UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

In re	Chapter 9
CITY OF DETROIT, MICHIGAN,	Case No. 13-53846
Debtor.	Hon. Steven W. Rhodes
CITY OF DETROIT, MICHIGAN,	Chapter 9
Plaintiff,	Adversary Proceeding No. 14-04112
vs.	Hon. Steven W. Rhodes
DETROIT GENERAL RETIREMENT SYSTEM SERVICE CORPORATION, DETROIT POLICE AND FIRE RETIREMENT SYSTEM SERVICE CORPORATION, DETROIT RETIREMENT SYSTEMS FUNDING TRUST 2005, and DETROIT RETIREMENT SYSTEMS FUNDING TRUST 2006,	
Defendants.	

CITY OF DETROIT'S MOTION TO DISMISS IN PART
THE FUNDING TRUSTS' COUNTERCLAIMS

Plaintiff City of Detroit, by and through its undersigned counsel, hereby files this Motion to Dismiss, and requests, pursuant to Federal Rule of Civil Procedure 12(b)(6) and 12(c) and Federal Rule of Bankruptcy Procedure 7012(b), that this Court dismiss in full Counts I, II and IV-XIV of the Counterclaims against it. In support of this Motion, the City respectfully refers the Court to the Memorandum in Support attached hereto as Exhibit 3.

Counsel for the City sought the concurrence in the relief requested herein from counsel for the Trustee of the Funding Trusts, but such concurrence was not obtained, necessitating the filing of this motion.

WHEREFORE, the City of Detroit respectfully requests that the Court grant its Motion to Dismiss pursuant to Fed. R. Civ. P. 12(b) and 12(c) and Fed. R. Bankr. P. 7012(b), and grant such other and further relief as the Court deems appropriate.

[signature page follows]

Dated: April 10, 2014

Respectfully submitted,

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ATTORNEYS FOR THE CITY OF DETROIT

EXHIBIT 1

Proposed Order

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
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Defendants.	

ORDER DISMISSING, WITH PREJUDICE, COUNTS I, II AND IV-XIV OF THE FUNDING TRUSTS' COUNTERCLAIMS

This matter having come before the Court on the motion (the "Motion")[1] of Plaintiff/Counter-Defendant City of Detroit, and the Court being otherwise advised in the premises;

IT IS HEREBY ORDERED that the Counts I, II and IV-XIV of the Counterclaims filed by the Trusts in the above-captioned adversary proceeding are DISMISSED WITH PREJUDICE.

[1] Capitalized terms not otherwise defined herein shall have the meanings set forth in the Motion.

EXHIBIT 2

Notice

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
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Defendants.	

NOTICE OF MOTION AND OPPORTUNITY TO RESPOND

PLEASE TAKE NOTICE that on April 10, 2014, Plaintiff/Counter-Defendant City of Detroit filed its *Motion to Dismiss in Part the Funding Trusts' Counterclaims* (the "**Motion**") in the United States Bankruptcy Court for the Eastern District of Michigan (the "**Bankruptcy Court**") seeking entry of an order dismissing in part the Counterclaims filed in the above-captioned adversary proceeding.

PLEASE TAKE FURTHER NOTICE that <u>your rights may be affected</u> by the relief sought in the Motion. You should read these papers carefully and discuss them with your attorney, if you have one. If you do not have an attorney, you may wish to consult one.

PLEASE TAKE FURTHER NOTICE that if you do not want the Bankruptcy Court to grant the City's Motion, or you want the Bankruptcy Court to consider your views on the Motion, within **17 days** you or your attorney must:

1. File a written objection or response to the Motion explaining your position with the Bankruptcy Court electronically through the Bankruptcy Court's electronic case filing system in accordance with the Local Rules of the Bankruptcy Court or by mailing any objection or response to:[1]

United States Bankruptcy Court
Theodore Levin Courthouse
231 West Lafayette Street
Detroit, MI 48226

You must also serve a copy of any objection or response upon:

Jones Day
51 Louisiana Ave. NW
Washington, D.C. 20001-2113
Attention: Geoffrey Stewart

-and-

Pepper Hamilton LLP
Suite 1800, 4000 Town Center
Southfield, Michigan 48075
Attn: Robert Hertzberg and Deborah Kovsky-Apap

[1] A response must comply with F. R. Civ. P. 8(b), (c) and (e).

2. If an objection or response is timely filed and served, the clerk will schedule a hearing on the Motion and you will be served with a notice of the date, time and location of the hearing.

PLEASE TAKE FURTHER NOTICE that if you or your attorney do not take these steps, the court may decide that you do not oppose the relief sought in the Motion and may enter an order granting such relief.

[signature page follows]

Dated: April 10, 2014

Respectfully submitted,

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ATTORNEYS FOR THE CITY OF DETROIT

EXHIBIT 3

Brief

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
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Defendants.	

CITY OF DETROIT'S MEMORANDUM IN SUPPORT OF ITS MOTION TO DISMISS IN PART THE FUNDING TRUSTS' COUNTERCLAIMS

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

CASES

STATUTES

OTHER AUTHORITIES

Pursuant to Fed. R. Civ. P. 12(b)(6) and 12(c), made applicable here by Bankruptcy Rule 7012(b), plaintiff the City of Detroit moves to dismiss Counts I, II and IV through XIV of the counterclaims propounded by counter-plaintiff Wilmington Trust, N.A., successor trustee for the defendant Funding Trusts (the "Trusts").[1] As set forth below, these counterclaims must be dismissed because:

(a) Counts II, IV and VI-XIV assert new claims against the City well after the bar date.

(b) Counts I, II, and V-XI seek an affirmative recovery of amounts transferred pursuant to the illegal Service Contracts, which cannot stand in law or equity.

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[1] The City does not move to dismiss Count III, which seeks declaratory judgment that the Service Contracts at issue here are valid and enforceable, since that Count, at bottom, simply is the mirror image of the City's own claims. *See* Answer With Affirmative Defenses And Counterclaims Of Defendants Detroit Retirement Systems Funding Trust 2005 And Detroit Retirement Systems Funding Trust 2006 To Complaint For Declaratory And Injunctive Relief, ¶¶ 43-57 at pp. 50-55 ("Trusts' Answer & Counterclaims"). However, the City denies all material allegations of Count III.

Rather than repeat the factual background of the case, the City respectfully refers the Court to the detailed facts set forth in the City's Complaint and the transactional documents attached to the Complaint and to the Trusts' Counterclaim. *See Field Day, LLC v. County of Suffolk*, 463 F.3d 167, 192 (2d Cir. 2006) (when ruling on a Rule 12(b)(6) motion to dismiss, the court may consider the "facts stated in the complaint, documents attached to the complaint as exhibits and documents incorporated by reference in the complaint") (internal quotation marks omitted).

(c) Count IV seeks a declaration that the City's claims are barred by the statute of limitations, but relies upon the wrong statute.

(d) Counts XII-XIV assert claims for due process, unlawful taking and conversion that are invalid because the Trusts have no property interest in the City's unsecured, illegal promises.

I. ARGUMENT

A. Counts II, IV and VI-XIV Are Barred by the Claims Bar Date

Wilmington Trust, N.A., as successor trustee of the Funding Trusts, filed proofs of claim numbers 1120, 1136, 1138 and 1197 (the "Proofs of Claim") on February 19, 2014. The Proofs of Claim were filed almost three weeks after the filing of this adversary proceeding. The Trusts had ample notice of allegations and counts asserted by the City in this proceeding and the opportunity to include any and all claims against the City in their Proofs of Claim. Yet, with small exceptions not relevant here,[2] the Proofs of Claim assert only that the City is liable to the Trusts for contract damages pursuant to the Service Contracts. It was not until March 17, 2014, more than three weeks *after* the February 21 bar date, that the Trusts suddenly asserted a host of new claims against the City. The claims set forth

[2] The additional claims are for certain administrative fees and costs and indemnification for legal expenses, which are not at issue in any of the Trusts' counterclaims. *See, e.g.,* Claim No. 1197, ¶ 6.

in the Trusts' Counterclaims – ranging from fraudulent misrepresentation to violation of substantive due process to statutory conversion seeking treble damages – appear nowhere in the three dozen combined pages of the Proofs of Claim.

It is procedurally improper for the Trusts to try to "back-door" new claims against the City by raising them in the guise of a counterclaim rather than seeking to amend their Proofs of Claim. Furthermore, the Trusts are barred from asserting new claims against the City in any format after the bar date without leave of the Court, and the Trusts cannot obtain such leave because they cannot establish that their failure to file the claims timely was the result of "excusable neglect." *See* Fed. R. Bankr. P. 9006(b); *Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. P'Ship*, 507 U.S. 380 (1993). Accordingly, Counts II, IV and VI-XIV must be dismissed as untimely.

In addition, Count IV, which seeks a declaration that the City's claims are barred by the statute of limitations, must be dismissed because the assertion of the statute of limitations is an affirmative defense, not a counterclaim. *See, e.g.* Trusts' Answer & Counterclaims, Third Affirmative Defense at 23 (alleging that "the City's claims are barred, in whole or in part, by the applicable six-year statute of limitation"). The Trusts have the ability, should they choose, to move to dismiss the City's Complaint based on their third affirmative defense. But it makes no sense and wastes the time of the Court and the City for the Trusts to duplicate their

affirmative defense in form of a counterclaim to which the City is required now to respond.

B. Counts I, II and V Must Be Dismissed Because the Trusts Cannot Recover Under an Illegal Contract

1. The City Is Entitled to Judgment on the Pleadings that the Service Contracts Are Illegal and Void

Under Fed. R. Civ. P. 12(c), a party is entitled to judgment on the pleadings when, even after taking as true "all well-pleaded material allegations of the pleadings of the opposing party . . . the moving party is nevertheless clearly entitled to judgment." *McGlone v. Bell*, 681 F.3d 718, 728 (6th Cir. 2012) (citation omitted). The relevant facts regarding the COPs transactions are well-known and largely undisputed; they are set forth in the City's enacting ordinance and transactional documents relied upon by the City and the Trusts in their respective pleadings. *See Finisar Corp. v. Cheetah Omni*, *LLC*, 2012 U.S. Dist. LEXIS 185232 (E.D. Mich. Dec. 10, 2012) (stating that "when determining whether a plaintiff is entitled to a Judgment on the Pleadings, such a judgment may be based on admissions by the Defendant under Fed. R. Civ. P. 8(b)").

As set forth in detail in the City's Complaint, the City is subject to strict ceilings on the amount of indebtedness it may incur. In particular, § 4a of the Home Rule City Act ("HRCA"), MCL § 117.4a, sets maximum limits on a city's net indebtedness at the greater of: (1) ten percent of the assessed value of all the

real and personal property in the city; or (2) fifteen percent of the assessed value of all the real and personal property in the city if that portion of the total amount of indebtedness incurred which exceeded ten percent was or had been used solely for the construction or renovation of hospital facilities. It is undisputed that the City had only $660 million remaining under its debt limit as of May 2, 2005. *See* 2005 Offering Circular, Complaint Ex. A.

By that time, the City already was in serious financial straits. Among other problems, it had fallen behind in making its contributions to its two employee retirement systems, the Detroit General Retirement System ("GRS") and the Detroit Police and Fire Retirement System ("PFRS"). According to the City's 2005 Comprehensive Annual Financial Report ("CAFR"), the PFRS had unfunded accrued actuarial liabilities ("UAAL") of $783 million and the GRS had UAAL of $914 million, for a total of almost $1.70 billion, at the end of the 2004 fiscal year. Due to the debt limit imposed by HRCA § 4a, however, the City could not legally issue debt in an amount sufficient to fund its UAAL shortfall.

The City, its advisors, and representatives of investment banks began casting about for ways of circumventing the HRCA's debt ceiling. In the end, they concluded that they could evade the law by structuring a transaction in which the City could raise money without calling it "debt." Relying upon Michigan cases that had held that a municipality's contractual obligations to pay for future services was

not indebtedness, they structured a transaction that, at least superficially, looked like a contract for future services. The City did so by (a) creating two entities called "Service Corporations," (b) having the Service Corporations create a trust to sell certificates of participation ("COPs") to investors, (c) requiring the Service Corporations and the trust to remit the proceeds of the COPs sale to the Retirement Systems, (d) arranging to have the Service Corporations pay the trust the monies required to service the interest upon and retire the principal of the COPs, and (e) agreeing, pursuant to "Service Contracts," to pay the Service Corporations the monies they would need to satisfy their obligations to the trust. *See* 2005 Offering Circular, Complaint Ex. A, at 1. The City did this twice, once in 2005 and again in 2006.

But the COPs transactions were an obvious sham. The *sine qua non* of a future services contract is that the contracting party, in truth, actually provide services in the future. This is critical, because under a true future services contract, no payment obligation arises until the services are rendered. Thus, the payments by the City under a future services contract are, not just in form but also in substance, payments of current expenses rather than satisfaction of pre-existing indebtedness. This is demonstrated by the very cases the parties to the 2005 and 2006 COPs transactions said they relied upon. In *Walinske v. Detroit-Wayne Joint Bldg. Auth.*, 39 N.W.2d 73, 77 (Mich. 1949), for example, the City could not finance the

construction of new city offices, so it incorporated a municipal building authority to which it transferred the land on which the offices were to be built. The building authority then issued bonds of its own, constructed the building, and leased it back to the City for a period of thirty years. 39 N.W.2d at 77. Each lease payment entitled the City to ongoing access to the offices. In *Drain Commissioner of Oakland County v. City of Royal Oak*, 10 N.W.2d 435 (Mich. 1943), the city received ongoing waste disposal services in exchange for the payments it made. In *Ludington Water-Supply Co. v. City of Ludington*, 78 N.W. 558 (Mich. 1899), the contract counterparty similarly provided ongoing services of supplying water.

It is not seriously disputed that this critical component is missing from the COPs transaction. In 2005, the Service Corporations did nothing more than sign a Service Contract with the City under which they were to receive a stream of payments; form Funding Trusts to issue the COPs; assign the stream of payments under the Service Contracts to the Funding Trusts; receive the proceeds of the COPs sale; and remit those proceeds to the respective Retirement Systems. The 2006 transaction was virtually identical, except that the proceeds were instead used to refund certain of the 2005 COPs. In each case, the "service" provided by the Service Corporations was a one-time event.

The COPs transactions resulted in a one-time infusion of $1.4 billion to the Retirement Systems, with certain of the 2005 COPs replaced in 2006. Since

the time of the transactions, until June 2013, the City has made payments of interest and principal to the Funding Trusts pursuant to the Service Contracts; however, the Service Corporations have provided no services to the City and, in fact, have done nothing at all. This was by intentional design. In the 2005 COPs transaction, for example, the Service Corporations signed their Service Contracts with the City on May 25, 2005. Their main obligation was the single duty to take the money they received from the Funding Trusts (the "Stated Funding Amount") and pay it over to the Retirement Systems. *See, e.g.,* GRS 2005 Service Contract General Terms, § 4.01, Complaint Ex. C.

In theory, the Service Corporations also were obligated to handle the ministerial task of receiving periodic payments from the City to service the principal and interest on the COPs and pass those funds along to the Funding Trusts. However, on June 2, 2005, the Service Corporations conveyed their rights to receive these payments to the Funding Trusts, who thereafter were paid directly by the City. *See* 2005 Trust Agreement, Complaint Ex. D. Thus, neither Service Corporation ever did anything, except provide, for a few days in May 2005, the *present* service of helping to close the deal.[3]

[3] The 2006 COPs transaction was identical in all material respects other than the use of the proceeds. *See* 2006 Offering Circular, Complaint Ex. J, at 1-2.

Neither the Service Contracts nor any other transactional document reveals that either Service Corporation was to provide any ongoing *future* services to the City. In fact, the Offering Circulars – which described the COPs deals to potential investors – openly admitted that the "Service Corporations are not expected to have a significant active role" following the closing of the COPs transactions. *See* 2005 Offering Circular at 5; 2006 Offering Circular at 6. Nor, for that matter, would the Service Corporations be rendering any "*services*." A document the Trusts rely on in their Counterclaim – the Underwriting Agreement for the 2005 COPs offering – all but concedes this essential point. It points out that the City will have to handle various administrative tasks itself on behalf of the Service Corporations and the Trusts "because neither Service Corporation has or will have any staff and the Funding Trust will have no staff." Counterclaim Ex. 1, at 2. This, of course, highlights the absurdity of the COPs transactions: since the Service Corporations had no staff, it would be the City – and not the Service Corporations – that would be rendering services and, strangely, it would be rendering these services to itself.

The Trusts now conflate the future *benefits* of the COPs transaction with the receipt of an ongoing *service*. Receipt of a future benefit from a past transaction, however, does not turn the transaction into a contract for future services. There must instead be some ongoing exchange of actions or goods for

payment. In *Royal Oak* and *Ludington*, for example, the periodic payments purchased the right to have sewage disposed of and water provided; if the city had failed to make a payment, those services would have terminated. Here, by contrast, the City obtained a discrete, present service from the Service Corporations in each of 2005 and 2006. The fact that the City may continue to experience the benefit of funding its UAAL with the proceeds of the COPs transaction therefore cannot transform that funding mechanism from a borrowing of money into a contract for future services. Indeed, it will be true with any debt offering that the benefits of the one-time infusion of cash may be experienced for years into the future, while the borrower must make periodic payments into the future for the right to receive the cash up-front. These are the classic hallmarks of debt.

Because the Service Contracts were not structured to provide the City with future services, they fail to meet the fundamental requirement of future services contracts. Instead, the obligations they imposed were those of indebtedness, in violation of the City's debt limit.[4]

[4] The City has alleged, and believes it is true, that the Service Corporations are mere shells and alter egos of the City itself. The Court need not decide that issue, however, in order to grant judgment in the City's favor. The dispositive fact is that the Service Contracts did not obligate the Service Corporations to provide future services in the years in which the City was to make scheduled payments thereunder. Thus, they do not fall within the court-created exception to the definition of indebtedness. The result would be the same even if the counterparty under the Service Contracts were a genuine third party.

2. As Illegal Contracts, the Service Contracts Are Void and Cannot Be Enforced

Courts in Michigan and elsewhere have long refused to enforce or grant affirmative relief under illegal contracts.

> It is well settled that the law will not aid either party to an illegal agreement. It leaves the parties where it finds them. Neither a court of law or equity will aid the one in enforcing it, or give damages for the breach of it, or set it aside at the suit of the other, or, when the agreement has been executed in whole or in part by the payment of money or the transfer of other property, lend its aid to recover it back.

Benson v. Bawden, 149 Mich. 584, 587 (Mich. 1907); *American Trust Co. v. Michigan Trust Co.*, 248 N.W. 829, 830 (Mich. 1933) ("The general rule of law is, that a contract made in violation of a statute is void; and that when a plaintiff cannot establish his cause of action without relying upon an illegal contract, he cannot recover." (quoting *Miller v. Ammon*, 145 U.S. 421, 426 (U.S. 1892)).

The fundamental principle set forth in *Benson*, *American Trust* and numerous similar cases continue to guide Michigan courts. *See, e.g. Kukla v. Perry*, 105 N.W.2d 176, 183 (Mich. 1960) (stating that "where an illegal contract is involved, the court will not enforce it or grant relief thereunder"); *see also Mino v. Clio Sch. Dist.*, 255 Mich. App. 60, 71 (Mich. Ct. App. 2003) (citing *American Trust* and finding that plaintiffs could not maintain an action for breach of contract where the contract clause at issue violated a Michigan statute); *Shapiro v. Steinberg*, 176 Mich. App. 683, 687 (Mich. Ct. App. 1989) ("It is well established

that the courts of this state will not enforce, either in law or in equity, a contract which violates a statute or which is contrary to public policy.").

Moreover, this principle has been applied expressly in the context of illegally-issued municipal debt. The leading Michigan case is *McCurdy v. Shiawasee County*, 118 N.W. 625 (1908). For over 20 years, Shiawasee County had occasionally borrowed money to pay ordinary expenses. In accordance with this well-known common practice, plaintiff loaned the county $10,000 (more than $270,000 in today's dollars), evidenced by two notes. The Michigan Supreme Court ruled that, notwithstanding two decades of practice and the good faith of the parties, the county had no authority to incur the debt, and therefore the notes were void. *Id.* at 629 (citing a number of cases holding that "there could be no liability against a municipality upon contracts not made in conformity with the statutes").

As demonstrated above, the Service Contracts created indebtedness of the City, which was illegal because it exceeded the City's debt limit. It is no defense for the Trusts to argue that they were unaware of the limitations on the City's ability to incur indebtedness. Rather, the Trusts are presumed to know the law. As the Michigan Supreme Court has explained, "[a]ll persons dealing with counties are bound to ascertain the limits of their authority fixed by statute or organic law, and are chargeable with knowledge of such limits. . . . We have had occasion several times to hold that all persons dealing with public corporations are

bound to make their contracts according to law, and will not be protected unless they do so." *Id.*; *see also Stratton v. City of Detroit*, 246 Mich. 139, 148 (1929) ("in dealing with the city [of Detroit] one was bound to take notice of the charter provisions"); *Wolverine Engineers & Surveyors v. City of Leslie*, 2011 Mich. App. LEXIS 2048, at *3 (Mich. Ct. App. Nov. 17, 2011) (noting the "fundamental" principle that "those dealing with public officials must take notice of the powers of the officials") (citations omitted).

In addition, the City acted as an agent of the Trusts in the COPs transactions. *See, e.g.* Underwriting Agreement, Counterclaim Ex. 1, at 2 (stating that "because neither Service Corporation has or will have any staff and the Funding Trust will have no staff, the City may take certain actions under this Underwriting Agreement on behalf of itself, the Service Corporations and/or the Funding Trust"). As a result, the City's knowledge of its own limitations is imputed to the Trusts. *See, e.g., NECA-IBEW Rockford Local Union 364 Health & Welfare Fund v. A&A Drug Co*., 736 F.3d 1054, 1059 (7th Cir. Ill. 2013) ("A trust's 'knowledge' may be imputed from its employees or agents.").[5]

[5] The Trusts' presumed and/or imputed knowledge is another reason that Counts VIII, IX and X, alleging fraudulent inducement and fraudulent and negligent misrepresentation, must be dismissed. Each of those causes of action requires the Trusts to prove justifiable reliance. *Boeve v. Nationwide Mut. Ins. Co*., 2010 U.S. Dist. LEXIS 102769, *13 (E.D. Mich. Sept. 28, 2010) (fraud in the inducement requires showing of justifiable reliance); *Versatrans, Inc. v. Hirsch Int'l Corp*., 2013 U.S. Dist. LEXIS 33171, *19 (E.D. Mich. Mar. 11, 2013) ("Reasonable or

Such presumption and imputation of knowledge is particularly appropriate here, given that the structure of the COPs transactions were plainly disclosed in the Offering Circulars and the transactional documents incorporated by reference into the COPs. *See, e.g.*, 2005 Offering Circular at 5-8; 2006 Offering Circular at 5-10. No secret was made of the facts that the Service Corporations were mere pass-through entities and that no future services would be provided under the Service Contracts. *See, e.g.*, 2005 GRS Service Contract § 4.01 (explaining that the "services of the Corporation consist of reducing the financial burden of the Subject UAAL to the City in the current and future years" and that this would be accomplished by making the one-time payment to the Retirement Systems); 2006 GRS Service Contract § 4.01 (same). Indeed, the Service Corporations had no ability to provide services to the City because they lacked any personnel to do so. *See, e.g.* Underwriting Agreement, Trusts' Answer & Counterclaims Ex. 1, at 2.

Nor was there any attempt to hide the fact that the transaction structure was a novel attempt to avoid the debt limit. To the contrary, the 2005 Offering Circular expressly identified as one of the "Investment Considerations" –

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justifiable reliance is an essential element of any fraudulent misrepresentation claim under" Michigan law.); *Reed v. USIS Corporate Headquarters*, 2013 U.S. Dist. LEXIS 183938, *11-12 (E.D. Mich. Dec. 9, 2013) (justifiable reliance is an element of a claim for negligent misrepresentation). Because, as a matter of law, the Trusts knew what the City knew, they cannot demonstrate this required element.

that is, the caveats to investors – the fact that "[t]his is a new financing structure which is being used for the first time in the State of Michigan." 2005 Offering Circular at 2. And the transaction was publicly extolled at the time for its "unique combination of legal precedents . . . dating back to the 19th century" that would "take the concept [of a future services contract] further" than ever before. *See* Elizabeth Carvlin, *Detroit Uses COPs to Shift Pension Burden and Set a Few Records*, The Bond Buyer, Dec. 29, 2005, at 28A, Complaint Ex. G.

It was therefore clear that the interposition of the Service Corporations in the transactions was a sham designed to mimic legitimate future services contract arrangements, and that the obligations incurred under the Service Contracts were, in reality, indebtedness of the City. Although the City expressed its legal opinion that the transaction did not create indebtedness for the City, Michigan law does not allow potential investors to blindly accept a municipality's legal conclusions about the validity of its debt. *See, e.g.*, *Bloomfield Village Drain Dist. v. Keefe*, 119 F.2d 157, 165 (6th Cir. 1941) (applying Michigan law) (holding that a municipality's recital that bonds complied with the law "was a legal conclusion upon which no purchaser was entitled to rely"). Rather, it was incumbent upon any potential investor to evaluate the structure of the transaction to reach its own conclusion about its validity. Any investor that did not do so bought the COPs subject to this risk. *See, e.g., id.* (refusing to enforce illegal bonds because "[a]n

examination of the records . . . would have revealed all the facts necessary for a determination that the project was illegal").

Thus, Counts I, II and V,[6] which are contract claims, must be dismissed because the Trusts cannot enforce an illegal contract.

C. Counts VI-XII Must Be Dismissed Because the Trusts Cannot Use Alternative Theories to Receive an Illegal Recovery

It is well-established under Michigan law – particularly in the context of illegally-issued public debt – that a creditor cannot recover in equity what would be illegal for the municipality to pay him under contract.

In *McCurdy*, the court found not only that the notes were void as illegal, but that the plaintiff was not even entitled to a return of his principal under any equitable theory. The Michigan Supreme Court explained that this "is the only rule which can be relied on to prevent fraud and collusion." 118 N.W. at 629. The court reasoned that "if a township can be held on implied contract, or estopped by the acts of its officers, when there is no valid contract, it would enable these persons to disregard the law entirely, and collude with their friends to do indirectly what, if directly done, would be a plain illegality." *Id.* (citations omitted).

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[6] In addition, Count V, which seeks a declaratory judgment that amounts due under the Service Contracts were accelerated upon the City's bankruptcy filing and are now immediately due and payable, must be dismissed for the separate reason that the Service Contracts' acceleration provisions are unenforceable *ipso facto* clauses. *See* 11 U.S.C. § 365(e).

On the lack of an equitable remedy for holders of illegally-issued debt, the United States Supreme Court's decision in *City of Litchfield v. Ballou*, 114 U.S. 190 (1885) is particularly instructive because it is so closely on point. That case, which was relied upon by the Michigan Supreme Court in *Newberry v. Nine Mile Halfway Drain Dist.*, 30 N.W.2d 430 (1948), dealt with an Illinois constitutional provision limiting the indebtedness of a municipal corporation. The bonds at issue were void because they exceeded the constitutional debt limit. *Litchfield*, 114 U.S. at 191-92. The plaintiff bondholder, apparently conceding that he could not, through a legal action for breach of contract, recover the money he had lent the city of Litchfield, instead alleged fraudulent inducement and sought to recover "ex aequo et bono." *Id.* The court below ruled in his favor, but on appeal, the Supreme Court reversed and remanded with instructions to dismiss his suit. The Supreme Court explained that the plaintiff could not circumvent the problem of suing on an illegal contract by bringing a claim in equity:

> [T]here is no more reason for a recovery on the implied contract to repay the money, than on the express contract found in the bonds. The language of the Constitution is that no city, &c., "shall be allowed to become indebted in any manner or for any purpose to an amount, including existing indebtedness, in the aggregate exceeding five per centum on the value of its taxable property." It shall not become indebted. Shall not incur any pecuniary liability. It shall not do this in any manner. Neither by bonds, nor notes, nor by express or implied promises. Nor shall it be done for any purpose. . . .

> If this prohibition is worth anything it is as effectual against the implied as the express promise, and is as binding in a court of chancery as a court of law.

Id. at 192-93.

Although strict adherence to the rule against imposing *any* liability on a municipality for an illegal contract might seem harsh in some instances, Michigan courts have recognized that it serves an important public interest:

> In cases where equitable reasons are urged for the purpose of placing liability upon a municipality, consideration of the rights and interests of those most seriously interested must not be lost sight of. ***The taxpayer is entitled to the protection of all constitutional and statutory restrictions***. In the aggregate he is the public for whose benefit the municipality exists, and which bears all the burdens put upon it, but which is not consulted when such burdens, as in this case, are assumed. . . .
>
> If this court should undertake to say that this indebtedness, admittedly illegal, must be paid by this county, it will practically declare the restrictions above mentioned to be inoperative, and subject the treasuries of all the municipalities of this State to the rapacity of designing and dishonest officials, leaving no protection whatever against recklessness, extravagance, crime, and bankruptcy. Such holding would be contrary to the spirit of previous decisions of this court, and against public policy.

McCurdy, 154 Mich. at 561-63 (emphasis added).

Some twenty years after *McCurdy*, the Michigan Supreme Court again stressed the importance to the public interest of strict adherence to limitations on a city's ability to incur obligations. In *Stratton v. City of Detroit*, 246 Mich. 139

(Mich. 1929), the City council had appropriated $700,000 for the construction of a tuberculosis sanitarium and contracted with architects to draw up the plans. The architects were to receive fees calculated as a percentage of the total building cost. *Id.* at 141. The architects instead prepared plans and specifications that were used in erecting the sanitarium at a cost of $1.7 million, and sought commissions based on the actual cost of the building. *Id.* at 142-43.

The City's charter prohibited the City from entering into a contract for public works that would obligate it for more than the amount appropriated by City council for the project. *Id.* at 142. The plaintiff architects argued that, because the City knowingly accepted the benefit of plaintiffs' services, it was liable to pay for the results, notwithstanding the limitations of the City's charter. *Id.* at 146. The Michigan Supreme Court disagreed. "To accept this proposition is to eliminate from the city charter the express limitation upon the power to bind it by contracts of this character. Neither the city officials nor the courts have the right or power to do this." *Id.* Furthermore, "not having the power to make an express contract, [the City of Detroit] could not become liable on an implied contract on the theory of ratification or estoppel." *Id.* (citations omitted).

The court recognized that "[i]t may seem hard to hold that the city can have the benefit of plaintiffs' services and not be bound to pay therefor." *Id.* at 147. But, the court held, such outcome was "an unavoidable consequence to those

who attempt to contract with municipalities in total disregard of the limitations placed upon their powers, and which have been found ***necessary to safeguard the rights of their citizens***." *Id.* (emphasis added).

The same result was reached in a number of subsequent cases:

- In *Hanslovsky v. Leland Twp*., 281 Mich. 652 (Mich. 1937), the plaintiff held two promissory notes signed by the clerk and treasurer of a township. A jury found that the plaintiff had no right to recover from the township because neither the clerk nor the treasurer had authority to bind the township, but the trial judge decided that the township should return the money on equitable grounds. The Michigan Supreme Court reversed, noting that "[t]ownship officers have no power or authority to bind the township generally. They may borrow money only when expressly authorized to do so. To hold the defendant liable in this case would be to disregard all the limitations upon the power and authority of the township officers prescribed by law to bind the township." *Id.* at 656 (citing *McCurdy* and *Stratton*).

- In *Newberry v. Nine Mile Halfway Drain Dist.*, 30 N.W.2d 430 (1948), the Michigan Supreme Court summarized several decisions involving bonds that, without valid basis, had been issued to finance drain and sewer projects. The court emphasized that the bondholders could not seek any recovery even though the bonds had been invalidated. It also refused to impose a constructive trust, whether based on fraud, "unjust enrichment, the right of restitution, restitution, or on the basis of good conscience and equity." *Id*. at 436.

- In *People v. Doyle and Associates, Inc.*, 132 N.W.2d 99 (1965), the Michigan Supreme Court invalidated a lease-back agreement because the county lacked authority to incur such indebtedness. "This being so," the court explained, "Doyle may not claim compensation under it, nor, under the settled law of this State, may Doyle make claim against the county in *quantum meruit* for the facility it erected upon the leased ground." *Id.*

To hold the City liable for illegally-incurred debt under any theory, whether sounding in contract, tort or equity, would strip away the protections and safeguards to which its citizens are entitled and would do violence to public policy. The COPs and related swaps transactions have already contributed to the City's need for bankruptcy protection. Requiring the City to continue paying the illegal debt would leave the people of Detroit further exposed to "the rapacity of designing and dishonest officials," *McCurdy*, 118 N.W. at 629, such as the mayor who championed the COPs deals and is now serving a record prison sentence for his financial crimes.

Thus, Counts VI through XI,[7] which seek to hold the City liable for illegal debt under alternative theories, must be dismissed because the Trusts cannot evade the consequences of an illegal contract by framing their counts as claims in tort or equity.

D. Counts XII – XIV Must Be Dismissed Because the Trusts Have No Property Interest in the Service Payments

The claims set forth in Counts XII through XIV of the Trusts' Counterclaim – that the City has deprived the Trusts of their "property interests" without due process, that the City has unlawfully taken the Trusts' property, and

[7] Count VII, which asserts a claim for equitable estoppel, additionally must be dismissed because Michigan law does not recognize equitable estoppel as an independent cause of action. *Conagra, Inc. v. Farmers State Bank*, 237 Mich. App. 109, 140 (Mich. Ct. App. 1999).

that the City is committing conversion by unlawfully asserting dominion over the Trusts' property – share a common, fatal flaw: all of the claims assume that the Trusts have a property or other protectable interest in the payments that were to be made under the Service Contracts. This assumption is wrong, and as a result, each of these counts fails.

1. The Failure to Pay an Unsecured Debt Does Not Give Rise to Claims for Due Process

Both substantive and procedural due process claims require a showing that a constitutionally protected property or liberty interest has been infringed. *Hahn v. Star Bank*, 190 F.3d 708, 716 (6th Cir. 1999) ("To establish a procedural due process claim pursuant to § 1983 . . . [plaintiffs] must establish . . . that they have a life, liberty, or property interest protected by the Due Process Clause of the Fourteenth Amendment to the United States Constitution. . . ."); *see also Braun v. Ann Arbor Charter Twp*., 519 F.3d 564, 573 (6th Cir. 2008) ("'To state a substantive due process claim ... a plaintiff must establish that (1) a constitutionally protected property or liberty interest exists, and (2) the constitutionally protected interest has been deprived through arbitrary and capricious action.'") (citation omitted).

Substantive due process "affords only those protections 'so rooted in the traditions and conscience of our people as to be ranked as fundamental.'" *Charles v. Baesler*, 910 F.2d 1349, 1353 (6th Cir. 1990). Many contractual rights

"do not rise to the level of 'fundamental' interests protected by substantive due process. Routine state-created contractual rights are not 'deeply rooted in this Nation's history and tradition,' and, although important, are not so vital that 'neither liberty nor justice would exist if [they] were sacrificed.'" *Id.* (citations omitted). To the contrary, "[g]overnments breach contracts virtually every day without dire consequences ensuing to the human dignity or basic autonomy of the promisees." *Id.* There is no allegation in the Counterclaim – nor could there be – that the Service Contracts create any "fundamental" interests or that the human dignity or basic autonomy of the Trusts is threatened by their breach. The Service Contracts, like so many garden variety contracts, are "simply not a proper subject of federal protection under the doctrine of substantive due process." *Bowers v. City of Flint*, 325 F.3d 758, 764 (6th Cir. Mich. 2003).

The Fourteenth Amendment's due process clause includes a guaranty of procedural fairness, assuring that a deprivation of life, liberty, or property must "be preceded by notice and opportunity for a hearing appropriate to the nature of the case." *Cleveland Bd. of Educ. v. Loudermill*, 470 U.S. 532, 542 (1985) (internal quotation marks omitted). To demonstrate their entitlement to procedural due process, the Trusts must, as a threshold matter, establish that they have a protected property interest in the payments under the Service Contracts. *Cf. Blazy v.*

Jefferson County Reg'l Planning Comm'n, 438 Fed. Appx. 408, 411-12 (6th Cir. 2011).

Courts generally distinguish between contractual rights and property interests. *Texaco, Inc. v. Short*, 454 U.S. 516, 531 (U.S. 1982) (contrasting property rights with contract rights); *In re Riso*, 978 F.2d 1151, 1153-54 (9th Cir. 1992) (noting that a contract right is not a protected interest in property). The Trusts, at best, have alleged a contractual right to payment.[8] Their suggestion that the City cannot default on the payments under Service Contracts without first giving them notice and an opportunity for a hearing is without merit. To the extent that the Trusts may be entitled to due process before the Service Contracts are completely abrogated or declared void, this lawsuit gives them all the process that is due.

Accordingly, Count XII must be dismissed for failure to state a claim on which relief can be granted or – to the extent that it demands due process prior to a determination of the validity of the Service Contracts – for mootness.

[8] In addition, the Trusts cryptically assert that they have a property interest in "investment assets" underlying the COPs transactions. To the City's knowledge, no such "investment assets" exist.

2. The Failure to Pay an Unsecured Debt Does Not Give Rise to an Unlawful Takings Claim

The Trusts' unlawful takings claim is based on their underlying contract action. However, as discussed above, property protection does not extend to ordinary contractual rights to payment. *See also S & D Maintenance Co., Inc. v. Goldin*, 844 F.2d 962 (2d Cir. 1988) (holding that claims for payment under city contract for services already rendered did not rise to constitutionally protectable property interest: "the doctrinal implications of constitutionalizing all public contract rights would raise substantial concerns"). Thus, the Trusts have no property to be "taken."

In addition, the Trusts cannot state a claim in bankruptcy for an unlawful taking because their claims – even if valid – are not secured by any property of the City. *See* Proofs of Claim Nos. 1120, 1136, 1138 and 1197 (asserting general unsecured claims). If a claim "is unsecured, it is not 'property' for purposes of the Takings Clause." *In re Treco*, 240 F.3d 148, 161 (2d Cir. 2001). Therefore, unsecured claims "do not rise to the level of a property interest afforded protection under the Takings Clause of the Fifth Amendment." *In re Varanasi*, 394 B.R. 430, 438 (Bankr. S.D. Ohio 2008). Rather, to the extent that a creditor is unsecured, it has only a contractual claim, which may be reduced or even eliminated in bankruptcy without presenting any issue under the Fifth Amendment's Takings Clause. *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 451-52

(1937); *see also Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 588 (1935) ("[T]he position of a secured creditor, who has rights in specific property, differs fundamentally from that of an unsecured creditor, ***who has none***.") (emphasis added).

The Trusts have not alleged a lien on the payments under the Service Contracts or any other security interest that could give rise to a takings claim. Even if their claims against the City were valid (which they are not), the fact that they are alleged as unsecured claims is fatal to Count XIII.

3. The Failure to Pay an Unsecured Debt Does Not Give Rise to a Claim for Statutory Conversion

Count XIV alleges statutory conversion. This count fails to state a plausible claim for relief. To prevail on a claim for statutory conversion under Michigan law, "the defendant must have an obligation to return the specific money entrusted to his care." *Live Nation Worldwide, Inc. v. Hillside Productions, Inc.*, No. 10-11395, 2011 U.S. Dist. LEXIS 34405, at *6-7 (E.D. Mich. Mar. 30, 2011) (internal quotation marks and citations omitted). The Trusts have not alleged that they entrusted any specifically identifiable funds to the City's care. Rather, the Trusts have merely alleged that the City failed to make payments to them under the Service Contracts. The "failure to pay a debt, without more, does not amount to conversion of the unpaid funds." *Id*. at *7; *see also Haviland v. Metro. Life Ins.*

Co., 876 F. Supp. 2d 946, 957 (E.D. Mich. 2012) (same). Accordingly, Count XIV must be dismissed.

E. Count IV Must Be Dismissed Because the Statute of Limitations, If Applicable At All, Is At Least 10 Years

The Trusts assert that the City's Complaint constitutes a "personal action" and is subject to the six-year limitations period of the Revised Judicature Act's catchall provision, MCL § 600.5318. *See* Counterclaim ¶¶ 59-60. "This argument misconceives the nature of a statute of limitations." *Riverside Syndicate, Inc. v. Munroe*, 882 N.E.2d 875, 878 (N.Y. 2008).

As numerous courts have found, limitations periods do not apply to acts and instruments that are void ab initio. *See, e.g., id.* (statute of limitations "does not make an agreement that was void at its inception valid by the mere passage of time"); *Smith v. JPMorgan Chase Bank, NA*, 825 F. Supp. 2d 859, 861 (S.D. Tex. 2011), *adhered to on reconsideration* at 2012 U.S. Dist. LEXIS 2109 (S.D. Tex. Jan. 9, 2012) (holding that under the Texas Constitution, a "noncompliant mortgage lien against a homestead is [ ] void ab initio" and that therefore the limitations period does not apply); *Bertelsen v. Harris*, 537 F.3d 1047, 1061 (9th Cir. 2008) ("Because the September 2001 corporate resolution under which Harris collected his fee was unenforceable due to this violation of RPC § 5.4(a), I do not regard the three-year statute of limitations that applies to actions for breach of fiduciary duty, Wash Rev. Code. § 4.16.080, as a bar to this

action."); *Farrell v. Wurm (In re Donnay)*, 184 B.R. 767, 784-785 (Bankr. D. Minn. 1995) (reasoning that "[s]ince a void contract is a nullity . . . no limitations period could apply").

Like the complaint in *Riverside*, "[t]his action is not one 'upon a contractual obligation or liability,' but one to declare that no valid contractual obligations ever existed." *Riverside*, 882 N.E.2d at 878. Accordingly, it cannot be time-barred.

Alternatively, if the Court were to apply a statute of limitations to the City's action, the six-year period prescribed by the generic catchall is the wrong one. If anything, the City's action falls within the scope of the statute of limitations for actions on public obligations, MCL § 600.5807(7). That section provides that "[t]he period of limitations is 10 years for actions on bonds, notes, or other like instruments which are the direct or indirect obligation of, or were issued by although not the obligation of, the state of Michigan or any county, city, village, township, school district, special assessment district, or other public or quasi-public corporation in the state of Michigan." The COPs transactions were consummated in 2005 and 2006. The City's lawsuit was initiated in 2014, well within the 10 year statute of limitations.

Thus, whether the statute of limitations is inapplicable altogether or prescribed by § 600.5807(7), the City's claims are timely and Count IV must be dismissed.

II. CONCLUSION

For the foregoing reasons, the City respectfully requests that the Court dismiss Counts I, II and IV-XIV of the Trusts' Counterclaim, and grant such other and further relief as the Court deems appropriate.

[signature page follows]

Dated: April 10, 2014

Respectfully submitted,

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ATTORNEYS FOR THE CITY OF DETROIT

EXHIBIT 4

Certificate of Service

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

In re	Chapter 9
CITY OF DETROIT, MICHIGAN,	Case No. 13-53846
Debtor.	Hon. Steven W. Rhodes
CITY OF DETROIT, MICHIGAN,	Chapter 9
Plaintiff,	Adversary Proceeding No. 14-04112
vs.	Hon. Steven W. Rhodes
DETROIT GENERAL RETIREMENT SYSTEM SERVICE CORPORATION, DETROIT POLICE AND FIRE RETIREMENT SYSTEM SERVICE CORPORATION, DETROIT RETIREMENT SYSTEMS FUNDING TRUST 2005, and DETROIT RETIREMENT SYSTEMS FUNDING TRUST 2006,	
Defendants.	

CERTIFICATE OF SERVICE

I hereby certify that on April 10, 2014, I caused to be electronically filed the *City of Detroit's Motion to Dismiss in Part the Funding Trusts'*

Counterclaims with the Clerk of the Court which sends notice by operation of the Court's electronic filing service to all ECF participants registered to receive notice in this adversary proceeding.

Dated: April 10, 2014

/s/ Deborah Kovsky-Apap
Deborah Kovsky-Apap (P68258)

EXHIBIT 5

Affidavits
(Not Applicable)

EXHIBIT 6

Documentary Exhibits
(Not Applicable)