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BLS
BUSINESS LAW SECTION

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The editorial staff of the *Michigan Business Law Journal* welcomes suggested business law topics of general interest to the Section members, which may be the subject of future articles. Proposed business law topics may be submitted through the Publications Director, D. Richard McDonald, *The Michigan Business Law Journal*, 39577 Woodward Ave., Ste. 300, Bloomfield Hills, Michigan 48304, (248) 203-0859, drmcdonald@dykema.com, or through Daniel D. Kopka, ICLE, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432, dan@icle.org. General guidelines for the preparation of articles for the Michigan Business Law Journal can be found on the Section's website at http://michbar.org/business/bizlawjournal.cfm.

Each issue of the *Michigan Business Law Journal* has a different primary, legal theme focused on articles related to one of the standing committees of the Business Law Section, although we welcome articles concerning any business law related topic for any issue. The primary theme of upcoming issues of the *Michigan Business Law Journal* and the related deadlines for submitting articles are as follows:

Issue	Primary Theme/Committee	Article Deadline
Spring 2015	Debtor/Creditors Rights Committee	November 30, 2014
Summer 2015	Nonprofits Corporations Committee	March 31, 2015
Fall 2015	Uniform Commercial Code Committee	July 31, 2015
Spring 2016	Commercial Litigation Committee	November 30, 2015

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All advertising is on a pre-paid basis and is subject to editorial approval. The rates for camera-ready digital files are $400 for full-page, $200 for half-page, and $100 for quarter page. Requested positions are dependent upon space availability and cannot be guaranteed. All communications relating to advertising should be directed to Publications Director, D. Richard McDonald, the *Michigan Business Law Journal*, 39577 Woodward Ave., Ste. 300, Bloomfield Hills, MI 48304, (248)203-0859.

MISSION STATEMENT

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

To fulfill this mission, the Section shall: (1) expand the resources of business lawyers by providing educational, networking, and mentoring opportunities; (2) review and promote improvements to Michigan's business legislation and regulations; and (3) provide a forum to facilitate service and commitment and to promote ethical conduct and collegiality within the practice.

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Volume XXII, Issue 1, and subsequent issues of the *Journal* are also available online by accessing http://www.michbar.org/business/bizlawjournal.cfm

From the Desk of the Chairperson

By Jeffrey J. Van Winkle

The Business Law Journal, published by the Business Law Section of the State Bar of Michigan, is one of our premier section products. The articles are written by experienced and knowledgeable Michigan lawyers who are experts in the subjects about which they write. Each time I open and read an article from one of our issues, I am reminded again of the skill of Michigan business lawyers. I know I speak for the entire section council and, particularly, our primary editor, Rick McDonald, when I give thanks for the many hours of volunteer effort put forth in producing this journal.

But the Business Law Journal is not the only Section product. The Business Law Institute held during the first Friday in June this year, produced in cooperation with ICLE, is another example of excellent information provided in a timely and relatively low cost basis for Michigan lawyers. I encourage all of you who find value in this Business Law Journal to consider attending the 2015 Business Law Institute, which will be held September 2015, in Grand Rapids. It will be held during ArtPrize in Grand Rapids. Although it will be a busy and active time in Grand Rapids, the availability of additional activities certainly adds one more reason to prompt your attendance at the Institute.

During this past year, as I have dealt with a variety of Section activities and met with leaders of other sections of the State Bar of Michigan, I have been reminded of the many ways lawyers influence society. Our service as attorneys is both a great honor, but also a tremendous responsibility. It is very easy for each one of us to become buried in our daily activities, whether serving one client as in-house counsel, managing many clients in a private practice, or serving governmental agencies as a lawyer, our sight is often not on the horizon but on the task directly in front of us. This is an important focus; work will not get accomplished if no one pays attention to the immediate details. However, from time to time, it is necessary to look up at the horizon to see what lies ahead. But what does lie ahead?

Recently, I reviewed the scorecard produced by MiQuest, a Michigan based nonprofit corporation, combining the business plan competition of Great Lakes Entrepreneur quest and other activities conducted by the Small Business Foundation of Michigan. The scorecard, produced for the last ten years, attempts to score Michigan in comparison to other states based upon over 130 indicators. The primary categories are entrepreneurial change, entrepreneurial vitality, and entrepreneurial climate. The 2014 edition of the scorecard showed that when we look at the horizon, we can be optimistic about momentum in the state of Michigan. One specific example: Michigan's ranking in economic climate has gone from a low position in 2002 of 36th out of 50 to rank 6th in this report. Although no single indicator can effectively predict the future, the general thrust of the results from the scorecard in 2014 indicate that when looking at the horizon we should have optimism in Michigan.

What does this mean for a business lawyer today? It means that we should help our clients discover opportunities to be effective in Michigan. It may mean for some of us that there are opportunities for new clients that we have not found in the past several years. I do not know what this positive momentum may mean for your practice, but I do hope that it gives you confidence that your work with clients today can be an important part of helping to create a good business environment for our state in the future.

Discussion about our personal future is also a common topic. I do not know how often I have started a conversation with another lawyer, perhaps talking about a particular project, a difficult client, or even an observation on some pending change in law, and quickly the conversation turns to children. Whether we are parents, grandparents, aunts and uncles, or just simply friends of young people, we want to share information about this next generation who are so important in our lives. And we know that the future is important to them, whether they know it or not; our aspirations for the future rest in substantial part on the actions of the next generation. I challenge the newer business lawyers to get after business opportunities to improve our state in whatever way you can.

During this past year as Section Chairperson, I have been helped in many ways by other lawyers in our Section. My fellow officers, Jim Carey as Vice Chair, Doug Toering as Treasurer, and Judy Calton as Secretary, have been of great help when preparing for Council meetings, sorting through issues confronting our section, or simply planning for the next activity. Our Council has been diligent this year in supporting many aspects of business law in Michigan. As a Section, we have a strategic plan that helps guide the energies of each of the committees, the directorships, and the Council as a whole. Our strategic plan is located on the Section website at http://www.michbar.org/business/councilinfo.cfm. I encourage you to review it to see what your Section is doing for you. I should also suggest that you look at it to see what you can be doing for your Section. As one of the many members, you have both the opportunity and, I submit, the obligation to do your part to promote a sound business law practice in Michigan.

I hope you become inspired to get more involved in our Section. Check out the committee activities on the website and sign up to participate. If you wonder how to get involved, call or e-mail me. We can get you connected so that you can do your part.

It has been a honor to serve as the chair of the Business Law Section for this past year. I encourage each one of you to keep your feet firmly planted in the practical day to day work of business law, but look ahead to the horizon often enough so that you do not forget where you are going.

2013-2014 Officers and Council Members
Business Law Section

Chairperson: Jeffrey J. Van Winkle, Clark Hill, PLC
200 Ottawa St. NW, Ste. 500, Grand Rapids, MI 49503, (616)608-1113

Vice-Chairperson: James L. Carey, Thomas M. Cooley Law School
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68496 Jennifer Erin Consiglio—41000 Woodward Ave., Bloomfield Hills, 48304

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34329 Douglas L. Toering—888 W. Big Beaver, Ste. 750, Troy, 48084

TERM EXPIRES 2015:

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40894 Jeffrey J. Van Winkle—200 Ottawa St. NW, Ste. 500, Grand Rapids, 49503

EX-OFFICIO:

38729 Diane L. Akers—1901 St. Antoine St., 6th Fl., Detroit, 48226

29101 Jeffrey S. Ammon—250 Monroe NW, Ste. 800, Grand Rapids, 49503-2250

30866 G. Ann Baker—P.O. Box 30054, Lansing, 48909-7554

33620 Harvey W. Berman—201 S. Division St., Ann Arbor, 48104

10814 Bruce D. Birgbauer—150 W. Jefferson, Ste. 2500, Detroit, 48226-4415

10958 Irving I. Boigon—15211 Dartmouth St., Oak Park, 48237

11103 Conrad A. Bradshaw—111 Lyon Street NW, Ste. 900, Grand Rapids, 49503

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34209 James R. Cambridge—500 Woodward Ave., Ste. 2500, Detroit, 48226

11632 Thomas D. Carney—820 Angelica Circle, Cary, NC, 27518

41838 Timothy R. Damschroder—201 S. Division St., Ann Arbor, 48104-1387

25723 Alex J. DeYonker—850 76th St., Grand Rapids, 49518

40758 Marguerite M. Donahue, 2000 Town Center, Ste. 1500 Southfield, MI 48075, (248)351-3567

13039 Lee B. Durham, Jr.—1021 Dawson Ct., Greensboro, GA 30642

31764 David Foltyn—660 Woodward Ave, Ste. 2290, Detroit, 48226-3506

13595 Richard B. Foster, Jr.—4990 Country Dr., Okemos, 48864

54750 Tania E. Fuller—300 Ottawa NW, Ste. 220, Okemos, 49503

13795 Connie R. Gale—P.O. Box 327, Addison, 49220

13872 Paul K. Gaston—2701 Gulf Shore Blvd. N, Apt. 102, Naples, FL 34103

14590 Verne C. Hampton II—500 Woodward Ave., Ste. 4000, Detroit, 48226

37883 Mark R. High—500 Woodward Ave., Ste. 4000, Detroit, 48226-5403

34413 Michael S. Khoury—27777 Franklin Rd., Ste. 2500, Southfield, 48034

31619 Justin G. Klimko—150 W. Jefferson, Ste. 900, Detroit, 48226-4430

45207 Eric I. Lark—500 Woodward Ave., Ste. 2500, Detroit, 48226-5499

37093 Tracy T. Larsen—171 Monroe Ave., NW, Ste. 1000, Grand Rapids, 49503

47172 Edwin J. Lukas—1901 St. Antoine St., Ste. 2500, Detroit, 48226

17009 Hugh H. Makens—111 Lyon St. NW, Ste. 900, Grand Rapids, 49503

17270 Charles E. McCallum—111 Lyon St. NW, Ste. 900, Grand Rapids, 49503

38485 Daniel H. Minkus—151 S. Old Woodward Ave., Ste. 200, Birmingham, 48009

32241 Aleksandra A. Miziolek—39550 Orchard Hill Place Dr., Novi, 48375

18009 Cyril Moscow—660 Woodward Ave., Ste. 2290, Detroit, 48226

18771 Ronald R. Pentecost—124 W. Allegan St., Ste. 1000, Lansing, 48933

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20741 Lawrence K. Snider—410 S. Michigan Ave., Ste. 712, Chicago, IL 60605

31856 John R. Trentacosta—500 Woodward Ave., Ste. 2700, Detroit, 48226

59983 Robert T. Wilson—41000 Woodward Ave., Bloomfield Hills, MI 48304

COMMISSIONER LIAISON:

55501 Jennifer M. Grieco—401 S. Old Woodward Ave., Birmingham, 48009

2013-2014 Committees and Directorships
Business Law Section

Committees

Commercial Litigation
Chairperson: Douglas L. Toering
Toering Law Firm, PLLC
888 W. Big Beaver, Ste. 750
Troy, MI 48084
Phone: (248) 269-2020
E-mail: dltoering@aol.com

Corporate Laws
Chairperson: Justin G. Klimko
Butzel Long
150 W. Jefferson, Ste. 900
Detroit, MI 48226-4430
Phone: (313) 225-7037
E-mail: klimkojg@butzel.com

Debtor/Creditor Rights
Co-Chair: Judy B. Calton
Honigman Miller Schwartz & Cohn LLP
660 Woodward Ave., Ste. 2290
Detroit, MI 48226
Phone: (313) 465-7344
E-mail: jbc@honigman.com

Co-Chair: Judith Greenstone Miller
Jaffe Raitt Heuer & Weiss, PC
27777 Franklin Rd., Ste. 2500
Southfield, MI 48034-8214
Phone (248) 727-1429
E-mail: jmiller@jaffelaw.com

Diversity
Chairperson: Julia A. Dale
LARA Bureau of Commercial Services
PO Box 30054
Lansing, MI 48909
Phone: (517) 241-6463
E-mail: dalej@michigan.gov

Financial Institutions
Co-Chair: Amy Durant
Bodman PLC
201 S. Division St., Ste. 400
Ann Arbor, MI 48104
Phone: (734) 930-2492
E-mail: adurant@bodmanlaw.com

Co-Chair: D.J. Culkar
Comerica Inc.
1717 Main St., Ste. 2100
Dallas, TX 75201
Phone: (214) 462-4401
E-mail: djculkar@comerica.com

In-House Counsel
Chairperson: Bharat C. Gandhi
Dow Chemical Co.
2040 Dow Center
Midland, MI 48674
Phone: (989) 636-5257
E-mail: bcgandhi@dow.com

Law Schools
Chairperson: Mark E. Kellogg
Fraser Trebilcock Davis & Dunlap PC
124 W. Allegan St., Ste. 1000
Lansing, MI 48933
Phone: (517) 482-5800
E-mail: mkellogg@fraserlaw.com

Nonprofit Corporations

Co-Chair: Jane Forbes
Dykema
400 Renaissance Center
Detroit, MI 48243-1668
Phone: (313) 568-6792
E-mail: jforbes@dykema.com

Co-Chair: Jennifer M. Oertel
Jaffe Raitt Heuer & Weiss PC
27777 Franklin Rd., Ste. 2500
Southfield, MI 48034
Phone: (248) 727-1626
E-mail: joertel@jaffelaw.com

Regulation of Securities
Chairperson: Patrick J. Haddad
Kerr, Russell and Weber, PLC
500 Woodward Ave., Ste. 2500
Detroit, MI 48226
Phone: (313) 961-0200
E-mail: phaddad@kerr-russell.com

Uniform Commercial Code
Chairperson: Darrell W. Pierce
Dykema Gossett PLLC
2723 S State St Ste 400
Ann Arbor, MI 48104
Phone: (734) 214-7634
E-mail: dpierce@dykema.com

Unincorporated Enterprises
Chairperson: Daniel H. Minkus
Clark Hill, PLC
151 S. Old Woodward Ave., Ste. 200
Birmingham, MI 48009
Phone (248) 988-5849
E-mail: dminkus@clarkhill.com

Directorships

Legislative Review
Eric I. Lark
Kerr, Russell and Weber, PLC
500 Woodward Ave., Ste. 2500
Detroit, MI 48226-5499
Phone: (313) 961-0200
E-mail: eil@krwlaw.com

Nominating
Tania E. (Dee Dee) Fuller
Fuller Law & Counseling, PC
300 Ottawa NW, Ste. 220
Grand Rapids, MI 49503
Phone (616) 454-0022
E-mail: fullerd@fullerlaw.biz

Programs
Tania E. (Dee Dee) Fuller
Fuller Law & Counseling, PC
300 Ottawa NW, Ste. 220
Grand Rapids, MI 49503
Phone (616) 454-0022
E-mail: fullerd@fullerlaw.biz

Eric I. Lark
Kerr, Russell and Weber, PLC
500 Woodward Ave., Ste. 2500
Detroit, MI 48226-5499
Phone (313) 961-0200
E-mail: eil@krwlaw.com

Christopher C. Maeso
Dickinson Wright, PLLC
38525 Woodward Ave., Ste. 200
Bloomfield Hills, MI 48304
Phone (248) 433-7501
E-mail: cmaeso@dickinsonwright.com

Daniel H. Minkus
Clark Hill, PLC
151 S. Old Woodward, Ste. 200
Birmingham, MI 48009
Phone: (248) 988-5849
E-mail: dminkus@clarkhill.com

Mark W. Peters
Bodman PLC
201 W. Big Beaver Rd., Ste. 500
Troy, MI 48084
Phone: (248) 743-6043
E-mail: mpeters@bodmanlaw.com

Small Business Forum
Douglas L. Toering
Toering Law Firm, PLLC
888 W. Big Beaver Rd., Ste. 750
Troy, MI 48084
Phone: (248) 269-2020
E-mail: dltoering@aol.com

Public Relations and Social Media
Jennifer E. Consiglio
Butzel Long
41000 Woodward Ave.
Bloomfield Hills, MI 48304
Phone: (248) 593-3023
E-mail: consiglio@butzel.com

Publications
D. Richard McDonald
Dykema
39577 Woodward Ave., Ste. 300
Bloomfield Hills, MI 48304
Phone: (248) 203-0859
E-mail: drmcdonald@dykema.com

Section Development
Kevin T. Block
Kerr, Russell and Weber, PLC
500 Woodward Ave., Ste. 2500
Detroit, MI 48226
Phone: (313) 961-0200
ktb@krwlaw.com

Mark R. High
Dickinson Wright, PLLC
500 Woodward Ave., Ste. 4000
Detroit, MI 48226-5403
Phone (313) 223-3500
E-mail: mhigh@dickinsonwright.com

Edwin J. Lukas
Bodman PLC
1901 St. Antoine St., 6th Fl.,
Detroit, MI 48226
Phone (313) 393-7523
E-mail: elukas@bodmanllp.com

Justin Peruski
Honigman Miller Schwartz & Cohn, LLP
660 Woodward Ave., Ste. 2290,
Detroit, MI 48226-3506
Phone (313) 465-7696
E-mail: jperuski@honigman.com

Technology
Jeffrey J. Van Winkle
Clark Hill, PLC
200 Ottawa St., NW, Ste. 500
Grand Rapids, MI 49503
Phone: (616) 608-1113
E-mail: jvanwinkle@clarkhill.com

Liaisons

ICLE Liaison
Marguerite M. Donahue
Seyburn Kahn Ginn Bess & Serlin PC
2000 Town Center, Ste. 1500
Southfield, MI 48075
Phone: (248) 351-3567
E-mail: mdonahue@seyburn.com

Probate & Estate Planning Section Liaison
John R. Dresser
Dresser, Dresser, Haas & Caywood PC
112 S. Monroe St.
Sturgis, MI 49091
Phone: (269) 651-3281
E-mail: jdresser@dresserlaw.com

Intrastate Offering Exemption and the Internet

The Securities and Exchange Commission ("SEC") Division of Corporation Finance posted on April 10, 2014, Compliance and Disclosure Interpretations ("CDIs") on the intrastate offering exemption. Question 141.03 was revised and new questions 141.04 and 141.05 were added. See http://www.sec.gov/divisions/corpfin/cfnew/cfnew0414.shtml.

The availability of the Michigan Invests Locally Exemption[1] depends on the transaction meeting the requirements of the federal intrastate offering exemption in section 3(a)(11) of the Securities Act of 1933 and Rule 147.[2] The CDIs are consistent with information previously available about the limitations of using the intrastate offering exemption. The CDIs remind Michigan issuers relying on the "Michigan invests locally exemption" to be cautious with advertising and solicitation to ensure they comply with the federal requirements for the intrastate offering exemption. The Michigan invests locally exemption will be lost if the federal intrastate offering exemption is lost.

They make it clear that advertising or solicitation of an offering made in reliance on section 3(a) (11) and Rule 147 must be made only to residents of the state of which the issuer is a resident. Access to general advertising or solicitation for an offering relying on the Michigan Invests Locally Exemption must be available only after first confirming that the person is a resident of Michigan.

Question 141.05 asks, "Can an issuer use its own website or social media presence to offer securities in a manner consistent with Rule 147?" The answer points out, "Issuers generally use their websites and social media presence to advertise their market presence in a broad, indiscriminate manner." As a result, it is likely that information about specific investment opportunities would be available to residents outside the state. The SEC Guide for small businesses on raising capital and complying with the federal securities laws states, "If any of the securities are offered or sold to even one out-of-state person, the exemption may be lost. Without the exemption, the company could be in violation of the Securities Act."[3]

An issuer may not want to risk losing the federal intrastate offering exemption by using a website or social media to promote an intrastate offering. In addition, the loss of the federal intrastate offering exemption also means loss of the state exemption.

Actions Involving Entity and Regulatory Statutes

Standing to pursue some actions may be limited to the regulatory agency and the attorney general. *Miller v Allstate Ins Co*[4] involved a no fault insurance claim and seemed an unlikely case to involve the Professional Service Corporation Act or Business Corporation Act. However, the case raised the issue of whether a provider was properly incorporated and questioned whether the company was eligible to receive insurance reimbursement. The lower courts in *Miller* considered whether PT Works was properly organized. The Michigan Supreme Court decision held that only the Attorney General had standing to challenge whether a corporation was properly formed.

Woodbury v Res-Care Premier, Inc[5] involved the sale of real estate by a homeowner, a requirement to notify the homeowners association prior to the sale, and a right of first refusal. The lower courts considered the rights of a corporation that had renewed its existence under section 925 of the Nonprofit Corporation Act, by filing missing annual reports and paying related fees and penalties. The Michigan Court of Appeals held the corporation could not enforce the right of first refusal because it was dissolved. The case was appealed to the Michigan Supreme Court.

After oral arguments the Michigan Supreme Court invited the Michigan Chamber of Commerce, the Business Law Section of the State Bar of Michigan (BLS), and the Michigan Department of Licensing and Regulatory Affairs (LARA) to submit amicus briefs on several questions, including renewal of existence under section 925 of the Nonprofit Corporation Act[6] and rights of a dissolved corporation. The parties reached an agreement before amicus briefs could be filed. Both BLS and the Attorney General, on behalf of LARA, submitted letters requesting the Supreme Court vacate the Court of Appeals decision. On March 26, 2014, the Michigan Supreme Court dismissed the appeal and vacated the January 19, 2012 decision of the Michigan Court of Appeals.

Although *Woodbury* was about the private sale of real estate, the case raised the issue of whether Center Woods was properly incorporated and in existence with all its rights as though a dissolution had not occurred. The Nonprofit Corporation Act has provisions substantially identical to the Business Corporation Act and provides that only the Attorney General has standing to question whether a corporation has been properly formed.[7]

Badeen v PAR, Inc[8] involves forwarding companies that contract with lenders to collect delinquent accounts. The forwarding companies contract with licensed collection agencies to carry out repossession for lenders. Plaintiff sought an injunction to prohibit forwarding companies from violating the Occupational Code by soliciting or performing collection activities without a license. The trial court found the forwarding companies were not collection agencies and granted summary disposition to the defendants. The Michigan Court of Appeals affirmed the trial court, stating that forwarders are not collection agencies and not required to be licensed. The case was appealed to the Michigan Supreme Court and oral arguments were held on April 2, 2014.

Section 605 of the Occupational Code[9] provides LARA and the Attorney General with authority to enforce the Occupational Code, including bringing an action regarding unlicensed practice of an occupation. Section 605 provides:

> (1) The department may bring any appropriate action, including mediation or other alternative dispute resolution, in the name of the people of this state to carry out this act and to enforce this act.
>
> (2) If the attorney general considers it necessary, the attorney general shall intervene in and prosecute all cases arising under this act.
>
> (3) This section does not prohibit the department from bringing any civil, criminal, or administrative action for the enforcement of section 601.
>
> (4) The department has standing to bring an administrative action or to directly bring an action in a court of competent jurisdiction regarding unlicensed practice of an occupation.

Article 6 of the Occupational Code includes a wide variety of administrative penalties that may be imposed for violation of the act, and a person engaged in the unlicensed practice of an occupation may be guilty of a misdemeanor or a felony.[10]

In February 2013, the Michigan Society of Professional Surveyors filed an action in Mackinac County Circuit Court alleging that a forester engaged in the unlicensed practice of professional surveying.[11] Professional surveyors are licensed under Article 20 of the Occupational Code, and foresters are registered under Article 21 of the Occupational Code. All occupations included in the Occupational Code are subject to Articles 1-6 of the Occupational Code.[12] LARA was not a party to the case. According to a press release of the Michigan Society of Professional Surveyors ("the Society"),[13] the case settled and the settlement included the entry of a permanent injunction, which requires that the defendant "cease and desist accepting jobs requiring him to establish or re-establish boundary lines in conjunction with a sale, conveyance, or transfer of real property." The defendant also agreed to reimburse the Society for a portion of its attorney fees incurred during the case.

Electronic Seal

Section 2008 of the Occupational Code requires "[a] plan, plat, drawing, map, and the title sheet of specifications, an addendum, bulleting, or report or, if a bound copy is submitted, the index sheets of a plan, specification, or report" prepared by a person licensed under Article 20 of the Occupational Code and submitted to a governmental agency to contain the seal of the "person in responsible charge."[14] HB 4585 amends Article 20 of the Occupational Code to specifically authorize architects, professional engineers, and professional surveyors to use an electronic seal. The amendment did not change the requirement for individuals to obtain a seal when they are issued a license as an architect, professional engineer, or professional surveyor under Article 20.

The amendment clarifies that an individual licensed under Article 20 may seal documents for submission to a public authority using an electronic seal that includes the licensee's name, licensed occupation, electronic signature, and any additional information that is required by the occupation's licensing board. This change will facilitate the expanded use of electronic records by governmental agencies.

NOTES

1. MCL 451.2202a.
2. 15 USC 77c(a)(11) and 17 CFR 230.147.
3. http://www.sec.gov/info/smallbus/qasbsec.htm#intrastate.
4. 275 Mich App 649, 739 NW2d 675 (2007), *aff'd on other grounds, remanded*, 481 Mich 601, 751 NW2d 463 (2008).
5. 295 Mich App 232, 814 NW2d 308 (2012), *vacated,* 495 Mich 961, 843 NW2d 746 (2014).
6. 440.2925.
7. MCL 450.2221.
8. 300 Mich App 430, 834 NW2d 85 (2013).
9. MCL 339.605.
10. MCL 339.601.
11. *Michigan Soc'y of Prof'l Surveyors v Veneberg Forestry.*
12. MCL 339.101-.606.
13. http://origin.library.constantcontact.com/download/get/file/1103816580654-313/Venergerg+Press+Release.pdf.
14. MCL 339.2008(3).

G. Ann Baker is Deputy Director of the Corporations, Securities and Commercial Licensing Bureau, Department of Licensing and Regulatory Affairs. Ms. Baker routinely works with the department, legislature, and State Bar of Michigan's Business Law Section to review legislation. She is a past chair of the Business Law Section and is the 2008 recipient of the Stephen H. Schulman Outstanding Business Lawyer Award.

SHIBLEY RIGHTON LLP
Barristers and Solicitors

Shibley Righton LLP is a full-service Canadian Law firm with offices in Toronto and Windsor, Ontario

A member of both the Ontario and Michigan Bars, Jeff is your contact for all your Business Law needs.

Jeffrey M. Slopen
519-561-7400
slopen@shibleyrighton.com

Angela D'Alessandro
519-561-7447
angela.dalessandro@shibleyrighton.com

A member of both the Ontario and Michigan Bars, Angela is your contact for all your Litigation needs.

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Windsor Office
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Windsor, Ontario N8X 1l4
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www.shibleyrighton.com

Toronto Office
250 University Ave, Suite 700
Toronto, Ontario, M5H 3E5
Toll Free: 1-877-214-5200
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Fax: 416-214-5400

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Of Swiss Banks, Privilege, and Facta

The Swiss (and Others) Have Fallen

The Spring 2014 Tax Matters column focused on Internal Revenue Service (IRS) and U.S. Department of Justice enforcement practices. In particular, it emphasized their collective focus of international tax enforcement as the top priority—think offshore financial accounts. On May 19, 2014, perhaps the most tangible signs of the fruits of their priorities played out in a federal courthouse in Virginia. In Criminal Case No. 1:14-cr-188, Swiss banking giant, Credit Suisse (parent company) pled guilty to one count of conspiring to aid tax evasion in a scheme that "spanned decades."

Specifically, Credit Suisse AG pled guilty to one count of violation of IRC 7206(2), the aiding, assisting, procuring, counseling, and advising of the preparation and presentation of false income tax returns to the IRS in violation of 18 USC 371.

The plea agreement provides, in part, for restitution of $666.5 million plus a $2 billion fine, as well as an independent monitor for two years.

The "good news" for Credit Suisse (and its clients) is that the plea agreement was structured in such a way that their ability to provide banking services in the United States was not revoked. While Credit Suisse was not required to provide names of U.S. account holders, it will authenticate records for other proceedings and close accounts of recalcitrant account holders. Some reports indicate the Swiss government would not allow Credit Suisse to provide account holder names and in exchange garner a deferred prosecution agreement. In 2009, UBS avoided criminal prosecution but paid a $78 million fine and turned over the names of 4,450 American account holders.

The nature and scope of the criminal plea, as opposed to a civil-only resolution, is still a big victory for the government. Several other Swiss banks, as well as other international and U.S. banks, are reportedly in the proverbial queue for similar resolutions. Only time will tell if American account holder names will be turned over as part of those expected deals.

For U.S. clients with undisclosed offshore accounts, the clock is ticking rapidly. U.S. account holders are being pushed to the fringes of global institutions if they still intend to hide. The stakes are escalating. In fact, detailed questioning for those seeking to participate in the offshore voluntary disclosure program requires that applicants list any movement of funds, including institutions, dates, and amounts. Also, meetings with advisors, consultants, and the like are required, including dates and locations. The result is that some clients may already have a difficult time being accepted into the program.

As noted in the Spring 2014 column, the IRS has garnered judicial approval of "John Doe" summonses to correspondent banks. Clients must be advised that their last and best chance at civil resolution of their offshore financial activities is rapidly closing. A voluntary disclosure (if available) must be seriously considered… and quickly. A modification to the voluntary disclosure program in the coming months may be forthcoming, albeit with more stringent terms. Stay tuned.

Privilege Waiver

Your client has been audited by the IRS. In what has become an almost default position of the revenue agent, civil penalties are proposed. Your client wants to contest the penalties in U.S. Tax Court. In the petition, the client almost routinely asserts (through counsel) reasonable cause and good faith as defenses. In a recent opinion, *Ad Inv 2000 Fund LLC v Commissioner*, 142 TC No 13 (2014), Judge Halpern ruled in favor of respondent's motion to compel the petitioner to produce documents and to sanction the petitioner if it failed to comply. Specifically, respondent sought production of letters expressing attorneys' opinions regarding certain tax benefits if the transactions in question would be upheld.

The fact that the transaction was a Son of BOSS tax shelter[1] never helps, but here the court held that the petitioner placed the state of mind of those who acted for the partnership and the partnership's good-faith efforts to comply with the tax law into question. By doing so, the respondent could explore the contents of the opinions and the opportunity to put those opinions into evidence. Simply, a petitioner cannot assert reasonable cause and good faith without putting the items relied on for that claim under scrutiny. More simply, before your client asserts an alibi witness, they had better be prepared for what the witness says or, in this case, authored.

The takeaway is that before clients start asserting certain defenses to penalties or even arguments to establish economic substance, they must make an honest assessment with their counsel if they want certain communications thought privileged at that place in time under the sanitizing light of day. For lawyers and other professionals, the potential for conflicts of interest are real. Circular 230 should be consulted, as it is likely that the IRS Office of Professional Responsibility (OPR) will evaluate the conduct of preparers (both signed and unsigned) as well as other tax professionals.

FACTA

Lastly, in Notice 2014-33, the IRS announced that it will treat 2014 and 2015 as a transition period for purposes of enforcement and administration of FACTA (Foreign Account Tax Compliance Act). The implementing regulations, proposed, temporary, and final are over 1000 pages. The devil is indeed in the

details. Careful attention for business clients in particular is not only advisable, but mandatory.

NOTES

1. Son of BOSS is a type of tax shelter used to reduce taxes through stepped-up basis, but the term is often used to describe any similar, abusive tax shelter marketed under different names but with similar goals and consequences.

Eric M. Nemeth of Varnum LLP in Novi, Michigan practices in the areas of civil and criminal tax controversies, litigating matters in the various federal courts and administratively. Before joining Varnum, he served as a senior trial attorney for the Office of Chief Counsel of the Internal Revenue Service and as a special assistant U.S. attorney for the U.S. Department of Justice, as well as a judge advocate general for the U.S. Army Reserve.

 By Theresa A. Orr

The New Normal: Transitioning from Law Firm to In-House

"Life is pleasant. Death is peaceful. It's the transition that's troublesome." –Isaac Asimov

As young practicing lawyers, you may find yourself wondering, "What exactly does an in-house counsel do every day? Why does it take my client so long to respond to e-mails, produce discovery, execute an affidavit, or return a telephone call?" Visions of a 9 to 5 job with no billing gig had us convinced that it is a cake walk, and we would have no problem working as an in-house lawyer. Once the decision is made to jump ship, however, the transition is enlightening. Here are just a few pointers from recently transitioned lawyers grasping their new normal.

Hierarchical Environment—Law firms are generally egalitarian with few recognized categories of personnel. All equity partners are technically owners of the business. Even associates don't really have one "boss" to whom they report. As an in-house lawyer, on the other hand, you are one of many employees each of whom is ranked at some numerical level for compensation and other purposes. Even the General Counsel has a boss—the CEO and the Board. In addition, a General Counsel must also be a boss in the traditional sense of the word and handle personnel matters, budgets, department strategy, etc. for the legal department.

Teamwork is Paramount—While law firms try to encourage teamwork and joint efforts, a lawyer with a strong book of business can thrive at a firm while working alone for the most part. As in-house counsel, you rely much more on team work to serve all the business clients within a company. Part of the reason may be because there is less need to compete for clients. Working with your legal colleagues as a team and interacting with the business teams in a friendly, non-threatening manner are key to you establishing the necessary rapport to be successful in-house.

Generalist—In a law firm, lawyers tend to specialize in certain areas of the law. Except for large in-house departments where specialization is feasible, as an in-house lawyer you will probably deal with a much greater variety of assignments in-house than in a firm. Your role, in many instances, is to be a sounding board for your operational clients dealing with a whole variety of different issues. You may not be the person with all the answers, but you need to know where to get them.

Just in Time Advice—In a law firm, a client typically understands if you don't know the answer and you need to come back later with a response. In-house lawyers are often expected to give "just-in-time" advice. You should already know the business and the issues. Also, there may not be enough time or budget to research a matter further or seek other guidance. You have to triage issues and do the best that you can with each one. Staying up to speed with business developments increases your opportunity to spot issues and decreases the possibility that you delay a project launch.

Your Calendar Is Not Your Own—In a law firm, meetings are scheduled with your consent for the most part. Even clients are respectful of your time and recognize that you may have other meetings already scheduled. The only time your calendar is not your own is when you are beholden to the court's schedule or working on a big project. In-house, your calendar is open to everyone, and it is typical for people to set up meetings without asking you in advance. You can generally decline if you cannot attend, although there are many operational meetings that are mandatory. Of course, the C-Suite always takes precedence.

Greater Visibility into Operations—Law firm lawyers may have limited visibility into business operations because the clients do not want to pay for them to gain that knowledge. Sometimes, law firm lawyers can act as general counsel for a client and can handle many of the client's needs. However, even a close working relationship between the outside lawyer and the company rarely gives the outside lawyer a firsthand look at how decisions are made, how products are made, etc. In-house exposure to the inner workings of the company is incredibly valuable in being a strategic and proactive legal advisor. It provides a window into the big picture of the business as well as the daily progress.

Less Paperwork/More Meetings—Many law firms are known for their ability to generate lengthy and complex briefs, legal analysis, and whitepapers. On the other hand, in-house lawyers participate in many meetings during the day. These meetings can be operational meetings where you have been made part of the team on a particular project or they can be the standing Global Leadership Team or other similar meetings reviewing overall company performance and strategy. Many executives prefer summaries, not whitepapers. Internal communication and training takes additional time and effort in your day.

When the Board Comes to Town—Dealing with a Board of Directors is another layer of complexity that most law firm lawyers do not have to manage. The entire management team is involved in preparation for Board meetings, including the General Counsel. There are meetings to identify Board topics, to review the presentations to the Board, to practice presentations to the Board and then the Board meetings themselves. A significant amount of time is spent on governance and compliance issues.

Travel Opportunities—Unless a law firm happens to have a client that is willing to pay for its lawyers to travel to different locations, the opportunities to travel abroad while at an outside firm are minimal. If you are in-house at a global company, there is opportunity to travel to Europe or Asia to handle various projects. Different time zones can also extend the business day.

No Sales—The competitive landscape of the legal profession has made practice development a key part of the law firm lawyer's world. Perhaps the biggest selling aspect of going in-house is the opportunity to focus on a single client. Have no fear; an in-house lawyer has more than plenty to do. In fact, you may feel overwhelmed by the number of internal clients and their needs. It is your job to prioritize them and make sure that you are focused on what is strategically important to the company.

There are many advantages to companies hiring experienced firm lawyers: the company benefits from a firm lawyer's understanding of time, billing and costs, litigation experience, and customer service. So too, there are many advantages for firm lawyers going in-house beyond the "no billing" fantasy that most lawyers envision—it is the transition that is troublesome.

Theresa A. Orr is an assistant general counsel at NSK Americas, Inc. in Ann Arbor, Michigan.

Doing Business in China – Tips from an In-House Lawyer

By Bharat Gandhi

Introduction

What if you were told your company's assets were at risk? Details were sketchy. You had to act quickly to limit your loss. You have people on the ground, but not the right ones. Upon investigation, you ran into roadblocks. When you sought legal remedies, you found limitations.

As facts begin to emerge, you learn that the responsible party may be your customer, your local partner, or your local employees. You have contracts, but they need to be enforced in the local jurisdiction. And remedies are subject to local law.

As an in-house lawyer, this is a real life situation that you may already have faced or will face if your company is doing business (or plans to do business) in the People's Republic of China ("PRC").

As in-house counsel, you can choose to address this situation yourself or assign it to outside counsel. If you are comfortable working in the international arena, as a savvy in-house lawyer (which of course you are), you can provide timely and critical assistance to your company by knowing and understanding the cultural, business, and legal framework that exists in the PRC and applying it to your particular circumstances. Doing so can address the issues early in the process while managing your company's business needs and controlling costs.

This article is intended as a primer for in-house counsel whose companies are (or are planning on) doing business in the PRC. Most of the information is anecdotal based on personal experiences.

The Lure

The PRC has significant needs in the durable goods market. It desires to obtain best-in-class technology, is receptive to foreign technology transfer, and has vast relatively untapped resources.

As a value proposition, your company will be looking to gain access to some of those resources, valued in the billions of dollars, which Chinese industries are spending annually to obtain assets and technology from foreign sources. It has been reported that Chinese companies have "war chests," with credit backed by the PRC, dedicated to capturing and/or acquiring such assets and technologies.[1]

There is substantial capacity for multiple participants. However, the stakes with respect to your company's business, proprietary assets, and technology are large.

Risks, Practices, and Procedures

Companies entering into the PRC are providing Chinese industries with advanced market-leading products and technologies that have been developed after significant investment in research and development. Chinese companies are eager to obtain such products and technologies and ready to enter into agreements that ostensibly protect your information. However, the practices and procedures followed by Chinese companies may be markedly different from practices and procedures to which your company is accustomed.

First, many Chinese companies have extended corporate or ownership structures. It is not always apparent who is an affiliate or related company. Second, many Chinese companies are working on large projects that involve multiple suppliers and subcontractors with whom they already have pre-existing contractual arrangements. Third, these projects generally require significant funding from external sources. That typically requires disclosure of your company's information to unrelated parties having a desire to know some or all of your information, and who may have differing obligations to your customer with respect to receipt and protection of such information. Understanding the interrelationship among interested parties to the project is important to best protect your information.

You also need to consider if the customer will want to use their form of contract. The challenge is whether to insist on stringent information control or rely on their standard terms. For your business, the focus will be on establishing a working relationship with the

customer and doing the deal, while leaving it to the lawyers to work out the legalities. But, unlike western transactions, the Chinese rarely involve their legal counsel directly during negotiations. Instead, they often use professional negotiators who may or may not fully appreciate your company's practices and procedures regarding use and protection of proprietary information. In these circumstances, it becomes incumbent on you to ensure that the terms related to confidentiality and restricted use are addressed sufficiently early, managed during the negotiations, and carried through to execution of the contract.

An efficient way to manage the transaction is to remain an integral part of the business team from the beginning of negotiations to closure. The ability to be successful in integrating into the business team depends on the magnitude of the transaction and the priorities of your business. The value is being in a position to provide strategic counsel on the overall transaction, while proactively managing the legal and quasi-legal issues that arise during negotiations. Further, it provides the opportunity to engage in more meaningful discussions with the customer (and any functional representatives) to understand how they will share and protect your information internally and externally.

[T]he practices and procedures followed by Chinese companies may be markedly different from practices and procedures to which your company is accustomed.

Being part of the transaction team also provides you with the opportunity to discuss the benefits of using your forms, which are undoubtedly customized for your company's products and technology. Be prepared to provide your forms early in the process and remain flexible in modifying the terms to accommodate concepts important to your customer. Once established, your first negotiated transaction and the associated contracts may become the precedent for all future transactions. This can help to achieve consistency throughout transactions.

Practice Tip—Rather than rely on confidentiality terms that require consent for third-party disclosure, define when such disclosure is permissible and include as an appendix the form of agreement that must be used if a disclosure is made. This will reduce exposure for your company with respect to third-party disclosures. Be sure to mark all documents, pages, presentations, e-mail, etc., with a confidentiality legend such as, "*Company (insert your company's name) Confidential – This document is intended for the sole use of Customer (add customer name). This document cannot be copied in whole or in part without the written consent of Company – Do not remove this legend.*" While this will not necessarily provide you with additional legal protection, the visual reminder may serve as a deterrent to copying of your confidential materials.

You may believe your company's products and technologies are suitably protected by patents, trademarks, copyrights, and trade secrets. But, the laws in the PRC and how they are applied may surprise you.

First, consider litigation practices. There are no discovery procedures under PRC law. This makes it difficult to prove unauthorized use or sales volumes that would otherwise be used in determining infringement to sustain injunctive relief and lost profits to measure damages. While a few PRC courts have historically been willing to grant large damage awards (in the range of $20 million—$50 million), the current trend is towards minimal awards within the existing statutory guidelines of RMB 10,000 to RMB 1 million (approximately $1600 to $160,000).

Second, consider the PRC law. A sample of a few excerpts from the PRC patent law, anti-unfair competition law, and an Interpretation of the Supreme Court on Some Issues Concerning the Application of Law in the Trial of Civil Cases of Unfair Competition illustrate the status of the law and its application in the PRC.

Article 65 of Chinese Patent Law (effective on October 1, 2009)

The amount of compensation for the damage caused by the infringement of the patent right shall be assessed on the basis of the actual losses suffered by the patentee. When the actual losses are hard to determine, it may be determined on the basis of the profit which the infringer has earned through the infringement. If it is difficult to determine the losses which the right holder has suffered or the profits which the infringer has earned, the amount may be assessed by reference to the appropriate multiple of the amount of the exploitation fee of that patent under contractual license. The compensation amount shall comprise the reasonable cost paid by the right holder for stopping infringement.

Where it is difficult to determine the losses which the right holder has suf-

fered, the profits which the infringer has earned, and the exploitation fee for patent, the People's Court may decide, in light of the factors, such as the type of the patent right, the nature of the infringing act and the circumstances, a compensation ranging from not less than RMB 10,000 to not more than RMB 1,000,000.[2]

As provided under the PRC Patent Law, if a company is successful in litigating a patent infringement case in the People's Court, it will have the ability to receive monetary compensation for actual losses (i.e., lost profits) that can be proved. However, if actual losses cannot be proved, the amount of the compensation will be subject to the defined statutory range, a minimal amount of damages to western companies.

Article 10 of Anti-unfair Competition Law (Effective on December 1, 1993)

An operator may not adopt the following means to infringe business secrets:

(1) obtaining business secrets from the owners of rights by stealing, promising of gain, resorting to coercion or other improper means;

(2) disclosing, using, or allowing others to use business secrets of the owners of rights obtained by the means mentioned in the preceding item;

(3) disclosing, using or allowing others to use business secrets that he has obtained by breaking an engagement or disregarding the requirement of the owners of the rights to maintain the business secrets in confidence.

Where a third party obtains, uses or discloses the business secrets of others when he obviously has or should have full awareness of the illegal acts mentioned in the preceding paragraph, he shall be deemed to have infringed the business secrets of others.

"Business secret" in this Article means technical information and operational information which is not known to the public, which is capable of bringing economic benefits to the owner of rights, which has practical applicability and which the owner of rights has taken measures to keep secret.[3]

Article 17 of Interpretation of the Supreme Court on Some Issues Concerning the Application of Law in the Trial of Civil Cases of Unfair Competition (Adopted on December 30, 2006)

To determine the amount of compensation for damage caused by acts of business secret infringement as stipulated in Article 10 of the Anti-Unfair Competition Law, reference may be made to the method for determining the amount of compensation for damage caused by acts of patent right infringement. To determine the amount of compensation for damage caused by acts of unfair competition as stipulated in Articles 5, 9, and 14 of the Anti-Unfair Competition Law, reference may be made to the method for determining the amount of compensation for damage caused by acts of infringement on exclusive use rights over registered trademarks.

Where a business secret becomes known to the public due to an act of infringement, the amount of compensation for damage should be determined by the business value of the said business secret. The business value of a business secret is to be determined by such factors as its research and development cost, earnings and obtainable earnings of implementing the said business secret, and the duration in which its competitive advantages could be maintained.[4]

In western parlance, business secrets would be equivalent to trade secrets and confidential information. It is noteworthy that the amount of compensation for business secret infringement is cross-referenced to the statutory compensation range for patent infringement, or about $1600 to $160,000.

Arbitration is often chosen in PRC contracts as a reasonable mechanism for dispute resolution. Choice of law is typically PRC law with arbitration by the CIETAC (China International Economic and Trade Arbitration Commission). Since May 2012, there has

The legal concept of apparent authority is not regularly accepted by Chinese courts.

been a rift in the CIETAC as a result of two of its most popular sub-commissions (Shanghai and Shenzhen) refusing to accept the CIETAC's latest 2012 Arbitration Rules. Instead, CIETAC Shanghai published its own arbitration rules based on the old CIETAC 2005 rules ("2005 Rules") and announced that it would form an independent arbitration commission.

Similarly, CIETAC Shenzhen announced that it would retain the 2005 Rules. While both of these sub-commissions have been terminated by the CIETAC from accepting and administering arbitration cases, regional authorities have permitted them to handle arbitrations where they are specifically selected. Intermediate courts have confused the situation by issuing inconsistent rulings regarding jurisdiction, validity and enforceability. The Supreme Peoples' Court (SPC) took up the issue in late 2013, but timing for a ruling is still uncertain.

Every Chinese negotiating team that you encounter very likely represents the best of their best and will be fluent in multiple languages (including yours), possess multiple advanced degrees, and be well traveled.

Foreign companies faced with existing arbitration clauses should consider renegotiating terms or wait for the SPC's ruling. For future transactions, companies may consider negotiating for foreign arbitration (Hong Kong or Singapore are typical). If required by their customers to accept, arbitration by the CIETAC's Beijing Office should be specified to avoid jurisdictional confusion and the uncertainties created by the rift. Note that the 2012 Rules provide certain additional protections not available under the 2005 Rules. These include interim relief in certain circumstances, expert witness testimony, selection of arbitrators, selection of the seat of arbitration, increased threshold for summary procedures, etc.

Third, there are a host of required rules, regulations, and specified customs to render a contract effective with Chinese entities. For example, to ensure that the signatory is a duly authorized signer, you should insist that the Chinese entity affixes their company chop (or seal) adjacent to their signature block. The legal concept of apparent authority is not regularly accepted by Chinese courts. You should also consider providing your corporate seal to confirm your signatory's authorization.

Following execution, certain contracts (primarily technology-based agreements) must be registered with the PRC. While this is the Chinese entity's responsibility, if they fail to do so within the prescribed 60-day period, your company will not be able to enforce certain provisions of the contract, including, for example, any payment obligations, until the registration is corrected (a laborious time-consuming exercise). In the meantime, the contract remains valid and is not subject to suspension of your obligations. A practice used by some companies to avoid this situation is to include clauses that define conditions precedent that must be met by the Chinese company before the main obligations of the contract are effective. Some conditions precedent may include having no obligation (on the part of the foreign company) to proceed with work and deliverables until the first payment is received or a letter of credit is established or requirements that all governmental registrations and approvals have been obtained as evidenced by official letters and statements from lending banks that project financing has been secured.

Practice Tip—Define both an "Agreement Date" and "Effective Date" in the contract, where the former is connected to the date of signature and the latter is connected with satisfactory completion of the conditions precedent. This will allow the contract to be valid when executed, but the main obligations (performance, deliverables, payments, etc.) will not come into effect until the conditions precedent is satisfied.

The tax implications of the transactions should also be carefully reviewed, especially regarding the application of withholding taxes and business and service taxes as well as the potential for creating a permanent establishment ("PE"). While withholding taxes may be capped at the prevailing treaty rate (assuming that a treaty exists), the party that pays business and service taxes (to the extent applicable) can be negotiated.

Unless you are a tax expert, issues of PE are best left to your tax professionals or outside counsel. It is worthwhile to appreciate that in-country services that exceed a statutory threshold (183 days per year in China) will give rise to PE considerations that may eliminate the profitably of doing business in the PRC. Some companies are creating and registering their local PRC companies for the purpose of providing certain in-country services related to contracts to better manage this issue.

Finally, consider the negotiation process. In the PRC, they generally follow a three-phase face-to-face process. There is the meet and greet (Phase 1), where you meet the negotiating team, important interpersonal relationships are formed and basic terms are

typically outlined. Then, there is the main negotiation (Phase 2) in which you will focus on the details and finalize on the standard terms of the contract. Lastly, there is the commercial/legal negotiation (Phase 3), where you will need to be ready to address all of the key points of the agreement, including price and schedule. As in-house counsel, you may need to attend one or all of the phases to appropriately support your client's needs. If all goes well, the PRC company will want your company to "initial" all the documents that define the "agreed" position. However, do not be surprised if, after initialing, the PRC company still needs to submit the contract to their legal department for further review, comment, and approval. You probably should not resist too much since you will likely need to do the same.

Practice Tip—Create a separate chart that tracks starting points, agreed terms, open terms, counter-proposals, and closed items. Negotiations often extend over months and involve multiple drafts by multiple groups (commercial, legal, finance, etc., for each party). Keeping a separate record may avoid future misunderstandings and bring your transaction to a quicker close.

Culture

While it is easy to think of the PRC as a land of more than a billion people that needs our products and technology, the PRC is also the land of Sun Tzu. *The Art of War,* a rite of passage in many business schools, remains a primary reference in today's environment in developing business strategies, negotiating transactions, and closing deals. To underestimate PRC companies in their mastery of these teachings and the skill of their business teams and negotiators would be unwise.

Every Chinese negotiating team that you encounter very likely represents the best of their best and will be fluent in multiple languages (including yours), possess multiple advanced degrees, and be well traveled. How good are they? To put it in colloquial terms, you will probably only deal with their A-Teams.

Contrast this with the concept of face, or more particularly "saving face," in the PRC. During negotiations, there will be a logical tension between asserting your position while providing respect for your Chinese partners. If you remember the old adage that "the customer is always right," it may help you to remain focused on the deal. Haggling is a part of Chinese culture, and ultimately, remaining respectful during passionate discussions is likely to carry the day.

Practice Tip—Bring your own interpreter who can translate and is also adept at conveying and understanding intent, meaning, and cultural nuances. This will assist in avoiding misunderstandings and help you avoid issues of face.

The Reward

If your company is engaged in the current environment in the PRC, you can help your business leaders to make carefully planned and strategic decisions that tap into the substantial resources available. Doing so can help your company achieve its goals while protecting its businesses, proprietary assets, and technology.

NOTES

1. See, *China Targets GE Wind Turbines With $15.5 Billion War Chest*, Bloomberg.com, Oct. 14, 2011; *States First in Line for a Share of China's $500 Billion War Chest*, Sydney Morning Herald (smh.com), Sept. 22, 2012.

2. http://www.ccpit-patent.com.cn/references/Patent_law_China.htm.

3. http://www.ccpit-patent.com.cn/references/law_against_unfair_competition_china.htm.

4. http://www.asianlii.org/cn/legis/cen/laws/iotspcosmataolittocciuc1390/.

Bharat Gandhi is Lead Counsel for Technology Licensing at The Dow Chemical Company, and Chair of the In-House Counsel Committee of the Business Law Section. The views expressed in this article are those of the author and do not necessarily represent the view of The Dow Chemical Company and its affiliated companies.

Expert Witnesses in Bankruptcy: Avoiding a Trap for the Unwary

By Joseph K. Grekin and Jeffery J. Sattler

Introduction

Most attorneys now take it for granted that their communications with expert witnesses are protected from discovery as work product, and they are almost always right. Under most circumstances, in most courts, attorney-expert communications are protected under the work product doctrine.

However, because of a quirk in the intersection between Federal Rules of Civil Procedure and the Federal Rules of Bankruptcy Procedure, these important communications are probably not always protected from discovery in bankruptcy court. The result is a classic trap for the unwary. Attorneys who do not litigate regularly in the bankruptcy courts can easily be unaware that communications with their experts might be discoverable, and many experienced bankruptcy attorneys are unaware as well. The unexpected requirement that an attorney produce these communications can be disastrous.

To avoid such a disaster, an attorney has to understand when communications with an expert are protected in a bankruptcy court setting. Providing that understanding is the aim of this article.

The Rule 26 Latticework

The Federal Rules of Civil Procedure protect most communications between an attorney and an expert as work product. The protection is contained within the intersection of four different sub-rules of Fed R Civ P 26: Rules 26(b)(3)(A), 26(b)(4)(C), 26(a)(2)(A) and 26(a)(2)(B).

Together, Rules 26(a)(2)(A) and (B) require all experts, "retained or specially employed to provide expert testimony" to prepare expert reports.[3] Rule 26(b)(4)(C) states that, with certain limited exceptions, any attorney communications with an expert who is required to provide a report are protected communications under Rule 26(b)(3)-(A). Rule 26(b)(3)(A) essentially mirrors the work product doctrine, protecting communications prepared in anticipation of litigation:

> Ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representatives[.]

Fed R Civ P 26(b)(3)(A).

Thus, together, these rules protect the communications between most experts and the attorneys with whom they work from disclosure to opposing parties under the work product doctrine. But since the protection is linked to the requirement to file an expert report, communications with the few experts not required to file reports are not protected. Fed R Civ P 26(b)(3)(A), 26(b)(4)(C), 26(a)(2)(A) and 26(a)(2)(B).

Most attorneys who practice in federal courts are aware that attorney-expert communications are generally protected. But because of the complicated interworking of the rules that grant this protection, many would have to take a careful look back at the rules to figure out exactly why. And for the same reason, many attorneys are unaware that this latticework of rules leaves an attorney's communications with experts who are not required to file a report unprotected.

As explained in more detail below, Congress' decision to leave these experts unprotected makes a certain amount of sense in the context of witnesses such as a treating physician who has not been retained as a paid expert, or an employee who also has some unusual expertise. Many of these witnesses are primarily fact witnesses who, because they have uncommon expertise which could assist the jury, are technically experts as well. As a result, historically these types of experts have not typically been required to file reports, and their communications with attorneys have not typically been considered work product. The potential problem arises when these rules, designed to address issues outside of the bankruptcy context, are applied not to a treating physician in a malpractice case, but to a certified public accountant testifying in a bankruptcy case.

Legislative History

Before 2010, it was not clear in the federal courts whether communications between

experts and attorneys were considered work product or protected from discovery.[4] Various federal courts had come to different conclusions on the question.[5]

The Civil Rules Advisory Committee noted that many courts read the 1993 amendments to Rules 26(a) and (b) to authorize discovery of attorney-expert communications. This led to routine attempts to discover these communications, which, in the minds of the committee, were undesirable. As the Civil Rules Advisory Committee stated:

> The Committee has been told repeatedly that routine discovery into attorney-expert communications and draft reports has had undesirable effects. Costs have risen. Attorneys may employ two sets of experts—one for purposes of consultation and another to testify at trial—because disclosure of their collaborative interactions with expert consultants would reveal their most sensitive and confidential case analysis. At the same time, attorneys often feel compelled to adopt a guarded attitude toward their interaction with testifying experts that impedes effective communication, and experts adopt strategies that protect against discovery but also interfere with their work.[6]

The Civil Rules Advisory Committee proposed amendments to Rule 26 in 2010, in part, to address these problems and to prevent them from reoccurring in the future.[7] This resulted in the current versions of Rules 26(a)(2)(B) and 26(b)(4)(C)—essentially incorporating the work product doctrine into Rule 26 and specifically applying it to communications with most experts.

But as noted above, these rules do not apply to *all* expert witnesses. Instead, the rules only apply, "if the witness is one retained or specially employed to provide expert testimony in the case or one whose duties as the party's employee regularly involve giving expert testimony." Rule 26(a)(2)(B). Expert witnesses who do not fit into these categories are governed by Rule 26(a)(2)(C) and are not required to file reports. Rules 26(b)(4)(C) and 26(b)(3)(A), the rules that protect communications between attorneys and experts required to file reports, do not protect communications with experts governed by Rule 26(a)(2)(C), or, arguably unintentionally, any other expert who is not required to file a report.

The Civil Rules Advisory Committee drafted Rule 26(a)(2)(C) with an eye toward physicians and employee experts.[8] The rule requires that the experts not required to file a report under Rule 26(a)(2)(B) are instead required to disclose the subject matter and a summary of the fact and opinions on which they are to testify. The intent of the rule is to provide adequate disclosure without being burdensome.[9] "The Rule strikes a balance between requiring an expert report from a witness like a treating physician, who was not specially retained to provide expert testimony[,] and requiring a defendant to search through hundreds of pages of medical records in an attempt to guess at what the testimony of treating physician might entail."[10]

As a result of this balancing act, Rule 26(a)(2)(C) does not require experts who are not retained to provide expert testimony, or for whom expert testimimony is not a regular part of their employment, to file reports. As noted above, Rule 26(b)(4)(C) protects attorney communications only with a *reporting* expert.[11] There is no similar rule protecting communications with experts who are not required to file a report.[12]

The omission is not due to oversight.[13] In fact, the Civil Rules Advisory Committee and its subcommittee gave the issue much consideration, but concluded,

> *[T]he time has not yet come to extend the protection for attorney expert communications beyond experts required to give an (a)(2)(B) report*…. Drafting an extension that applies only to expert employees of a party might be tricky, and might seem to favor parties large enough to have on the regular payroll experts qualified to give testimony. Still more troubling, employee experts often will also be "fact" witnesses by virtue of involvement in the events giving rise to the litigation. An employee expert, for example, may have participated in designing the product now claimed to embody a design defect. Discovery limited to attorney-expert communications falling within the enumerated exceptions might not be adequate to show the ways in which the expert's fact testimony may have been influenced.[14]

These concerns led to the committee protecting communications with a reporting expert under the work product doctrine, while leav-

The Civil Rules Advisory Committee drafted Rule 26(a)(2)(C) with an eye toward physicians and employee experts.

ing communications with a non-reporting expert subject to discovery.

While the committee largely focused on employees in products liability cases and treating physicians, the resulting rules are not so limited. But since almost all experts in the federal courts are required to produce reports, the different rule for non-reporting experts can catch attorneys who do not normally work with these types of witnesses off-guard. *United States v Sierra Pac Indus* shows the potentially serious consequences that can result if an attorney is not vigilantly aware of the differing treatment of reporting and non-reporting experts under Rule 26.

In *Sierra Pac Indus*, the United States Attorneys' Office and the California Attorney General's Office brought a joint prosecution against Sierra Pacific Industries and a landowner based on damages caused by the "Moonlight Fire" of 2007.[15] Although the government relied on the findings of non-reporting fire investigators to support its case, it refused to disclose its attorney communications with those investigators.[16] The defendants filed a motion to compel production of the communications and the *Sierra Pac Indus* court granted the motion.[17]

In reaching this decision, the *Sierra Pac Indus* court relied heavily on the legislative history of Rule 26, and the intent of the committee to protect attorney-expert communications only when the expert was required to file a report.[18] The court concluded that attorney communications with experts like the fire investigators, who are not required to file a report, were not privileged and ordered the government to reveal all of its attorneys' communications with its fire investigators to the defendants.[19]

Application in Bankruptcy Court

Although the Civil Rules Advisory Committee drafted the differing requirements for reporting and non-reporting experts primarily to alleviate unnecessary demands on physicians and employees, the resulting rules have the potential of having wide-ranging effects on bankruptcy court litigation. An examination of the different rules that govern bankruptcy litigation explains why.

Bankruptcy litigation takes two different forms: adversary proceedings and contested matters. Adversary proceedings are nothing more than lawsuits litigated in the bankruptcy court and are conceptually no different than other federal court lawsuits.[20] The bankruptcy rules governing adversary proceedings reflect this reality.

Bankruptcy litigation takes two different forms: adversary proceedings and contested matters.

Adversary proceedings are governed by Part VII of the Federal Rules of Bankruptcy Procedure, encompassing Bankruptcy Rules 7001-7087. Bankruptcy Rules 7001-7087 incorporate many of the Federal Rules of Civil Procedure and make them applicable to adversary proceedings. This includes Rule 26, which is incorporated into all adversary proceedings under Bankruptcy Rule 7026. All of the sections pertaining to expert reports and communications are incorporated. The result is that experts in adversary proceedings are generally required to draft and serve reports under Bankruptcy Rule 7026(a)(2)(B), and communications with these experts are protected work product under Bankruptcy Rule 7026(b)(4)(C).

In contrast to adversary proceedings, contested matters are resolved through motion practice and are governed by a different rule, Bankruptcy Rule 9014. Many contested matters are resolved based solely on briefing and attorney argument. But there are other contested matters that require the bankruptcy court to resolve disputed factual issues. It is not unusual for bankruptcy courts to resolve these issues through evidentiary hearings.[21]

Because contested matters are based on motion practice, the timelines built into a normal lawsuit are not generally used even where there are factual issues that must be resolved through taking evidence.[22] The issues in a contested matter often must be addressed quickly because of practical considerations, which is why they are addressed by motion rather than by a lawsuit in the form of an adversary proceeding.

Bankruptcy Rule 9014 is designed to account for the potential urgency of the issues decided under the rule in several ways. This includes the sections of Rule 26 that Rule 9014 incorporates to govern contested matters. Most importantly here, Rule 9014 does not incorporate Fed R Civ P 26(a)(1), (a)(2) or (a)(3), which require the parties to make a number of time consuming disclosures—including the production of expert reports.

Because Rules 26(a)(2)(A) and 26(a)(2)(B) do not apply to contested matters, experts are not required to file reports in evidentiary hearings to resolve contested matters under Rule 9014 unless a bankruptcy court orders otherwise. And in many instances, the bankruptcy courts do not order that the parties' experts file reports. This is because the rela-

tively urgent nature of many contested matters requires a shortened trial preparation schedule, which often makes the filing of expert reports impractical.

The effect of Rule 26(a)'s lack of application to contested matters is somewhat debatable. Rule 26(b)(4)(C) states that the communications between an attorney and "any witness required to provide a report under Rule 26(a)(2)(B)" are protected. Bankruptcy Rule 9014 incorporates Rule 26(b), even though it does not incorporate Rule 26(a). Consequently, it is at least a little ambiguous whether non-reporting experts in bankruptcy court are covered by the Rule or subject to the case-law on the applicability of the work product doctrine to attorney-expert communications that existed prior to the 2010 amendments to Rule 26. Similarly, whether a bankruptcy court order requiring experts to provide reports renders communications with the reporting experts protected by the work product privilege is also arguable.

But because Bankruptcy Rule 9014 does not incorporate Rules 26(a)(2)(A) and 26(a)(2)(B), there is no rule that makes communications between attorneys and expert witnesses in contested matters protected under the work product doctrine. In fact, Rule 9014 specifically does not adopt the rules that provide that protection. As a result, there is a very significant risk that a bankruptcy court could hold that attorney-expert communications under Rule 9014 are not protected—particularly if the expert is not required to file a report.

This is not an obvious result; as explained above, it takes an analysis of a number of different interwoven rules to realize that these communications might not be protected. The result is that it is easy for attorneys to miss the implications of experts not being required to file expert reports in a contested matter under Rule 26(a). This is particularly true for attorneys who do not regularly practice in bankruptcy court and may take the work product protection of expert communications for granted.

Practical Consequences

The importance of the link between the protection of attorney-expert communications under the work-product doctrine and the requirement that an expert file a report is greater than an attorney who does not normally practice in the bankruptcy courts might realize, even after understanding the dichotomy between adversary proceedings and contested matters. This is because, unlike most other courts, bankruptcy courts decide many of the most important issues that come before them on motion and, thus, as contested matters. Attorneys who normally practice in state courts may be taken aback by the number, importance, and complexity of the issues that are decided on motion and how many of them require expert witnesses.

For example, starting on day one, most Chapter 11 debtors will be unable to use operating cash without the consent of their secured creditor or the authority of the bankruptcy court. A debtor's cash that is subject to the security interest of a creditor is referred to as "cash collateral" in the bankruptcy context. Without the right to use cash collateral, most debtors will be unable to meet payroll, preserve assets, or simply to continue to do business.[23] If the secured party does not consent to the debtor's use of cash collateral, a debtor cannot use this cash until the bankruptcy court holds a preliminary hearing and first determines that parties with interests in the cash collateral have "adequate protection."[24]

The effect of Rule 26(a)'s lack of application to contested matters is somewhat debatable.

The importance of the debtor's right to use its cash collateral cannot be overstated. If a bankruptcy court decides that the secured creditor is not adequately protected from the potential diminution of the value of its security interest in the debtor's cash, it can refuse to allow the debtor to use the cash collateral to run its business. This makes it impossible for the debtor to reorganize and usually puts the debtor out of business.

An expert's opinion regarding a debtor's financial wherewithal and a creditor's adequate protection is often critical to prevailing on a contested cash collateral motion. The essence of the issue that is normally being disputed is whether there is a risk that, as a result of a debtor's use of cash collateral, the value of the secured creditor's collateral will deteriorate. This often involves a determination of whether the debtor's operations generate enough cash flow to replace the cash it is spending, or whether the value of the other assets subject to the creditor's lien is such that the creditor is fully secured in any event. An expert's input into these issues is sometimes so integral to deciding the cash collateral issue that a court will even appoint its own expert *sua sponte*.[25]

Requests by the debtor to use its cash collateral are made by motion under Bankrupt-

cy Rule 9014. As a result, Rules 26(a)(2)(A) and 26(a)(2)(B) do not apply. Expert reports are not required unless the bankruptcy court specifically requires them.

However, bankruptcy courts almost never require reports to be drafted related to a cash collateral motion because the motions must be resolved quickly. A debtor cannot long survive without the ability to spend its cash. The Bankruptcy Code explicitly recognizes the potential urgency by allowing a preliminary hearing on the motion to be conducted "as quickly as necessary" if the debtor so requests, and permitting a subsequent final hearing.[26]

As a result, even though experts testify at virtually every cash collateral motion, bankruptcy courts rarely require that these experts file reports. And since the experts are not required to file reports, attorney communications with these experts, so critical to the success or failure of a bankruptcy case, are arguably not protected from discovery under Rule 26(a)(2)(C).

There are many other important evidentiary hearings in the bankruptcy courts for which expert testimony is usually required, but expert reports are usually not.

There are many other important evidentiary hearings in the bankruptcy courts for which expert testimony is usually required, but expert reports are usually not. For example, any party in interest may seek the appointment of a Chapter 11 trustee to displace a debtor in possession.[27] The appointment of a Chapter 11 trustee can be justified, "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management…or if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate."[28] Just as with cash collateral motions, Bankruptcy Rule 9014 provides the expedited protocol for seeking the appointment of a Chapter 11 trustee.[29]

Much like cash collateral hearings, most hearings on whether a Chapter 11 trustee should be appointed are critical to the parties involved. The debtor's management never wants to cede control of its business affairs and assets; on the other hand, the party in interest bringing the motion usually believes that as the result of either fraud or incompetence, the debtor will soon have no assets left to manage if a trustee is not appointed.

Also much like cash collateral hearings, experts are usually required to prevail in a hearing on the appointment of a Chapter 11 trustee. The very nature of the central allegation—that the debtor's current management is either incompetent or committing fraud—generally requires either a financial expert or an expert in the particular business of the debtor. As a result, experts with backgrounds from accounting and business valuations to even agriculture find their way to the witness chair at hearings to appoint a Chapter 11 trustee.[30]

Once again, many, if not most, of these experts are required to file reports. Bankruptcy courts usually set an expedited schedule for the evidentiary hearing that is required to resolve a motion for the appointment of a Chapter 11 trustee, generally believing that if the debtor's management is committing malfeasance that justifies a trustee, management should be replaced as soon as possible. Time for discovery, if any, is usually limited. It is rare that time is built in for the drafting of expert reports.

These examples are not uncharacteristic. The most critical issues in bankruptcy proceedings are usually decided on an expedited basis through motion practice under Bankruptcy Rule 9014; expert testimony is usually required, and expert reports are usually not. The practice is so common that even when the process does not have to be expedited, bankruptcy courts do not regularly require expert reports. Chapter 11 confirmation hearings, for example, cannot proceed too quickly because of rigorous disclosure requirements and the solicitation of the votes of creditors necessary to confirm a plan of reorganization.[31] But even with the built-in time parties have to prepare for a confirmation hearing, expert reports are not usually required, despite the fact that a myriad of experts make their way to the witness chair to proffer their expert opinions upon the viability of a proposed Chapter 11 plan.[32]

As a result, there is a significant risk that attorney-expert communications are discoverable in much of the most important litigation in bankruptcy courts. Since this is not simply stated in a bankruptcy rule (or anywhere else), it can take attorneys by surprise.

The consequences of this surprise can be the difference between winning and losing a case. This is particularly true because in many bankruptcy court hearings the expert is the most important witness. For example, whether the bankruptcy judge accepts your expert's valuation of the debtor's property can easily be the most important aspect of a cash collateral hearing. If your expert's frank e-mails to you about weaknesses in your case are unexpectedly produced to oppos-

ing counsel, this critical testimony may lose much of its credibility on cross-examination.

Conclusion

To prevent a fall into the disclosure trap, attorneys litigating in bankruptcy court should first be cognizant of whether an adversary proceeding has been filed or whether they are litigating under Rule 9014. If a complaint has been filed, all subsections of Rule 26(a) apply, and an attorney's communications with an expert will generally be protected under the work product doctrine. If, however, the litigation is based on a motion under Bankruptcy Rule 9014, attorneys should assume that their communications with their experts are not protected. This is particularly true if the court does not order that experts produce reports.

This makes communications less convenient. But the loss of convenience is worth it to prevent another, more important loss—the loss of the credibility of the person who is probably your most important witness.

This word of caution has another aspect. Opposing counsel may not be aware of this quirk in the Federal Rules of Bankruptcy Procedure. So requesting that opposing counsel produce all communications between counsel and an expert may yield the key to the cross-examination of the expert. While this result was probably not foreseen by the drafters of the 2010 amendments to the federal rules, your client will nonetheless be appreciative.

NOTES

1. *See generally* Longhofer, *Michigan Court Rules Practice*, 2.302.11 (2004).

2. 163 Mich App 774, 778-779, 415 NW2d (1987).

3. Rule 26(a)(2)(A) requires that a party disclose, "the identity of any witness it may use at trial to present evidence under Federal Rule of Evidence 702, 703, or 705." These three evidentiary rules regulate the introduction of expert testimony, thus, any witness giving expert testimony must be disclosed under Rule 26(a)(2)(A). *See* FRE 702, 703 and 705. Rule 26(a)(2)(B) requires that most witnesses disclosed under Rule 26(a)(2)(A) must file an expert report.

4. *Elm Grove Coal Co v Director, Office of Workers' Comp Programs*, 480 F3d 278, 300 (4th Cir 2007) (acknowledging the view that "the case law in this area is far from clear…[T]his material could be treated as either discoverable, or protected work product.") (citation omitted).

5. *Id.* at 301-02 (listing numerous cases with differing views).

6. Advisory Committee Notes, 2010 Amendments, Rule 26.

7. *Id.*

8. *Robinson v HD Supply, Inc.*, No 2:12-cv-00604-GEB-AC, 2013 US Dist LEXIS 155196, at *5 (ED Cal Oct 28, 2013) (citation and quotation omitted); *United States v Sierra Pac Indus*, No CIV S-09-2445 KJM EFB, 2011 US Dist LEXIS 60372, at *18, 20-24 (ED Cal May 26, 2011).

9. Advisory Committee Notes, 2010 Amendments, Rule 26.

10. *Ibey v Trinity Universal Ins Co*, CV 12-31-M-DWM, 2013 US Dist LEXIS 116491, at *5 (D Mont Aug 16, 2013) (citation, quotation, and internal punctuation marks omitted).

11. *See United States v Veolia Env't North American Operations, Inc*, 13-mc-03-LPS, 2013 US Dist LEXIS 153245, at *9-10 (D Del Oct 25, 2013); Rule 26 (Committee Notes).

12. *Sierra Pac Indus*, 2011 US Dist LEXIS 60372, at *18.

13. *Id* at *20-25.

14. Id. at *20-24 (emphasis in original) (citing "Report of the Civil Rules Advisory Committee (May 8, 2009, amended June 15, 2009, pp. 4-5")).

15. 2011 US Dist LEXIS 60372, at *5-7.

16. *Id.*

17. *Id.*

18. *Id.* at *20-24.

19. *Id.* at *24, *33, *38-39.

20. *See Staker v Jubber* (*In re Staker*), 525 Fed Appx 811, 814 (10th Cir 2013) (citation and quotation omitted).

21. *Cf Caviata Attached Homes, LLC v US Bank, NA (In re Caviata Attached Homes, LLC)*, 481 BR 34, 44 (BAP 9th 2012):

> (Rule 9014(d) was added to clarify that if a motion cannot be decided without resolving a disputed material issue of fact, an evidentiary hearing must be held at which testimony of witnesses is taken in the same manner as testimony is taken in an adversary proceeding or at a trial in a district court civil case. … Under Rule 9017, the Federal Rules of Evidence also apply in a contested matter.) (citing Rule 9014(d), Advisory Comm Note to 2002 amendments).

22. *See generally In re Motors Liquidation Co*, 447 BR 150, 165 (Bankr SDNY 2011) (recognizing "the expedited bankruptcy procedure for resolving contested matters") (citation and quotation omitted).

23. *Collier on Bankruptcy* P 4001.06 (Alan N. Resnick & Henry J. Sommer eds, 16th ed).

24. 11 USC 363(c).

25. *See, e.g.*, *In re Gainey Corp*, 400 BR 576, 578 (Bankr WD Mich 2008).

26. Bankruptcy Rule 4001(b)(2).

27. 11 USC 1104(a).

28. 11 USC 1104(a)(1) & (a)(2).

29. *See Citizens Corp v Tennessee Commerce Bank* (*In re Citizens Corp*), No 311-11792, 2012 Bankr LEXIS 719, at *1-2 (Bankr MD Tenn Feb 27, 2012).

30. *See, e.g.*, *Pajaro Dunes Rental Agency v Spitters* (*In re Pajaro Dunes Rental Agency*), 174 BR 557, 563 (Bankr ND Cal 1994) (accounting and business valuation); *Sims v Sims* (*In re Sims*), No NM-97-022, 1997 Bankr LEXIS 2112, at *5 (BAP 10th Dec 30, 1997) (agriculture).

31. *See* 11 USC 1125.

32. *See, e.g.*, *In re WR Grace & Co*, 475 BR 34, 143 (D Del 2012) (expert in mass tort bankruptcy litigation), *aff'd*, 729 F3d 311 (3d Cir 2013); *HG Roebuck & Son, Inc v Alter Communications, Inc*, No RDB-11-0157, 2011 US Dist LEXIS 59781, at *8 (D Md June 3, 2011) (accounting and business valuation).

Joseph K. Grekin, a partner with Schafer and Weiner, PLLC, in Bloomfield Hills, Michigan, has represented businesses and individuals in state, federal, bankruptcy, appellate, and administrative courts in several states. Mr. Grekin has been an advocate for debtors' rights principles in the litigation context, and he has extensive trial experience on commercial and involvency issues.

Jeffery J. Sattler, an associate with Schafer and Weiner, PLLC, in Bloomfield Hills, Michigan, focuses his practice on bankruptcy.

Is Bitcoin the Future of Currency?

By Margaret E. Vroman

Introduction

Unless you have successfully avoided reading the financial news, you must have heard about bitcoin. But what exactly is bitcoin and what should businesses know about it?

Bitcoin is a digital currency that uses cryptography to control the creation and transfer of money. Unlike other forms of currency, however, it has no physical form and its value is not backed by anything tangible. It is the first example of money known as cryptocurrency, and its existence is entirely virtual. Its creation and continued viability is dependent on a network of computers that solve complex mathematical problems, which are so complex no single computer could create bitcoins on its own. This network of computers verify, record, and store the details of every bitcoin transaction made. Currently, there are around 12 million bitcoins in circulation, and the algorithm used to create them establishes a maximum limit of 21 million bitcoins.[1] This system is also set up so that it becomes increasingly difficult to produce bitcoins with the limit expected to be reached around the year 2140.[2]

Another distinguishing feature of bitcoin, and all other cryptocurrencies, is that unlike traditional currencies there is no central bank, government, group, or person that controls their supply.[3] The bitcoin market is therefore very volatile, although this volatility does not seem to have affected its functionality.[4]

This article discusses how bitcoin works, its advantages and disadvantages, the bitcoin exchange system, the impact of the Mt. Gox bitcoin exchange bankruptcy, and concludes with an analysis of the future of bitcoin and of cryptocurrencies in general.

How Does Bitcoin Work?

Bitcoins are created by computational calculations called "mining." The people who help run the bitcoin network are called "miners," and they earn bitcoins as they work. Whichever member of the network is the first to validate a bitcoin transaction receives several bitcoins as payment.[5]

The software used to create bitcoin is open source software that uses public-key cryptography, peer-to-peer networking, and proof-of-work to verify payments. Bitcoins are sent from one computer address to another, with each user having the ability to have many addresses. Each bitcoin payment transaction is broadcast to the network and is included in the blockchain so that the included bitcoins cannot be spent twice. A user's bitcoins are held in virtual wallets, each with its own unique key. Transactions are made by sending bitcoins from one wallet to another wallet in a cryptographic process that is verified by computers across the bitcoin network. Bitcoin wallets can be stored offline or at online exchanges. Once a transaction is made it is locked in time by the computer network that continues to extend the blockchain.[6]

Because there is no bank or middle man involved, bitcoins can be transferred directly from one entity to another without any transaction fee, which makes this a very attractive way of conducting business.[7]

Individuals can purchase bitcoins directly using real currency, or they can earn them through the bitcoin "mining" process. The bitcoin network keeps a public register of every bitcoin in existence since there is no central authority or "bank."[8]

Because it operates over the Internet, bitcoin is international in scope, which allows anyone to send money anywhere, instantly and cheaply.[9]

Bitcoin's Advantages

Bitcoin is truly the world's first global, decentralized, digital currency. It allows anyone to send value anywhere in the world without a third-party intermediary. This allows extremely low-cost international remittances to anyone with an Internet connection or mobile phone. Unlike other forms of online payment, such as Paypal, there are no charges for using bitcoins, and no commission is paid. Also unlike other methods of online transactions, once a bitcoin transaction is complete, it is irreversible, which is a very positive attribute to some, and a not so positive attribute to others. Bitcoin is also one of the most private ways to send money online since the owner of an online wallet typically remains unknown.[10]

For merchants, the advantages of using bitcoin are clear. Bitcoin is a guaranteed pay-

ment, and it is a transaction that cannot be reversed at a later date under any circumstance. This has obvious advantages for merchants selling goods over the Internet. Visa, MasterCard, and other credit cards cover only about 60 of the world's nearly 200 countries and require merchants to pay transaction fees.[11] Bitcoin, on the other hand, has the advantage of allowing anyone in any country to securely pay a merchant without the merchant having to worry about the risk of fraud and without incurring a fee. Bitcoin users can make purchases from anyone who accepts bitcoins, and merchants who accept bitcoins can exchange them against real currencies. Currently, however, only around 20,000 merchants accept bitcoins worldwide, and very few mainstream stores accept them. Some online retailers such as Overstock.com do accept them but their adoption is not widespread. However, in some countries it is possible to pay for a taxi, book a hotel room, or even receive your salary in bitcoins.[12]

Because it operates over the Internet, bitcoin is international in scope, which allows anyone to send money anywhere, instantly and cheaply.

Ben Bernanke, former chairman of the Federal Reserve System, is on record as having said virtual currencies "may hold long-term promise."[13] In the United States at least, there are enough people who believe that once experienced venture capitalists get into the development of bitcoin and other cryptocurrencies, which has up to this point been created and maintained by "amateurs and hobbyists," bitcoin will become a viable way to do business around the world.[14] These analysts believe that the online cryptocurrency will eventually be traded similar to commodities such as gold and silver.[15]

Bitcoin's Disadvantages

For many people the fact that bitcoins are exchanged anonymously is an advantage, but unfortunately there are many people who prefer the anonymity of bitcoin because they are conducting illegal transactions that they do not want traced. This anonymity, as well as the irreversible nature of bitcoin transactions, has made bitcoin and other cryptocurrencies a preferred form of payment for drug traffickers, murders-for-hire, and illicit weapons sales (the now defunct underground website Silk Road used bitcoin as its exclusive form of payment).[16] Critics say bitcoin's use to pay for these illegal transactions makes it unlikely that it will ever become a consequential form of currency, and they also point to its lack of regulation and volatility as other reasons why it will never be widely adopted.[17] However, although bitcoin makes certain criminal activities easier, it also makes legitimate business activities easier and less expensive, and it remains to be seen which activities will dominate its use.

Another area of concern that makes widespread adoption of bitcoin difficult is that if a user's hard drive crashes or a virus corrupts data and the wallet file is corrupted, a user's bitcoins have essentially been "lost." Once this happens, if no back-up system is in place, there is nothing that can be done to recover the lost bitcoins and the money it represents.[18]

Recently, it has also been made clear that bitcoins stored on online exchanges are vulnerable to massive theft, fraud, and loss, which has some pundits predicting that the end of this digital currency is near.[19] But the Mt. Gox fiasco, discussed below, which is the cause of this claim, does not seem to be the death blow envisioned.

Bitcoin Exchanges

Bitcoin exchanges serve as marketplaces where users come together to buy and sell bitcoins. Just as with a stock exchange, there are users who are active traders or speculators and, as with other commodities and currencies, the value of bitcoins depends on traders' confidence. If this confidence is shaken, the price of bitcoins suffers, and, if confidence in the entire system is destroyed, the existence of the cryptocurrency regime may be called into question. What kind of crises could cause users and potential users of bitcoin to question the entire bitcoin system? A security flaw at one of the largest bitcoin exchanges resulting in the loss of almost half a billion dollar's worth of bitcoins may be just such a crisis.

The Rise and Fall of the Mt. Gox Exchange

Mt. Gox, which became one of the world's largest bitcoin exchanges, began its existence as a website for exchanging trading cards.[20] In 2010, the Tokyo-based website became one of the first to open as an exchange for the little known virtual currency.[21] Soon, however, with little competition, it became the dominant bitcoin exchange. Mt. Gox was run by a Frenchman named Mark Karpeles, and, by 2013, it had over one million users.[22] Unfortunately, it appears the exchange had poor security measures, and in December 2013 bitcoin withdrawals at Mt. Gox were halted

after "unusual activity" was detected, and more than 744,000 bitcoins were discovered "missing due to malleability-related theft."[23] Only two months later, on February 28, 2013, Mt. Gox filed for bankruptcy protection in Tokyo, stating that it could not account for 750,000 of its customers' bitcoins and 100,000 of its own, worth as much as $474 million.[24] Assuming this number is correct, it means a loss of approximately 6 percent of the 12.4 million bitcoins created since the currency's inception in January 2009. The company also could not account for $27.3 million in customer deposits.[25]

Many experts blamed the Mt. Gox hacking on a long-known security flaw called "transaction malleability" that allowed hackers to make the fraudulent withdrawals. Others, however, accused the company itself of fraud, even alleging the collapse was an orchestrated scheme.[26]

However, one source, who worked for the company, said that software bugs were routinely ignored, and, according to leaked information, theft at the exchange had been happening for years.[27]

Regardless of the cause, almost half a billion dollars of bitcoin user's money has been lost. What will this mean for the future of bitcoin and other digital currencies?

The Effect of the Mt. Gox Bankruptcy

Critics say Mt. Gox's apparent failure proves that the unregulated currency is far from ready for widespread use. They also point to hacking attacks at other exchanges as evidence that cryptocurrencies cannot be trusted.[28]

Yet despite this mind boggling loss, and lesser problems at some other exchanges, the price of bitcoin has been relatively stable, and it does not appear that bitcoin and other cryptocurrencies are disappearing.[29]

What the Mt. Gox fiasco does point out, however, is that the lack of online security, regulation or oversight, and the anonymity of cryptocurrency seem to be significant obstacles to its widespread adoption.[30] A better system of online security would probably not be a hard sell to bitcoin's creators, but the addition of auditors, insurers, and even regulators would require a significant change in their philosophy. After all, human intervention was the very thing they created a system to avoid. Will it be possible then to allow enough human oversight to ensure that bitcoin is secure enough to prevent hacking without destroying the openness that makes it a cheap, efficient, and innovative financial platform?

There are those who think that it is, and they are working to make bitcoin and other cryptocurrencies more appealing to mainstream investors and businesses.[31] They are setting up stringent technical and financial audits of trading sites in an effort to create insurance mechanisms that will prevent holders of bitcoin from being wiped out by catastrophic losses like the one at Mt. Gox.[32] There are even efforts to pursue government regulation and independent audits of sites.[33] One of the major problems of the Mt. Gox exchange, which people complained of once it imploded, was that it never once offered a public accounting showing it possessed all the funds it claimed to be storing, nor did it show the technical methods it was using to safeguard those funds.[34]

U.S. Regulation

Currently, the U.S. government considers it entirely legal for users to buy, sell, or use bitcoins to purchase goods.[35] There is, however, a serious concern with the use of bitcoin for illegal money laundering purposes, and, as a result, the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) issued guidelines in 2013 on bitcoin use.[36] Although the FinCEN guidelines do not mention bitcoin by name, anyone involved in exchanges of decentralized virtual currency for real currency must register as a money services business and obey existing regulations. FinCEN's guidelines define the circumstances under which virtual currency users could be categorized as money services businesses (also known as money transmitting businesses or MTBs) and states that MTBs must enforce Anti-Money Laundering (AML) and Know Your Client (KYC) measures.[37] In a peer-to-peer currency transaction, however, it is not always obvious what counts as an exchange, and, as such, bitcoin miners might find they have to register even if all they do is sell their bitcoins for their monetary equivalent.[38]

IRS

The Internal Revenue Service (IRS) has recognized bitcoins but has ruled that they are to be taxed as property, not currency, which means a 1099 form is required just as for any other payment made with property.[39]

Currently, the U.S. government considers it entirely legal for users to buy, sell, or use bitcoins to purchase goods.

In 2009, the IRS posted information about the tax applications of using virtual currencies inside virtual economies, stating that taxpayers can receive income from a virtual economy and can be required to report it as taxable income. However, it based this assertion on guidance related to bartering, gambling, business, and hobby income.[40]

However, the IRS has yet to post guidance on "open flow" virtual currencies that can be used outside of virtual economies. In a report published in May 2013, the U.S. General Accounting Office (GAO) called for more guidance from the IRS on this issue. The IRS responded that its guidance could be taken to cover virtual currencies used outside of virtual economies. It also said it was looking at the potential tax compliance risks posed by anonymous electronic payment systems and was working with other federal agencies on this issue.[41]

Recently, the IRS unit that investigates cyber threats also said that the use of "cyber-based currency and payment systems" to hide unreported income from the IRS is a threat that it was "vigorously responding to."[42]

Only time will tell whether digital currency becomes secure enough, regulated enough, and accepted enough to become the twenty-first century's preferred method of conducting business transactions.

CTFC

The U.S. Commodity Futures Trading Commission (CTFC), which looks after financial derivatives, has yet to announce any regulations concerning digital currencies but has made it clear that it could do so if it so wanted.[43]

SEC

The U.S. Securities and Exchange Commission (SEC) is another agency that currently has no regulations on virtual currencies, but its Office of Investor Education and Advocacy has published an investor alert to warn people about fraudulent investment schemes involving bitcoin. One such example involved Trendon Shavers, founder and operator of Bitcoin Savings and Trust. Mr. Shavers was charged with operating a Ponzi scheme by allegedly raising 700,000 bitcoins as a result of promising investors up to 7 percent weekly interest.[44]

Legislation

The Trendon Shavers SEC case forced Congress to consider bitcoin's legal status. Shavers claimed that he could not be prosecuted for securities fraud because bitcoin was not money. However, the judge in the case, Amos Mazzant, issued a memorandum in which he argued that bitcoin can be used as money.[45]

In response to a request by the U.S. Senate in August 2013, inquiring about the threats and risks relating to virtual currency, several law enforcement agencies expressed concern that the lack of a paper trail for regulators and enforcement agencies to follow for virtual currency transactions needed to be addressed.[46] The U.S. Department of Homeland Security requested policies and guidance related to the treatment of virtual currencies and information about any ongoing strategic efforts in the area.[47] Although the U.S. Department of Homeland Security was most concerned about the criminal use of bitcoin, the U.S. Department of Justice, the Federal Reserve, and the U.S. Department of Justice all acknowledged the legitimate use of virtual currencies.[48] The SEC argued that "any interests issued by entities owning virtual currencies or providing returns based on assets such as virtual currencies" were considered securities and thus fell under its remit.[49]

The States

Since every state has its own financial regulators and laws, each approaches the regulation of digital currency differently. California and New York have been the most aggressive in their pursuit of bitcoin-related regulation, while others, such as New Mexico, South Carolina, and Montana, do not regulate money transmitting businesses at all.[50] At this time, New York State's top financial regulator has announced plans to regulate the use of bitcoins in that state sometime this year.[51]

There is also a task force of state regulators who are attempting to create a bitcoin "rulebook" in an effort to protect users of virtual currency from fraud while simultaneously avoiding stifling regulations of digital currency.

David Cotney, Massachusetts Commissioner of Banks, was appointed to head this "Emerging Payments Task Force," which is a group of nine members of the Conference of State Bank Supervisors (CSBS). He stated that the group hoped to issue some type of model definitions, laws or regulations, and recommendations that could be referred to either federal colleagues or to Congress for consideration.[52]

Foreign Regulation

In Canada, bitcoins are not considered legal tender, but transactions in digital curren-

cies do fall under its tax rules that apply to barter and speculative assets.[53] France does not regulate bitcoin at all, and, although it is not legal tender in Germany, it is considered a financial instrument similar to foreign currency that can be used for private transactions or traded for other currencies.[54] The European Central Bank has decided that bitcoin meets only two of the three legal criteria for electronic money, and therefore the European Union (and Italy) are not quite sure how to treat bitcoin.[55] Bitcoin is currently unregulated in the United Kingdom.[56]

Not every country, however, is as open to the current and future use of cryptocurrencies as is the United States and Europe. China has restricted banks from using bitcoin and Russia's top prosecutor declared that bitcoin and all anonymous payment systems are illegal.[57]

Industry and Institutions

Industry has responded to growing regulator concerns with bitcoin and digital currencies by creating a committee to form a self-regulatory body called DATA. This committee is designed to encourage an open conversation with regulators. In addition, the Bitcoin Foundation has formed other committees to offer legal guidance, assist policy, and work with regulators. Bitcoin exchanges have also been attempting to secure MTB licenses at the state and federal levels, and some have avoided doing business with U.S. customers until this is resolved.[58]

At the institutional level, many banks are already acknowledging that cryptocurrencies are here to stay and may be the future of business transactions. Last year, JPMorgan Chase quietly filed a patent for a bitcoin-like payment system that included both digital wallets and user anonymity.[59]

Conclusion

Obviously, this is a developing area of technology and commerce just as a technology called the Internet was twenty years ago. Currently there are over a hundred cryptocurrencies in use, and, although bitcoin is the best known, it may eventually go the way of Netscape or Napster, which were once the leaders in their fields.[60] There are those who predict that the almighty dollar might one day itself become a cryptocurrency.[61] Only time will tell whether digital currency becomes secure enough, regulated enough, and accepted enough to become the twenty-first century's preferred method of conducting business transactions.

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Margaret E. Vroman is currently an Associate Professor of Business Law at Northern Michigan University. Her diverse background includes working as a research attorney for the Michigan Judicial Institute, practicing bankruptcy law, serving as the Deputy City Attorney in Lansing, Michigan, as well as teaching law courses at Western Michigan University and Michigan State University's College of Law.

Case Digests

Motor Vehicle Dealer Act—Notice to Existing Dealership

LaFontaine Saline, Inc v Chrysler Group, LLC, No 146722, 146724, 2014 Mich LEXIS 1037 (June, 10, 2014). The 2010 amendment of the Motor Vehicle Dealer Act that expanded the relevant market area in which automobile manufacturers are required to notify an existing dealership of the manufacturer's intent to establish a dealership selling the same line of vehicles does not apply retroactively. Thus, the six-mile relevant market area in effect in 2007 governed the 2007 manufacturer-dealer agreement at issue in this case, and the supreme court remanded the case to circuit court for reinstatement of summary disposition in favor of the defendants.

Shareholder-Oppression Statute—Right to Jury Trial

Madugula v Taub, No 146289, 2014 Mich LEXIS 1281 (July 15, 2014). Michigan's shareholder-oppression statute (MCL 450.1489) does not give a claimant a right to a jury trial and instead expresses a legislative intent to have shareholder-oppression claims heard by a court of equity. There is also no constitutional right to a jury trial for claims brought under this statute. Violations of a shareholder agreement may constitute evidence of shareholder oppression under MCL 450.1489(3). Because the trial court erred by submitting plaintiff's claim to the jury and allowing it to award an equitable remedy, the court of appeals erred by affirming the trial court's judgment in favor of plaintiff. Therefore, the judgments of both the court of appeals and trial court were reversed, and the case was remanded to the trial court to determine whether, sitting as a court of equity, it could make the requisite findings of fact and conclusions of law or whether a new trial was necessary.

Employment—Severance Pay

Klein v HP Pelzer, No 310670, 2014 Mich App LEXIS 1286 (July 8, 2014). Because there was no unilateral contract for severance pay and the employer properly revoked its severance pay policy, the plaintiffs were not entitled to severance when they later resigned. The trial court erred by finding that defendant breached an express contract to pay severance to the plaintiffs and granting summary disposition in favor of the plaintiffs for that breach. In light of the letters revoking the severance pay policy, the plaintiffs' breach of implied contract and promissory estoppel claims also could not survive summary disposition.

Promissory Notes—Lender Liability Defense

Huntington Nat'l Bank v Daniel J Aronoff Living Trust, No 309761, 2014 Mich App LEXIS 1025 (June 3, 2014). In action by a bank to enforce several notes, letters of credit, and guaranties, the trial court did not err when it concluded that the undisputed evidence showed that the bank was entitled to summary disposition on its claims. The defendants did not dispute their liability and failed to support their proposed "lender liability" defense with evidence that the bank had breached a written agreement to loan them $5 million to extort more favorable terms at a later date. In addition, the trial court did not err when it determined that defendants would not benefit from further discovery or be able to cure the deficiencies in their position by an amendment to their answer.

Trademarks—Validity of Trademark

Travis, Inc, v Preka Holdings LLC, No 315560, 2014 Mich App LEXIS 1432 (July 31, 2014). The plaintiff owned a restaurant and had used a surname, "Travis," as a mark in connection with the food-service industry since the 1940s. It registered the "TRAVIS" mark in 1996 pursuant to MCL 429.34. The dispute leading to this action arose in 2011 when the defendant began to operate a restaurant called "Travis Grill" in the same area as the plaintiff's restaurant and licensees. The plaintiff sued the defendant for trademark infringement under MCL 429.42 in circuit court, and the court granted an injunction against the defendant's further use of "Travis"-related marks. On appeal the defendant argued that the injunction should be reversed because the plaintiff's trademark was not valid. The court of appeals held that the trial court had correctly ruled that the plaintiff's "TRAVIS" mark had acquired secondary meaning and was thus a valid trademark under the Michigan trademark act. The court of appeals affirmed the trial court's grant of a permanent injunction under MCL 429.43 because the plaintiff proved that it had priority, that the defendant's mark was confusing, and that the defendant had used the confusing mark in the sale or advertising of services in Michigan.

Unemployment Insurance—Misconduct

Hodge v US Sec Assocs, Inc, No 311387, 2014 Mich App LEXIS 1319 (July 15, 2014). An airport security guard's actions in accessing a computer to assist a passenger in violation of rules governing the use of computers was a good-faith error in judgment and did not constitute misconduct under the unemployment insurance statute. The circuit court did not err by addressing whether the agency's decision violated the law and reversing the decision that claimant committed misconduct and was therefore disqualified from unemployment benefits.

Index of Articles

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SECTION CALENDAR

Council Meetings

DATE	TIME	LOCATION
September 11, 2014*	4:00 p.m.	Sheraton Detroit, Novi
December 6, 2014	10:00 a.m.	Clark Hill, Birmingham

*Annual Meeting