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## BUSINESS LITIGATION

### BEST PRACTICES FOR PRESERVING CORPORATE ATTORNEY-CLIENT PRIVILEGE IN MASSACHUSETTS

BY SARAH HEATON CONCANNON AND ROBYN R. SCHWARTZ

Consider the following hypothetical:

A bank's general counsel (GC) learns that \$200,000 has been illegally wired from a customer's account to an account overseas. The GC immediately asks the branch manager (who is not an attorney) to interview the employees involved. The branch manager summarizes her interviews for the GC, and the GC drafts a memo to outside counsel detailing the information uncovered, and the GC's conclusion is that the fraud occurred because branch employees did not follow the bank's fraud-prevention policies.

Fast-forward two years, and the customer has sued. Aware of the bank's investigation, the customer demands production of the GC's memo and related interview summaries, notes and communications. The bank claims that the documents sought, though relevant and responsive, are attorney-client privileged. The customer moves to compel.

The court's decision whether these documents must be produced will hinge on questions implicating the scope and applicability of the corporate attorney-client privilege, including whether:

- the GC was acting in a legal, or business, capacity during the investigation;
- the branch manager acted as an agent of the GC while conducting her interviews;
- the branch manager's summaries to the GC were for the purpose of seeking legal advice and kept confidential;
- the GC's memo to outside counsel was for the purpose of seeking legal advice; and
- the investigation was "in anticipation of litigation."<sup>1</sup>

As this hypothetical illustrates, corporate assertions of attorney-client privilege raise myri-

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ad questions. Here, it seems likely that the court will order some production. Given the opportunity, what would you have advised the GC *before* the investigation to create and preserve the privilege?

### OVERVIEW OF THE ATTORNEY-CLIENT PRIVILEGE IN THE CORPORATE SETTING

The attorney-client privilege generally protects clients' communications with their attorneys from disclosure to third parties — including both civil litigants and governmental regulators — provided the communications are: (i) confidential; (ii) between an attorney and client; and (iii) for the purpose of obtaining or providing legal advice.

In the corporate setting, step (ii) is often complicated. Since a corporation acts through its principals, directors, officers, and employees, who, then, is the "client"? More importantly, who may invoke or waive the privilege on behalf

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Judicial Court

See page 9 for details.

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## RESOLVING FRANCHISE DISPUTES THROUGH MEDIATION

### FACTORS FOR A FRANCHISOR TO CONSIDER WHEN DRAFTING A MEDIATION CLAUSE

BY ERIC H. KARP, CHUCK DORAN AND ARI N. STERN

Among the questions asked as part of FranchiseGrade.com's Franchise Expert Survey of 2015 was the following: "When reviewing alternative dispute resolution clauses[,] what do you feel is the most reasonable structure for a balanced relationship?" More than half of survey respondents answered that "[m]ediation followed by arbitration" supported such a relationship. In fact, 66% of respondents believed that mediation prior to the commencement of any type of legal action was the best path forward for a franchisor and its franchisee.

The importance of a "balanced relationship" cannot be overstated. The relationship between franchisor and franchisee stands apart from other commercial relationships because the success of one is reliant upon the success of the other. A franchisor, for example, needs a franchisee to properly execute the established business concept; failure will not only impact the individual franchisee, but may negatively affect the franchise system. Similarly, a franchisee needs a franchisor to provide proper guidance and oversight, and to be consistently finding innovative ways of growing the brand and meet-

ing competitive challenges, as well as other external pressures.

It should come as no surprise, therefore, that "collaboration" is the name of the game in franchising. Both franchisor and franchisee stand to gain if they "co-labor" for the betterment of the brand. If one party refuses to engage, both may suffer.

From the franchisor's perspective, there is good reason to include mandatory early mediation as part of a comprehensive dispute resolution process. This is especially true where the relationship will continue after the dispute is settled. For starters, a franchisor that can resolve a conflict through early mediation is under no obligation to disclose the dispute and the outcome as part of its franchise disclosure document. Such a disclosure could very well scare off potential franchisees from joining the system. Additionally, by settling a dispute early, a franchisor is able to keep a conflict from reverberating throughout its franchise system and inhibiting brand success.

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### BEST PRACTICES

#### CONTINUED FROM P. 1

of the company?

The authoritative test for the scope of the attorney-client privilege in the corporate setting comes from the U.S. Supreme Court's decision in *Upjohn Co. v. United States*, 449 U.S. 383 (1981). In *Upjohn*, the Supreme Court held that communications between corporate counsel and employees at any level can be protected, provided: (i) the communication is made at the direction of corporate officials to obtain legal advice; (ii) the matters communicated fall within the scope of the employees' duties and are not available from upper level employees; (iii) employees are aware that the purpose of the inquiry is to help in obtaining legal advice; and (iv) the communications are intended to be kept confidential. Massachusetts follows the *Upjohn* test.

### SELECTED CORPORATE SITUATIONS GIVING RISE TO ATTORNEY-CLIENT PRIVILEGE ISSUES

Counsel should be aware of the corporate situations where privilege issues are most likely to arise and adopt proactive strategies to protect privileged communications:

- **Conducting an Internal Investigation.** In-house counsel should formally document the initiation of an internal investigation and establish that the purpose of the investigation is to provide legal advice to the company. The company should consider hiring outside counsel to conduct the investigation, because courts are often more willing to view outside counsel as operating in a legal capacity, making their communications related to the investigation privileged. If, as above, non-attorneys like the branch manager must be involved in gathering information during the investigation, then counsel should document that the employee's actions are at the direction and under the supervision of legal counsel and for the purpose of providing legal advice to the company. Further, before any interviews are conducted, counsel should give *Upjohn* warnings to the interviewees, in which counsel explains that the interviewers are acting at the direction of counsel and that the purpose of the interviews is to gather information to provide legal advice to the company.
- **Responding to a Regulatory Inquiry.** Today's companies operate in a highly regulated environment and frequently receive inquiries from regulators calling for the production of confidential, sensitive, and poten-

tially privileged information. In their effort to cooperate fully, some companies may be too quick to open their files, producing privileged information and creating waiver issues for subsequent civil litigation. Companies should identify privileged material before producing it to regulators and waive the privilege only after making a conscious assessment of the benefits and detriments of doing so. In addition, any company producing documents to a regulator should be aware of applicable state and federal freedom of information laws, which provide the public with a right of access to government-held information.

- **Board Meetings.** Both in-house and outside counsel frequently attend board of directors' meetings as corporate secretaries or observers. The mere presence of counsel at board meetings, however, does not make the board's discussions privileged. Indeed, board minutes are often one of the *first* categories of documents sought in litigation. If, however, the board seeks legal advice from counsel, then that portion of the meeting (and the minutes) may be protected by the attorney-client privilege. All third parties should be asked to leave

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# WHAT HAPPENS WHEN A “LEGAL” MARIJUANA BUSINESS GOES UP IN SMOKE?

BY TIM DURKEN

So what happens when the boom of legal marijuana goes bust for a grower, dispensary or its stakeholders? The answer is not a straightforward one because federal bankruptcy is off the table.

## I. LEGAL MARIJUANA IS GREEN (\$\$) AND GROWING IN THE STATES

Legal marijuana sales hit \$5.4 billion in the United States last year. Sales are expected to rise to \$6.7 billion this year and \$21.8 billion by 2020 according to a recent report.

Twenty-three states have legalized the use of medical marijuana, including Massachusetts, whose voters approved medical marijuana by a 63 percent to 37 percent margin in November 2012. As of early 2016, six medical marijuana dispensaries are licensed and operating in Massachusetts (Ayer, Brockton, Brookline, Lowell, Northampton and Salem) and another dozen have received provisional approval.

Four states (Alaska, Colorado, Oregon and Washington) and the District of Columbia have legalized recreational use of marijuana. A Massachusetts bill is pending, but Governor Charlie Baker has voiced opposition to full legalization. If the Legislature and governor do not enact the bill, marijuana advocates are planning a ballot initiative for November 2016. Several polls show a majority of Massachusetts voters favor full legalization, making legal marijuana a seri-

ous possibility this year.

The rapidly expanding legalization of marijuana across the country is creating a “gold rush” for entrepreneurs and investors seeking a piece of the profits. There are big opportunities — and risks — for these new businesses and their stakeholders.

## II. FEDERAL MARIJUANA PROHIBITION IS AN ONGOING BUZZKILL

While states have been moving to legalize it, the federal government continues to criminalize marijuana as a “Schedule I” drug with “no currently accepted medical use” under the Controlled Substances Act.<sup>1</sup> Under federal law, it is not only illegal to sell marijuana, it is also criminal to knowingly fund the operations of or take the proceeds from a marijuana business, as well as manage or control any real property used for it. Federal law also prohibits banks from doing business with marijuana sellers, forcing marijuana businesses to operate as “cash only” businesses.

During President Obama’s administration, the federal government has taken an evolving approach to enforcement of federal marijuana laws. The Department of Justice has advised federal law enforcement officers and prosecutors not to enforce federal marijuana laws against marijuana businesses that are legal under state law. The DOJ even asked the Supreme Court

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in December 2015 not to hear a neighboring state’s challenge to Colorado’s recreational marijuana laws.

The omnibus Consolidated Appropriations Act of 2016, signed by President Obama this past December, bars the DOJ and DEA from expending federal funds to prosecute the use, possession and sale of medical marijuana in those states that previously legalized it, although it did not address the use of forfeiture proceeds (which are substantial and available) for enforcement. The omnibus act and enforcement spending prohibition expires when the current federal fiscal year concludes on Sept. 30, 2016.

Marijuana however remains an illegal Schedule I drug under the CSA and its sale constitutes a federal crime. The next president could take a different approach and decide to aggressively enforce the CSA against medical and recreational marijuana businesses that are

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# A DIFFERENCE OF OPINIONS

BY JUSTIN P. ROSTOFF

May a property owner who is “underwater” on her mortgage force her mortgagee bank to accept the deed to the property in satisfaction of the debt in bankruptcy? Two bankruptcy judges sitting in Massachusetts have issued decisions within the last 12 months reaching opposite conclusions on this question. This conflict has created a lack of predictability when it comes to the handling of Schedule A (real property) assets in Massachusetts bankruptcies.

Section 1322(b) of the Bankruptcy Code sets forth a list of provisions that may be included in a Chapter 13 plan, including “the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity.” Section 1325(a)(5)(C) instructs the Bankruptcy Court to confirm a plan if it provides with respect to an allowed secured claim that the debtor surrenders the

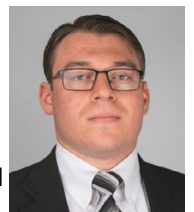
property securing such claim to the holder of the claim. But neither “vest” nor “surrender” are defined within the Code, so interpretation and application of these bankruptcy provisions are left to the sitting judge.

This comment will provide an overview of Judge Hoffman’s opinion and reasoning in *In re Sagendorph*,<sup>1</sup> allowing a debtor to unilaterally vest surrendered property in a mortgagee, and Judge Boroff’s opinion and reasoning in *In re Weller*,<sup>2</sup> where such unilateral vestment was denied.

## IN RE SAGENDORPH: PERMITTING UNILATERAL VESTMENT

The debtor owned an income-producing property in Ware, Massachusetts, subject to a mortgage issued to Wells Fargo Bank, but after default Wells Fargo never foreclosed on the property. Upon filing for Chapter 13 bankruptcy, the debtor produced a plan that read

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in relevant part, “[p]ursuant to §§ 1322(b)(8) and (9), title to the property .... shall *vest* in Wells Fargo ... upon confirmation ... and the Confirmation Order shall constitute a deed of conveyance of the property ... . All secured claims will be paid by *surrender* of the collateral and foreclosure of the security interest.” Wells Fargo objected to the plan’s confirmation because of the forced vesting in satisfaction of its debt.

According to Wells Fargo, the vestment provision of Section 1322 is a permis-

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## CYBER LIABILITY FOR DATA SECURITY BREACHES

BY CHRIS HAWKINS, ROBERT ROSENZWEIG AND JAY BRODSKY

Cyber security is a hot topic in the business world. Many business owners and professionals handle confidential plans and sensitive employee and customer information, such as Social Security numbers, addresses, dates of birth, credit card numbers and health care records. To guard this sensitive information, most states, including Massachusetts, have enacted data security laws that govern what a company must do in the event of the loss of this data through theft or negligence. Cyber-theft may expose the business to a variety of risks, including the direct risk of identity theft, illicit access to financial accounts, abuse of wrongly-obtained credits cards and reputational harm. Cyber-theft also exposes companies to risks of suits from customers whose confidential information is stolen and used.

### MASSACHUSETTS DATA SECURITY LAW

Under Massachusetts law, a security breach is an unauthorized acquisition or use of data that is capable of compromising the security or confidentiality of personal information that creates a substantial risk of identity theft or fraud against a Massachusetts resident. Mass. G.L. ch. 93H, § 1(a). "Personal information" is defined as a resident's first and last name, or first initial and last name, in combination with the person's Social Security number, driver's license number, or financial account, or credit or debit card account, numbers. Mass. G.L. ch. 93H, § 1(a). Every person in Massachusetts who owns or licenses the personal information of others is required to develop, implement and maintain a written comprehensive information security program appropriate to the size, scope and type of business. 201 CMR 17.03(1). The written data security program must encompass information maintained in electronic form as well. 201 CMR 17.04.

### COMMON SOURCES OF DATA SECURITY BREACHES

Security breaches may spring from many different sources. One of the most common sources is file disposal (both paper and electronic). Stories have appeared in the media of medical and financial records being retrieved from dumpsters or landfills, and computers containing social security numbers turning up in pawn shops. Another common source is loss of electronic devices containing sensitive client or customer information. For example, in 2006, a laptop containing personal information of millions of veterans was stolen from a U.S. Department of Veterans Affairs data analyst, although it was

later recovered with the data apparently intact.

Increasingly we are seeing instances involving social engineering. Social engineering attacks include leaving an infected USB device in a place where it is sure to be found, sending fraudulent emails disguised as legitimate emails, or emails that appear to be from coworkers. Hackers are using information that they are able to gather from public sources and the dark web to send emails to businesses enticing the individual recipient to click a link or download an attachment with the goal of infecting the businesses' systems with malware to gain access to confidential information or lock legitimate users out of the system so that they can make a large ransom demand of the business. In other instances, the hackers are simply attempting to convince individuals to wire funds under the guise that the recipient is a legitimate business partner.

Additionally, many breaches are caused by a vendor or outsourced information technology provider that do not have sufficient controls. Under the Massachusetts Data Security Law and other state laws, the obligation to respond is still the responsibility of the business that collected the information. It should go without saying that you truly are only as strong as your weakest link.

### THE CONSEQUENCES

Most businesses are required to report the loss of sensitive customer data to regulatory authorities, which may conduct an investigation. A regulatory inquiry is an investigation into an actual or alleged violation of a privacy breach notification law, or any law relating to a breach of privacy, such as HIPAA. For example, under the Massachusetts data security statute, Mass. G.L. ch. 93H, a data security breach must be reported as soon as practicable to the Attorney General, the Director of the Office of Consumer Affairs and Business Regulation, and each affected Massachusetts resident. The notice to the resident must state, at minimum, the person's right to obtain a police report, how the person may request a security freeze, the necessary information to be provided when requesting a security freeze and any fees to be paid by the business to any of the consumer reporting agencies.

The Attorney General is authorized to file suit to remedy violations of the data security laws pursuant to section 4 of Chapter 93A of the Massachusetts General Laws. The court is authorized under this statute to levy civil penal-



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ties of up to \$5,000 per violation if its finds the violator knew or should have known that they were violating the law. The release of data for a single person could be considered a single violation. The release of data for a large number of people could quickly add up to very significant penalties. In July 2014, for example, Women's and Infants Hospital of Rhode Island agreed to pay \$150,000 to settle claims arising from its loss of 19 backup tapes containing personal and medical information for 12,127 Massachusetts residents.

Additionally, even if a business is domiciled in Massachusetts, you are beholden to respond in accordance with the data security and breach response laws in the other 46 states that have similar legislation if you have information on individuals that reside in those states. The definition of personal identifiable information, what constitutes a breach, and the required response and potential penalties differ from state to state.

The loss of a confidential business information or customer data can entail other costs as well, including the cost of identifying and plugging the source of the breach and reputational harm.

### NEXT STEPS TO CONSIDER

Risk management starts with risk awareness. The risk of a data security breach depends on a number of factors including information technology infrastructure, information governance and people. Businesses need to train on existing policies and procedures relating to the

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## BEST PRACTICES CONTINUED FROM P. 2

the meeting before privileged matters are discussed, and the meeting minutes should clearly distinguish between the business and legal portions of the meeting. If minutes are recorded while legal advice is being sought and provided, then the minutes should document the legal nature of the discussion, be marked as privileged, and state that only the client and attorney (and no third parties) were present.

- **Compliance Departments.** Corporate compliance departments play a key role in ensuring companies' compliance with applicable laws, rules, and regulations. The distinct, yet related, functions of the compliance and legal departments can create uncertainty about the scope of the attorney-client privilege. Whether compliance departments' investigations and communications are privileged is a fact-intensive inquiry, which depends on facts such as whether: (i) the work of the compliance department is undertaken at the request and direction of the legal department; (ii) attorneys are regularly involved in the compliance department's investigations; and (iii) compliance department investigations are conducted as part of the regular course of business, to provide legal advice to the company, or in anticipation of litigation.

## BEST PRACTICES FOR PROTECTING THE ATTORNEY-CLIENT PRIVILEGE

So what should we, as outside counsel, advise our hypothetical GC before he launches an investigation? As an initial matter, clients should always be told that the only way to *guarantee* that a communication or document will not be discoverable is not to make it. Because the pros of an internal investigation often outweigh the cons, however, the steps below will

help our GC ensure that the bank's investigation stays internal:

- **Explicitly State that Legal Advice is Being Provided.** The GC should state that the investigation is being undertaken to inform the GC of facts necessary to seek (from outside counsel) and provide (to the bank's principals, officers, and directors) legal advice. Counsel should clearly label legal communications as "Attorney-Client Privileged," and expressly state that the communications are providing (or seeking) legal advice. In addition, counsel should protect against inadvertent waiver of privileged written communications by labeling communications with "Do Not Forward." In all instances, these labels should be used thoughtfully and only where applicable.
- **Corporate Employees Should Specify that They are Seeking Legal Advice.** In our hypothetical above, the GC asked the branch manager (the person closest to the branch's employees, policies, and procedures) to speak with her employees about what occurred. The GC should document that these tasks were assigned to the branch manager as part of the legal function, and that there is no other employee who could as readily carry out the investigation. Ideally, a member of the legal department would participate in the interviews, and Upjohn warnings should always be provided. Finally, when providing summaries to the GC, the branch manager should indicate that the summaries are intended to provide information to the GC for the purpose of requesting legal advice and discuss the summaries only with legal counsel.
- **Separate Legal and Business Advice.** In-house counsel often wear two "hats," assisting their companies with both business and legal functions in the course of a work day. If business advice is sought along with legal

advice, then it is important to distinguish the two functions. In the above hypothetical, for example, the GC may ask the branch manager to review and update the branch's fraud-prevention policies and procedures. Whether the GC's request is a legal or business function is not immediately clear. Therefore, the GC should document precisely what is being requested and for what purpose. In-house counsel should be aware of their dual roles at all times, and employees should be instructed, as a best practice, to initiate separate communications with in-house counsel when requesting legal, as opposed to business, advice.

- **Avoid Routine Copying of In-House Counsel on Non-Legal Communications.** Merely copying in-house counsel on communications does not make them privileged. To the contrary, such a practice may undermine the company's legitimate privilege claims. Here, for example, the branch manager may be tempted to copy the GC on day-to-day communications concerning branch management, to give the GC an opportunity to weigh in on the ongoing operations of the branch and the prevention of further fraud. The branch manager should be instructed to only copy the GC when legal advice is expressly sought.

## CONCLUSION

Questions of corporate attorney-client privilege often arise only after the cat is out of the bag. To prevent compelled disclosure, counsel should advise clients as to privilege best practices and proactive steps they can take to protect the privilege. ■

<sup>1</sup> This question concerns the applicability of the attorney work product doctrine, a more limited protection that applies to materials created in anticipation of litigation. In practice, the work product protection is often asserted hand-in-hand with the attorney-client privilege.

## FRANCHISE DISPUTES CONTINUED FROM P. 2

An effective mediation clause should, at a minimum, reflect balance in collaboration by taking into account the following factors:

- **Cost:** A franchisor that desires to engage in a "good faith" mediation should be willing to incur at least half of the mediator's fees and expenses.
- **Venue:** A franchisor will typically choose a site that is convenient for it, and not a franchisee. A neutral and mutually convenient

location has a better chance of having a productive mediation.

- **Mediator:** A franchisor will often seek a mediator that is partial to "the words of the contract" over the shared interests of the parties. In other words, a franchisor will often want to engage in an "evaluative mediation" that more narrowly assesses the merits of a case instead of a "facilitative mediation" that aims to find opportunities for mutual gain (growing the pie), particularly in a continuing relationship, rather than merely cutting up and dividing the pie. For optimal results, a franchisor should

look for a mediator who is able to help the parties find a "win-win" outcome.

Importantly, not every dispute between a franchisor and franchisee will be solved through mandatory early mediation. The principles and/or interests held by a given party may be such that only a court or arbitrator can resolve the dispute. But in the majority of instances, mandatory early mediation will allow a franchisor and franchisee to settle a dispute in a cost-effective, efficient, and relationship-preserving manner. This is for the good of the franchisor, the franchisee, and the entire franchise system. ■

## OPINIONS CONTINUED FROM P. 3

sive provision subject to the surrender provision of Section 1325 and that under Section 1325 Wells Fargo could not be required to take the property in satisfaction of the debt. Judge Hoffman first set forth his interpretation of the terms “vest” under Section 1322(b)(9) and “surrender” under Section 1325(a)(5)(C) — defining “vest” as transferring title, and “surrender” as making the property available to be taken. Judge Hoffman then rejected Wells Fargo’s argument, reasoning that a transfer of property under Section 1322(b)(9) presupposes its surrender and does not implicate Section 1325(a)(5)(C).

After consideration of Section 1322 and Section 1325, Judge Hoffman concluded “the Bankruptcy Code permits a Chapter 13 debtor to propose a plan that provides for transferring title to mortgaged real estate to the mortgagee in full satisfaction of its claim ... .”

Wells Fargo also argued that Massachusetts state law prohibited a mortgagor from unilaterally vesting property in a mortgagee. Acknowledging this undisputed fact, Judge Hoffman relied on *Butner v. U.S.*, a United States Supreme Court case holding that a federal interest could preempt a conflicting state law, and found that the fresh start policy of Chapter 13 bankruptcy proceedings was a paramount federal interest that supported federal preemption of the relevant Massachusetts law.

Judge Hoffman found that Debtor’s Plan satisfied the code, was consistent with the spirit of the fresh start policy, and was put forth in good faith. Judge Hoffman held that the debtor’s Chapter 13 plan to vest property in a mortgagee under section 1322(b)(9) was

confirmable upon surrender under 1325(a)(5)(C), even though the mortgagee did not consent. On August 14, 2015, Wells Fargo filed a Notice of Appeal to the District Court. The appeal is *sub judice* at the time of this writing.

### IN RE WELLER: PROHIBITING UNILATERAL VESTMENT

The property at the heart of this dispute was the debtors’ residence in Massachusetts. The property was subject to a mortgage issued to Wells Fargo Bank, but after default Wells Fargo never foreclosed on the property. In 2012, the debtors filed for Chapter 13 bankruptcy and vacated the property. The debtors continued to pay post-confirmation maintenance and insurance on the vacated property until August 2015 when a Post-Confirmation Amended Chapter 13 Plan was filed that proposed to vest title of the property in Wells Fargo. The proposed plan read in relevant part, “Pursuant to §§ 1322(b)(8) and (9), title to the property ... shall vest in Wells Fargo .. upon confirmation, and the Confirmation Order shall constitute a deed of conveyance of the property ... ” in satisfaction of the debt. Wells Fargo objected.

Judge Boroff limited the scope of his opinion to this question: Does Section 1322(b)(9) permit confirmation of a plan that vests title in an objecting creditor? Recognizing the relevance of the *In re Sagendorph* decision, Judge Boroff expressed agreement with much of Judge Hoffman’s preliminary reasoning, including Judge Hoffman’s finding that Sections 1325(a)(5) and 1322(b)(9) were not in conflict. But Judge Boroff nevertheless found that a plan may not force a secured creditor to take title to its collateral in satisfaction of a debt.

Judge Boroff observed that Section 1325 provides a debtor with the right to include surrender in its plan, but that under Section 1322(b)(9) or Section 1325(a)(5), the plan may not force a secured creditor to take title to its collateral in satisfaction of the debt. The court reasoned that the secured creditor has the right not to accept the property and therefore a plan which “vests” property in a mortgagee over that mortgagee’s objection does not fulfill the requirements of the code and may not be confirmed.

### CONCLUSION

The Bankruptcy Code provides flexibility to judges as they seek to interpret and apply the law consistent with the principles of the code. The price of this flexibility is an occasional conflict in reasoning or decisions between courts, or even judges of the same court. The byproduct of the recent controversy over forced vestment is that debtor’s counsel may argue Judge Hoffman’s opinion in *Sagendorph* and creditor’s counsel may argue Judge Boroff’s opinion in *Weller* on the same issue.

As Judge Boroff observed in *Weller*, the plight of debtors whose economic suffering (and uncooperative mortgagees) brought this issue to the fore is “a sad commentary on the times.” The legal standoff over forced vestment does not benefit these debtors or their creditors. This is an issue best resolved quickly so that there may be predictability on this issue in the Bankruptcy Court. ■

1 *In re Sagendorph*, 2015 WL 3867955 (Bankr. D. Mass. June 22, 2015).

2 *In re Weller*, 2016 WL 164645 (Bankr. D. Mass. Jan. 13, 2016).

## CYBER LIABILITY CONTINUED FROM P. 4

confidentiality, accessibility, and security of sensitive information in the firm. An understanding of the steps involved, along with the attendant costs of identifying, investigating, remediating and reporting a data security breach is advisable, as well as a clear understanding of the nature and extent of available insurance coverage relative to those costs. Businesses and professional firms, as repositories of sensitive personal and business information, must be aware of the rapidly developing risks of data security, and should carefully examine their policies and insurance coverage to ensure those risks are adequately addressed.

### AVAILABLE INSURANCE SOLUTIONS

As this exposure continues to develop, traditional insurance policies such as property, general liability, and professional liability have added exclusions to ensure that they are not providing coverage for data breach incidents that were not contemplated when underwriting traditional risks. The insurance marketplace has responded by crafting a stand-alone insurance policy commonly referred to as cyber liability. There are more than 30 insurers both domestically and in London that are offering some modicum of coverage for this exposure. As a potential buyer of cyber liability insurance it is important to understand the level of coverage that is being provided. For middle market businesses the majority of the potential expenses for

a data breach incident will be from the necessary vendors to assess and respond to the incident at hand. The amount of insurance available for each element of coverage and the policy language vary greatly from insurer to insurer. Beyond the benefit of transferring this potential exposure off of your balance sheet, the true value in this insurance is having access to an expert team of attorneys, forensic consultants, public relations consultants, and vendors to assist with notification and the offer of credit monitoring. As this exposure is constantly evolving it is of critical importance to work with an insurance brokerage and law firm that understands the intricacies of the policy contract and that can assist with risk management, risk transfer and breach response. ■



## MARIJUANA BUSINESS CONTINUED FROM P. 3

legal under state law. Marijuana investors, lenders, landlords and other interested parties are rightfully wary of the risks they may face under federal law.

### III. “LEGAL” MARIJUANA IS TOO SEEDY FOR FEDERAL BANKRUPTCY COURTS

Unfortunately, for individuals and businesses who knowingly deal with a medical or recreational marijuana business that is legal under state law but remains illegal under federal law, the federal courts have largely held that bankruptcy is not available to them.

In the 2012 case of *In re Rent-Rite Super Kegs West Ltd.*, the debtor derived 25 percent of its revenue from leasing its warehouse to marijuana growers.<sup>2</sup> The bankruptcy court found that the debtor’s business — arguably legal under Colorado law — was a continuing violation of the CSA, which makes it a federal crime to knowingly and intentionally lease the space for the purpose of unlawfully manufacturing, storing, distributing or using marijuana. The court recognized that although “federal prosecutors may well choose to exercise their prosecutorial discretion and decline to seek indictments under the CSA where the activity that is illegal on the federal level is legal under Colorado state law,” “[u]nless and until Congress changes that law, ... a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing criminal federal crime.”

The court further found that the real property remained subject to criminal forfeiture, that the federal government’s police powers were not enjoined by the automatic stay, and that no plan could be confirmed because no plan “that relies in any part on income derived from criminal activity” could be “proposed in good faith and not by any means forbidden by law” as required by Section 1129(a)(3). Accordingly, the *In re Rent-Rite Super Kegs West Ltd.*, court concluded that “cause” existed for the debtor’s “gross mismanagement of the estate” and lack of “clean

hands” (i.e., the continuing violation of the CSA) requiring dismissal or conversion of the case under Bankruptcy Code Section 1112(b) (4). The court also questioned whether a Chapter 7 trustee upon conversion could administer an estate whose “major asset” “is the location of ongoing criminal activity.”

In the 2014 case of *In re Arenas*, the same bankruptcy judge dismissed a Chapter 7 bankruptcy filing by a married couple who owned a two-unit commercial building. One unit was used by the husband to grow marijuana to sell wholesale and the other unit was leased to a third-party marijuana dispensary — both activities legal under Colorado law.<sup>3</sup> The court found “cause” to dismiss the case under Bankruptcy Code Section 707(a) because the Chapter 7 trustee could not take control of and administer the building and 25 marijuana plants without himself committing a federal crime in violation of the CSA. The court reasoned that the Chapter 7 trustee would be unable to liquidate the valuable (albeit illegal) non-exempt assets for the benefit of creditors. The court also denied a motion to convert the Chapter 7 case to Chapter 13 because any plan proposed by the debtors would be funded by proceeds or rents derived from the sale of marijuana, “a means forbidden by law,” and involve the Chapter 13 trustee administering and distributing the illegal funds. A 10th Circuit Bankruptcy Appellate Panel affirmed.

In the 2015 case of *In re Johnson*, the Bankruptcy Court ordered that a Chapter 13 individual debtor must choose between continuing his state authorized business of cultivating and selling medical marijuana and availing himself of the benefits of the Bankruptcy Code, which he desperately needed to avoid foreclosure on his residence. The Bankruptcy Court rejected the debtor’s effort to segregate the illegal proceeds and fund a Chapter 13 plan solely with his social security income. The court ordered as a condition of the debtor’s eligibility to proceed in bankruptcy that the debtor immediately cease growing and selling marijuana and destroy the remaining marijuana plants, product and

inventory.<sup>4</sup>

In *In re Medpoint Management LLC*, following the *Rent-Rite Super Kegs* and *Arenas* decisions, the bankruptcy court dismissed an involuntary Chapter 7 petition by petitioning creditors against a marijuana dispensary management company.<sup>5</sup> The court concluded that the petitioning creditors had “unclean hands” because they had entered into contracts with the debtor knowing it was in the business of managing and operating a medical marijuana business that was illegal under federal law. The court observed that the petitioning creditors were not without remedies and may well pursue the debtor in state court for breach of contract and fraudulent transfer claims.

In *Northbay Wellness Group Inc. v. Beyries*, an attorney-debtor filed for bankruptcy and a medical marijuana dispensary challenged the dischargeability of a judgment against the attorney for the theft of \$25,000 from a legal defense trust fund. The dispensary argued under Section 523(a)(4) that the judgment was a non-dischargeable debt for fraud or defalcation while acting as a fiduciary.<sup>6</sup> The bankruptcy court held that the dispensary’s illegal marijuana sales prevented it from obtaining relief under the “unclean hands” doctrine and the district court affirmed. But in 2015, a panel of the Ninth Circuit Court of Appeals reversed because the doctrine of “unclean hands” requires a balancing of the wrongful activity by the parties and the attorney who partnered in the business “was as responsible as [the dispensary] for its illegal marijuana sales” so “[t]hat illegal activity must be attributed to both parties” and “does not tip the balance in either direction.”

### IV. A BLUNT TRUTH: A MARIJUANA BUSINESS RESTRUCTURING IS SUBSTANTIALLY MORE DIFFICULT WITHOUT THE BANKRUPTCY OPTION

Reorganization of a distressed marijuana business is more difficult without the usual benefits of federal bankruptcy protection. In bankruptcy, owners and management can continue

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## MARIJUANA BUSINESS CONTINUED FROM P. 7

to control and run the business, benefit from the automatic stay of actions against the debtor, cure defaulted or accelerated obligations, assume and assign or reject executory contracts and unexpired leases for real property and equipment, sell property free and clear of liens, and confirm a reorganization plan to restructure debt and other obligations with the affirmative vote of a majority of creditors and cram down a restructuring plan over a class of dissenting creditors.

In contrast, state remedies of assignment for the benefit of creditors (colloquially called ABCs) and receivership require owners and management to give up control of the business to an assignee or receiver and are designed for liquidation of its assets. Without the option and threat of bankruptcy, it is more difficult for a troubled marijuana business to negotiate and get unanimous support of its major creditors — and a single holdout could disrupt or doom any potential reorganization. Given the probable lack of bankruptcy protection, marijuana businesses need to hire experienced restructuring professionals early in the process in the hope of constructing a reorganization plan that maintains the going concern value of the business and benefits all parties, if possible.

### V. PREPLAN EXIT AND WIND-DOWN OPTIONS BEFORE THE MARIJUANA BUSINESS IS CHRONICALLY IMPAIRED

Both marijuana businesses and their stakeholders should consult with experienced restructuring attorneys before embarking into a new venture to preplan exit and wind down options.

Management and owners will benefit from planning and contracting for exit options, for return of equity in specific liquidity events, and to wind down a failed enterprise to avoid personal liability. The prohibition of banks accepting cash from marijuana businesses requires owners to be particularly acute to the issue of cash holdings and transfers to their personal bank accounts. Care is required to avoid fraudulent transfer clawback liability and a loss of limited liability protection of corporations and LLCs for commingling assets under alter-ego or veil-piercing causes of action.

Upon distress, management and owners should carefully consider an orderly liquidation by an assignment for the benefit of creditors under state law if the entity can obtain the assent of a majority of its unsecured creditors to be bound by the ABC wind-down and distributions.<sup>7</sup> The bankruptcy priority scheme and preference avoidance actions will not apply

so owners may prioritize payments for taxes, employees, and debts backed by guarantees to limit their personal exposure, and legitimate debts held by insiders subject to fraudulent transfer clawback.

Creditors of a marijuana business likely will not be able to prosecute an involuntary bankruptcy petition against the debtor and knowing participants may not have access to other federal courts under the “unclean hands” doctrine. Accordingly, these stakeholders must also look to state law remedies.

Lenders should seek to obtain mortgages on real property, security interests in personal property, and personal guarantees that can be enforced under state law. Because the business may not be able to open bank accounts subject to a security interest, the lender may want to require the borrower to pay over and maintain cash balances directly with the lender. Upon default, lenders may exercise state court remedies for judgment, foreclosure, collection, breach of contract, fraudulent transfers and, if appropriate, the appointment of a receiver to preserve assets, operate the business, and liquidate its assets and pay claims.

Lenders are not the only creditors of a marijuana business who may have to look to state law. Landlords, lessors and counterparties may seek to terminate their contracts, take possession of their property and assert breach of contract claims for damages. Suppliers may seek

to reclaim delivered goods. Employees may file actions for unpaid wages and benefits against the debtor and responsible management. Taxing authorities may seek to enforce liens and recover unpaid taxes.

All of these individual creditors may find themselves in the kind of “race to the courthouse” to recover from a debtor’s limited assets — a race that federal bankruptcy is designed to prevent.

### VI. CONCLUSION

The legal landscape for a distressed marijuana business and its stakeholders operating legally under state law does not include the bankruptcy option available to other businesses. Interested parties should consult with experienced restructuring attorneys to better understand these risks and find out how to protect their interests prior to and during times of financial distress. ■

1 See 21 U.S.C. §§ 801-904.

2 484 B.R. 799 (Bankr. D. Colo. 2012). 514

3 B.R. 887 (Bank. D. Colo. 2014), *aff’d*, 535 B.R. 845 (10th Cir. B.A.P. 2015).

4 532 B.R. 53 (Bankr. W.D. Mich. 2015).

5 528 B.R. 178 (Bankr. D. Ariz. 2015).

6 789 F.3d 956 (9th Cir. 2015).

7 Mass. G.L. ch. 203, §§ 40-42.

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