debtor's property to satisfy the requirements of related to jurisdiction.[12]

The *related to* category encompasses all matters which may be placed in the *arising under* or *arising in* categories. "Therefore, for purposes of determining section 1334(b) jurisdiction, it is necessary only to determine whether a matter is *at least* 'related to' the bankruptcy."[13]

*Related to* actions are non-core proceedings. The bankruptcy judge's findings of fact and conclusions of law in a "related to" action are subject to objection by the parties under Federal Rule of Bankruptcy Procedure (Bankruptcy Rules) 9033(b) and *de novo* review by the district court judge, unless the parties have consented to the entry of final orders or judgment by the bankruptcy judge.[14]

## The Bankruptcy Court's Abstention from Hearing State Law Causes of Action

Bankruptcy courts *must* abstain from hearing certain cases.[15] Mandatory abstention under section 1334(c)(2) applies if the following six

requirements are satisfied: (1) a motion to abstain is timely filed; (2) the proceeding is "based upon a State law claim or State law cause of action;" (3) the claim or cause of action is related to a bankruptcy case but did not arise in or under the bankruptcy case; (4) the only basis for original jurisdiction in federal court is the bankruptcy filing; (5) the state law claim or cause of action is the subject of "an action [that] is commenced…in a State forum of appropriate jurisdiction;" and (6) the state court action "can be timely adjudicated."[16] Where a bankruptcy court determines that it must abstain from a case, the proceeding is remanded to the state court where it was initially pending.

Even where a bankruptcy court has jurisdiction over a case because it arises in or under title 11 or is related to a case under title 11, the bankruptcy court may abstain from hearing the case under 28 USC § 1334(c)(1) "in the interest of comity with State courts or respect for State law…." This is known as "permissive abstention." Bankruptcy courts have listed over a dozen non-exclusive factors as relevant to determining whether abstaining from hearing a state law cause of action is appropriate.[17]

## "Removal" – Transferring a State Court Case to Bankruptcy Court

Section 1452 of title 28 permits a party to remove a claim or cause of action to the bankruptcy court where the bankruptcy court has jurisdiction under 28 USC § 1334.[18] The liberal bankruptcy jurisdiction rules under 28 USC § 1334(b)—that a bankruptcy court has jurisdiction over a claim "arising in or related to cases under title 11"—means that removal should be permitted where the case could conceivably have any effect on the debtor's estate.[19] There is no requirement in section 1452 that the debtor be a party to the case being removed.

Removal is accomplished by filing a "notice of removal" "with the clerk for the district and division within which is located the state or federal court where the civil action is pending."[20] For example, removing a case filed in the Kent County, Michigan Circuit Court that is related to a pending bankruptcy in Detroit's Eastern District of Michigan would require filing a notice of removal and a motion to transfer venue to the bankruptcy court in Detroit with the bankruptcy court for the Western District of Michigan in Grand Rapids, as well as a copy of the notice of removal with the clerk of the Kent County Circuit Court.[21] Bankruptcy Rule 9027 outlines the requisite contents of a notice of removal and the procedure and time for filing the notice.

## Adversary Proceedings

Adversary proceedings are lawsuits within the bankruptcy case commenced by filing a complaint.[22] Part VII (Rules 7001-7087) of the Bankruptcy Rules contains most of the rules governing adversary proceedings.[23] Bankruptcy Rules 7001 through 7087 generally incorporate the Federal Rules of Civil Procedure. For example, Bankruptcy Rule 7003 simply states, "Rule 3 F.R.Civ.P. applies in adversary proceedings." However, some of the Bankruptcy Rules differ from the Federal Rules of Civil Procedure, with the modifications ranging from slight to dramatic. Bankruptcy Rule 7001 lists proceedings that are adversary proceedings. Those proceedings are:

- to recover money or property, with several exceptions;
- to determine the validity, priority, or extent of a lien or other interest in property;
- to obtain approval for the sale of both the interest of the estate and of a co-owner in property;
- to object to or revoke a discharge;
- to revoke an order of confirmation of a chapter 11, 12, or 13 plan;
- to determine the dischargeability of a debt;
- to obtain an injunction or other equitable relief;
- to subordinate any allowed claim or interest;
- to obtain a declaratory judgment relating to any of the foregoing; and
- to determine a claim or cause of action removed under 28 USC § 1452.

Additionally, an objection to a claim that includes a demand for relief of the kind specified in Bankruptcy Rule 7001 is an adversary proceeding.[24]

A common mistake non-bankruptcy practitioners make is seeking relief of the type specified in Bankruptcy Rule 7001 by motion rather than by filing a complaint. Because adversary proceedings must be commenced by filing a complaint, they get case numbers separate from the underlying bankruptcy case and are docketed separately. The cap-

Bankruptcy courts have listed over a dozen non-exclusive factors as relevant to determining whether abstaining from hearing a state law cause of action is appropriate.

tion of an adversary proceeding will include the caption and case number from the bankruptcy case as well as an additional caption listing the adverse parties. For example:

In re BrokeCo. Case No. XX-XXXXX

Chapter 11

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Unsecured Creditors Committee
of BrokeCo.

Case No. XX-YYYYY

v.

BrokeCo.'s Former Directors

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## Contested Matters

The Advisory Committee Notes on Bankruptcy Rule 9014 state that "[w]henever there is an actual dispute, other than an adversary proceeding, before the bankruptcy court, the litigation to resolve that dispute is a *contested matter*."[25] Most bankruptcy court litigation is conducted through contested matters.

Bankruptcy Rule 9014 outlines the procedures applicable to contested matters. Relief must be requested by a motion in the bankruptcy case. The motion must be served in the same manner as a summons and complaint, and it must provide "reasonable notice and opportunity for hearing…." This does not necessarily mean that there will be a hearing.

Section 102(1) of the Bankruptcy Code[26] defines the phrase "after notice and a hearing" or "similar phrase" to mean "after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances," but goes on to authorize an act without an actual hearing if notice is proper and "such a hearing is not requested timely by a party in interest." Local rules of procedure often provide for entry of orders on such "negative notice."[27]

A common example of a contested matter is a motion for relief from the automatic stay provided by section 362 of the Bankruptcy Code.[28] If a party files a motion for relief from the automatic stay and gives proper notice and an opportunity for parties in interest to object and no one objects, the judge may enter the order granting relief from stay without a hearing. If, however, an objection to the motion is filed, Bankruptcy Rule 9014(c) specifies the Part VII adversary proceeding rules that will apply to the contested matter. Discovery, for example, will proceed as it does in adversary proceedings.[29] Testimony of witnesses with respect to disputed material factual issues is also taken in the same manner as testimony in adversary proceedings.[30]

It is important to check the rules governing a contested matter in each jurisdiction. Local bankruptcy court rules or administrative orders often vary the Part VII rules that apply in contested matters and the procedures for invoking them. In addition, there appears to be a trend in larger bankruptcy cases that debtors are moving early in the case for entry of comprehensive *procedures orders* governing contested matters.[31] It is imperative to review the debtor's bankruptcy docket for such an order because filings that comply with the Bankruptcy Rules and the jurisdiction's local rules, but do not follow the procedures order, may be stricken.

## Rules of Evidence and Additional Rules of Procedure

### *Evidence*

The Federal Rules of Evidence apply in cases under the Bankruptcy Code,[32] though most practitioners would probably agree that they are not strictly enforced because almost all matters are tried by the bankruptcy judge. Offers of proof are often utilized in bankruptcy cases in lieu of testimony, particularly in contested matters.

The Federal Rules of Evidence apply in cases under the Bankruptcy Code,[32] though most practitioners would probably agree that they are not strictly enforced because almost all matters are tried by the bankruptcy judge.

### *Nationwide Service of Process by Mail in Adversary Proceedings and Contested Matters*

Service of process in bankruptcy litigation typically requires nothing more than an envelope and a stamp. Bankruptcy Rule 7004 provides, subject to limited exceptions,[33] that service of process may be accomplished in adversary proceedings and contested matters[34] by first class mail. Bankruptcy Rule 9006(e) provides that service is complete upon mailing.

***"Corporate Ownership Statement" Requirement in Adversary Proceedings***

Bankruptcy Rule 7007.1 requires that any corporation that is a party to an adversary proceeding must file "a statement that identifies any corporation…that directly or indirectly owns 10% or more of any class of the corporation's equity interests…."[35] This statement must be filed by a party with its first filing and must be updated to reflect any subsequent change in circumstances.[36] The purpose of this filing is to assist bankruptcy judges in making informed disqualification decisions.[37]

***Pleading***

Bankruptcy Rule 7008 incorporates Rule 8 of the Federal Rules of Civil Procedure, but includes a requirement that the claim "shall contain a statement that the proceeding is core or non-core and, if non-core, that the pleader does or does not consent to entry of final orders or judgment by the bankruptcy judge."[38]

***Answer***

Bankruptcy Rule 7012 incorporates some, but not all of Rule 12 of the Federal Rules of Civil Procedure, and provides that a defendant must serve an answer within *30* days after the *issuance* of the summons.[39]

***Counting Days in Bankruptcy***

Litigating in bankruptcy court may require re-learning how to count "days." Many a seasoned federal court litigator, familiar with the nuances of computing time under Rule 6 of the Federal Rules of Civil Procedure, has been late with a filing as a result of Bankruptcy Rule 9006. That rule, unlike its Rule 6 counterpart, provides that intermediate Saturdays, Sundays, and legal holidays are excluded in the computation of a time-period when the period is *less than 8 days*.[40] Rule 6 of the Federal Rules of Civil Procedure contains identical language to Bankruptcy Rule 9006, but provides an 11-day cutoff for the special counting.[41] State court litigators are often unaware that every day may not count as a day in calculating a response period.

Another wrinkle in the time calculation, also contained in Bankruptcy Rule 9006, applies most commonly where service is by mail. In certain circumstances, service by mail (including electronic mail) results in an additional three days being added to a time to respond.[42]

The Committee on Rules of Practice and Procedure of the Judicial Conference of the United States has created a Time-Computation Subcommittee to examine the time-computation provisions found in the federal appellate, bankruptcy, civil, and criminal rules "with a view to simplifying those provisions and eliminating inconsistencies among them."[43] "The project was launched in response to frequent complaints by practitioners about the time, energy and nervous anxiety expended in calculating time periods and to comments by judges about the anomalous results of the current computation system."[44] As of the writing of this article, the Time-Computation Subcommittee was seeking comments on proposed amendments to time-computation rules. For now, a "day" is not necessarily a "day."

## Jury Trial Rights and Waiver

The right to a trial by jury under the Seventh Amendment fully applies to bankruptcy proceedings that are legal, as opposed to equitable in nature, regardless of whether the proceeding is core or non-core.[45] Bankruptcy Rule 9015 incorporates a number of Federal Rules of Civil Procedure pertaining to jury trials, including Rule 38, and provides that the parties may consent to have the bankruptcy judge conduct the jury trial.[46] Local rules of bankruptcy procedure often provide detailed procedures and time lines for demanding that an Article III district court judge conduct the jury trial rather than the Article I bankruptcy judge.[47]

The largest trap for the unwary is that the right of a bankruptcy litigant to a jury trial is *waived* if the party has filed a proof of claim in the bankruptcy court. The reasoning behind the rule is that the filing of a claim initiates the process of allowing and disallowing claims, such that the filer is deemed to have submitted to the equitable powers of the bankruptcy court.[48]

## Conclusion

Procedural hazards abound in bankruptcy litigation. Successfully litigating bankruptcy matters requires a keen awareness of bankruptcy-specific statutes, rules of procedure, and, oftentimes, case-specific orders.

The right to a trial by jury under the Seventh Amendment fully applies to bankruptcy proceedings that are legal, as opposed to equitable in nature, regardless of whether the proceeding is core or non-core.

## NOTES

1. 458 US 50 (1982).

2. *See In re Granger Garage, Inc*, 921 F2d 74, 77 (6th Cir 1990) ("The bankruptcy court is a court of limited jurisdiction."). Bankruptcy judges for each circuit are appointed by the United States court of appeals for that circuit. 28 USC § 152. "[Bankruptcy courts] do not operate under an exclusive grant of jurisdiction as in § 1471(c) but rather derive their jurisdiction from the district courts . . . ." *White Motor Corp v Citibank NA*, 704 F2d 254, 263 (6th Cir 1983).

3. Emphasis added.

4. The Sixth Circuit Court of Appeals defined a "title 11 case" in *Stewart v Henry (In re Stewart),* 62 Fed Appx 610, 613 (6th Cir 2003) as "containing a claim made under an actual provision of title 11. * * * In other words, the claim itself must invoke a provision of title 11. * * * [A]n action commenced in a federal district court or bankruptcy court with the filing of a petition pursuant to 11 U.S.C. §§ 301, 302 or 303." (internal citation and quotation omitted.)

5. Emphasis added.

6. Section 157(b)(2) of title 28 contains a non-exclusive list of core proceedings.

7. *Mich Empl Sec Comm'n v Wolverine Radio Co (In re Wolverine Radio Co),* 930 F2d 1132, 1144 (6th Cir 1991).

8. *Id.*

9. 28 USC § 157(b)(1).

10. *See Eglinton v Loyer (In re GAD, Inc),* 340 F3d 331, 336 (6th Cir 2003) (a "core proceeding" is one that "invokes a substantive right created by federal bankruptcy law or one which could not exist outside of the bankruptcy."); *Lowenbraun v Canary (In re Lowenbraun),* 453 F3d 314 (6th Cir 2006).

11. *Lindsey v O'Brien (In re Dow Corning Corp),* 86 F3d 482, 489-90 (6th Cir 1996).

12. *Id.* (holding that claims asserted against a non-debtor defendant that had the potential to result in the debtor's liability for indemnification were sufficiently related to the bankruptcy to warrant jurisdiction in federal court).

13. *8300 Newburgh Rd Partnership v Time Constr (In re Time Constr),* 43 F3d 1041, 1044 (6th Cir 1995), quoting *Mich Empl Sec Comm'n v Wolverine Radio Co*, 930 F2d at 1141 (emphasis added).

14. See 28 USC § 157(c) and Bankruptcy Rules 7008 and 9033(d).

15. Section 1334(c)(2) of 28 USC provides:

Upon timely motion of a party in a proceeding based upon a State law claim or State law cause of action, related to a case under title 11 but not arising under title 11 or arising in a case under title 11, with respect to which an action could not have been commenced in a court of the United States absent jurisdiction under this section, the district court shall abstain from hearing such proceeding if an action is commenced, and can be timely adjudicated, in a State forum of appropriate jurisdiction.

16. *In re K-Mart Corp*, 307 BR 586, 591 (Bankr ED Mich 2004).

17. (1) the effect or lack of effect on the efficient administration of the estate if a court abstains;

(2) the extent to which state law issues predominate over bankruptcy issues;

(3) the difficulty or unsettled nature of the applicable state law;

(4) the presence of a related proceeding commenced in state court or other non-bankruptcy court;

(5) the jurisdictional basis, if any, other than 28 U.S.C. § 1334;

(6) the degree of relatedness or remoteness of the proceeding to the main bankruptcy case;

(7) the substance rather than form of an asserted "core" proceeding;

(8) the feasibility of severing state law claims from core bankruptcy matters to allow judgments to be entered in state court with enforcement left to the bankruptcy court;

(9) the burden [on the bankruptcy court's] docket;

(10) the likelihood that the commencement of the proceeding in bankruptcy court involves forum shopping by one of the parties;

(11) the existence of a right to jury trial;

(12) the presence in the proceeding of non-debtor parties; and

(13) any unusual or other significant factors.

*See K-Mart,* 307 BR at 596-97 (citations omitted).

18. Section 1452(a) provides:

A party may remove any claim or cause of action in a civil action other than a proceeding before the United States Tax Court or a civil action by a governmental unit to enforce such governmental unit's police or regulatory power, to the district court for the district where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title.

Although 28 USC § 1452 expressly addresses the district court, a district court may refer all cases and proceedings that fall within 28 USC § 1334 to the bankruptcy court. 28 USC § 157(a). Although this power is discretionary, "courts 'routinely refer' most bankruptcy cases to the bankruptcy court." *In re Resorts Int'l, Inc,* 372 F3d 154, 162 (3d Cir 2004).

19. *See Lindsey v O'Brien (In re Dow Corning Corp),* 86 F3d at 489-90.

20. Bankruptcy Rule 9027(a)(1).

21. Bankruptcy Rule 9027(c).

22. Bankruptcy Rule 7003.

23. Bankruptcy Rule 7001 states that "[a]n adversary proceeding is governed by the rules of this Part VII."

24. Bankruptcy Rule 3007.

25. Notes of Advisory Committee on Rule 9014 (1983) (emphasis added).

26. 11 USC § 101 et seq.

27. For example, see Local Rule 9014-1 of the Bankruptcy Court for the Eastern District of Michigan.

28. See Bankruptcy Rule 4001(a)(1).

29. Bankruptcy Rule 9014(c) incorporates Bankruptcy Rules 7028-7037.

30. Bankruptcy Rule 9014(d).

31. *See, e.g.*, Delphi's Claim Objection Procedures Order, United States Bankruptcy Court for the Southern District of New York, Case No. 05-44481 (Docket No. 6089).

32. See Bankruptcy Rule 9017.

33. For example, service on an insured depository institution must be by certified mail. Bankruptcy Rule 7004(b) and (h). In addition, personal service of a subpoena is required by Bankruptcy Rule 9016, which provides that Federal Rule of Civil Procedure 45 applies in cases under the Bankruptcy Code.

34. Bankruptcy Rule 9014(b) makes Bankruptcy Rule 7004 applicable to contested matters.

35. Bankruptcy Rule 7007.1(a).

36. Bankruptcy Rule 7007.1(b).

37. See Bankruptcy Rule 7007.1 Advisory Committee Note – 2003 Amendment.

38. Bankruptcy Rule 7008(a).

39. Bankruptcy Rule 7012(a). Bankruptcy Rule 7004(e) requires that the complaint be served within ten days of its issuance.

40. Bankruptcy Rule 9006(a) states: "When the period of time prescribed or allowed is less than 8 days, intermediate Saturdays, Sundays, and legal holidays shall be excluded in the computation."

41. Fed R Civ P 6.

42. "When there is a right or requirement to act or undertake some proceedings within a prescribed period after service and that service is by mail or under Rule 5(b)(2)(C) or (D) F. R. Civ. P., three days are added after the prescribed period would otherwise expire under Rule 9006(a)." Bankruptcy Rule 9006(f).

43. June 29, 2007 Memorandum from the Time-Computation Subcommittee to Judge David F. Levi and the Standing Committee on Rules of Practice and Procedure, p 1.

44. *Id.* (footnote omitted).

45. *See Granfinanciera, SA v Nordberg,* 492 US 33, 41-42 and 60-91 (1989).

46. Bankruptcy Rule 9015 provides:

(a) Applicability of Certain Federal Rules of Civil Procedure. Rules 38, 39, and 47-51 F.R.Civ.P., and Rule 81(c) F.R.Civ.P. insofar as it applies to jury trials, apply in cases and proceedings, except that a demand made pursuant to Rule 38(b) F.R.Civ.P. shall be filed in accordance with Rule 5005.

(b) Consent to Have Trial Conducted by Bankruptcy Judge. If the right to a jury trial applies, a timely demand has been filed pursuant to Rule 38(b) F.R.Civ. P., and the bankruptcy judge has been specially designated to conduct the jury trial, the parties may consent to have a jury trial conducted by a bankruptcy judge under 28 U.S.C. § 157(e) by jointly or separately filing a statement of consent within any applicable time limits specified by local rule.

47. *See, e.g.,* Local Rule 9015-1 of the Eastern District of Michigan:

A party who demands a jury trial shall be deemed to have consented to the bankruptcy judge conducting the jury trial unless, concurrently with the filing of the jury demand, the demanding party files a motion to withdraw the reference. The other party or parties shall have 10 days after the service of a jury demand to file a motion to withdraw the reference; otherwise the non-demanding party shall be deemed to have consented to a jury trial conducted by the bankruptcy judge.

48. *See Granfinanciera, SA v Nordberg*, 492 US at 51-57.

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# *The Michigan Business Tax*

by Jack Van Coevering

In July 2007, the Michigan Legislature passed the Michigan Business Tax (MBT).[1] The MBT took effect January 1, 2008, replacing the thirty-year-old Single Business Tax (SBT).

Among its many objectives, the MBT was developed to provide a stable revenue stream that did not have the complexity of the SBT.[2] To achieve this, the tax combines a separately calculated income tax[3] (providing simplicity) with a separately calculated gross receipts tax[4] (providing stability). Drafters hoped that the gross receipts levy would raise two-thirds of the business tax revenue with the business income tax raising the remaining one-third. The recent budget deficit was also addressed by imposition of a surcharge,[5] which increases the total amount of tax calculated from both income and receipt taxes by 21.99 percent.[6] Regardless of how the objectives were achieved, they were conditioned on limiting, if not reducing, the tax burden on Michigan businesses. Hence, the MBT's two most distinguishing features are its significant expansion of the taxpayer base, particularly as to nonresident businesses, and the substantial credits provided to Michigan businesses. The purpose of this article is to review those objectives, their conceptual underpinnings, and the constitutional challenges they raise.

## Taxpayers and Exempt Entities

Most SBT taxpayers will continue to be MBT taxpayers.[7] The MBT retains the same filing threshold as the SBT. Taxpayers with $350,000 in allocated or apportioned "gross receipts" are required to file and pay the MBT.[8]

The MBT defines "taxpayer" to mean "a person or unitary business group liable for the tax, interest, or penalty under this act."[9] The term "person," under the MBT, is similar to the SBT definition[10] with the addition of three new entities: limited liability partnerships, subchapter S corporations, and limited liability companies.[11] The addition, however, is a clarification, as the SBT contained a general "catch-all" provision, which the MBT continues, for any "other group or combination acting as a unit." Both versions included trusts and estates.

What is new is the introduction of a "unitary business group" as a single "taxpayer." The MBT defines a unitary business group as:

> A group of United States persons, other than a foreign operating entity[12], 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other United States persons, and that has business activities or operations which result in a flow of value between or among persons included in the unitary business group or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. For purposes of this subsection, flow of value is determined by reviewing the totality of facts and circumstances of business activities and operations.

The first half of the definition addresses a control test. The Michigan Department of Treasury has stated that it will use the attribution rules contained in IRC 318 to determine control.[13] The second half of the definition incorporates standards enunciated by the United States Supreme Court in *Mobile Oil Corp v Commissioner of Taxes of Vermont*[14] and *Container Corp of Am v Franchise Tax Bd*[15] and represents alternative tests: flow of value, or contribution or dependency. The flow of value is often present with centralized management or economies of scale. Contribution or dependency might exist if one entity finances the other, but between the two, there may or may not exist centralized management or economies of scale.[16]

Because the "unitary business group" is considered a "taxpayer," everything from the determination of the filing threshold to the qualification or disqualification for credits are determined at the unitary business group level and not determined at the member level. A limited liability company with less than the $350,000 in receipts and that would not have been required to file an SBT return will, if it is a member of a unitary business group with total receipts that exceed the

filing threshold, be required to be included in the "unitary business groups" return.[17]

The MBT exempts the agencies and political subdivisions of the United States, Michigan, and other states.[18] It also exempts most entities that are exempt federally, i.e., charitable or education organizations. Organizations exempt under IRC 501(c)(12) or 501(c)(16) are not exempt from the MBT.[19] For the remaining exempt entities, the MBT exemptions are limited to specific portions of the tax base attributable to specific nonprofit activities. The entities subject to this partial exemption include nonprofit cooperative housing corporations, farmers' cooperative corporations, agricultural producers, an attorney-in-fact to reciprocal insurers, and multiple employer welfare arrangements for dental benefits.[20]

## Nonresident Taxpayers: Nexus

SBT and now MBT taxpayers will have more company. The MBT pursues an aggressively low nexus standard to subject the highest number of nonresident businesses to the tax. "Nexus" refers to federal constitutional limitations on a state's jurisdiction. Due Process Clause "nexus" between a person and a state is established when the person purposefully avails itself of the state's benefits.[21] Michigan courts have held that Commerce Clause "nexus" requires a taxpayer's physical presence in the state. A third restriction applies only to state income taxes by federal law, Pub L No 86-272 (also known as 15 USC 381), and prohibits states from imposing an income tax if the only activity in the state was sales solicitation. That law did not apply to the SBT, as the Michigan Court of Appeals in *Gillette*[22] and *Guardian Industries*[23] determined that the SBT was *not* a tax on, or based on, net income.

*Gillette* and *Guardian* allowed Michigan to aggressively pursue nonresident businesses under the lower constitutional standard.[24] Though the expansion of the taxpayer base to nonresidents through a lower nexus standard was unanticipated when the SBT was first enacted, the state has gained a first-hand understanding of its revenue potential.[25] Nationally, fundamental nexus disputes remain regarding the extent to which a taxpayer must have physical presence or even whether a physical presence standard applies to a business tax at all.[26]

Within this context, the MBT establishes, by statute, the lowest nexus standard known to exist in the United States by mandating a finding of nexus if the taxpayer has *either* physical presence of more than one day in Michigan *or*, alternatively, "actively solicits" sales in the state that resulted in at least $350,000 in gross receipts.[27] In other words, the MBT rejected prior SBT case law requiring physical presence. Instead, the MBT's alternative test suggests the legal conclusion that there is no difference between the Commerce Clause and the Due Process tests.

Regarding the physical presence test, the MBT defines "physical presence" to mean "any activity conducted by the taxpayer or on behalf of the taxpayer."[28] The Department of Treasury has indicated that it will supplement this definition with reference to published standards contained in an SBT Revenue Administrative Bulletin (RAB) regarding SBT nexus.[29] For the alternative test of solicitation and sales, the MBT gives the Department of Treasury discretion to define the phrase "actively solicits," though it requires that any guidance be written and that it apply prospectively.[30] In December 2007, the Department of Treasury issued a Revenue Administrative Bulletin defining the term "actively solicits" to mean "purposeful solicitation of persons within this state" that "explicitly or implicitly invite[ ]" an order or are entirely "ancillary to requests for an order".[31] Solicitation, according to the RAB, is purposeful when "it is directed at or intended to reach persons within Michigan or the Michigan market." Some examples in the RAB include the use of mail, telephone, radio, Internet, television, including the maintenance of an Internet site over which sales transactions occur.

Though the MBT does not address Pub L No 86-272, the Department of Treasury has said that Pub L No 86-272 would only apply to the business income tax portion of the MBT.[32] Once any activity in the state exceeds the solicitation of sales threshold (the Pub L No 86-272 standard), the taxpayer will be subject to the Business Income Tax (BIT) on its entire tax base for the tax year. Conceivably a taxpayer could be subject only to the gross receipts tax, if the taxpayer's sole activity was the solicitation of sales. A taxpayer soliciting through an Internet site, for example, would be protected under Pub L No 86-272 from the Michigan Business Tax but would be still be subject to the modified gross receipts tax because its activity meets the definition of "actively solicits." The low

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nexus standard also has implications to related entities of the taxpayer. If the taxpayer is a flow-through entity that has nexus, the individual partners and shareholders will be subject to apportionment under Michigan's Income Tax Act on their distributive share of income.[33] While the nexus impact on partners and shareholders has not changed, the MBT's lower nexus standard will affect more flow-through entities, and, consequently, more partners and shareholders. A similar dynamic applies to the unitary business group. If one member of a unitary group has nexus, the income and receipts for all the members will be apportioned to Michigan.

A statutory nexus standard does provide a clearer starting point for the battles that will follow. It does not, however, eliminate the likelihood that the ultimate standard will be framed by courts. Having the most aggressive nexus standard may make meaningful compliance by nonresident businesses more difficult, generate more litigation, provide less meaningful insight into the nexus, and engender a considerable risk of large refunds.

### The Business Income Tax

The BIT is imposed on every taxpayer with business activity in the state, unless prohibited by Pub L No 86-272.[34] It is calculated by imposing a 4.95 percent rate on the "business income tax base" after allocation and apportionment.[35] The base is determined by making several adjustments to "business income," before allocation and apportionment, and by deducting MBT business losses after allocation and apportionment. The adjustments reverse the federal tax treatment by adding income items to the extent they were excluded from federal taxable income and subtracting to the extent the item was included in federal taxable income. A summary of the adjustments follows:

- Add back interest and dividends from non-Michigan obligations and securities.
- Add back taxes imposed on or measured by net income.
- Add back carryback or carryover net operating losses.
- Subtract dividends and royalties received from non United States persons or from a "foreign operating entity," (United States persons that would be part of a unitary group with substantial operations in foreign countries and that derive 80 percent of their income from active foreign business). See MCL 208.1109 (5))
- Subtract interest income from United States securities.
- Subtract net earnings from self-employment of the taxpayer, or a partner or limited liability company member of the taxpayer, except to the extent that the net earnings represent a reasonable return on capital.
- Add the loss or subtract the income attributable to another entity whose business activities are taxable under the BIT, or would be subject to the BIT if the business activities were in this state.
- Add back any royalty, interest, or other expense paid to a related person for the use of an intangible asset, if that person is not included in the taxpayer's unitary business group.[36]

The last adjustment addresses tax plans using intangible holding companies to redirect royalty income to another entity in a non-taxing state, reducing the taxpayer's income by expensing a royalty payment. See *Geoffrey, Inc v So Carolina Tax Comm'n,* 437 SE2d 13 (1993), *cert den* 114 S Ct 550. Thus, this planning tool is denied under the MBT. The MBT presumptively adds back royalty, interest, or other expenses unless the taxpayer can overcome four rather significant hurdles. These include a nontax business purpose other than avoidance of the tax, arms-length pricing, rates and terms as applied by IRC 482[37] and 1274(d), and one of three exceptions is satisfied: the item represents a pass-through of another transaction between a third-party and the related person with comparable rates and terms, or it results in double taxation because the transaction is subject to tax in another jurisdiction, or it is unreasonable as determined by the Department of Treasury.[38]

Given the long-voiced complaints regarding the SBT's inclusion of compensation in the SBT tax base, it bears underscoring the MBT's more favorable treatment of compensation. In addition to the very significant credit for compensation in Michigan that potentially eliminates half of the MBT liability, the BIT has eliminated compensation both in the definition of "business income"[39] and as an adjustment, noted above, for "any earnings that are net earnings from self-employment…of the taxpayer or a partner or limited

Given the long-voiced complaints regarding the SBT's inclusion of compensation in the SBT tax base, it bears underscoring

liability company member of the taxpayer except to the extent that those net earnings represent a reasonable return on capital."[40]

The "business income" of a unitary business group is the sum of the business income of each person. In addition to the adjustments described above, the group would also subtract any items of income and related deductions from transactions between members of the unitary business group. The "business income" of "foreign operating entities," financial institutions, and insurance companies is excluded.[41]

What is "business income"? The MBT's statutory definition of "business income"[42] lacks an exception for income functionally and transactionally *unrelated* to a taxpayer's regular trade or business. The Due Process Clause requires that, for nonresident businesses, the income must still have some constitutionally sufficient relationship, under the unitary business principle, to the activity of the business in the taxing state.[43] "Business income" is defined as "that part of federal taxable income derived from business activity." However, the broad SBT definition of "business activity"[44] has been retained without the exception for a "casual transaction." As a result, there is no connection to "transactions and activity in the regular course of the taxpayer's trade or business."[45] Whether the MBT's definition of "business activity" meets the requirements of Due Process when applied to income from "incidental" activity in "interstate or foreign commerce," having only "indirect" benefit to the nonresident business's regular trade or business in Michigan, is questionable.

The definition of "business income" continues with entity-specific guidelines for: a partnership or S Corp; an exempt cooperative electric company; an exempt entity; and "an individual, estate, or partnership organized exclusively for estate or gift planning purposes."[46] The first three guidelines parallel federal tax treatment. The last item addresses the income from trusts, family limited partnerships, and other estate planning entities. As to this last set of entities, however, the language raises some questions regarding whether the qualifier, "organized exclusively for estate or gift planning purposes," excludes other business purposes that may be required under federal case law.[47]

## The Modified Gross Receipts Tax

A general business tax measured by gross receipts is not new to Michigan. The precursor to Michigan's corporate income tax was a Business Activities Tax that imposed an excise tax on gross business activities, measured by gross receipts. Though gross receipts taxes use some of the same receipts that are used to determine a retail sales tax, gross receipt taxes are not taxes on the sales to the ultimate consumer and are not collected on a sales transaction basis. Typically, exclusions for business inputs are not present, and the tax itself is not deductible from the base. These distinctions exist because the gross receipts tax seeks to encompass all of the business' activity in the state, not just sales.

For 25 years, Michigan held to roughly the same definition of "gross receipts" that had been used in the Business Activities Tax. The definition changed significantly in 2000, when the Department of Treasury sought to remedy seemingly inconsistent court cases and resolve the pending litigation.[48] In addition to new exceptions,[49] the MBT retains the SBT's definition of "gross receipts" and all of the definition's exceptions."[50] The definition of "gross receipts" was not as important with the SBT, which used the definition of "gross receipts" to set the parameters of the tax, establishing a filing threshold and a maximum cap on the SBT liability—the maximum SBT liability. By contrast, the MBT uses gross receipts both to determine the MBT filing threshold and to calculate the modified gross receipts tax base. Having a tax based on gross receipts under which all taxpayers will pay means the MBT may have ramifications for taxpayers who generally did not incur a tax liability under the SBT.

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The MBT's modified gross receipt tax reflects both the breadth of a gross receipts tax and the problem of including business inputs that may not always logically portray a business's activity. Both characteristics are found in the MBT's definition of "gross receipts," which is not tied to a trade or business (i.e., sale of inventory or services) but applies to any "direct or indirect gain, benefit, or advantage to the taxpayer or *to others*."[51] The retained SBT exceptions took out receipts that benefited someone other than the taxpayer, such as a taxpayer-property manager's receipt of rent for the owner or receipts that did not represent an actual profit to the taxpayer (such as an exchange of like-kind property), the receipt of a security deposit, a purchaser

discount, or insurance reimbursements for stolen or damaged property. For mortgage companies, sales finance companies, or securities brokers or dealers, the new MBT exceptions eliminate from "gross receipts" the repayment or sale of the *principal* amount of loans, bonds, mutual funds, certificates of deposit, or marketable instruments.[52] Another new MBT exception from "gross receipts" for professional employer organizations (PEO) excepts the amounts a PEO would receive to pay a covered employee of the employer-client.[53] Finally, an amendment similar to the "business income" exception addresses the gross receipts of trusts, family limited partnerships, and other estate planning entities, but this is limited to those entities that are "exclusively organized for estate or gift planning purposes."[54] The new MBT exceptions are the first statutory effort to except passive investment receipts from "gross receipts" for individuals, estates, and for trusts or partnerships "organized exclusively for estate or gift planning purposes." As to this last set of entities, however, it is unclear whether the qualifier "organized exclusively for estate or gift planning purposes" excludes other business purposes.[55] Receipts from personal investment activity and disposition of property held for personal use and enjoyment are also excluded. [56]

A taxpayer's gross receipts are modified by the subtraction for "purchases from other firm."[57] The MBT defines this phrase to mean:

a) Inventory acquired during the tax year, including freight, shipping, delivery, or engineering charges included in the original contract price for the inventory.
b) Assets, including the cost of fabrication and installation, acquired during the tax year…that are, or under the internal revenue code will become, eligible for depreciation, amortization, or accelerated capital cost recovery…
c) To the extent not included in inventory or depreciable property, materials and supplies, including repair parts and fuel.
d) For a staffing company, compensation of personnel supplied to customers of staffing companies. …
e) .payments to subcontracts for a construction project under a contract specific to that project.
f) For the 2009 tax year, 50% of film rental or royalty payments paid by a theater owner to a film distributor, a film producer, or a film distributor or producer. For the 2010 tax year and each tax year after 2010, all film rental or royalty payments paid by a theater owner to a film distributor, a film producer, or a film distributor and producer.[58]

The definition of "purchases from other firms" raises a number of questions. First, a number of terms are not defined, i.e. "materials," "supplies," etc. Second, intangible personal property or services are not excluded. It may not be clear with respect to the inventory deduction whether these items could be treated as part of the inventory cost (i.e. warranties) if they were included in the contract price for inventory. The Department of Treasury has stated that "labor" is not included as a "purchase from other firms." While a staffing company may deduct compensation paid to personnel supplied to the staffing company's clients, the client's payments to the staffing company do not constitute "purchases from other firms."[59]

For a unitary business group, the modification (or deduction for "purchases from other firms") from gross receipts is a sum of the individual calculations by each member, and the deduction of "modified gross receipts arising from persons included in the unitary business group."[60] For the 2008 year only, both individual businesses and unitary business groups may also subtract unused business loss carryforwards from the 2006 and the 2007 tax years. For unitary business groups, the loss carryforward may only be deducted by the individual members as if the member were not included in the group.[61]

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## Apportionment and Allocation of the Tax Base

To identify business activity in Michigan, both the business income tax base and the modified gross receipts tax base are subject to apportionment or allocation.[62] If the taxpayer's "business activity" is confined solely to Michigan, then the MBT tax base will be *allocated* to Michigan. Taxpayers whose "business activities" are both in Michigan and in other states must *apportion* the tax base by use of a sales factor, the numerator of which represents the taxpayer's total sales in Michigan and the denominator of which represents total sales everywhere else.[63]

The MBT does not include any "throw back" provision for apportionment in which sales occurring outside of Michigan would nevertheless be "thrown back" into the Michigan numerator if the other state could not tax the sale. Sales remain in the denominator regardless of whether they are taxed or whether the other state has constitutional nexus to tax. There is a caveat: if the taxpayer does not have nexus with at least one other state, regardless if it has sales in that state, the taxpayer cannot apportion its MBT tax base at all.[64]

The MBT's provisions sourcing sales revenue utilize three general rules: the location of the property being sold, the location of where the property is used, and where the service customer is located or where the benefit is received. At the risk of over-simplification, the following guidelines are a starting point to determine whether the business activity is attributable to Michigan:

Location of the property

- Sales of tangible personal property are sourced by the shipping or delivery point
- Sales of gas or electricity are sourced to the ultimate destination point
- Receipts from origination of a loan, interest from a loan secured by real property
- Loan servicing fees on loans secured by real property

Location of use

- Lease or rental of tangible personal property
- Lease or rental of mobile transportation property
- Royalties, use or right to use intangible property, licenses, franchises, copyrights
- Receipts from transportation services

Location of customer or the benefit received

- Performance of services
- Security brokerage services
- Management, distribution, administration of brokerage services
- Interest from a loan not secured by real property
- Receipts from credit card receivables, the sale of credit cards, and interest
- Receipts from the sale of securities or other investment instruments
- Receipts from the sale of telecommunication services
- Receipts from live radio or television programming[65]

Exceptions to the above generalization are the various sales of telecommunication services,[66] which largely reflect the industry's capability in tracing the service. The rules also contain a general rule for receipts that have not been specifically addressed, requiring that the receipts be sourced based on where the benefit to the customer is received, or, if that cannot be determined, the customer's location.[67] A number of the provisions have similar default sourcing rules if the first sourcing rule cannot be determined.

One constitutional question is whether a single sales factor itself is constitutional. Though a single sales factor apportionment increases the tax for businesses with less physical presence and generally less business activity in the state, the United States Supreme Court approved of a single sales factor in *Moorman Manufacturing Co v Bair,*[68] concluding that a single sales factor was not "inherently arbitrary" and "did not produce an unreasonable result." However, the MBT single sales factor apportionment may present some additional questions. One issue may be the disparity between the significant number of site-based credits given to businesses with a significant physical presence in the state but utilizing a different measure of business activity to apportion the tax base. Another similar issue may be the difference that exists between the income and receipts in the MBT tax base and the MBT's definition of sales used as a basis for apportionment.[69] The MBT defines "sales" in part to be:

> the amounts received by the taxpayer as consideration from…[t]he transfer of title to, or possession of, property that is stock in trade or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the tax period or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. For intangible property, the amounts received shall be limited to any gain received from the disposition of that property….[70]

By contrast, the definition of "sales" excludes income/receipts from isolated transactions and excludes income/receipts from trans-

One constitutional question is whether a single sales factor itself is constitutional.

actions that are not functionally related to the taxpayer's trade or business. The same income and receipts are included in the tax base but not included in the apportionment factor.[71] It is unclear, particularly in the instance of large out-of-Michigan asset sales, liquidations, and mergers or acquisitions, whether this narrow apportionment scheme is reasonable.

Another issue concerns the treatment of the unitary business group. A unitary business group is required to include the sales in Michigan of every person included in the unitary business group without regard to whether the person has nexus in this state.[72] The obvious question this raises is whether it is constitutional to include as Michigan sales, sales made by a member of the unitary business group, even though the member has no nexus with Michigan. Is the MBT taxing income and receipts that would not otherwise be taxed?

The obvious question this raises is whether it is constitutional to include as Michigan sales, sales made by a member of the unitary business group, even though the member has no nexus with Michigan.

While this method of unitary apportionment has been litigated in other states, most notably California,[73] most states have three-factor formulary apportionment schemes (property, payroll, and sales); that is to say, that even if the sale factor "overstated" the taxable sales in the state, the lack of a property or payroll in the state would have "dampened" extent of the purported "overstatement." Coupled with the MBT's aggressive nexus standard, these issues may suggest that the MBT's single sales apportionment factor, even under *Moorman,* has produced an "unreasonable result."

The MBT's alternative apportionment provisions may ultimately be the method of resolving these questions.[74] If the Department of Treasury determines that the apportionment provisions of the act do not "fairly represent the taxpayer's business activity in this state," the Department of Treasury is authorized to "use any other method" that will achieve an "equitable allocation and apportionment of the taxpayer's tax base."[75] The alternative apportionment provision leaves much to the Department of Treasury's discretion.

## Credits

### *In General*

One goal underlying the MBT was to attract jobs to Michigan, particularly in research and development and manufacturing. To achieve this goal, the MBT provides a number of tax credits that reduce the tax liability for qualifying taxpayers and addresses common complaints regarding the SBT: the compensation credit, the personal property tax credit, the "phase in" credit, and changes to the small business credit.

The calculation of credits is made after allocation and apportionment and the surcharge. There is an order in which the credits may be taken. The largest three credits (compensation, net investment, and research and development) are all new under the MBT and must be taken before any other credits.[76] The compensation and net investment credits, together, are capped at 50 percent of the taxpayer's total liability after the surcharge. The cap increases to 52 percent in 2009.[77] The cap also rises to 65 percent of the taxpayer's liability with the inclusion of the third credit for research and development.[78] After the three large credits, the taxpayer must take the Alternate (formerly Small Business) Credit.[79] Thereafter the taxpayer may take a "phase-in" credit, which was created for the purpose of providing a gradual increase of the MBT for those small MBT taxpayers that are just over the $350,000 filing threshold but under $700,000.[80] Other credits may then be taken.

Most of the credits have a lower rate for the 2008 tax year, again the result of the surcharge tax and the effort to resolve the state's budget crisis. For 2009 and subsequent tax years, the rate for most credits increase. The MBT permits any unused SBT credit carryforwards to be taken in the 2008 and 2009 tax years. Thereafter, the SBT credit carryforwards are extinguished[81] with the exception of two SBT credits: the Michigan Historic Preservation Credit and the Brownfield Credits.[82] The credits are generally, with a few exceptions (personal property tax credit and the disability act credit) not refundable.

## New Credits

### *Compensation Credit*

For the 2008 tax year, taxpayers may claim a credit of 0.296 percent of the "taxpayer's compensation in this state" against their MBT liability.[83] The credit increases to 0.37 percent for the 2009 tax year and afterwards. The MBT retains, for the most part, the SBT's definition of "compensation." There is no definition for determining the phrase "in this state." Professional employer organizations (PEO) are not excluded from this credit, but are limited to the compensation paid to their own officers and employees who operate the PEO. The PEO may not claim the compensa-

tion paid to the leased officers and employees of the client.[84]

***Net Investment Credit***[85]

The MBT permits taxpayers to claim a credit for the cost to acquire tangible assets "physically located in this state for use in a business activity in this state" and for "mobile tangible assets" that are "transferred into the state and purchased or acquired for use in a business activity." The costs include fabrication and installation but are netted against the gross proceeds from the sale or disposition of similar property. The rate for 2008 is 2.32 percent. For 2009 and thereafter, the rate increases to 2.9 percent.

***Research and Development Credit***[86]

Taxpayers may claim a credit for "research and development expenses in this state." The phrase "research and development expenses" references IRC 41(b), which covers wages, supplies, and computer licenses for both "in-house" and "contract" research. For the 2008 tax year, the credit is 1.52 percent but increases in 2009 to 1.9 percent. Combined with the other credits—compensation and net investment—this credit is capped at 65 percent.

***The Alternate (formerly Small Business) Credit***[87]

The SBT's small business credit[88] became a focal point for tax planning, in which different entities were created to disperse income and compensation and thus avoid the small business credit's income and compensation disqualifiers. The Department of Treasury was not successful in combining non-Michigan parent companies with a Michigan subsidiary seeking the credit.[89]

Since the entire unitary business group constitutes a "taxpayer," the group must meet the income, gross receipts, and compensation tests. The threshold for those three tests has increased. The gross receipts maximum is now $20 million. "Adjusted business income" ("business income" with the addition of compensation and fees of active shareholders and losses) has been increased to $1.3 million. The maximum single officer or shareholder compensation is now set at $180,000. Like the compensation credit, PEO clients must include, in the calculation of the credit, compensation and fees of the client's officers, owners, or shareholders even if they are leased from the PEO. The SBT attribution rules to determine "active shareholders" and "shareholder" for the SBT will likely continue to be used to determine these same, nearly identical terms, in the MBT.

***Phase-In Credit***[90]

A criticism of the SBT was that once a taxpayer exceeded the $350,000 filing threshold—by as little as a dollar—the taxpayer paid the full amount of the SBT. The MBT phases in the tax for those taxpayers with gross receipts between $350,000 and $700,000. The "phase in" credit is calculated by multiplying the MBT liability by a fraction, the numerator of which is the difference between the taxpayer's apportioned gross receipts and $700,000 and the denominator of which is $350,000.

***MEGA Approved Research and Development Credit***[91]

This credit is different in several respects from the more general research and development credit. First, it is very targeted. The credit applies to "eligible taxpayers" who must propose to work with an "eligible business" and invest no less than $350,000 in the business. Further, the taxpayer must not have received the credit in the previous year. An "eligible business" is generally a small business of less than 50 employees and less than $10 million in gross receipts. Second, the credit is equal to 30 percent of the taxpayer's "eligible contribution" but is capped at $300,000. Third, the taxpayer must first obtain a certificate from the Michigan Economic Growth Authority, which may only grant 20 credits a year.

***Entrepreneurial Credit***[92]

For the 2008 through 2010 tax years, qualified businesses that create or transfer new jobs into the state are able to claim a 100 percent credit against an adjusted tax liability (which is the taxpayer's total tax liability multiplied by a fraction of the payroll due to increased jobs and the taxpayer's total payroll in the state). To qualify, the taxpayer may not be a retail establishment (though some small restaurants are permitted), must have less than $25 million in gross receipts, make a capital investment of not less than $1.25 million in the state, and create or transfer to Michigan 20 or more jobs.

***Personal Property Tax Credit***[93]

In late 2005, the Michigan Legislature added a refundable personal property tax credit of 15 percent for taxes levied and paid on industrial personal property in the tax year.[94]

Since the entire unitary business group constitutes a "taxpayer," the group must meet the income, gross receipts, and compensation tests.

The MBT increased the credit to 35 percent of the taxes paid on industrial personal property. Together with the exemption from the 6-mill state education tax and the 18-mill local school property tax, industrial personal property would realize an average effective personal property tax reduction of 64.9 percent. Credits for eligible telephone personal property (23 percent), and eligible natural gas pipeline property (13.5 percent) were also provided. No credit was provided for commercial personal property.

To qualify for this credit, the taxpayer must have filed a personal property tax statement by February 20 of the tax year and have paid the personal property tax before claiming the credit on the taxpayer's annual MBT return. The Department of Treasury will likely require proof of timely filing and of payment. An important consideration is that the personal property must be classified as industrial, as opposed to commercial personal property. To appeal classifications, the taxpayer must appeal to the March Board of Review and, if not satisfied, to the State Tax Commission.

With taxes, the line between encouraging economic growth and discriminating against nonresident businesses is thin.

### *Arts and Culture Charitable Credit*[95]

The MBT provides a credit to taxpayers that make a charitable contribution of at least $50,000 to art, historical, or zoological institutes and other museums that "care, study and display…objects of lasting interest or value." This last phrase, the Department of Treasury has determined, is a "facts and circumstances" test.[96] The credit is equal to 50 percent of the amount that exceeds the threshold of $50,000.

### *Industry-Specific MBT Credits*

Various other credits are provided to specific industries, such as, retail enterprises headquartered in Michigan with specified square feet of retail space,[97] motor sports complexes,[98] and motor vehicle dealer inventory.[99]

### *SBT Credits Retained in the MBT*

In addition to the Renaissance Zone Credit and the Brownfield Credit, the MBT retains a number of SBT credits, such as: an Early Stage Venture Credit,[100] a Start-up Business Credit,[101] Next-Energy Credit,[102] MEGA Credits,[103] Charitable Contribution Credits,[104] Foundation Contribution Credit,[105] Food Bank and Homeless Credit,[106] and Disability Compensation Credit.[107]

With taxes, the line between encouraging economic growth and discriminating against nonresident businesses is thin. Undeniably, the MBT credits favor businesses with substantial investments in plants and personnel in the state. On the other hand, the constitutional law in this area has not yielded predictable results. A challenge to the MBT's site-based tax scheme as unconstitutional continues litigation that has never found success in Michigan.[108] While the Michigan cases do not comfortably fit within the broad language of a number of United States Supreme Court decisions,[109] the interpretation of that jurisprudence is also debated. The United States Supreme Court's reversal of the Sixth Circuit Court of Appeals decision in *Cuno*, which invalidated a site-based state credit for machinery and equipment on jurisdictional grounds, leaves the area unsettled.[110]

## Filing and Administration

Taxpayers that expect an annual liability exceeding $800 are required to file estimated returns and pay the tax for each quarter.[111] For calendar year filers, those due dates are April 15, July 15, October 15, and January 15. Fiscal year filers must file estimated returns "on the appropriate due date which in the taxpayer's fiscal year corresponds to the calendar year."[112] This is the 15th day of the first month of each quarter. The return form will contain both BIT and modified gross receipts taxes. No underpayment interest will be assessed if the estimated payment for the month is at least 85 percent of the liability.[113] The Department of Treasury anticipated mailing quarterly estimated Michigan Business Tax forms this January, and it has provided an "MBT Estimator" on its Web site (https://treas-secure.state.mi.us/MBTEstimator/MBTEstimator-start.asp) to assist taxpayers.

Annual returns are due on the last day of the fourth month after the end of the taxpayer's tax year, or, if the taxpayer is a calendar year filer, April 30.[114] As with the SBT, an extension for filing the federal income tax return does not extend the time for filing and paying the MBT return unless the taxpayer takes several specific steps including, filing a copy of the request for extension with a tentative return and payment of the estimated tax by the due date for filing the annual return. The extension will be "automatic" to the last day of the eighth month following the original due date.[115] Also like the SBT, a longer extension may be available "for cause," provided the taxpayer files a timely application

and pays the remaining unpaid estimated tax liability.[116] For the 2008 fiscal year, fiscal year filers with years ending in 2008 will be granted an automatic extension for their annual fiscal year MBT return, which will be due the same date as the return for calendar year filers, April 20, 2009. At the option of the taxpayer, SBT overpayments from the final SBT return may be carried forward and applied to the MBT or refunded.[117]

Special provisions address taxpayers whose tax year is less than 12 months.[118] The MBT gives such taxpayers an election to either:

- Compute the tax as if it were effective on the first day of the taxpayer's accounting period and apportion the tax by a fraction the numerator of which is the number of months in the taxpayer's first year and the denominator of which is 12; or,
- Compute the tax base by a method approved by the Department of Treasury.

Unitary business groups are required to file a "combined return." A combined return includes the income and receipts for all firms other than foreign operating entities, but it eliminates transactions between members of the group from the business income tax base, the modified gross receipts tax base, and the apportionment formula.[119] Though it is unclear how Michigan will apportion for unitary groups, since typically the total income and receipts sourced to taxing state for the unitary business group are determined by the unitary group's apportionment factor. From the group's sourced income and receipts, each member then is apportioned an amount that represents the ratio of the member's apportionment factor to the groups apportionment factor. Thus, while members included within the unitary business group that lack nexus with Michigan will not be taxed, other members of the group with nexus will be paying a greater portion of the unitary business group's tax.

## Conclusion

The discussion thirty years ago after the SBT was passed is similar to the public discussion over the past year.[120] Like the SBT then, the MBT in its present form is merely a starting point. A good part of the MBT's further development, and there will be development, has been left to tax professionals. That there are a number of constitutional questions concerning the MBT is not necessarily a critique of the policy makers and legislators that crafted the MBT. In some respects, it may illustrate that the state's experience with the SBT produced an institutional knowledge such that the state was willing to put down markers for the constitutional litigation that will follow. From that standpoint, the tax has gone where no other state has, fully aware of the potential challenges, but compelled to address important policy questions. At this time, judgments as to the tax's success may be premature. More probably, the extent to which the MBT is a success now depends on the work of tax professionals. There is a lot to do.

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### NOTES

1. 2007 PA 36, adding MCL 208.1101 et seq.
2. In lieu of the MBT, insurance companies are subject to a direct premiums tax and financial institutions are subject to a franchise tax on net equity capital. Both taxes are separate from a general business tax, the MBT.
3. MCL 208.1201.
4. MCL 208.1203.
5. MCL 208.1281, *et seq.*; Chapter 2C; 2007 PA 145. A surcharge is also imposed on franchise taxpayers. There is no surcharge imposed on insurance companies. The primary purpose of the surcharge was to close a budget deficit that resulted from repeal of state's short-lived (four hours) service tax (2007 PA 93).
6. MCL 208.1281(1)(a).
7. The Department planned to send them the required tax returns in January 2008. Michigan Business Tax Frequently Asked Questions, A 10.
8. MCL 208.1505(1).
9. MCL 208.1117(5).
10. MCL 208.6(1) "Person" means an individual, firm, bank, financial institution, limited partnership, copartnership, partnership, joint venture, association, corporation, receiver estate, trust, or other group or combination acting as a unit.
11. MCL 208.1113(3).
12. MCL 208.1109(5) "Foreign operating entity" means a United States person that satisfies each of the following:

Would otherwise be part of a unitary business group that has at least 1 person included in the unitary business group that is taxable in this state.

Has substantial operations outside the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, or a political subdivision of any of the foregoing.

At least 80% of its income is active foreign business income as defined in section 861 (c) (1) (B) of the internal revenue code.

13. Michigan Business Tax Frequently Asked Questions, U6, U8.
14. 445 US 425, 100 S Ct 1223, 63 L Ed 2d 510 (1980).
15. 463 US 159, 103 S Ct 2933, 77 L Ed 2d 545 (1983).
16. Michigan Business Tax Frequently Asked Questions, U8.

17. Michigan Business Tax Frequently Asked Questions, C5, U11, U18.

18. MCL 208.1207(1)(a)

19. MCL 208.1207((1)(b)(i).

20. MCL 208.1207(1)(c)-(h).

21. *Burger King v Rudzewicz*; 471 US 462, 105 SCt 2174; 85 Led 2d 528 (1985).

22. *Gillette Co v Dept of Treas*, 198 Mich App 303, 497 NW2d 595 (1993).

23. *Guardian Industries v Dept of Treas* 198 Mich App 363, 499 NW2d 349 *lv app den* 444 Mich 943, 512 NW2d 846 (1994).

24. See, Gandhi, *International Home Foods, Inc.*: *A Final Determination of the Retroactive Application of Michigan's Single Business Tax Nexus Standards*, Michigan Tax Lawyer, XXXIII, No. 1, Winter, 2007.

25. *Syntex v Dept of Treas.*, 233 Mich App 286, 590 NW2d 612 (1998).

26. [1] *MBNA America Bank v Tax Comm'r of West Virginia*, 640 SE2d 226 (W Va S Ct, 2006), *cert den; FIA Card Services v Tax Comm'r of West Virginia*, 127 S Ct 2997 (2007); *Lanco, Inc v Director, New Jersey Div of Taxation*, 879 A2d 1234 (NJ Super Ct App Div, 2005), *cert den* 127 S Ct 2974 (2007); *A&F Trademark, Inc v North Carolina*, 605 SE2d 187 (NC Ct App, 2004), *cert den* 546 US 821 (2005); *Geoffrey, Inc v So Carolina Tax Comm'n,* 437 SE2d 13 (1993), *cert den* 114 S Ct 550;

27. MCL 208.1200(1).

28. MCL 208.1200(3).

29. Michigan Business Tax Frequently Asked Questions, N2 (referencing RAB 1998-1).

30. MCL 208.1200(2).

31. Rev Admin Bulletin 2007-6.

32. Michigan Business Tax Frequently Asked Questions, N2.

33. Michigan Business Tax Frequently Asked Questions, N3.

34. MCL 208.1201.

35. MCL 208.1201(1).

36. MCL 208.1201(2).

37. 26 USC 482. "Allocation of income and deductions among taxpayers. In any case of two or more organizations, trades, or businesses(whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses…."

38. MCL 208.1201(2)(f).

39. The definition of "business income," MCL 208.1105 (2), reduces the effect of compensation somewhat indirectly. The definition of "business income" captures that part of federal taxable income derived from "business activity." The later definition excepts, "services rendered by an employee to his or her employer or services as a director of a corporation." MCL 208.1105(1).

40. MCL 208.1201(2)(h).

41. MCL 208.1201(3).

42. MCL 208.1105(2).

43. *Allied-Signal, Inc. v Director of Division of Taxation*, 504 US 768; 112 SCt 2251; 119 L Ed 2d 533 (1992).

44. MCL 208.1105 (1) "Business activity" means a transfer of legal or equitable title to or rental of property, whether real, personal, or mixed, tangible or intangible, or the performance of services, or a combination thereof, made or engaged in, or caused to be made or engaged in, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or indirect, to the taxpayer or to others, but does not include the services rendered by an employee to his or her employer or services as a director of a corporation. Although an activity of a taxpayer may be incidental to another or to other of his or her business activities, each activity shall be considered to be business engaged in within the meaning of this act.

45. The Uniform Division of Income for Tax Purposes Act (UDITPA)MCL 205.581, Art. IV (1) (a). "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

46. MCL 208.1105(2).

47. Recent federal court decisions suggest that family limited partnerships must serve a legitimate business purpose to be excluded from the value of the gross estate for federal estate and gift taxes. See *Estate of Thompson v Commissioner,* 382 F3d 367 (3rd Cir. 2004) and *Estate of Strangi v Commissioner,* 417 F3d 468 (5th Cir. 2005).

48. *Stratton-Cheeseman Management Co v Dept of Treas,* 159 Mich App 719, 407 NW2d 398 (1987); *Systems Parking, Inc. v Dept of Treas,* MTT No. 91346 (1988); *Credit Acceptance Corp v Dept of Treas,* MTT No. 204459 (1997); 236 Mich. App. 478, 601 NW2d 109 (1999), *app den* 462 Mich 865, 616 NW2d 686; *PM One, Ltd, v Dept of Treas,* 240 Mich App 255, 611 NW2d 318 (2000).

49. MCL 208.1111(1) (q)-(v).

50. MCL 208.1111(1) (a)-(p). See also subsection 7(3) of the Single Business Tax Act (SBTA), MCL 208.7 (3).

51. MCL 208.1111(1).

52. MCL 208.1111(1) (q)-(s).

53. MCL 208.1111(1) (t).

54. MCL 208.1111(1)(v).

55. Recent federal court decisions suggest that family limited partnerships must serve a legitimate business purpose to be excluded from the value of the gross estate for federal estate and gift taxes. See *Estate of Thompson v Commissioner,* 382 F3d 367 (3rd Cir. 2004) and *Estate of Strangi v Commissioner,* 417 F3d 468 (5th Cir. 2005).

56. MCL 208.1111(1)(v).

57. MCL 208.1203 (3).

58. MCL 208.1113 (6).

59. Michigan Business Tax Frequently Asked Questions, M7, M9.

60. MCL 208.1203 (4).

61. *Id.*

62. MCL 208.1301.

63. MCL 208.1303(1).

64. Michigan Business Tax Frequently Asked Questions, Ap3.

65. MCL 208.1305.

66. MCL 208.1305(13).

67. MCL 208.1311.

68. 437 US 267, 98 S Ct 2340, 57 L Ed 2d 197 (1978).

69. MCL 208.1115.

70. MCL 208.1115(1).

71. Michigan Business Tax Frequently Asked Questions, Ap1.

72. MCL 208.1303 (2). The group is also required to eliminate sales between members of the unitary business group.

73. *Appeal of Huffy Corp,*Cal St Bd of Equal, April 22, 1999; *Appeal of Finnegan Corp* Cal St Bd of Equal, August 25, 1988; *Appeal of Joyce, Inc* Cal St Bd of Equal,

Nov. 23, 1966; See also, *Great Northern Nekoosa Corp v State Tax Assessor,* 675 A2d 963 (1996); *Dover Corp v Dept of Rev* 648 NE2d 1089 (1995).

74. MCL 209.1309.

75. In *Jones & Laughlin v Dept of Treas,* 145 Mich App 405, 377 NW2d 397 (1985) *lv den* 424 Mich 895 (1986), the Court of Appeals upheld a finding that where a taxpayer's apportioned compensation under the SBT exceeded the taxpayer's actual compensation in Michigan by more than 50% that the apportionment was not fair.

76. MCL 208.1403(1).

77. *Id.*

78. MCL 208.1405.

79. MCL 208.1417.

80. MCL 208.1411.

81. MCL 208.1401.

82. MCL 208.1435, .1437.

83. MCL 208.1403 (1).

84. MCL 208.1403 (2)

85. MCL 208.1403(3).

86. MCL 208.1405

87. MCL 208.1417.

88. MCL 208.36.

89. *Alameda Gage Corp v Dept of Treas,* 159 Mich App 693, 407 NW2d 61 (1987).

90. MCL 208.1411.

91. MCL 208.1407.

92. MCL 208.1441.

93. MCL 208.1413.

94. 2005 PA 289.

95. MCL 208.1422.

96. Michigan Business Tax Frequently Asked Questions, C15.

97. MCL 208.1449.

98. MCL 208.1409.

99. MCL 208.1445.

100. MCL 208.1419.

101. MCL 208.1415.

102. MCL 208.1429.

103. MCL 208.1431.

104. MCL 208.1422.

105. MCL 208.1425.

106. MCL 208.1427.

107. MCL 208.1423.

108. *Caterpillar, Inc v Dept of Treas,* 440 Mich 400, 488 NW2d 182 (1992); *Jefferson Smurfit Corp v Dept of Treas,* 248 Mich App 271, 639 NW2d 269 (1999); *Dana Corp v Dept of Treas,* 267 Mich App 690, 706 NW2d 204 (2005).

109. *Armco, Inc v Hardesty,* 467 US 638, 104 S Ct 2620, 81 L Ed 2d 540 (1984); *Tyler Pipe Industries, Inc v Washington Dept of Rev,* 483 US 232, 107 S Ct 2810, 97 L Ed 2d 199 (1987); *West Lynn Creamery, Inc v Healy,* 512 US 186, 114 S Ct 2205, 129 L Ed 2d 157 (1994).

110. *Cuno v DaimlerChrysler*, 386 F3d 738 (CA 6, 2004) *lv app den* 126 S Ct 2286 (2006).

111. MCL 208.1501.

112. MCL 208.1501 (2).

113. MCL 208.1501 (4) (a).

114. MCL 208.1505 (1).

115. MCL 208.1505 (4).

116. MCL 208.1515(3).

117. Michigan Business Tax Frequently Asked Questions, A16.

118. MCL 208.1503.

119. MCL 208.1511.

120. *Symposium on the Single Business Tax*, 22 Wayne L R 1017-1213 (1976); Getz, *Questions and Answers on the Michigan Single Business Tax: A Review,* Det. C. L. R 489 (1976).

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# Case Digests

## Securities—Private Right of Action under Rule 10b-5--Reliance

In *Stoneridge Inv Partners, LLC v Scientific-Atlanta, Inc*, 2008 US LEXIS 1091, 128 S Ct 761 (2008), investors in a class action alleged losses after purchasing common stock. They sought to impose liability on entities that, acting both as customers and suppliers, agreed to arrangements that allowed the investors' company to mislead its auditor and to issue a misleading financial statement affecting the stock price. The plaintiffs alleged that, by participating in the transactions, respondents violated § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.

In a typical § 10(b) private action, a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation. The § 10(b) implied private right of action does not extend to aiders and abettors and the conduct of a secondary actor must satisfy each of the elements or preconditions for liability. With regard to reliance, respondents had no duty to disclose and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Therefore the petitioner could not show reliance on any of the respondents' actions except in an indirect chain that the court find too remote for liability. Thus, the court ruled that the implied right of action did not reach the customer/supplier companies because the investors did not rely on their statements or representations.

## Contracts—Condition Precedent

In *Harbor Park Market, Inc v Gronda*, 277 Mich App 126 (2007), plaintiff offered to purchase defendants' fixtures and liquor license for a party store for $55,000. The defendants accepted the offer, which was expressly conditioned on the approval of the purchase agreement by defendants' attorney. Before their counsel had the opportunity to review this purchase agreement, the defendants conditionally accepted a second offer from another party to purchase defendants' real property, along with the business, liquor license, and fixtures, for $250,000. The second offer was also conditioned on approval of the purchase agreement by the defendants' attorney. The defendants' attorney reviewed the agreements and approved the second offer. Plaintiff then filed suit for breach of contract and requested specific performance of the contract. The trial court ruled that the defendants placed an obstacle in the way of the attorney's approval of plaintiff's offer and ordered specific performance of the first purchase agreement.

The court of appeals determined that the central issue on appeal was whether the defendants interfered with, and consequently waived, the condition precedent by simultaneously submitting to their attorney a second conditional agreement. Because the contract language giving the defendants' attorney complete discretion to approve or disapprove the agreement for whatever reason was clear and unambiguous, it had to be accepted and enforced as written. In addition, there was no finding by the trial court that the defendants otherwise actively interfered with their attorney's approval, such as instructing the attorney to disapprove the agreement. After reviewing the record, the court of appeals concluded that the trial court erred in holding that the defendants acted in bad faith by submitting to two conditional agreements to their attorney at the same time. The contract did not forbid the defendants from considering other offers, and it did not require them to take their property off the market while the attorney was reviewing plaintiff's offer. Considering that the second purchase agreement was not legally impermissible where the first was only conditionally accepted, it was not a bad-faith act to accept it and submit it for review.

## Employment—Same Sex Sexual Harassment

In *Robinson v Ford Motor Co*, 277 Mich App 146 (2007), plaintiff alleged that a male coworker sexually harassed him while they both worked in defendant's manufacturing plant. The harassment included verbal comments of a sexual nature as well as several incidents of inappropriate touching. Defendant moved for summary disposition on plaintiff's claim, arguing that sexual horseplay by a heterosexual male directed against another male fell outside the statutory definition of sexual harassment. The trial court disagreed and denied defendant's motion with regard to the alleged violation of the Elliott-Larsen Civil Rights Act (ELCRA).

The court of appeals held that the ELCRA protects employees from sexual harassment by individuals of the same sex so long as the "because of sex" requirement is met. The court of appeals observed that *Corley v Detroit Bd of Educ*, 470 Mich 274, 681 NW2d 342 (2004), did not indicate that conduct or communication that inherently pertains to sex must also include proof of the harasser's sexual desire, and the *Robinson* court refused to read into the statutory definition of sexual harassment a requirement that is not expressly stated, i.e., a harasser's sexual desire. In *Robinson*, the alleged conduct involved direct contact with sexual organs or sexual parts of the body accompanied by either express or implied references to sexual activity, and the court concluded that plaintiff presented sufficient evidence to allow a reasonable trier of fact to conclude that the harassing person's conduct and communication inherently pertained to sex.

## Employment—Age Discrimination—Retaliation

In *Fox v Eagle Distrib Co*, 510 F3d 587 (6th Cir 2007), plaintiff worked for defendant for 11 years and received good evaluations and regular promotions. Approximately 30 days after his 40$^{th}$ birthday, his supervisor informed plaintiff that he was being demoted and that he could accept

this position or be terminated. After he was denied a promotion in favor of a younger man who had less experience with defendant, plaintiff filed an EEOC charge with the Tennessee Human Rights Commission, alleging age discrimination. He then filed a lawsuit in Tennessee state court in February 2003, alleging age discrimination in violation of state law (this action was later dismissed without prejudice). Plaintiff was vocal about his displeasure with defendant and admitted that he discussed his pending lawsuit with co-workers and defendant's customers. After customer complaints regarding plaintiff, he was discharged by the defendant and brought a claim against defendant, alleging, among other things, retaliation under the federal Age Discrimination in Employment Act (ADEA).

To state a retaliation claim under the ADEA, a plaintiff must show that he or she engaged in protected activity, that the employer had knowledge of the protected conduct, that the employer took an adverse employment action towards the plaintiff, and that there was a causal connection between the protected activity and the adverse employment action. The ADEA's antiretaliation provision is similar to Title VII's, and it is appropriate to look to cases construing Title VII as authority for interpreting the ADEA's antiretaliation provision. Also, an employee need not file a formal EEOC complaint to engage in protected activity. Instead, it is the assertion of statutory rights that triggers protection under the ADEA. Because plaintiff's discussion with one of defendant's customers did not concern alleged acts of age discrimination, he failed to show that he engaged in protected activity under the ADEA, and the court affirmed the trial court's grant of summary judgment for the employer.

## Employment—Arbitration Agreement

In *Seawright v Am Gen Fin, Inc*, 507 F3d 967 (6th Cir 2007), the employer had a longstanding Employee Dispute Resolution (EDR) program that was the sole means of resolving employment-related disputes. Plaintiff was discharged and brought suit against the employer, alleging that the employer discharged her in violation of state anti-discrimination law and the Family and Medical Leave Act. The employer moved to compel arbitration, proffering an arbitration agreement to which plaintiff had previously agreed while plaintiff denied that she agreed to arbitrate.

The Sixth Circuit rejected a number of challenges under state law to the mandatory arbitration agreement, ruling, among other things, that plaintiff's continued employment after the effective date of the arbitration program constituted acceptance of a valid and enforceable contract to arbitrate employment-related disputes. Also, the FAA requires arbitration agreements to be written, but they do not have to be signed.

## Michigan Single Business Tax—Interest on Refunds

In *NSK Corp v Department of Treasury*, No 274633 (Mich Ct App Jan 29, 2008), the Department of Treasury in 2004 performed a single business tax audit of plaintiff for the tax period of July 1, 1997 to December 31, 2002. The Department determined that plaintiff had over-calculated its tax liability on returns it had submitted, and had therefore overpaid its single business tax liability, concluding that plaintiff was entitled to a refund of $1,444,298.00. The Department sent plaintiff an audit determination letter, informing it of the overpayment. Plaintiff responded by agreeing with the amount of the overpayment, but asserting that it was entitled to interest on the overpayment pursuant to MCL 205.30. The Department disagreed, and this action followed. On plaintiff's later motion for summary disposition, the trial court held that interest was due on the overpayment, commencing 45 days after the due date of the return for each of the years in issue. The trial court further granted plaintiff additional statutory interest on the interest defendant was ordered to pay, accruing from November 23, 2005 until paid in full.

The court of appeals found that the plain language of MCL 205.30 requires the Department of Treasury to pay interest on refunds of overpayments at the same rate as would be required for a taxpayer when making a late payment of taxes to defendant. The case was remanded for a determination of the exact date in March 2005 when defendant became aware that a refund was due and for entry of an order incorporating its finding on that issue and the resulting interest owed.

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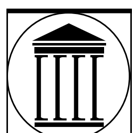


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