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Extraction

A Tale of Preference Law and the Changes Adopted by the Small Business Reorganization Act

By: A. Todd Almassian and Greg J. Ekdahl
Keller & Almassian, PLC

Introduction

In his treatise on bankruptcy, Charles Tabb defines a preference as "a transfer that favors one creditor over others."[1] Contemporary preference law is internally inconsistent, often leads to increased litigation against innocent creditors, and utilizes exceptions that effectively dilute the equitable justification for its rigid liability rules.

Preference law under section 547 of the Code is primarily a rule of strict liability. As a result, the historic *mens rea* requirement was effectually extinguished and with it the need to prove intent, and culpability—a requirement that dates back to English common law, from which our preferential transfer law was derived.[2] In fact, prior to the current version of the Code, nearly all bankruptcy law concerning preferences considered some concept of culpability or intent as an essential element of a preferential transfer.[3]

Absent an applicable exception, the only consideration in determining the existence of a preferential transfer is whether the transfer occurred within 90 days (or one year for an insider) of the petition date, resulting in a rule focused nearly exclusively on preferential effect.[4] However, the application of this harsh rule often does not, in practice, result in creditors receiving an equal distribution from the estate, thereby subverting the very rationale of such avoidance in first place.[5]

The Preference Law You Know

Preference law is inconsistent. "On the one hand, it purports to be a law of strict liability intended to ensure equal distribution: regardless of the merit of any particular creditor or transaction, all similarly-situated creditors must share in the estate on a pro rata basis. On the other hand, it discriminates in favor of certain creditors by establishing exceptions to the rule of strict liability, and also by permitting the trustee of the bankruptcy estate, which in reorganization cases may be the debtor itself, broad discretion in deciding which preferential transfers to avoid."[6] Furthermore, the existence and latitude of numerous exceptions manifests an intent-based dichotomy between creditors that seek to inequitably amass debtor assets in the

[1] *See* Charles J. Tabb, The Law of Bankruptcy 524 (2d ed. 2009).

[2] *See* Lawrence Ponoroff, Bankruptcy Preferences: Recalcitrant Passengers Aboard the Flight from Creditor Equality, American Bankruptcy Law Journal, Vol. 90 (April 18, 2016).

[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] Brook E. Gotberg, *Conflicting Preferences in Business Bankruptcy: The Need for Different Rules in Different Chapters*, 100 IOWA L. REV. 51 (2014).

days leading up to bankruptcy (characterized as a "bad" preference), and creditors that continue doing business with the debtor in the days leading up to bankruptcy (characterized as a "good" preference).[7] In other words, such exceptions permit some types of preferential transfers, while preventing others.[8] "The recipients of 'good' preferential transfers are therefore better off than their fellow creditors, particularly those who received 'bad,' and therefore avoidable, preferences", whereas "a true policy of equality would avoid all transfers, whether 'good' or 'bad'."[9]

Such exceptions also contribute to the substantial costs borne by the estate in pursuing an avoidance action. Additionally, preference actions often lead to settlements from trade creditors for fundamentally innocent conduct in light of the high costs of litigation and possible liability. This has the effect of forcing otherwise blameless creditors who received a transfer from the debtor within the preference period to return the value received from the debtor, irrespective of the fact that the payment received was valid and accepted in good faith.[10] The creditor is left with a claim against the estate for a pro rata distribution of the debtor's remaining assets, which often results in the creditor receiving a mere fraction of its claim with the balance discharged in bankruptcy. This harsh outcome is often borne by trade creditors without any assurance that such avoidance will actually result in a net-benefit to general unsecured creditors.[11] As a result, collectively, preference actions generally benefit bankruptcy professionals but do little to meaningfully benefit the creditors themselves.[12]

Preference Law Under the Small Business Reorganization Act

The Small Business Reorganization Act ("SBRA") addresses preference issues by requiring a debtor or trustee to consider a party's statutory defenses "based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses" prior to commencing an action under section 547. No such obligation previously existed in a typical chapter 7 or chapter 11, exacerbating preference litigation. Such deviations from the general, indiscriminate rule of strict liability can be used to promote and heal the use of preference litigation under the SBRA.

Affirmative Duty to Analyze Affirmative Defenses

The SBRA ushered in a number of changes to the Code. Some of the lesser heralded amendments are found in Section 547, and related venue rules found in 28 U.S.C. 1409(b).

The change to Section 547 (b) addresses the due diligence required of a Trustee in evaluating the pursuit of a preference action. The Section now states:

> . . . the Trustee may, based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative

[7] *See, e.g.*, Carlson, *supra* note 41, at 216
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *See* Daniel J. Bussel, *The Problem with Preferences*, 100 IOWA L. REV 11 (2014).

> defenses under subsection (c), avoid any transfer of an interest of the debtor in property."

The change to 547(b) raises issues. The first is to question what the term "reasonable due diligence" actually means. It is not defined by the Code nor used elsewhere in similar context. A Trustee or debtor will likely be left wondering what is required in order to move forward with a preference action, and just as importantly, what the obligation means after the due diligence is performed. Further, there are no easily determined consequences or guidance in the Code regarding the potential failure to perform such "reasonable due diligence." There is no clear understanding of what steps would reasonably satisfy such a due diligence requirement, and what occurs if a party alleges that the Trustee failed to satisfy the standard.

There is also a question of how far the duty extends. Commentators have noted that it appears to at least be a limitation on the Trustee's right to file a preference lawsuit, but acknowledging it is less clear as to how such a duty would extend beyond the filing of a complaint. For example, might a party threaten a Trustee with a claim for damages (fees incurred, etc.) for violating a 547(b) due diligence duties if the information regarding a defense is provided shortly after the case is filed? Alternatively, can a lack of due diligence be raised as an affirmative defense in a preference action? Granted a party is not going to pursue meritless claim in any event, but the question remains as to whether the 547(b) due diligence duty is satisfied by pre filing efforts, or whether it extends to post filing prosecution of the claim, and how that in turn might affect the resolution of a preference proceeding. The lack of guidance leaves a large opening for litigation on the issue.

Location, Location, Location… or Not

Another significant and open issue is found in the reading of the SBRA amendments to 28 U.S.C. § 1409(b). The Section 1409(b) change simply increases the statutory minimums that control whether a preference action can be filed in the court where the bankruptcy case is pending, or alternatively if the case needs to be filed in a district court where the defendant is located. It states:

> (b) Except as provided in subsection (d) of this section, a trustee in a case under title 11 may commence a proceeding arising in or related to such case to recover a money judgment of . . . against a noninsider of less than $25,000, only in the district court for the district in which the defendant resides.

The concept of the increase appears to be intended to reduce the potential burden on smaller preference defendants, and on the subchapter V debtor who would need to expend the time and often limited (or nonexistent) administrative resources to pursue them. Despite the common defenses available to defendants in a preference action, the costs in a preference case can quickly present a hurdle for both the defendant and debtor.

However, the new language has not necessarily resolved this issue. Bankruptcy courts find subject matter jurisdiction when the matter is "arising in, arising under and related to" a bankruptcy case. The issue with the newly amended Section 1409 language is that the section states it still only applies to a "proceeding arising in or related to" the case. Note there is no reference to a case "arising under" for jurisdictional purposes. The problem is that preference lawsuits can be proper under the court's "arising under" jurisdiction because they are seeking the enforcement of rights that are created by the filing of a bankruptcy

case. Therefore, some courts that have ruled on this issue have held that a Trustee may still file a preference action in the jurisdiction where the bankruptcy was filed even when the amount at issue is less than the jurisdictional limit established in 1409. *See In re Tadich Grill of Washington DC LLC*, 598 BR 65 (Bankr. D.D.C. 2019); *see also In re Rosenberger*, 400 B.R. 569 (Bankr. W.D.Mich. 2008)(finding under the previous lower threshold that the venue limitation provision contained in 28 U.S.C. § 1409(b) does not apply to an adversary proceeding to avoid and recover a preference). In short, despite the apparent intent to lower the burden of relatively low level preference actions on both trustees and defendants, the new SBRA amendments have left this issue unresolved. It remains an issue for a Trustee or debtor in possession that is determining whether to proceed and presents additional ambiguity for a possible preference defendant who is faced with a relatively small claim.

Appreciate the Possible Business Solutions

When conducting your initial intake for a possible Chapter 11 filing and in the days leading up to the filing, work with the debtor and its financial advisor to get a good understanding of what preferences exist. Keep in mind your duty as a bankruptcy attorney is to help the debtor in its fiduciary role with respect to preference law, but also to manage and message the issue and challenges presented by preference law as they relate to the debtor's relationship with its vendors. These are not cases where the debtor is no longer doing business and a 3rd party unrelated to the debtor is pursuing a preference. Many of these vendors have long-time relationships with the debtor, and often many of these vendors will be needed to continue operations. Ask the debtor for a list of payments made within 90 days of the bankruptcy petition. It is advisable to actually go out 100 days just to make sure you catch all possible preferences. Then, prior to filing a bankruptcy proceeding sit down with the debtor and analyze these preferences to discuss what defenses exist and to have a good understanding of those defenses. Talk with the debtor about the defenses. Do not let the debtor be surprised when they are later reminded of their fiduciary responsibility to send demand letters and collect any preferences.

Additionally, small business debtors often need to be reminded of the distinction between the "owner's interests" and the Debtor-In-Possession's duties. It is helpful to have the owner have his or her individual debtor's attorney to keep the relationships in their respective lanes.

The Subchapter V Plan – 90 Days

Remember that in a Subchapter V case, a plan must be filed within 90 days of the bankruptcy proceeding 11 U.S.C. § 1189(b). This does not give you a lot of time to deal with preferences. After the flurry of activity related to the first day motions, the debtor should reach out to the possible preference defendants to explore and determine what defenses exist. And if there are no realistic defenses, talk about what a settlement might look like based on a mutually agreeable approach. In other words, you may be able to quickly reach a fair and reasonable settlement to avoid litigation, and begin talking to the vendor about payment terms for that preference.

In sum, it is beneficial to all parties to quickly address and attempt to resolve preference matters in Subchapter V Chapter 11 cases.

The Kinder, Friendlier, Less Lame Demand Letter

Eventually, you may need to send preference demand letters to preference defendants. Many vendors want to continue the relationship with the debtor. Therefore, communication is essential. One of the greatest mistakes debtor's counsel can make is to send a stale, mechanical, and robotic sounding preference demand letter to one of the debtor's current vendors.

Below is an example of language that can be used to approach the preference defendant diplomatically.

Dear Company A:

Please be advised that Hapter & Isharge, PLC represents Don't Convert Me Industries, LLC d/b/a The Little Engine That Could ("Debtor" or "Debtor-in-Possession") in the above referenced bankruptcy case (the "Bankruptcy Case). As you may know, five minutes ago (the "Petition Date"), the Debtor filed a voluntary petition for relief under Subchapter V of Chapter 11 of the Bankruptcy Code and continues to operate its business as a debtor-in-possession.

Pursuant to Sections 547 and 550 of the Bankruptcy Code, 11 U.S.C. §§ 547 and 550, the Debtor-in-Possession is entitled to avoid and recover certain transfers of the Debtor's property, to or for the benefit of a creditor, for or on account of an antecedent debt, while the Debtor was insolvent, during the ninety-day period preceding the Petition Date. This is a fiduciary requirement of the Debtor.

The Debtor's records indicate that your company received payments totaling $79,056.40 (the "Preferential Transfers") from the Debtor during the Preference Period that appear to be recoverable by the Debtor-in-Possession. These Preferential Transfers may be avoidable and recoverable. Your company appears that it may have a New Value Defense in the amount of $40,406.25. Therefore, the current demand is in the reduced amount of $38,650.15.

The Debtor-in-Possession is preparing to initiate lawsuits to recover any avoidable transfers, including the Preferential Transfers that are identified in this letter. In order to avoid any adverse legal action against your company based on the Preferential Transfers, the Debtor-in-Possession hereby demands the return of all of the Preferential Transfers your company received from the Debtor during the Preference Period within 15 days of your receipt of this letter. The check should be made payable to the Debtor and mailed to the address provided in this letterhead.

We have sent this letter directly to you because no attorney has entered an appearance on your company's behalf in the Debtor's bankruptcy case. ***I recommend you send this to a creditor rights attorney to assist you with this matter.*** *If you would like attorney names, please do not hesitate to call. We recognize that your company may have defenses to an action to recover the Preferential Transfers, including but not limited to, that there was a contemporaneous exchange of new value, the debt and*

transfers were made in the ordinary course of business, and/or there was subsequent new value provided. We have identified a New Value Defense as noted above. These are difficult demand letters to send. The Debtor does not take lightly your loss. However, the Debtor is required to pursue these preferences pursuant to the Bankruptcy Code. If you have any questions or believe that your company has any other relevant defenses to an action to recover the Preferential Transfers, please contact the undersigned.

Sincerely,

HAPTER & ISHCHARGE, PLC

Conclusion

Not every change or addition to the Bankruptcy Code is perfect (see credit counseling), but in the case of the SBRA, Congress included some beneficial and intelligent additions to help make Chapter 11 feasible and more practical for the small business debtor. The elimination of the absolute priority rule, the creditor's committee, disclosure statements, the exclusive right to file plan, the ability to confirm a plan even if all classes reject, elimination of the UST quarterly fees, along with the due diligence required of the debtor to evaluate defenses all help make Subchapter V cases a reliable vehicle for a reorganization. The post-petition relationship with a debtor and its pre-petition vendor are essential to many small businesses. The SBRA amendments provide debtors and various chapter 11 parties opportunities to work through common issues.

THE INTERSECTION OF BANKRUPCTY AND PROBATE LAW: IS YOUR CLIENT COMPETENT? DOES YOUR CLIENT HAVE THE AUTHORITY TO FILE PETITION FOR BANKRUPTCY? DOES THE BANKRUPTCY ESTATE HAVE THE ABILITY TO SELL ASSETS WITHOUT THE APPROVAL OF PROBATE COURT?

By: Lana M. Escamilla and Staci L. Salisbury
Escamilla & Salisbury, PLLC
Probate law and court-appointed attorney-GALs for Kalamazoo County

Nothing in the Bankruptcy Code requires that a debtor be competent. In fact, the Bankruptcy Code specifically provides an avenue for incompetent individuals to seek bankruptcy relief through Rule 1004.1:

> *If an infant or incompetent person has a representative, including a general guardian, committee, conservator, or similar fiduciary, the representative may file a voluntary petition on behalf of the infant or incompetent person. An infant or incompetent person who does not have a duly appointed representative may file a voluntary petition by next friend or guardian ad litem. The court shall appoint a guardian ad litem for an infant or incompetent person who is a debtor and is not otherwise represented or shall make any other order to protect the infant or incompetent debtor.*

So why does it matter if your client is competent? One thing to note, is that your client may or may not have the right to file Bankruptcy, or the Bankruptcy Court may or may not have the ability to make a determination relative to the assets listed in the Bankruptcy Schedules without first obtaining authority from the Probate Court. Also, if your client is deemed incompetent and afforded a fresh start through Bankruptcy, your client may be relieved of the credit counseling requirement due to their incapacity pursuant to 11 U.S.C. §109(h)(4).

Our country and the U.S. Constitution was built on the premises that individuals are entitled to certain basic civil rights and liberties. However, society has recognized that in some circumstances an individual may be born with limited decision-making abilities, or an individual's decision-making abilities may become impaired later in life which can place the individual's safety, welfare and assets at risk. Therefore, every state has enacted statutes which allow for the creation of specialized courts to act as *parens patriae* for such persons. In Michigan, the probate courts have the authority to appoint guardians and conservators for individuals pursuant to Article V of the Estates and Protected Individuals Code (EPIC) and also Chapter 6 of the Mental Health Code.

The appointment of a guardian and/or conservator may result in a substitute decision maker for the incapacitated individual. This means a loss of many fundamental rights related to personal decision-making that most individuals take for granted, such as the freedom to freely spend money, sell assets, make healthcare decisions, enter into contracts, and even the right to decide whether to file Bankruptcy.

Guardianships in Michigan

The probate courts have exclusive legal and equitable jurisdiction over all guardianship, conservatorship, and protective proceedings; with the family division of the circuit courts holding ancillary jurisdiction, except as provided in MCL 600.1021, MCL 700.1302.

Pursuant to MCL 700.5306, a guardian for a legally incapacitated individual may be appointed after a petition is filed with the probate court where the alleged incapacitated individual is present or residing. MCL 700.1105 defines an *incapacitated individual* as one "who is impaired by reason of mental illness, mental deficiency, physical illness or disability, chronic use of drugs, chronic intoxication, or other cause, not including minority, to the extent lacking sufficient understanding or capacity to make or communicate informed decisions."

Once a petition for guardianship is filed, a guardian ad litem is appointed for the alleged incapacitated individual. The alleged incapacitated individual is then personally served with the petition and provided notice of his/her rights. A hearing on the petition is held and the probate courts then determines whether or not to grant the request for appointment of a guardian. The probate courts must find by clear and convincing evidence that the individual for whom a guardian is sought is an incapacitated individual and that the appointment is necessary as a means of providing continuing care and supervision of the incapacitated individual. The probate courts grant a guardian only those powers necessary to provide for the needs of the incapacitated individual; it may, in the alternative, grant a limited guardianship.

The probate courts may find be clear and convincing evidence that the individual is incapacitated and is totally unable to care for the individual's needs and will specify that finding of fact in an order and may appoint a full guardian. Further, a person who is adjudicated to be legally incapacitated is not legally capable of entering into a binding contract. *Burgess* v *Burgess*, No. 348068 (Mich Ct. App March 24, 2020) (unpublished). Any contracts entered into prior to the adjudication may be voidable. *Id.*

Conservatorships in Michigan

Pursuant to MCL 700.5401, a conservator may be appointed for an individual. The individual who is the subject of conservatorship proceeding is referred to as a "*protected individual*." The procedures and the due process safeguards to protect the interests of the protected individual in a conservatorship proceeding are very similar to those for the appointment of a guardian. A petition must be filed, a guardian ad litem is appointed for the individual, the individual is provided notice of his/her rights, and a hearing is held. However, unless a guardian has also been appointed, the appointment of a conservator, or entry of a protective order, does not affect the legal capacity of the protected individual. MCL 700.5407(4)

Probate courts are given statutory authority over conservatorship estates for the benefit of the protected individuals and members of the protected individual's immediate family. The probate courts have all the powers, whether directly or indirectly through the conservator, over the protected individual's estate and business affairs; with the exception of the power to make a will. MCL 700.5407.

Probate courts may appoint a conservator or make another protective order for an individual after making a finding that the individual is unable to manage her/his property and business affairs effectively for reasons such as mental illness, mental deficiency, physical illness or disability, chronic use of drugs, chronic intoxication, confinement, detention by a foreign power, or disappearance and either (1) the individual has property that will be wasted or dissipated unless proper management is provided or (2) money is needed for the individual's support, care, and welfare or for those entitled to the individual's support, and protection is necessary to obtain or provide money. *Id.*, MCL 700.1106(y), MCL 700.5401; *Bittner-Korbus v Bittner (In re Bittner)*, 312 Mich App 227, 879 NW2d 269 (2015).

Public policy favors that the probate court's authority should be the least intrusive as possible while maintaining protection of the individual. Therefore, it is imperative for attorneys to review the orders of conservatorship and letters of authority for the conservator to verify the conservator's rights.

When the probate courts make a determination that an individual needs a conservator, either an individual or entity is appointed to manage the assets of the protected individual. The conservator is a fiduciary and is subject to the supervision and jurisdiction of the probate court. A conservatorship is typically ongoing and lasts until the protected person's death. If termination is requested before death, the court will discharge a conservator from responsibility, only after the conservator files a final account that the probate court approves showing it is satisfied that the assets have been properly protected and preserved.

The appointment of the conservator vest in the conservator title as trustee to all of the protected individual's property if not specifically limited by an order of conservatorship. MCL 700.5419. The property is not transferable nor assignable by the protected individual, and assets may only be reached through the conservator through procedures specified in MCL 700.5429.

Since conservators are entrusted with the protection of the individual's assets, the conservator must account to the probate court regarding the management of the property. MCL 700.1104. Therefore, when entering an order of conservatorship, the probate court may limit rights under statute and only authorize letters of authority.

Guardianship of Developmentally Disabled Individuals in Michigan

There are two types of guardianships for individuals with developmental disabilities under the Mental Health Code: (1) guardians of the person, and (2) guardians of the estate. Guardians can also be full/plenary or partial. The Mental Health Code, however, strongly favors partial guardianships as it encourages the development of maximum self-reliance. MCL 330.1712.

In 1975, Michigan enacted Chapter 6 of the Mental Health Code for individuals with developmental disabilities for the purpose of developing the individual. MCL 330.1602 (1). This was to prevent individuals with developmental disabilities from being stripped of their Constitutional rights. These provisions included numerous safeguards for when a guardianship is sought for an individual with a developmental disability.

The Mental Health Code and the Michigan Department of Health and Human Services have continued to develop law and policy in Michigan that recognize the abilities and contributions of individuals with developmental disabilities and specifically favors listening to individual choices. This

is further evidenced by the incorporation of "*Person Centered Planning*"; which is a process of planning for and supporting an individual that honors the individual's preferences, choices, and abilities. MCL 330.1700(g). Therefore, again, it is important to review the order and letters issued by the probate courts.

The Incompetent Debtor Not Under the Supervision of the Probate Court

Courts, in general, are required to protect infants and incompetents, and Bankruptcy Court is no exception. However, when there is a durable power of attorney executed and acknowledged when an individual had capacity, which under state law imposes fiduciary duties upon the attorney-in-fact when acting as an agent of the debtor, it may satisfy the similar fiduciary standard of Fed. R. Bankr. P. 1004.1.[13] *In re Drenth*, the Bankruptcy Court did not require the appointment of a guardian ad litem to represent the interests of the debtor. The Bankruptcy Court did, however, require debtor's counsel to file the original petition with the attorney-in-fact's signature in her representative capacity to reflect the execution by the non-debtor in her representative capacity and also file the durable power of attorney document. *In re Hurt*, B.R. 1, 2-3 (Bankr. D.N.H. 1999).

Final Thoughts

When a bankruptcy practitioner is retained to file a bankruptcy petition for an incapacitated individual, they will want to review the order and letters of authority provided to the guardian to recognize what rights the probate court has determined the incapacitated individual has and what rights the guardian has over the ward. Further, it is possible, depending on when the debts were incurred by the debtor, that the debts may be voidable leaving other avenues outside of bankruptcy to handle those creditors.

It is imperative to determine if your client is under the supervision of a probate court. If they are, a careful review of the orders and letters of authority is necessary to determine if the debtor, or debtor's representative, has the right to file a bankruptcy petition. If the individual is not under the supervision of a probate court, but rather a durable power of attorney, review the durable power of attorney to ensure the document has the necessary language to allow and meet the standards required to be used without the need of a guardian ad litem. If the document allows for filing bankruptcy, the proper signature needs to be on the petition and schedules. If the client was determined not to have capacity, a thorough review of any debts should be undertaken to determine if they are voidable and if the filing of a bankruptcy is necessary. If determined that bankruptcy is necessary and the client is incompetent, make sure to file the motion to waive the credit counseling requirement.

[13] *In re Drenth,* Case No. 15-04217 (Bankr. W.D. Mich. Sep. 10, 2015); the Bankruptcy Court determined that it was not necessary to appoint a guardian ad litem for the debtor after looking at the testimony and representations of the U.S. Trustee, the debtor's attorney, and attorney-in-fact because despite the mental capacity, the debtor was adequately represented in the bankruptcy proceeding.