

# 30<sup>th</sup> Annual Tax Symposium

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## OH, THE THINGS YOU SHOULD KNOW!

### Important Tips for the Accountant When Addressing Insolvency Related Matters

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#### I. TRANSFERING REAL ESTATE AND OTHER ASSETS – EXEMPTIONS AND IMPLICATIONS

Transferring assets when addressing creditor concerns requires careful consideration of exemptions and the implications of any transfer. An initial reaction to addressing creditor concerns of a client may trigger the immediate thought of transferring your client's assets outside the reach of creditors – "Let's just get it out of your name." This sometimes instinctive reaction, however, may be detrimental to your client's best interests and not the best course of action in many situations.

A. Exemptions – Michigan law provides that certain property is beyond the reach of creditors. The principal, but not only, Michigan statutes that set forth exemptions are MCL 600.6023 and MCL 600.5451. Exemptions can protect assets from creditor claims, thereby eliminating the consideration to transfer the asset.<sup>1</sup>

Any transfer of assets, and in particular assets owned by a husband and wife, must be carefully evaluated in light of the protections afforded by certain entireties exemptions available under Michigan and/or federal law.

1. The following factors are critical to address before a quick transfer of an asset is made:
  - a. Does your client own the asset in his or her name alone?
  - b. Is the asset owned jointly with the spouse or anyone else?
  - c. Is your client single, married or divorced?
  - d. If married, is a divorce contemplated?
  - e. Is the creditor's claim against one spouse or both?

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<sup>1</sup> The Bankruptcy Code provides for bankruptcy specific exemptions at 11 U.S.C. §522(d). Those exemptions are not addressed in these materials.

2. Considerations of transfers of assets owned by a husband and wife typically involve:

a. REAL PROPERTY

- i. Under Michigan law, real property owned by a husband and wife, and titled in the names of the husband and wife as “tenants by the entirety”<sup>2</sup> is entirety property and thus a judgment lien does not attach to such property, unless the judgment lien or creditor’s claim is a claim against both the husband and the wife (i.e., a joint debt).<sup>3</sup>

MCL 600.2807(1) provides:

A judgment lien does not attach to interests in real property owned by tenants by the entirety unless the underlying judgment is entered against both the husband and the wife.

Therefore, careful consideration of a creditor’s claim must be made to determine if the claim is asserted against only one spouse or both.

ii. Real Property and Bankruptcy

Under a potential bankruptcy scenario involving the need for your client to seek relief under any chapter of the Bankruptcy Code, the State of Michigan bankruptcy exemptions (MCL 600.5451) (if elected) likewise afford valuable protections concerning real property. Under the Michigan bankruptcy exemptions, real property owned by a husband and wife is not only exempt from the reach of creditors of only one spouse (not for joint debt), it may also be exempt property of the bankruptcy estate in a bankruptcy case and the married couple can retain the asset free from the reach of any creditors of only one spouse (not for joint debt).

MCL 600.5451 provides, in relevant part:

- (1) A debtor in bankruptcy under the bankruptcy code, 11 USC 101 to 1532, may exempt from property of the estate property that is exempt under federal law or, under 11 USC 522(b)(2), the following property:

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<sup>2</sup> Tenants by the entirety is a type of joint tenancy with full rights of survivorship and is only available to spouses.

<sup>3</sup> The IRS has the right to file a lien against, and to sell, entirety property. *U.S. v. Barczyk*, 697 F. Supp.2d 789 (E.D. Mich. 2010), *U.S. v. Barr*, 617 F.3d 370 (6th Cir. 2010), *U.S. v. Davis*, 815 F.3d 253 (2016).

- (n) Property described in section 1 of 1927 PA 212, MCL 557.151, or real property, held jointly by a husband and wife as a tenancy by the entirety, except that this exemption does not apply with regard to a claim based upon a joint debt of the husband and wife.

iii. Bottom Line

With regard to real property, the bottom line is that real property owned by a husband and wife as tenants by the entirety is afforded certain protections under Michigan law, and the transfer of the entirety property to some form of alternative ownership in the face of creditor claims asserted against only one spouse provides no benefit.

b. CERTAIN EVIDENCES OF INDEBTEDNESS

MCL 557.151 provides:

Evidence of indebtedness payable to husband and wife; ownership in joint tenancy.

Sec. 1. All bonds, certificates of stock, mortgages, promissory notes, debentures, or other evidences of indebtedness hereafter made payable to persons who are husband and wife, or made payable to them as endorsees or assignees, or otherwise, shall be held by such husband and wife in joint tenancy unless otherwise therein expressly provided, in the same manner and subject to the same restrictions, consequences and conditions as are incident to the ownership of real estate held jointly by husband and wife under the laws of this state, with full right of ownership by survivorship in case of the death of either.

Like real property, "certain evidences of indebtedness" may be owned by husband and wife as tenants by the entirety and afforded the same protections as real property from the reach of a creditor of only one spouse. Examples of certain evidences of indebtedness which may constitute entirety property include:

- i. A debenture (such as a bond or other debt instrument that is unsecured by collateral);
- ii. Promissory notes payable to a husband and wife;
- iii. A check made payable to a husband and wife; and
- iv. Brokerage accounts established in the name of a husband and wife as tenants by the entirety and which distributions and withdrawals are payable to, and accessible by, only the husband and wife, not just either one of them.<sup>4</sup>

c. LIMITED LIABILITY MEMBERSHIP INTERESTS

MCL 450.4504(1) provides:

A membership interest is personal property and may be held in any manner in which personal property may be held. A husband and wife may hold a membership interest in joint tenancy in the same manner and subject to the same restrictions, consequences, and conditions that apply to the ownership of real estate held jointly by a husband and wife under the laws of this state, with full right of ownership by survivorship in case of death of either.

Membership interests in limited liability companies held by husband and wife as tenants by the entirety are afforded the same protections as ownership of real property owned by a husband and wife as tenants by the entirety.

II. FRAUDULENT CONVEYANCES/VOIDABLE TRANSACTIONS, IMPLICATIONS AND RAMIFICATIONS

- A. Michigan has enacted the Uniform Voidable Transaction Act, Act 434 of 1988, MCL 566.31, *et seq* (the "Act"), which is:

"An Act to provide for the setting aside and modification of certain transfers of conveyances, and obligations; to make uniform the law of fraudulent transfers and to provide remedies."

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<sup>4</sup> In the case of a brokerage account, it is critical that the brokerage account be properly established as an entirety account in the name of the husband and wife at the time of the formation of the account (or prior to the existence of any known creditor claims). Distributions need to be made payable to both the husband and the wife, and withdrawals should require signatures of both the husband and the wife. Not all brokerage firms offer entirety elections, nor have the ability to comply with such strict guidelines, and proper attention to these formalities is

1. Understanding the definitions under the Act is critical to evaluating the appropriateness of an asset transfer. As a starting point, significant definitions under the Act include, but are not limited to:
  - a. "Asset" means: "property of a debtor." "Asset" does not include any of the following:
    - i. Property to the extent it is encumbered by a valid lien.
    - ii. Property to the extent it is generally exempt under non-bankruptcy law.
    - iii. An interest in property held in tenancy by the entirety to the extent it is not subject to process by a creditor holding a claim against only 1 tenant."  
(MCL 566.31(b)).
  - b. "Creditor" means: "a person who has a claim." (MCL 566.31(d)). Simply put, a creditor means a person or entity who has a claim, and the definition of a claim is very broad.
  - c. "Claim" means: "except as used in 'claim for relief', means a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." (MCL 566.31(c)).
  - d. "Transfer" means: "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset. Transfer includes payment of money, release, lease, license, and creation of a lien or other encumbrance." (MCL 566.31(q)).
  - e. "Insolvent" means: "if, at a fair valuation, the sum of the debtor's debts is greater than the sum of the debtor's assets," (MCL 566.32, Sec. 2. (1)), or "a debtor that is generally not paying the debtor's debts as they become due other than as a result of a bona fide dispute . . ." (MCL 566.32(1)).
  - f. "Transfer with intent to defraud" means: "Except as otherwise provided in subsection (4), a transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation in either of the following circumstances:

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critical. If these limitations are not in place, the exemption for the brokerage account could be at risk.

With actual intent to hinder, delay, or defraud any creditor of the debtor... " (MCL 566.34 Sec. 4(1) and (1)(a)).

- B. Fraudulent Conveyances/Voidable Transactions (with or without intent to defraud). Transfers of assets in the face of a creditor claim(s) or under certain circumstances can be problematic and subject to being set aside as a fraudulent conveyance or a voidable transaction under Michigan law. Careful consideration should be given to any potential transfer of assets by a client who has financial difficulties and/or creditors. The first reaction under certain circumstances should not immediately be to simply "transfer the asset."
- C. Important considerations. It is critical to be aware of the voidable transfer laws before making a transfer of any asset(s). Not all transfers of assets give rise to immediate concern. However, there are certain circumstances where knowing the consequences of an asset transfer is crucial. Typical areas of concern include, but are not limited to, the following:
1. Your client has existing creditor claims. Note: "claim" has a very broad definition.
  2. Your client has been sued, or is about to be sued.
  3. Your client is insolvent (debts exceed assets), or might be rendered insolvent by making the asset transfer.
  4. Your client has an intent to hinder, delay or defraud a creditor.
- D. Ramifications. When your client (i) has creditor claims, (ii) is insolvent, or (iii) intends to transfer assets in order to hinder, delay or defraud a creditor (all as defined above), among other concerns, very careful consideration should be given to any transfer of assets. The Act provides a mechanism for avoiding a transfer, for attachment or other provisional remedy against the transferred asset and against the recipient of the transferred asset, injunction against further disposition of the asset or other property, appointment of a receiver to take charge of the transferred asset or other property of the transferee, and "any other relief the court determines appropriate." (See MCL 566.37).

### III. IMPLICATIONS OR CONSEQUENCES OF THE TRANSFER OF ENTIRETIES PROPERTY AND FRAUDULENT CONVEYANCES/VOIDABLE TRANSACTIONS

- A. The fraudulent transfer/voidable transaction laws have implications and consequences for the transfer of assets, including the transfer of entireties property. What those implications and consequences may be depend on the arena in which a creditor's claim is invoked.

B. If a creditor of just one spouse is pursuing a fraudulent transfer/voidable transaction claim in the state courts of Michigan, the transfer of entireties property to a third party or to the non-debtor spouse will not rise to the level of a voidable transfer due to the so-called “no harm, no foul” rule.

1. This is because the entireties asset was not reachable in the first instance, so it cannot be further placed beyond the reach of the creditor.

(1) “Therefore, [property] held as tenants by the entirety cannot be the subject matter of a UFTA claim if only one spouse is the debtor. This conclusion fits into the larger statutory purpose of avoiding fraudulent transfers because it is difficult to comprehend how disposing of property that a creditor cannot reach could ‘defraud’ that creditor.” *Estes v. Titus*, 481 Mich. 573, 751 N.W.2d 493, 498 (2008).

Indeed, as discussed above, the definition of an “asset” under the Act, does not include property to the extent it is generally exempt under non-bankruptcy law, or property held in tenancy by the entireties to the extent it is not subject to process by a creditor who has a claim against only 1 tenant.

2. However, if it is a bankruptcy trustee that seeks to avoid the transfer, the “no harm, no foul” rule may not insulate the transfer, but it depends on the timing of the transfer.

3. Section 548 of the Bankruptcy Code is the bankruptcy specific provision that allows a bankruptcy trustee to avoid fraudulent transfers. Section 548 concerns any transfer of property that was made within two years of the initiation of the bankruptcy proceeding.

4. Section 546(a) of the Bankruptcy Code provides that an action under Section 548 must be commenced within the later of either 2 years after the entry of an Order for Relief under the Bankruptcy Code or within 1 year after the appointment or election of the first trustee to the bankruptcy case.<sup>5</sup>

5. Section 550 of the Bankruptcy Code allows a bankruptcy trustee to recover and bring back into the bankruptcy estate any property whose transfer has been avoided under Section 548.

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<sup>5</sup> In a typical Chapter 11 or Chapter 7 case, the 2-year limitations period would control. However, if a trustee is appointed 23 months into a case, then the trustee still gets 1 year from the date of appointment to pursue the claims.

6. Under Section 522(g) of the Bankruptcy Code, a debtor may not exempt assets that have been recovered by the bankruptcy trustee under Section 550 if the debtor voluntarily transferred the asset.
7. In other words, if the bankruptcy spouse transfers entireties property within two years of the initiation of the bankruptcy proceeding, the bankruptcy trustee can avoid the transfer, bring the property back into the bankruptcy estate, to be held jointly by the bankruptcy trustee and non-bankrupt spouse, and prevent the bankruptcy spouse from exempting the property, including exempting it as entireties property. This will allow the bankruptcy trustee to sell the property free of the non-bankrupt spouse's interest under Section 363(h) of the Bankruptcy Code. See *In re Wickerstrom*, 113 B.R. 339, 349 (Bankr. W.D. Mich. 1990); *In re Barbera*, 1996 Bank. LEXIS 965 at 24 (Bankr. E.D. Mich. 1996).
8. In Michigan, this result appears only to involve transfers avoided under Section 548 (or under other bankruptcy specific avoidance powers, such as preferential transfers) because, although a bankruptcy trustee is allowed to utilize state (i.e., Michigan) voidable transaction laws, which can reach back six years, the "no harm, no foul" rule under Michigan law would also prevent a bankruptcy trustee from recovering such property
  - a. In addition, perhaps an even more onerous effect of such a transfer is that the bankrupt spouse may not be entitled to a bankruptcy discharge.
    - i. Section 727(a)(2) of the Bankruptcy Code states that the bankruptcy court shall not grant the debtor a discharge if the debtor, "with intent to hinder, delay, or defraud a creditor...has transferred...property of the debtor, within one year before the date of the filing of the petition."

Therefore, to the extent that the transfer of entireties property to a third party or the non-bankrupt spouse is avoided pursuant to Section 548 of the Bankruptcy Code, it could result in a denial of the bankrupt spouse's discharge.
9. In addition to the foregoing, you should also keep in mind that the transfer of property held initially by only one spouse to both spouses as tenants by the entireties is a voidable transaction as to a creditor of the initial spouse/owner, despite the fact that said spouse/owner retains an ownership interest.
  - a. This is of course because such a transfer acts to transform an otherwise non-exempt asset into an exempt asset.



10. Finally, regardless of whether one can invoke the “no harm, no foul” rule to escape a voidable transaction cause of action, you should be aware that any decent creditor attorney will take a very close look at any and all transactions of a debtor if it is apparent that transfers of assets occurred after the creditor’s claim arose. In other words, the appearance of impropriety will most certainly invite closer scrutiny.

#### IV. PREFERANCES – IDENTIFYING, TENDERING, DISGORGING

Section 547(b) of the Bankruptcy Code permits a trustee or a debtor in possession to recover, under certain defined circumstances, payments made by a debtor to a creditor within 90 days prior to the date of a bankruptcy filing. It also allows a trustee or a debtor in possession to recover, under certain defined circumstances, payments made to an “insider” (as that term is defined under the Bankruptcy Code<sup>6</sup>) within 90 days and up to 1 year prior to the date of filing a bankruptcy petition.

- A. The underlying purposes of a preference action is to (i) ensure a fair and equal distribution of the debtor’s assets among all creditors, and (ii) to discourage aggressive collection actions against an insolvent debtor at the expense of other creditors.
- B. A preference is defined in §547 of the Bankruptcy Code and includes the following essential elements:<sup>7</sup>
  1. Any transfer (as that term is broadly defined by the Bankruptcy Code<sup>8</sup>) of an interest of the debtor in property:
    - a. To, or for the benefit of, a creditor;
    - b. For, or on account of, antecedent debts owed by the debtor before such transfer was made;
    - c. Made while the debtor was insolvent;
    - d. Made on, or within 90 days before, the date of the filing of the bankruptcy petition or between 90 days and 1 year before the date of the filing of a bankruptcy petition if such creditor at the time of such transfer was an insider; and
    - e. Enables a creditor to recover more than said creditor would recover under (i) a Chapter 7 bankruptcy filing, or (ii) if the transfer had not been made.

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<sup>6</sup> See, 11 USC §101(31)(A-F).

<sup>7</sup> See, 11 USC §547(b).

<sup>8</sup> See, 11 USC §101(54)(A-D).

2. Typically, preference actions are preceded by a demand letter from the debtor or the trustee.
  - i. The demand letter will set forth the specifics of the debtor's or trustee's claims and demand immediate payment.
3. The limitations period for pursuing a preference action is the same as set forth regarding pursuit of a fraudulent transfer/voidable transaction under Section 546 of the Bankruptcy Code.
4. A preference action under §547 of the Bankruptcy Code requires the trustee or debtor in possession to file a lawsuit known as an adversary proceeding in the Bankruptcy Court to recover the "preference" payment.
5. Many preference actions can be settled prior to the necessity of formal litigation or the filing of the required adversary proceeding.
6. As such, a creditor faced with a "preference" demand letter should promptly seek the advice of experienced bankruptcy counsel to review the case and ascertain whether valid defenses are available.
  - a. Common defenses (which are known as "affirmative defenses") to a preference demand or action include:
    - i. A contemporaneous exchange for new value – 11 USC §547(c)(1). This defense protects creditors that provide new value in exchange for a contemporaneous transfer. The value of new goods in exchange for payment, such as a "COD" transfer is an example.
    - ii. Subsequent new value – 11 USC §547(c)(4). A creditor must essentially prove that new goods or new value were sold or provided to the debtor after one or more of the preference payments were made. This is a somewhat tedious analysis, as it does not simply "net out" sales against payments.
    - iii. Ordinary Course – 11 USC §547(c)(2). A creditor can attempt to defend against a preference claim on the basis that the payment(s) it received were made in the ordinary course of business between the debtor and creditor or were made according to ordinary business terms. Payments made earlier than invoice terms, as well as longer than invoice terms, may be subject to a preference claim.

Thus, payments made by an insolvent person or entity on the eve of a bankruptcy are clearly cause for concern as a potential preference recovery target.

- C. Key considerations when dealing with financially distressed individuals or businesses in contemplation of a preference issue.
1. Try to know the true financial condition of what appears to be a financially distressed individual or entity and proceed with caution when accepting payment or extending credit.
  2. If you suspect that a customer is having financial problems, or if you receive notice of a bankruptcy filing, do not include this customer's account information in any periodic or automatic computer records removal or destruction of emails, accounting records or payment records. Maintain records (electronic and/or paper) which will be necessary to establish defenses to a preference demand.
  3. Always accept the payments but be aware of the risks and potential for disgorgement if there is a preference demand or action.
  4. Promptly seek the advice of experienced bankruptcy counsel to evaluate the preference demand and any potential defenses, and make sure there is a prompt response to a preference demand letter.

V. CONCLUSION

The considerations addressed in these materials are a starting point for any analysis of the propriety of a transfer of assets or the evaluation of a potential preference issue. However, even the most "innocent" transfer can have significant consequences to not only the transferor, but also to the transferee. Likewise, the proper analysis of a preference demand is critical to the ultimate outcome of the preference issue. Insolvency counsel should always be consulted to evaluate the impact of any transfer in light of the debtor's entire creditor and asset picture, and to properly address any potential preference issue.

