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The editorial staff of the *Michigan Business Law Journal* welcomes suggested topics of general interest to the Section members, which may be the subject of future articles. Proposed topics may be submitted through the Publications Director, Robert T. Wilson, The Michigan Business Law Journal, 150 W. Jefferson, Suite 900, Detroit, Michigan 48226-4430, (248) 258-1616, or through Daniel D. Kopka, Senior Publications Attorney, the Institute of Continuing Legal Education, 1020 Greene Street, Ann Arbor, Michigan, 48109-1444, (734) 936-3432.

**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 (a) provides a forum to facilitate service and commitment and to promote ethical conduct and collegiality within the practice; (b) expands the resources of business lawyers by providing educational, networking, and mentoring opportunities; and (c) reviews and promotes improvements to business legislation and regulations.*
March, 2006

Dear Business Law Section Member:

I am very proud to welcome you to another fantastic issue of the Michigan Business Law Journal. A great deal of time and effort go into each Journal and we are extremely thankful to our contributors and to our Publications Director, Robert Wilson. This issue features informative articles written and solicited by the Section’s Nonprofit Corporations Committee, including useful pieces on proposed amendments to the Nonprofit Corporation Act and related statutes, proposed revisions to the Charitable Solicitations Act, charitable gaming, intermediate sanctions on tax-exempt organizations, property tax issues for nonprofit entities, relief from the Sarbanes-Oxley Act for smaller public companies, extending credit to automotive suppliers, and the expansion of the “ordinary course” bankruptcy defense. Our regular columns also feature useful and up-to-date information on tax matters and other topics of interest.

The Section has worked hard to review and update its Strategic Plan to develop clear goals and objectives to better serve its members. You can view a copy of the Strategic Plan on our Web site at http://www.michbar.org/business/. One of the Strategic Plan’s key objectives is to encourage member participation. Our Section needs your involvement. Feel free to contact any of the Section leaders listed on our Web site for more information. The Section has many active committees and directorships that are seeking the talents of our members. Please contact any of the Committee or Directorship Chairpersons listed on our Web site if you would like to become involved.

Section Web Site and Listserv. Essential goals of the Strategic Plan are to improve Internet and other technology services and to collect information about Section members. To that end, the Section has developed a fantastic Web site. The Web site is a great place to obtain information and learn of our many ongoing events. We hope you will visit it often to learn of Section activities. The Section Listserv is used to provide important information to our members by e-mail. If you are not currently a member of the Listserv, sign up today on the Section Web site.

Mid-Year Meeting and Business Law Institute. Key goals in our Strategic Plan are to continue to sponsor a Business Law Section annual spring meeting and to continue to sponsor programs for continuing legal education. The Section’s 18th Annual Mid-Year Meeting and Business Law Institute, co-sponsored by ICLE, is scheduled for June 2 and 3 at the Soaring Eagle Casino & Resort in Mt. Pleasant. The central Michigan location has been chosen for the third consecutive year in an effort to provide a convenient location for our members. Members can keep up-to-date on developments in business law while relaxing and enjoying the amenities at this great location. This year’s special guest is Kenneth Wolf, Ph.D., of the Incident Management Team. Dr. Wolf’s multi-media show on the components of a mass-casualty response program is both timely and thought-provoking. This occasion also provides a great opportunity to network at social events. The Section will host a reception and dinner on Friday evening featuring Humorist at Law Sean Carter. Go to www.icle.org to sign up for these exciting events today.

Council Meetings. A good way to become involved in Section activities and to determine your areas of interest is to participate in quarterly Council meetings. Our next Council meeting will be held on Saturday, June 3 at 7:30 a.m. at Soaring Eagle. Please contact any of the Section’s officers if you would like to attend a meeting and become more involved in Section activities.

Annual Scholarship Award. A vital goal of the Strategic Plan is to encourage students to develop an interest in business law. To that end, the Section’s Third Annual Scholarship Award contest is coming to a close with submissions due on April 15. The Award is open to all law students enrolled in an ABA accredited law school in Michigan. A monetary prize of $2,500 will be awarded at Soaring Eagle in June. In addition, the winner will have his or her article published in the Journal.

Business LawJournal. Another important goal in our Strategic Plan is to provide a regularly published high-quality written communication to Section members. As such, you will receive the Journal by mail three times per year, and it is also available on our Web site. The Journal offers interesting and informative articles on topics of interest to business lawyers, including regular columns such as Did You Know? by G. Ann Baker and Technology Corner by Michael Khoury. If you are interested in submitting an article (or an idea for an article) to be considered for an upcoming issue, please contact Daniel Kopka at ICLE. If you have any other questions or comments about the Journal, please contact our Publications Director, Robert Wilson.

Business Boot Camp: Basic Training for Every Business Lawyer and The Business of Being a Business Lawyer. Other key goals in our Strategic Plan are to continue the award-winning associate training series “Boot Camp” with ICLE and to increase participation by young lawyers. One way the Section is working to meet that objective is through its Business Boot Camp program. The 9-session program, co-sponsored with ICLE, has been a great success with monthly programs running from September 2005–May 2006 in both Grand Rapids and Beverly Hills. Further information regarding Boot Camp is available at www.icle.org. As a further tool to meet this goal, the Section co-sponsored a luncheon panel discussion with the Young Lawyers Council meetings. The event was an overwhelming success with over 80 attendees. The Section is exploring the possibility of presenting this program in other locations throughout the State.

Stephen H. Schulman Outstanding Business Lawyer Award. The Section is pleased to announce the establishment of the Stephen H. Schulman Outstanding Business Lawyer Award. The purpose of the Award is to recognize the Michigan Business Lawyer who, over his or her career, best exemplifies the characteristics outlined in the Section’s Mission Statement, including the highest quality of professionalism, the highest quality of practice, service and commitment to the business bar and those it serves, and the highest quality of ethical conduct and collegiality within the practice. The Award will be presented each year at the Annual Meeting in September. Look for upcoming announcements identifying the initial recipients of the Award.

The Section is dedicated to achieving the goals outlined in its Strategic Plan in an effort to better serve its members. We are extremely fortunate to have many committed and talented members who help make the achievement of these goals possible. I encourage you to participate in Section activities and to take advantage of all the Section has to offer!

Sincerely,

Eric I. Lark, Chairperson 2005-2006
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Did You Know? By G. Ann Baker

Profit Corporation Fees Reduced

Public Act 212 of 2005, effective January 1, 2006, substantially reduced fees for authorized shares of domestic for-profit corporations. The old fee schedule was based on increments of 20,000 shares, with caps at $5,000 for under 10 million shares and at $200,000 for more than 10 million shares; the minimum fee was $50 for up to 60,000 authorized shares. With the revision, the minimum fee is still $50, but the increments have been significantly increased and the fee per increment has been reduced. The new fee schedule applies both to Michigan profit corporations, including their initial authorized shares and any increase in authorized shares, and to foreign profit corporations qualified to do business in Michigan.

Foreign corporations pay only for the authorized shares attributable to Michigan. The new fees apply to the first 60,000 shares initially considered attributable to Michigan and to any increase in shares attributable to Michigan. The latter amount is determined by multiplying the total number of authorized shares of the foreign corporation by the most recent apportionment percentage used in the computation of the single business tax. If the corporation’s business activities are confined solely to Michigan, the total number of authorized shares is considered attributable to Michigan.

For a domestic corporation incorporating or increasing its authorized shares after January 1, 2006, and for a foreign profit corporation whose shares attributable to Michigan increase after January 1, 2006, the savings under the new fee schedule may be significant. The examples in the table to the right provide some comparisons.

New Expedited Services

Do you need to file a document quickly? Public Acts 217–220 of 2005, effective January 1, 2006, provide that customers can, for a fee, request expedited service to help them meet time constraints or deadlines. Customers can choose from four levels of expedited processing—1 hour, 2 hour, same day, and 24 hour—with fees adjusted accordingly. These expedited fees are nonrefundable and are charged in addition to the standard document fees.

When using expedited service, submit a separate Expedited Service Request form, BCS/CD 272, for each expedited document. This form is available on the Department of Labor and Economic Growth’s Web site, at http://www.dleg.state.mi.us/bcsc/forms/corp/corp/272.pdf. Documents may be submitted via MICH-ELF, in person, or by U.S. mail to P.O. Box 30054, Lansing, MI 48909. First-time MICH-ELF users requesting expedited service must obtain a MICH-ELF filer number before submitting a document for expedited service. The MICH-ELF Application, BCS/CD-901, is available online, at http://www.dleg.state.mi.us/bcsc/forms/corp/elf/901.pdf.

With the implementation of these new service options, the Corporation Division has added a Service

<table>
<thead>
<tr>
<th>Number of Shares</th>
<th>Fee</th>
</tr>
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<tbody>
<tr>
<td>1–60,000</td>
<td>$50</td>
</tr>
<tr>
<td>60,001–1,000,000</td>
<td>$100</td>
</tr>
<tr>
<td>1,000,001–5,000,000</td>
<td>$300</td>
</tr>
<tr>
<td>5,000,001–10,000,000</td>
<td>$500</td>
</tr>
<tr>
<td>More than 10,000,000</td>
<td>$500 plus $1,000 for each additional 10 million shares or portion thereof</td>
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</table>

<table>
<thead>
<tr>
<th>Authorized Shares</th>
<th>Old Fee</th>
<th>New Fee</th>
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<tbody>
<tr>
<td>60,000</td>
<td>$50</td>
<td>$50</td>
</tr>
<tr>
<td>1,000,000</td>
<td>$1,410</td>
<td>$100</td>
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<tr>
<td>5,000,000</td>
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<td>$300</td>
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<tr>
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<td>$500</td>
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<tr>
<td>50,000,000</td>
<td>$65,000</td>
<td>$4,500</td>
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<table>
<thead>
<tr>
<th>Increase in Authorized Shares</th>
<th>Old Fee</th>
<th>New Fee</th>
</tr>
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<tbody>
<tr>
<td>60,000</td>
<td>$90</td>
<td>$50</td>
</tr>
<tr>
<td>1,000,000</td>
<td>$1,500</td>
<td>$100</td>
</tr>
<tr>
<td>5,000,000</td>
<td>$5,000</td>
<td>$300</td>
</tr>
<tr>
<td>10,000,000</td>
<td>$5,000</td>
<td>$500</td>
</tr>
<tr>
<td>Increase from 10 million to 15 million</td>
<td>$7,500</td>
<td>$300</td>
</tr>
<tr>
<td>Increase from 10 million to 50 million</td>
<td>$60,000</td>
<td>$4,500</td>
</tr>
</tbody>
</table>
Deadlines and Fees for Submitting Documents for Expedited Service

<table>
<thead>
<tr>
<th>Expedited Processing Time</th>
<th>Submission Deadline (EST or EDT)</th>
<th>Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 hour</td>
<td>4 p.m.</td>
<td>$1,000</td>
</tr>
<tr>
<td>2 hour</td>
<td>3 p.m.</td>
<td>$500</td>
</tr>
<tr>
<td>Same day</td>
<td>1 p.m.</td>
<td>Documents for existing entity: $200</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Formation documents and Applications for Certificate of Authority: $100</td>
</tr>
<tr>
<td>24 hours</td>
<td>N/A*</td>
<td>Documents for existing entity: $100</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Formation documents and Applications for Certificate of Authority: $50</td>
</tr>
</tbody>
</table>

*With 24-hour service, if the next day is a Saturday or holiday, the 24-hour period is extended to the next day that is not a Saturday, Sunday, or holiday.

Announcement area to its Web site, www.michigan.gov/corporations, to inform customers about situations beyond the Division’s control that may affect or interrupt service. The Division will also use this area to provide updates on when full service will be restored. For example, when a power outage on January 30 shut down the server room, a notice was immediately posted online, and when power was restored on January 31, a follow-up notice was posted.

Regular service for documents, annual reports, and annual statements remains the same: non-expedited documents will be reviewed within 10 days of receipt. Documents, annual reports, and annual statements may be submitted with their required fee by U.S. mail or in person. Documents also may be submitted via MICH-ELF, with fees paid by credit card through the user’s filer account.

Expedited service for certificates and copies is basically unchanged. Expedited orders can be placed in person at the Okemos office, at 2501 Woodlake Circle, for pick up the next day or for delivery by fax or mail. An expedited order can be placed via MICH-ELF for a copy or certificate relating to a document submitted for an expedited filing also placed via MICH-ELF. In accordance with the fee schedule approved by the State Administrative Board, a 25 percent service fee will be added to the cost of the certificates or copies for any expedited orders placed in person or via MICH-ELF.

Regular service available for certificates and copies remains the same. Uncertified copies are still available on the Corporation Division’s Web site. Orders for certified and uncertified copies and certificates may be placed by phone, at (517) 241-6470; by fax, at (517) 241-0538; or by regular mail, at P.O. Box 30054, Lansing MI 48909-7554. Documents will be returned by mail or fax.

**Frequently Asked Questions**

**Q:** Is expedited service available for both documents and annual reports?

**A:** Yes. Public Acts 217, 218, 219, and 220 of 2005 provide that expedited service may be requested for any document required or permitted to be filed under the Business Corporation Act, the Michigan Limited Liability Company Act, the Nonprofit Corporation Act, or the Michigan Revised Uniform Limited Partnership Act.

**Q:** What happened to the 48-hour service for MICH-ELF?

**A:** The ad hoc 48-hour service did not meet the needs of customers. The legislation included in the jobs package signed by Governor Granholm on November 21, 2005, responds to the demand for faster service. The four expedited service options—1-hour, 2-hour, same-day, and 24-hour—allow customers to choose the option that best meets their needs. The statutory review period for documents, other than for annual reports and annual statements, is still 10 days. Documents submitted by U.S. mail, in person, or through MICH-ELF are reviewed in the order received, with the customer notified if the document cannot be filed.

**Q:** Can I request expedited filing after I have already submitted my document, annual report, or annual statement?

**A:** No. The request for expedited service must be made at the time that the document or report is submitted for review.

**Q:** Why do I have to update my filer account or apply for a filer number before submitting a document through MICH-ELF for expedited service?

**A:** The filer account is needed for payment by credit card through MICH-ELF. Updating an existing filer account or establishing a new filer account may take up to two hours, but payment of the expedited fees, along with the regular fees applicable to the specific document, are due when a document is submitted for review. Documents submitted via MICH-ELF without a filer number cannot be assigned for review.

**Q:** What address should I use to overnight my document, report, or annual statement to your office?

**A:** Different post office boxes are used to receive documents, profit corporation annual reports, nonprofit corporation annual reports, and limited liability company annual statements and reports. Mail should be directed to the P.O. box number noted on the applicable form.

**Q:** Am I required to use expedited service?

**A:** No. Expedited service options were established for those customers who need an expedited review of
documents and reports or statements. Non-expedited documents are reviewed within 10 days. Annual reports and statements are reviewed in the order in which they are received but are not subject to the 10-day review period.

**File Corporation Annual Reports and LLC Annual Statements Online**

Public Acts 217–222 of 2005 require the agency to establish procedures for accepting delivery of documents by electronic mail or over the Internet by December 31, 2006, and to implement this service by January 1, 2007. The first of these new services will allow corporations and limited liability companies to submit annual reports and annual statements online.

In January 2006, online filing for the most recent nonprofit corporation annual reports and limited liability companies was launched. Online filing of 2006 domestic profit corporation annual reports is expected to be available in March 2006. Domestic profit corporations that filed a 2004 annual report or that were not required to file a 2004 report will be able to file their 2006 reports online. The accompanying fees must be paid by credit card.

This initial phase of online filing is available to domestic corporations and domestic and foreign limited liability companies. Online filing for foreign corporation and professional service corporation annual reports, as well as for professional limited liability company annual statements and reports, is expected to be available in the next phase.

To file a report using the Internet, go to the Corporation Division’s Web site, www.michigan.gov/corporations, click on “Online Services,” and select “FILEOnline.” You will need the six-digit file number assigned by the Corporation Division; “Business Entity Search” may be used to confirm this number. FILEOnline will display the entity’s current resident agent and registered office, but this information can be changed online. The names of the current officers and directors will need to be entered, but if there are no changes to the information provided in the last filed report, the corporation can certify this and file a simplified report online. After the information is completed and the fee is paid, a receipt will be generated. The information provided online will create an electronic document that will be available within 24 hours on “Business Entity Search.”

The Corporation Division is working with the Department of Information Technology to establish procedures for the submission of additional documents by e-mail or over the Internet. Any new services will be announced as they become available.

**NOTES**

1. See MCL 450.2062 for the complete new fee schedules and corresponding ranges in numbers of shares.

G. Ann Baker is an attorney with the Corporate Division of the Michigan Bureau of Commercial Services in Lansing. Ms. Baker is a member of the International Association of Commercial Administrators. She also is a member of the State Bar of Michigan Committee on Libraries, Legal Research, and Legal Publications and is a past chairperson of the Business Law Section. She served as the director of the Office of Franchise and Agent Licensing from 1981 to 1984, administering the Michigan Franchise Investment Law and the broker, dealer, agent, and investment adviser portion of the Michigan Uniform Securities Act. She is a member of the Corporate Law Committee and the Unincorporated Enterprises Subcommittee on the LLC Act. She has been a frequent speaker at ICLE courses and is actively involved in programs to train officers and directors of nonprofit corporations.
Unfortunately, the carpenter’s motto of “measure twice, cut once” is not always followed in the busy practice of business law. However, there are simple steps you can take to help your clients avoid some all-too-common tax fiascos. For example, little or no thought is sometimes given to the choice of entity at an entity’s formation or acquisition. This can spawn profound problems when the enterprise becomes quite valuable—and taxable. More commonly, the helter-skelter process of assembling and closing a deal results in inattention to tax allocations, values, and other factors, and tax consequences are either omitted or misstated in transaction documents.

Begin with the End in Mind

The proper time to consider the type of legal cloak that should be wrapped around an entity is at its formation. Both the short-term and long-term consequences should be looked at, and attorneys should detail an exit strategy. The usual problem, however, is that when a business is going to be sold it is a C corporation or some other tax-wise, disadvantaged entity for those particular facts, and this greatly reduces the after-tax proceeds that the owners will ultimately receive. There can also be ongoing problems of startup losses not passing through, double tax on distributions, etc.

Understand the Danielson Rule and its Substantial Implications

Many attorneys and their clients only learn about the very important tax-practice Danielson rule after an IRS revenue agent has entered the picture. Under Commissioner v. Danielson, 378 F2d at 775, “a party can challenge the tax consequences of his agreement as construed by the IRS only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.” The Sixth Circuit adopted Danielson in 1984. While not all appeals courts have followed suit, a computer search reveals over 300 citations of this case. North American Rayon v Commissioner, 12 F3d 583 (6th Cir 1993), represents a splendid example of Danielson’s application. A textile business in hard times decided to liquidate several of its operational divisions and then to sell all but one, North American Rayon, to third parties. The company then sold North American Rayon to essentially those same parties, but in a manner that would allow the substantial losses to be realized for tax purposes. The transaction documents were prepared by the same law firm for the less-than-independent buyer and seller, with assistance from the same accounting firm. However, these documents did not reflect economic reality in their allocation of consideration and, thus, the purchaser’s starting tax basis. Unfortunately for the purchasing entity, the Sixth Circuit ruled that even though the numbers were obviously incorrect, as well as unfavorable to the taxpayer, the taxpayer was still bound by the erroneous allocations in the documents.

Counsel should understand that this is a one-way street. Only the IRS can use Danielson to hold a taxpayer to the terms, values, and allocations in an agreement. In situations where there are commonly controlled taxpayers, a plethora of cases under IRC 482 allows the IRS to reallocate dollars in accordance with fair value.

The Solutions Are Obvious

First, even if the client wants things done in a rush, counsel needs to take the time in an organization’s early days to consider entity selection, and later the contractual terms, conditions, valuations, and allocations in the documentation. Second, how can an attorney be prepared for these issues? He or she must take advantage of the available educational opportunities. From the Institute of Continuing Legal Education’s Business Boot Camp for young lawyers to more in-depth and sophisticated programs, ICLE, the State Bar’s Business Law Section, and other organizations and entities provide educational opportunities to help practitioners avoid tax traps. I wholeheartedly suggest that you periodically review the available offerings and enhance your knowledge base and skills.

NOTES

1. 378 F2d at 775.
Proposed Amendments to the Nonprofit Corporation Act and Related Statutes

By Jane Forbes

On December 3, 2005, the Business Law Section Council endorsed proposed amendments to the Michigan Nonprofit Corporation Act (the “Nonprofit Act”) and two related statutes that were prepared by members of the Nonprofit Corporations Committee. The draft bills, which are about 180 pages long in their current form, are updated versions of proposed legislation that was initially prepared in the mid-1990s and subsequently revised in 2003. The draft was included in the Committee’s December 2005 report, which is available on the State Bar Web site, at http://www.michbar.org/business/nonprofit.cfm.

Introduction

The Nonprofit Act is modeled on the Michigan Business Corporation Act (the “BCA”). Unlike the BCA, however, it has not undergone any comprehensive revisions since its enactment in 1982. Accordingly, the proposed amendments have two overall objectives: (1) to bring the statute up to date by incorporating many of the changes that have been made to the BCA since 1982; and (2) to add provisions that would legalize the existing practices of some nonprofit corporations and facilitate their operations. Because many nonprofits stand to benefit from these amendments, the proposed bills do not include any especially controversial changes.

Changes Already Made to the BCA

Several of the previous amendments to the BCA involve substantive matters that are important to nonprofit corporations as well as to business corporations. As a result, the proposed amendments include provisions similar to those now in the BCA governing matters such as capital structure and state filings. Many nonprofit organizations are particularly eager to add language from the BCA that specifically allows the use of e-mail and other electronic transmissions for notices and communications with members, shareholders, and directors.

Members of the Committee believe that it is important that the language used in the Nonprofit Act be consistent with that in the BCA, except when differences between the two types of corporations are clearly necessary. Although the Nonprofit Act has been in effect for more than 23 years, there have apparently not yet been any published appellate decisions interpreting its provisions. Uniform language would enable trial judges and lawyers who are called upon to interpret the Nonprofit Act to rely on cases decided under the BCA. Consistency in language and procedures between the statutes would also help attorneys, who are already more familiar with the BCA than with the Nonprofit Act, to avoid making mistakes when advising nonprofit corporations or serving on community boards.

Differences Between the Nonprofit Act and the BCA

Introduction

While many of the proposed editorial and substantive changes to the Nonprofit Act are designed to make it consistent with the BCA, there are a number of instances in which Committee members felt that the differences between the two statutes were necessary or appropriate. While some of these differences are very significant, some are merely technical in nature.

Forms of Nonprofit Corporations

One important way Michigan nonprofit corporations differ from business corporations is that they presently come in three basic forms: stock corporations, membership corporations, and directorship corporations. Under the current Nonprofit Act, the only difference between stock corporations and membership corporations is that while members are limited to only one vote, shareholders can cast one vote per share of stock held. This has not been changed in the proposed legislation. The amendments do, however, expand the procedural and substantive provisions applicable to directorship corporations, which have no shareholders or voting members. Section 451 of the proposed amendments, for example,
specifically permits cumulative voting in the election of directors of a directorship corporation, and proposed Section 489 allows a member of the board of a directorship corporation to initiate a derivative action.

**Corporate Distributions**
The most fundamental difference between nonprofit and business corporations is that, aside from cooperatives, nonprofit corporations are generally prohibited from making distributions to their members or shareholders before dissolution. Charities are prohibited, both under state and federal tax law, from making all distributions to private individuals. These limitations are currently found in Section 301 of the Nonprofit Act, which would be clarified by the proposed changes. The amendments also would add a new section explicitly allowing a nonprofit corporation to make distributions to a parent organization having similar purposes without having to call these “donations.” Language was also added to proposed Section 701 extending the limitations on distributions to payments made in connection with mergers.

**Director Liability**
The Nonprofit Act contains several provisions limiting the personal liability of directors and other volunteers. Unlike the BCA, the act also provides for the “assumption” of liabilities by third parties. Similar to Section 209 of the BCA, the Nonprofit Act restricts the liability for monetary damages in actions brought by shareholders or members. The provisions currently included in Section 209 of the Nonprofit Act are narrower than the corresponding language in the BCA, applying only to “volunteer directors” and containing an exception for acts constituting “gross negligence.” The Nonprofit Act does, however, extend the protection to “volunteer officers.”

The proposed changes would conform the language in Section 209 of the Nonprofit Act with the BCA by (1) eliminating the requirement that directors, but not officers, be volunteers; and (2) by removing the gross-negligence exception. No changes are being proposed to the provisions dealing with the assumption of third-party liabilities.

**Governance**
Groups of nonprofit corporations often have tiered corporate structures in which one or more parent organizations retain the power to approve a subsidiary board’s specified actions, such as financings, or to act on behalf of subsidiaries in place of their boards. For example, religious orders sponsoring Catholic hospitals often retain the powers necessary to ensure that the hospitals act in accordance with the ethical and religious policies of the church. To provide additional statutory authority for these “reserved powers,” the draft added a new subsection (f) to Section 209 and a revised version of BCA Section 488, which authorizes the management of closely held business corporations under shareholder agreements. Even with these proposed amendments, however, the Nonprofit Act would still differ from the present BCA in the following respects:

- Section 488 of the BCA, which allows the elimination of board and director proxies, was not included in the Nonprofit Act because of the risk of misuse.
- The proposed amendments to the Nonprofit Act require that any provisions allowing members or shareholders to act in place of the board be included in the articles of incorporation. Such provisions also could be adopted without the unanimous consent of members or shareholders.
- Language proposed for new Section 488 of the Nonprofit Act would specifically permit restrictions on the voting powers of individual directors.

**Damages in Derivative Actions**
The diversity of nonprofit corporations makes it difficult to devise appropriate remedies for derivative actions. While the Nonprofit Act currently provides for derivative suits, it does not specify all the remedies available in such actions or clearly indicate whether or not a member or shareholder bringing such an action may ever receive monetary damages.
Tax-exempt corporations organized for charitable purposes are prohibited under state and federal law from distributing their assets, either as dividends or upon dissolution, to shareholders and members. Therefore, it is ordinarily inappropriate to pay monetary damages, other than as reimbursement for costs, to members or shareholders of charitable corporations. In contrast, members and shareholders of other kinds of nonprofit organizations, i.e., social clubs or cooperatives, usually are entitled to receive a pro rata share of a corporation’s assets upon dissolution. Accordingly, these members and shareholders may have substantial proprietary interests in their memberships or shares, and for this reason the amendments may include provisions similar to those of Section 489 of the BCA, which allows the court to order the purchase of shares or memberships or to award damages. The proposed language provides, however, that any property held by the corporation for charitable purposes, as well as property that would not be distributable to members or shareholders upon dissolution, is not to be considered when determining the value of shares or memberships.

Corporate Reorganizations

Introduction
Most of the amendments proposed for the portions of the Nonprofit Act that deal with mergers and dissolutions are similar to amendments already made to the BCA. There are, however, a few differences:

Share Exchanges
The proposed amendments to the Nonprofit Act do not expressly provide for “share exchanges.” This is not because nonprofit corporations might not enter into such transactions, but rather because they might do so without being aware that the BCA currently requires the approval of the shareholders of the acquiring corporation. Nonprofit membership corporations such as trade associations or churches sometimes acquire similar organizations by becoming the sole member of the acquired corporation and allowing that corporation’s former members to join the acquiring organization. Under the current Nonprofit Act, that transaction, which could be made by amendment of the articles of the acquired corporation, would likely require the approval of the members of that corporation—but might not require any action by the members of the acquiring corporation. Adding provisions for share exchanges might mandate additional approvals on behalf of the acquiring corporation that could easily be overlooked.

Voting on Mergers and Dissolutions
The BCA and the Nonprofit Act currently require that all mergers, sales of all or substantially all assets, and dissolution be approved by a vote of a majority of the total shares or members entitled to vote. For some nonprofit corporations with large memberships, this requirement can effectively prevent such transactions from taking place. Unlike the BCA, Section 611 of the Nonprofit Act has always allowed article amendments to be approved by a majority of the members or shares actually voting. The proposed amendments to the Nonprofit Act add language to Sections 703a, 753, and 804 that would allow organizations with more than 20 members or shareholders to approve mergers, asset sales, and dissolution by a similar vote.

Asset Sales
The proposed amendments to the Nonprofit Act include language now contained in Section 753(1) of the BCA, which provides that shareholder approval of asset sales is not required when the corporation “retains a significant continuing business activity.” This should be very helpful to a nonprofit corporation, which might sell a building or another major asset without discontinuing its function. Under the BCA, the retention of activities involving more than 25 percent of an organization’s assets and contributing more than 25 percent of its revenues during the immediately preceding fiscal year are presumed to qualify. Many nonprofit corporations conduct activities that do not generate income or that are supported wholly or in part by donations, grants, or membership dues not specifically associated with a particular function. Accordingly, the proposed test under the Nonprofit Act is based on program service expenditures instead of on revenues.

Special Issues for Nonprofit Corporations
A number of the proposed changes are designed to meet the special needs of nonprofit corporations, including the following:

Voting by Mail and at Polling Places
Some nonprofit corporations have large memberships that are geographically dispersed or

Most of the amendments proposed for the portions of the Nonprofit Act that deal with mergers and dissolutions are similar to amendments already made to the BCA.
that, for other reasons, are unlikely to attend formal membership meetings held at a single place or at a single time. For this reason, some of those organizations currently elect board members and conduct other business through ballots mailed (or sent by e-mail) to members or shareholders. Other organizations, especially clubs, set up polling places at which members can cast ballots during specified periods.

While voting by mail or at polls may be a sensible method to secure widespread participation by members or shareholders, neither procedure is directly authorized by the current Nonprofit Act. It may still be possible to comply with present law by characterizing the ballots as proxies or as written consent resolutions, but this can be awkward. Many organizations do not, in fact, observe all of the technicalities necessary to be in full compliance with the statute. Therefore, the proposed amendments include new Sections 408 and 409 that allow nonprofit corporations to provide in their articles or bylaws for membership voting by regular mail, e-mail, or at polls. The proposal also addresses related practical issues, such as record dates, procedures for placing items on the ballots, and deadlines for receiving ballots.

Master Indenture Financings

Health systems often finance their activities through tax-exempt or taxable bonds issued pursuant to “master trust indentures,” which require that all participating entities in a corporate group pay all obligations issued under the master indenture. These arrangements may require a Michigan nonprofit corporation to discharge indebtedness issued on behalf of an out-of-state organization from which it has received no direct benefit. Accordingly, the proposed amendments to Section 251 add language that would specifically allow such activities.

Corporate Practice of Medicine and Other Professions

In the past, there has been active debate about whether nonprofit corporations such as hospitals and HMOs were empowered to employ members of the “learned professions,” particularly physicians. This debate was conducted both on substantive issues of health care policy and on technical readings of the Nonprofit Act. In 1993, the Michigan Attorney General issued a ruling that found that nonprofit—but not business—corporations have this right under existing law. The proposed amendments to Section 251 would make this holding an explicit part of the statute. The practice of law by corporations, meanwhile, is governed by a separate statute and is not intended to be affected by the proposed amendments.

Informal Activities

Some nonprofit corporations hold membership meetings at which no formal corporate business is conducted. For example, a trade association might hold a meeting to inform members about its legislative agenda, or a garden club might hold a meeting to discuss how best to cultivate roses. Many organizations carry out their functions by establishing committees comprised of employees and other individuals who are not directors or who do not exercise powers of the board. Sections 404 and 527 of the proposed amendments contain language that would specifically allow such activities.

Incorporation of Churches under the Nonprofit Act

The proposed changes to Section 251(1) would enable churches to incorporate directly under the Nonprofit Act. Currently, churches must incorporate under the un-repealed provisions of the General Corporation Act applicable to “ecclesiastical corporations,” or under separate statutes designed for churches of particular denominations. The latter tend to assume that the churches are controlled by their congregations. Since not all churches use that model, however, incorporation under the Nonprofit Act would provide another alternative.

Solicitation of Donations by Foreign Corporations

Under the proposed amendments to Section 1012, a foreign corporation located outside of Michigan would not need to qualify to do business here in order to solicit contributions in this state. The proposal is not intended, however, to exempt an out-of-state charity from any other regulations, including the requirement that it obtain a solicitation license from the Attorney General’s Office.

Pending Amendments to the BCA

The proposed Nonprofit Act amendments include some of the proposed amendments to the BCA that are currently before the
legislature. This pending legislation includes allowing a single mailing to multiple shareholders residing at the same address, providing for subcommittees, and dealing with the effects of abstentions. The Nonprofit Corporations Committee decided, however, that the provisions of two bills were not appropriate for nonprofit corporations: HB 5317, which would require board action on article amendments, and HB 5323, which deals with termination of employment as “shareholder oppression.”

Related Legislation

The proposed amendments to the Nonprofit Act raised issues under two other statutes. Therefore, changes are being proposed to those laws as well.

Uniform Management of Institutional Funds Act (“UMIFA”)

Enacted in 1976, this statute governs the investment and expenditure of endowment funds and includes an “ordinary business care and prudence” standard of care. Under the provisions of the current Nonprofit Act, UMIFA takes precedence over any conflicting provisions of the Nonprofit Act. The proposed amendment to UMIFA would ensure that any limitations on the liability of directors and volunteer officers included in the articles of incorporation under the Nonprofit Act would also apply to obligations arising in connection with the investment and expenditures of endowments that are governed by UMIFA.

Dissolution of Charitable-Purpose Corporations

A 1965 statute provides for the attorney general’s involvement in the dissolution of corporations formed for charitable purposes. For many years, the Charitable Trust Division of the Michigan Attorney General’s Office has taken the position that mergers of charitable corporations are also subject to its approval under this statute. From a charity’s point of view, it is better that a merger not be characterized as a “dissolution,” since that could affect its eligibility to receive outstanding bequests or impair its title to donor-restricted assets. The proposed amendments to the dissolution statute provide for the attorney general’s continuing regulation of these mergers, as well as the conversion of charitable corporations to business or professional service corporations, without characterizing such transactions as “dissolutions.”

Conclusion

At the time that this article was written, the proposed legislation was still in the bill-preparation stage and had not yet been introduced in the legislature. It is likely that the proposed bills will be revised before they are enacted. Therefore, any comments on the proposals or suggestions for other matters that might be addressed are still welcome. They can be sent by e-mail to jforbes@dykema.com.

NOTES

1. MCL 450.2101 et seq.
2. MCL 450.1101 et seq.
3. MCL 450.2301.
4. MCL 450.1209.
5. MCL 450.2209(c).
6. MCL 450.1488(1).
7. In the proposal, the applicable language is moved from Section 488 to new Section 209(f).
8. MCL 450.2491 et seq.
9. MCL 450.1489.
10. MCL 450.1703a.
11. MCL 450.2611.
12. MCL 450.1753(1).
13. OAG No 6770 (Sept 17, 1993).
14. MCL 450.681.
15. MCL 450.178 et seq.
16. MCL 451.1201 et seq.
17. MCL 451.1207.
18. MCL 450.2124.
19. MCL 450.251 et seq.

Jane Forbes, of Dykema Gossett PLLC, Detroit, practices in the areas of health law and nonprofit and charitable organizations law. Ms. Forbes has extensive experience representing health care organizations, foundations, rural electric cooperatives, trade associations, and other nonprofit institutions. This work includes issues related to tax-exempt status under federal and state law, organization and reorganization of corporations and corporate groups, mergers and acquisitions, finance, insurance and self-insurance and public institutions. Ms. Forbes has served as an adjunct professor of Law at Wayne State University, teaching courses on tax-exempt organizations in its graduate tax program. She is the principal author of the Michigan Municipal Health Facilities Corporations Act and the current co-chairperson of the Nonprofit Corporations Committee of the State Bar of Michigan.
Proposed Revisions to the Charitable Solicitations Act

By John F. Fleming

Background
Most states have enacted regulations governing charities and the solicitation of charitable giving,1 with the purpose of gathering information about nonprofit organizations and preventing donor fraud. Legitimate charitable organizations are forced to comply with sometimes very different regulations in each state where they do business, but this fractured regulatory environment has no real impact on fraudulent conduct, which always seems especially pronounced whenever a new disaster strikes.

These are not new complaints. In October 1986, the National Association of Attorneys General Committee on Trusts and Solicitations drafted a proposed model act related to the state registration of charities and the regulation of solicitations made on their behalf. This came at a time of uncertainty, when many of the regulatory enforcement techniques that had been applied to charitable solicitations were being struck down as unconstitutional by the U.S. Supreme Court.2 The proposed law addressed a two-fold objective of (1) providing for the registration of charitable organizations and fund-raising professionals, thereby facilitating the public disclosure of information related to charities; and (2) providing an arguably constitutional enforcement regime to prevent donor fraud and overreaching by professional fund-raisers.

This model act, however, was not universally adopted by the states,3 and 20 years later the same concerns exist about keeping prospective donors informed about charities and appropriately sanctioning offenders. With the growing use of the Internet to solicit donations and spread information about charitable causes, the need for uniformity of regulation and enforcement remains an important issue.

Michigan has taken a step toward uniformity by proposing substantial amendments to the Charitable Organizations and Solicitations Act, MCL 400.271 et seq. (the “Act”). In terms of registration requirements, this proposed legislation4 is generally similar to the model act and to the regulations of most states. The enforcement regime, however, would be unique to Michigan, imposing significantly greater burdens on offenders and prohibiting a wide array of questionable conduct. As with all legislation, the effectiveness of its enforcement is the bottom line. Without concrete and consistent action against violators, regulatory requirements will have no meaningful impact and the legislation’s professed objectives will not be achieved. The bill, SB 1115, is sponsored by Senator Thomas George and is still before the Committee on Commerce.

Purpose of Revisions
The stated purpose of the proposed revisions is to provide for the registration of charities, through which the public disclosure of certain information would be mandatory. In connection with this, limitations would be imposed on the business practices of charities when they engage in the solicitation of funds.5 Nonprofits are the targets of the legislation, as are “professional fund-raisers,” those for-profit entities hired to raise funds on behalf of a charity. The unstated but implied message is that unscrupulous activities and the nondisclosure of pertinent information will not be tolerated. This intent is clear from the expansion of the terms defined in the legislation and from the description of the conduct expected of charitable organizations and of the fund-raisers acting on their behalf. Some of the more significant changes to the Act are noted below.

Changes to Definitions
Some provisions of the proposed legislation are more helpful than the current law. The amendments clarify, for example, the different types of organizations that are subject to the new provisions. A “charitable organization” would be defined as any entity that is tax exempt under IRC 501(c)(3), including any person or entity whose activities are described under that section, regardless of whether the entity has obtained a tax-exempt certificate from the IRS. Instead of a “benevolent, educational, philanthropic, humane, patriotic, or eleemosynary organization,”6
any person or entity that fits within this new definition of a charitable organization would be subject to the Act.\textsuperscript{7}

Under current law, a “duly constituted” religious organization is exempt from the provisions of the Act, as is an organization “affiliated with and forming an integral part of a religious organization no part of the net income of which inures to the direct benefit of any individual if it has received a declaration of current tax exempt status.”\textsuperscript{8} The proposed amendments simplify the exclusion of religious organizations from the definition of a charitable organization by indicating that any organization established for religious purposes is exempt, regardless of its tax-exempt status.\textsuperscript{9}

The definition of a “contribution” is essentially retained as “the promise, grant, or payment of money or property of any kind or value, including the promise to pay.”\textsuperscript{10} One difference in the definition relates to situations in which a nonprofit assesses a membership fee. Current law excludes membership dues or fees from the definition of a contribution if some benefit other than the right to vote is conferred on a member in exchange for that fee.\textsuperscript{11} The proposed “contribution” definition, to the contrary, includes membership fees, but only to the extent that the amount received exceeds the value of the benefits made available to a member. In this regard, if a premium is given to a person in exchange for becoming a member of a charitable organization, the amount of the dues paid by that person in excess of the value of that premium will be considered a contribution. In addition, if the membership fee is used primarily to support the charitable organization’s activities (and it is difficult to think of a situation in which the fee would not be used for such a purpose), it also will constitute a contribution, regardless of the amount.\textsuperscript{12}

The revised definition of a “professional fund-raiser” continues to describe a person or entity paid to conduct, manage, or carry out a campaign to solicit contributions on behalf of a charity. This includes an officer or employee of the charitable organization if his or her compensation is based on the amount of money he or she raises. As with the current law, while religious organizations are not subject to the regulation of this statute, a professional fund-raiser who is retained by a religious organization to raise funds is subject to regulation and to the registration requirements of the act.\textsuperscript{13} This particular definition, like the model act and the regulations in place in many states, now explicitly distinguishes between those professionals who raise and handle money for the charity and those who only advise a charity about raising funds. If a person is only providing training or advice, or is only hired to prepare documents like grant applications or solicitation materials, then he or she is not considered a professional fund-raiser and is not subject to registration.\textsuperscript{14}

Nearly every conceivable method of requesting funds on behalf of a charitable organization is included in the new definition of “solicitation.” The revision lists the typical methods, including direct requests in person, by telephone, or through the mail, as well as any announcements made in the media or any sale of merchandise for a charitable purpose.\textsuperscript{15}

\textbf{Registration Requirement}

One of the more significant changes proposed is the requirement that all charitable organizations, and all professional fund-raisers, be registered with the Michigan Attorney General’s Office. Currently, any charity that seeks to solicit or that receives donations in this state faces a license requirement; a special solicitation license is required if a charity solicits or receives donations of more than $8,000. Even if the charity knows that it will not receive donations exceeding that amount, it still must file an initial application with the attorney general and provide some basic documents, including the articles of incorporation and any filed certificates of an assumed name. The organization’s bylaws or constitution also must be included, together with any determination from the IRS about its tax-exempt status. The attorney general then will determine whether a license is required and, if so, the organization must apply for that license and provide more information, including its purpose, its founding date and location, the name and address of any officers or directors, the purposes for which the solicited funds will be used, and whether or not it has ever been enjoined from soliciting donations. Finally, and maybe most importantly to state regulators, the organization must provide a copy of any contract with a professional fund-raiser.\textsuperscript{16}

Replacing the license requirement with mandatory registration may initially seem to be more a matter of form over substance,
but there are some major differences with registration, including the following:

- **Minimum Staff.** To be registered and properly solicit and receive donations in this state, an organization must have at least two directors, trustees, or members. This requirement may have been added in response to suspicions about organizations that can only muster the administrative support of the founder.

- **Contact Information.** The organization must provide for public review its name and any name it uses to solicit funds. This would presumably include any name it uses in any jurisdiction. The organization also must disclose the address and telephone number of the principal office and of any offices in this state from which it conducts business.

- **Professional Fund-Raisers.** The entity must identify any professional fundraisers it uses.

- **Tax-Exempt Status.** As with the current law, the organization must affirm that it is tax exempt and provide the IRS determination letter to this effect.

- **Previous Penalties for Solicitation.** In an apparent attempt to ensure against the fraudulent solicitation of money, the charity must disclose whether it, or any of its principals, has ever been penalized as a result of a solicitation campaign. This disclosure is more specific than the current requirement, which seeks information only about injunctions issued against the entity itself.

- **Staff Interest in Any Fund-Raising Business.** The organization must disclose whether any officer or director, or even any employee, has an interest in any fund-raising business.\(^\text{17}\)

- **Financial Documents.** The organization must submit whatever informational returns it provides to the IRS, i.e., Form 990. If the entity is not required to file a 990, it still must provide the attorney general with at least a pro forma of that return. Financial statements also must be submitted. If an organization receives $500,000 or more in contributions, those statements must be audited. Organizations receiving between $250,000 and $500,000 can submit financial statements that have been reviewed but not audited.\(^\text{18}\)

### Record Retention

Revised MCL 400.274 is more specific about the records that a charity must maintain. For instance, the organization would be required to retain for three years a copy of the registration of any professional fund-raiser it uses, and both the organization and the fundraiser must keep copies of any contracts for six years after the end of any solicitation campaign.\(^\text{19}\) While the current law provides that “accurate and detailed books and records” must be maintained,\(^\text{20}\) the proposed law is more explicit, specifying that the nonprofit must maintain all records that are required for registration. If a charity solicits or obtains money in Michigan or from Michigan residents, a written record must be kept of those funds and of how they were used. If any action was taken against a charity related to the solicitation of funds, records of that investigation also are subject to disclosure. Although it has been a relatively common practice to enter into confidentiality agreements whenever an investigation is conducted into the solicitation practices of a charity, those agreements would be specifically prohibited.\(^\text{21}\)

### Immediate Effect of Registration

Unlike the current license requirement, registration would be immediately effective upon the submission of a proper registration request, without the delay of waiting for the license to be issued. A registration could be rescinded or suspended, however, for reasons such as misrepresentations, omissions, or deficiencies in the registration application. The attorney general would be required to notify the organization of any such deficiencies within 30 days. If the current Act is vague about revoking or suspending a license, permitting this only after a notice and hearing, the revision specifically states that the Administrative Procedures Act of 1969, MCL 24.201–.328, applies to any rescission or suspension of registration.\(^\text{22}\)

If a solicitation license is required and issued, existing law provides that the license will expire one year after the date of issuance, and that to renew it an application must be submitted at least 30 days before the expiration date set forth on the license.\(^\text{23}\) The registration under the proposed act would be in effect for up to 18 months after the end of the fiscal year during which the registration was first effective, unless the registration is renewed. However, the proposed
act also provides that a registered organization must “report on its previous fiscal year and renew its registration within 6 months after the close of its fiscal year.” While still technically registered 6 months after the end of its fiscal year, an organization could be in violation of the act if it waits more than that 6-month period to renew. Also, an organization that once was registered but that no longer fulfills the registration requirements (such as a nonprofit that receives donations of more than $25,000 one year but less than that in a subsequent year) still must report to the attorney general.25

Registration Fees
The revised act introduces a registration fee, which would be based on the amount of contributions received. Under proposed MCL 400.275, an entity receiving less than $100,000 in a fiscal year would pay a fee of $35. This would increase incrementally, to a maximum $250 fee for organizations receiving more than $5 million in donations. Professional fund-raisers would pay a flat fee of $300, which could be significant for those charitable organizations that pay employees based on the amount of contributions generated or received. Technically, such employees are professional fund-raisers and are subject to the registration requirements of the act, meaning that each such employee would be required to register and pay the fee.26

Exemptions
The current statute provides that certain organizations are exempt from the license requirements. One example is an organization that receives donations of less than $8,000 during any 12-month period, provided that all of its fund-raising activities are conducted by volunteers and that the charity supplies the public and its members with a financial statement. This means that any charity receiving funds of more than $8,000 during any 12-month period—whether occurring in separate fiscal years or not—must obtain a license.27

The proposed revisions increase the donation threshold to $25,000 and limit the calculation to the current fiscal year. However, the revisions maintain the condition that all fund-raising activities be conducted by volunteers, meaning that an organization that pays persons to raise funds on its behalf is still subject to the registration requirements, regardless of the dollar amount it receives in donations.28

Professional Fund-Raiser Requirements
The proposed amendments contain significant changes regarding professional fund-raisers. Currently, the Act requires fundraisers to file an application “in the form prescribed by the attorney general” and to post a $10,000 bond. Those persons whom the fund-raiser hires to solicit donations also must be registered as “professional solicitors.” In addition, the attorney general requires a summary of each contract that a fund-raiser has with a charitable or religious organization.

The new act, if adopted, would require more extensive disclosure from fund-raisers. In addition to paying the registration fee and posting a $25,000 bond, the professional fund-raiser must disclose, with its written application, the following:

- The date and jurisdiction of its founding;
- The location and telephone number of its principal office and of each office it maintains in this state;
- The name and business address of all persons involved in its management, such as officers, directors, owners, members, or managers;
- The name and address of any business that it operates that provides services or products to charitable organizations, or if any principal of a fund-raiser provides services or products to a charity, the name and address of that side business also must be disclosed;
- The name, address, and telephone number of all persons responsible for solicitation activities in this state;
- Any penalty the fund-raiser has faced as a result of soliciting contributions;
- All names currently or previously used to solicit donations;
- The principal methods through which it intends to solicit contributions; and
- The name, address, and telephone number of any charities for which it has agreed to provide services or solicit funds in Michigan, presumably referring to any agreement at any time.

The fund-raiser also must provide a complete copy of any agreement it has or has had with a charity. While the act as proposed does not specify that the contract to be provided relate only to solicitation activities, that is presumably the intent of this section.
If the fund-raiser has hired someone else to conduct solicitation activities, that agreement also must be provided. The proposed act appears to express a great concern over any potential ownership interest a fund-raiser might have in a charitable organization, and any such relationship must be disclosed, if the fund-raiser is acting on behalf of that charity.\textsuperscript{30}

One of the concerns that has been raised over the years is the sometimes significant amount of fees paid to a professional fund-raiser to conduct a fund-raising campaign. Previous legislation has focused on limiting the amount that a fund-raiser can take from the funds solicited, but, as indicated above, these acts have been declared unconstitutional as an unjustifiable restraint on the exercise of free speech.\textsuperscript{31} In an apparent attempt to make potential donors more aware of how their donated funds are applied, the proposed act would require the fund-raiser to submit to the attorney general a financial report detailing the gross receipts and all expenses of the solicitation within 90 days after the campaign is completed. For campaigns lasting more than one year, the report would be due on the anniversary date of the beginning of that campaign.\textsuperscript{32} While compelled disclosures from the fund-raiser directly to the potential donor have been declared unconstitutional for hampering “the legitimate efforts of professional fund-raisers to raise money for the charities they represent,” the U.S. Supreme Court has suggested that a state can collect this kind of information and make it publicly available.\textsuperscript{33}

Prohibited Conduct

Another major change in the proposed legislation is the addition of sections detailing specifically prohibited conduct. Certain types of conduct are proscribed, including any action that violates the statute. Apparently designed to avoid misrepresentations or the omission of information that would be helpful to prospective donors, the revisions include the following prohibitions:

- Misrepresentation. A fund-raiser cannot represent himself or herself as sponsored, approved, or affiliated with a charitable organization when he or she is not so affiliated. Similarly, a fund-raiser cannot represent that a contribution is to be used for a charity or a charitable purpose unless specifically authorized by the charity to make such a representation.

- Use of misleading name or symbol. The fund-raiser cannot use a name or other symbol that could confuse or mislead a potential donor about whether or not the fund-raiser is acting on behalf of a charity. Certainly, the use of a bogus, fictitious, or nonexistent organization is prohibited.

- Misrepresentation of amount to be given to charity. Any false representation or suggestion that an amount or percentage of a contribution will be given to a charitable organization is prohibited. A fund-raiser who implies that “proceeds” will be provided to a charity, when in fact the fund-raiser intends to take substantially all of the contribution for “administrative” expenses, could run into problems with this particular section of the statute if a donor is left with the impression that “proceeds” means something more than a token amount. In addition, and understandably, solicited contributions cannot be diverted to some other purpose or to some organization other than the charity.

- Registration. The act also requires both the charity and the fund-raiser to verify that the other is properly registered. A fund-raiser also cannot make any representation that registration under the act constitutes state endorsement or approval.\textsuperscript{34}

Vendor Regulations

The revisions also propose regulations of vendors, which are defined as persons, other than charitable organizations, conducting sales or solicitation campaigns using vending machines, honor boxes, or similar devices, such as the can on the counter of the local store where customers can donate loose change. A vendor cannot conduct any campaign on behalf of a charity that is not registered in the state, apparently regardless of the amount of funds raised. In addition to identifying the charity at the point of donation, a vendor also must disclose the percentage of sales that the charitable organization will receive, as well as the specific amount the organization will receive regardless of sales.\textsuperscript{35}

Disclosure Requirements

In a solicitation campaign, the charitable organization on behalf of which the solicitation is made must be identified by name, city, and state. In addition, the fund-raiser must identify his or her name and specify
that the solicitation is being conducted by a professional fund-raiser. This new requirement seems designed to ensure that potential donors are aware of exactly which organization will be receiving the donated funds and that an organization is being paid to solicit those funds.

**Certain Pledges Unenforceable**

Interestingly, oral contribution promises that are made in telephone or door-to-door solicitations would not be enforceable under the proposed revisions as written. This would make the telephone solicitation a different experience. While direct contact in this fashion is not prohibited under the revisions and even appears to be expected (hence the number of requirements related to verbal disclosure of the charity and the relationship with the fund-raiser set forth in proposed MCL 400.289a), this section certainly makes it more difficult to conduct a typical campaign and will probably require the fund-raiser or charity to follow a pledge with a written verification.

**Penalties for Violations**

A violation of the Act obviously can result in a suspension or revocation of a solicitation license, but it also may result in a criminal prosecution, as certain violations constitute misdemeanors. The proposed revisions are more specific about the nature of the violations that will result in the imposition of a penalty. The revisions also increase the penalties for certain conduct.

For instance, while certain conduct remains as misdemeanor violations, the proposed law treats the diversion of funds in an amount exceeding $1,000 as a felony, punishable by imprisonment of up to five years and a fine of up to $20,000. Knowingly misusing a name confusingly similar to a charity’s name, misrepresenting how proceeds will be applied, or conducting a solicitation campaign without being registered could all result in a felony conviction if more than $5,000 is received through these activities. The knowing submission of false information to the attorney general also constitutes a felony under the proposal.

**Conclusion**

The proposed revisions would significantly change the manner in which charities and their fund-raisers solicit donations in Michigan and should provide substantial protections to potential donors. The revisions related to the penalties for violating the Act appear particularly directed at the bogus charity or the less-than-honest fund-raiser. For legitimate and properly operated organizations, this kind of regulation imposes a burden that would not otherwise be necessary.

If these proposals are adopted, they must be enforced to ensure that further revisions—imposing more stringent measures to combat fraudulent solicitation campaigns or to require secretive organizations to inform the donating public about their affairs—will not be necessary.

**NOTES**

1. Thirty-eight states and the District of Columbia have enacted statutes concerning the solicitation of funds on behalf of charitable organizations. Because many of these acts do not preempt municipal or other ordinances, many local governments also weigh in on the regulation of charitable activities within their jurisdictions.


3. Some states, including Connecticut, whose then attorney general, Joseph Lieberman, was chairperson of the committee that drafted the model act, did ultimately adopt most of the act’s provisions as written. See *Conn Gen Stat 21a-190a*. Other states, including Michigan, retained the basic framework of regulations then in effect.


5. The prohibited conduct identified in the proposed MCL 400.288 is similar in nature to some of the unfair business practices identified in the Michigan Consumer Protection Act at MCL 445.903.

6. MCL 400.272(a).
7. Proposed MCL 400.272(a).
8. MCL 400.272(a).
10. Proposed MCL 400.272(e).
11. “‘Contribution’ means the promise, grant, or payment of money or property of any kind or value, including promises to pay, except payments by members of an organization for membership fees, dues, fines, or assessments, or for services rendered to individual members, if membership in the organization confers a bona fide right, privilege, professional standing, honor, or other direct benefit, other than the right to vote, elect officers, or hold offices ...” MCL 400.272(b) (emphasis added).

12. Proposed MCL 400.272(e).
13. Proposed MCL 400.272(h).
14. This exemption applies only if all materials created or prepared by that person are subject to approval by the charity, if all requests for grants are submitted by the charity, if the person is not engaged in the direct

**The proposed revisions are more specific about the nature of the violations that will result in the imposition of a penalty. The revisions also increase the penalties for certain conduct.**
solicitation of funds, and if his or her compensation is not based on the amount of funds which the charity receives. 

15. Proposed MCL 400.272(i).
16. MCL 400.273.
17. Proposed MCL 400.273(1)(j).
18. Proposed MCL 400.273(2).
19. Proposed MCL 400.274.
20. MCL 400.278.
21. Proposed MCL 400.278.
22. Proposed MCL 400.275.
23. MCL 400.277.
25. Id.
26. See Proposed MCL 400.272(h).
27. MCL 400.283.
29. MCL 400.287.
30. Proposed MCL 400.287.
32. Proposed MCL 400.287(5).
33. Riley at 780-781.
34. Proposed MCL 400.288.
35. Proposed MCL 400.289.
36. Proposed MCL 400.289a.
37. Proposed MCL 400.292a.
38. MCL 400.290, .293.
39. Proposed MCL 400.293.

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Introduction

“We’re only giving away door prizes. That’s not a raffle.”

If you are on a charitable organization’s board and you hear that comment, be afraid. Attorneys are often asked to serve on boards to lend their experience and expertise. This article will give you enough knowledge to ask the right questions and keep your organization compliant with Michigan’s charitable gaming laws.

Background

Until roughly thirty years ago, this state was hostile to all types of gambling except wagering on horse races. Michigan’s first constitution, adopted in 1835, stated that “[n]o lottery shall be authorized by this State nor shall the sale of lottery tickets be allowed.” The subsequent Michigan constitutions of 1850, 1908, and 1963 contained similar prohibitions, expressly precluding the Legislature from authorizing lotteries. Wagering on horse racing was allowed after the supreme court’s 1946 ruling that this was not a form of prohibited lottery.

Michigan’s policy toward gambling shifted dramatically in 1972, when voters approved a constitutional amendment reversing the lottery ban. New language stated that “[t]he legislature may authorize lotteries and permit the sale of lottery tickets in the manner provided by law.” The legislature quickly established a state lottery and provided for charitable organizations to raise funds through raffles and Las Vegas-style events at which people could engage in limited-stakes, casino-style gambling.

Shuffle Up and Deal: A Primer on Charitable Gaming in Michigan

By Sandra M. Cotter and Jason Hanselman*

Gaming is Legal Only When Conducted Legally

Michigan law prohibits gambling unless authorized pursuant to the Bingo Act (charitable gaming), the Michigan Gaming Control and Revenue Act (commercial casino gaming), the Horse Racing Law (parimutuel wagering), and the Lottery Act (the Michigan Lottery). The Michigan Penal Code provides criminal penalties for gambling activities occurring within the State of Michigan that are not specifically authorized under Michigan law. Individuals involved in unauthorized gambling may be prosecuted for a misdemeanor that is punishable by up to one year incarceration or a fine of up to $1,000. While an organization’s intent in engaging in charitable gaming activities may be pure and charitable, it is important that the organization and its board operate within the confines of the law.

Certification—Obtaining a License

Only certain nonprofit organizations that are organized for charitable purposes are eligible to conduct charitable gaming. All of these organizations must secure a charitable gaming license (“License”) before hosting any event. Licenses are specific to each type of event and require an eligible organization to submit an application to the Bureau of State Lottery (the “Bureau”). Although the required materials vary slightly for each type of organization, generally speaking all applications must include the following:

- the articles of incorporation
- a copy of the organization’s current bylaws or constitution

* The authors wish to thank Shaun Johnson for his assistance with this article.
common pitfall does not allow gaming events for the Bureau to process its application. The most common pitfall for charitable gaming events is that the organization does not allow enough time for the Bureau to process its application.

Types of Events

Millionaire Party

A millionaire party is probably what most people think of when they hear the term charitable gaming: a typical Las Vegas-style event at which players wager on games of chance, such as blackjack, poker, and craps. A millionaire party application requires a $50 fee for each day the organization plans to host the event. A license may be issued for up to four consecutive days, but qualified organizations may receive only four millionaire party licenses per calendar year.

Several regulations govern the staff who run millionaire parties. The licensed organization first must appoint a chairperson who will oversee and be present during the entire event. The chairperson must have been an organization member for at least six months, should understand all applicable rules and regulations, and is responsible for ensuring that all the appropriate forms are filed. The organization may pay the chairperson up to $50 a day for these services.

Organizations must also appoint several different types of event workers, including cashiers, pit bosses, and dealers, who are responsible for engaging in certain functions and completing specific forms provided by the Bureau. At least 50 percent of workers must be members of the organization or the spouses of members, and all workers must be at least 18 years old. Workers are prohibited from playing games on which they are working or assisting, and they cannot split prizes with players or accept tips. While not on duty, however, a worker may participate in games if he or she pays all fees in the same manner as other players. Except for raffle ticket sellers, all workers can be paid up to $30 a day by the licensed organization.

Michigan law also dictates which games can be played at millionaire parties and how these games must be conducted. The Bureau has authorized playing the following: wheels; roulette; dice games in which the players compete against the organization; blackjack; let it ride; seven card stud; and Texas hold ‘em. Let it ride, seven card stud, and Texas hold ‘em all have specific rules published on the Bureau’s Web site. Wagering on athletic events or games involving personal skill is prohibited.

Only the use of Bureau-authorized equipment is acceptable. The organization must use equipment that it obtains free of charge or that it owns, rents, or purchases from a licensed supplier, unless the Bureau grants prior written permission. The organization may not spend any percentage of the event’s revenue or net profits on equipment, and all equipment used at a rental location must be removed within two days of the event. In addition, players may use only imitation money or chips, purchased only from authorized sellers.

All millionaire parties must occur between 8:00 a.m. and 2:00 a.m. The Bureau does not specifically regulate where a millionaire party may take place, but if the organization rents a location, a written agreement including all rental terms must be approved by the Bureau. The rental agreement may not be based on a percentage of profits
earned at the event. The location owner must not participate in any manner in the operation or management of the event or rent equipment for the conduct of the event. The organization must post its License and keep the License application on site and available for review.

Regulations limit an organization’s profits to $15,000 per day, and all proceeds must be used for lawful purposes of the organization. An individual is limited to $500 in winnings for each day of the event, although this amount is exempt from state and local taxation.

Raffle

The most common types of raffles are “50-50” drawings or drawings for door prizes. The Act provides for two different types of raffles: “small raffles,” in which prizes do not exceed $500 during one occasion, and “large raffles,” in which the prizes total more than $500 per occasion. For a small raffle, the license fee is $15 for one to three dates, or $5 per drawing for four or more dates. The large raffle fee is $50 per drawing.

If a qualified organization sells all raffle tickets at a single gathering, makes the drawing at that same gathering, and does not award more than $100, no license is required. If the organization is already hosting a licensed millionaire party, the Bureau does not require a separate license for holding a raffle at that party. However, for millionaire-party raffles, an organization cannot sell tickets before the event, must only sell tickets in the gaming area, and must award the prize that same day.

Regulations governing raffle personnel differ slightly from those for millionaire parties. For example, to sell raffle tickets on behalf of an organization, an individual does not have to be a member of that organization, although anyone selling tickets must be at least 18 years old. If an organization wishes to reward its ticket sellers, an incentive prize may be established, but the organization must be mindful that ticket sellers cannot receive direct payment for their efforts. Instead, the organization can establish an incentive prize to be awarded to the top raffle ticket seller, to the seller who sold the winning ticket, or to a seller determined by a drawing; if another method is used, this must be approved in writing by the Bureau. The only stated limitations on incentive prizes are that the prize amount must be included in the prize limitation for small raffles, and that the prize must be “reasonable.”

For raffles held at millionaire parties, an organization must appoint to oversee the raffle event a chairperson who has been an organization member for at least six months, is present at the event at all times, and is readily identifiable to all persons attending the raffle. The chairperson should review the applicable law before the raffle, and an attorney board member can help ensure that the chairperson truly understands how to conduct the event.

Attorney board members also can help ensure that the form of the raffle ticket complies with regulations. All raffle tickets not sold at a millionaire party must include the following:

- the organization’s name and license number
- the word “raffle”
- the date, time, and location of the drawing
- the top prize for the drawing
- the price of an individual ticket
- a unique sequential number, used to track each purchaser, printed on both the ticket and ticket stub
- a space for the ticket purchaser’s name, address, and phone number

In addition, no raffle ticket may use the words “lotto” or “lottery” or involve removing material to determine the winner, i.e., a scratch-off ticket.

The organization must draft house rules for the event detailing its refund policy, a “rain date” if the drawing cannot be held on the planned day, and the process for selecting a winner. If the organization wants to determine the winner other than by randomly drawing a ticket stub, it must obtain the Bureau’s written approval. The house rules also must list the price of tickets and the organization’s name and license number. The rules must be prominently displayed at the raffle, along with the organization’s license, and should be printed for distribution at the event.

Michigan law strictly prohibits the organization itself from purchasing tickets, but any individual organization member over the age of 18 may purchase a ticket. After the tickets are purchased, their stubs must be placed in a bin that gives each ticket an equal chance of being drawn. The organization must announce before the drawing the order

**Attorney board members can help ensure that the form of the raffle ticket complies with regulations.**
in which it will draw winners, and it must draw only one ticket at a time. Every prize must be awarded, with nothing forfeited to the organization. If a winner is not present at the drawing, the organization must make a “diligent effort” to find him or her. If the winner cannot be located after 60 days, the organization must have another drawing using the same pool of tickets, or obtain written Bureau approval to donate the prize to a nonprofit organization with a charitable purpose. Unless it was a small raffle, the organization must submit a financial statement to the Bureau by the tenth day of the month following the month that the raffle was held.

Bingo games are more regulated than both millionaire parties and raffles.

An organization may use only authorized equipment and must keep all equipment in good repair. If the organization hosts its bingo games at a leased location, the organization may also lease the equipment from that location, as long as the lease document provides for the use of the equipment and the Bureau approves this contract. Alternatively, the organization may rent equipment from a licensed supplier.

Each event also must have its own set of house rules, including a contingency plan for emergencies like power outages or broken equipment. The rules must explain what workers will do with the bingo cards if there is an emergency break in the game, and whether a person may play another person’s cards or make another person’s bingo known.

Bingo

Bingo normally involves a series of games played consecutively by the same people. In carnival-style bingo, however, players enter and leave the event at various times. Large bingo games are a series of bingo games that occur on a regular basis and where the total value of prizes awarded at one occasion does not exceed $2,000, with no award for a single game exceeding $500. Small bingo games also are a series of games occurring on a regular basis; the total value of prizes awarded at one occasion cannot exceed $300, and the total award for one game cannot exceed $25. Special bingo, in contrast, is a single or consecutive series of bingo games, with a maximum of $2,000 in prizes awarded at the single occasion and a maximum of $500 awarded for a single game.

Bingo games are more regulated than both millionaire parties and raffles. As for the other types of gaming events, the organization must appoint a chairperson who understands all applicable laws and regulations, who will oversee the fundraiser, and who will be present at all times. All bingo workers must be at least 18 years old, and at least 50 percent of them must be members of the organization or the spouses of members. Workers cannot participate in any game in which they are currently working, but they may stop working before a new game begins and participate in that game. No worker, location owner, hall employee, lessor, or concession worker may purchase a bingo card for anyone else, nor may those individuals share in any prize awarded to a player.

Workers may accept compensation as determined by the Bureau’s Service Compensation Schedule, but no worker may accept tips from players.
cards at a price equivalent to that charged for a regular card.\textsuperscript{81}

\textbf{After the Event}

Regardless of the type of charitable gaming event that an organization hosts, certain requirements apply after the event is over:

- \textbf{Accounting}. An organization must account for all cash, prizes, and equipment used during the event. It is estimated that approximately $500 million is wagered each year on charitable gaming and that approximately 5 percent of those funds are lost due to theft and accounting inaccuracies. Although this percentage may seem small, it amounts to more than $25 million lost by Michigan charities each year.

- \textbf{Recordkeeping}. The organization must keep all records pertaining to the event for at least three years after the event is over.

- \textbf{Spending}. All monies earned from the event must be devoted to the organization's lawful purposes.\textsuperscript{82} To ensure this, the Bureau may review all financial accounts into which the organization deposits funds earned from the event.

\textbf{Conclusion}

With the ever increasing popularity of gambling, charitable gaming events can be a fun way for an organization to raise money. Provided the Bureau's requirements are met, these events can be quite successful. However, while these regulations are relatively easy to understand, organizations are well advised to seek a lawyer's counsel before conducting a major event. In this way, attorney board members can provide a valuable service to their organizations.

\textbf{NOTES}

5. McCauley-Trader-Law-Bowman-McNeely Lottery Act, MCL 432.1 et seq.
7. \textit{Id}; see also MCL 432.203.
11. "Any person ... who, directly or indirectly, takes, receives, or accepts ... any money or valuable thing with the agreement ... that any money or valuable thing will be paid or delivered to any person where the payment or delivery ... is contingent upon the result of any race, contest, or game or upon the happening of any event not known by the parties to be certain, is guilty of a misdemeanor punishable by imprisonment for not more than 1 year or a fine of not more than $1,000.00." MCL 750.301.
12. Bona fide religious, educational, service, senior citizen, fraternal, or veterans' organizations operating without profit and for at least five years are eligible to host charitable gaming events. MCL 432.103(6).
13. For a complete list of each organization's application requirements, see the Bureau's directives, available at http://www.michigan.gov/cg/0,1607,7-111-1171---,00.html.
14. MCL 432.104.
15. AC, R 432.21205.
16. AC, R 432.21403.
17. Id. All such forms are available in the Millionaire Party Forms Packet, available at http://www.michigan.gov/cg/0,1607,7-111-35016_35023---,00.html.
18. AC, R 432.21412.
19. AC, R 432.21404.
20. AC, R 432.21412.
21. Id.
22. Id.
23. Id.
24. See Charitable Gaming Directive Nos. 4.01.01, 4.02.01, 4.03.01.
25. AC, R 432.21409.
26. AC, R 432.21406.
27. Id.
28. Id.
29. AC, R 432.21408.
30. AC, R 432.21409.
31. AC, R 432.21416.
32. Id.
33. AC, R 432.21811.
34. Id.
35. AC, R 432.21408, 21415.
36. MCL 432.110a(e); AC, R 432.21411.
37. MCL 432.111.
38. MCL 432.103a(16).
39. MCL 432.103a(4).
40. MCL 432.104a(1)(f).
41. MCL 432.104a(e).
42. AC, R 432.21502.
43. AC, R 432.21503. These raffles are known as "in-house" raffles. See AC, R 432.21501.
44. AC, R 432.21511.
45. AC, R 432.21514(1).
46. AC, R 432.21514(2).
47. AC, R 432.21517(1).
48. AC, R 432.21517(2), (3).
49. AC, R 432.21505(2), (4), (5).
50. AC, R 432.21506(1)(a)–(c).
51. AC, R 432.21506(1)(f), (g), (h).
52. AC, R 432.21506(2)(b).
53. AC, R 432.21506(2), (3).
54. AC, R 432.21510(1); AC, R 432.21513(2).
55. AC, R 432.21513(4).
56. AC, R 432.21513(10).
57. Drawings may only occur between 8 a.m. and 2 a.m. AC, R 432.21513(1).
58. AC, R 432.21513(11), (12).
59. AC, R 432.21515(1), (3).
60. AC, R 432.21515(3), (5).
61. AC, R 432.21522.
62. AC, R 432.21301(2)(c).
63. MCL 432.103a(3).
64. MCL 432.103a(15).
65. AC, R 432.21303.
66. AC, R 432.21326(1), (6).
67. AC, R 432.21326(2).
68. AC, R 432.21326(4).
69. Available at http://www.michigan.gov/cg/0,1607,7-111-34996_35015---,00.html.
70. AC, R 432.21326(7).
71. AC, R 432.21312(1).
72. Id.
73. AC, R 432.21313(1). A list of licensed suppliers is available at http://www.michigan.gov/cg/0,1607,7-111-34996_35012---,00.html.
74. AC, R 432.21314.
75. AC, R 432.21315(1).
76. AC, R 432.21315.
77. AC, R 432.21319.
78. AC, R 432.21318.
79. AC, R 432.21320.
80. AC, R 432.21311.
81. AC, R 432.21311(2).
82. AC, R 432.21105.

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Are Intermediate Sanctions on Tax-Exempt Organizations a Slippery Slope to Termination?

By Sean H. Cook

Introduction
As part of the Internal Revenue Service’s increased scrutiny of tax-exempt organizations, the Treasury Department has linked the excess benefit rules and private inurement rules in newly issued Proposed Regulations. These regulations offer guidance on when excess benefit transactions will contribute to the termination of an organization’s tax-exempt status.

The “excess benefit” rules were passed in 1996. Also known as the intermediate sanctions rules, the legislation is located in IRC 4958 and applies to IRC 501(c)(3) and 501(c)(4) organizations. The rules prohibit transactions that provide excess benefits to the recipients, with the intention of punishing the individuals who engage in the prohibited acts with the organizations without penalizing the organizations themselves. Before the passage of the intermediate sanctions, a tax-exempt organization that engaged in prohibited transactions risked the termination of its tax-exempt status. The goal of the intermediate sanctions was to protect the well-meaning tax-exempt organization and to punish, through assessment of material or severe excise taxes, those individuals who benefited from or approved the prohibited transactions.

IRC 501 uses the term “private inurement” to describe those prohibited transactions that will result in the termination of tax-exempt status. Under the private inurement rules, an organization that provides an impermissible private benefit to an individual or individuals risks the loss of its tax-exempt status or the denial of its application for this status.

The IRS has also revised Form 1023, Application for Recognition of Exemption, and Form 990, Return of Organization Exempt from Income Tax, to further increase its enforcement of excess benefit transactions.

Who is Exposed
The intermediate sanctions impose excise taxes on “disqualified persons” who engage in excess benefit transactions with “applicable tax-exempt organizations” and the “organization managers” who knowingly approve such transactions. The real target of the rules is any person who is “in a position to exercise substantial influence over the affairs” of the applicable tax-exempt organization. This includes persons who have voting rights on the board, or who are ultimately responsible for implementing board decisions or managing the organization’s financial affairs. The class of disqualified persons is rather broad and not necessarily based on such titles as president, chief executive officer, executive director, or chief operating officer, although these will create a presumption that their holders implement board decisions or manage the finances. The designation cannot be quickly reversed, as it remains in effect for a five-year period. Certain other tax-exempt organizations and certain non-highly compensated employees are exempt from this designation.

The identification of a disqualified person is a fact-intensive process. The Treasury Department has set forth the following factors that tend to suggest the existence of substantial influence:

1. The person founded the organization;
2. The person is a substantial contributor (i.e., has given more than 2 percent of the total contributions received by the organization), taking into account only contributions received by the organization during the current and previous four fiscal years;
3. The person’s compensation is based primarily on revenues from activities of the organization, or of the particular department or function that he or she controls;
4. The person has or shares the authority to control or determine a substantial portion of the organization’s capital expenditures, operating budget, or employee compensation;
5. The person manages a discrete segment or activity that represents a substantial
portion of the organization’s activities, assets, income, or expenses;

6. The person owns a controlling interest (determined by vote or value) in a corporation, partnership, or trust that is a disqualified person; or

7. The person is a non-stock corporation controlled directly or indirectly by one or more disqualified persons.

Likewise, the following factors tend to show that a person is not a disqualified person:

1. The person has taken a bona fide vow of poverty on behalf of or as an employee or agent of a religious organization;

2. The person is an independent contractor, such as an attorney, accountant, investment manager, or adviser, whose sole relationship with the organization is to provide professional advice (without decision-making authority) with respect to a transaction from which that person will not benefit economically, either directly or indirectly (except for customary fees for services rendered);

3. The direct supervisor of the person is not a disqualified person;

4. The person does not participate in any management decisions affecting either the organization as a whole or a discrete segment or activity that represents a substantial portion of the organization’s activities, assets, income, or expenses;

5. If the person is a donor, any preferential treatment that he or she receives based on the size of his or her donation is also offered to all other donors making comparable donations as part of a solicitation intended to attract a substantial number of contributions.

Once an individual is designated as a disqualified person, family members and 35-percent-controlled entities also are designated as disqualified persons.

In addition to persons who directly benefit from the transactions, organization managers who approve of excess benefit transactions also will be subject to excise taxes.

An excess benefit transaction is one in which the value received from the organization exceeds the value provided to the organization. The primary target is compensation or other payments for services, although all transactions with disqualified persons are included, such as leases and sales of property. The IRS already has the resources to attack unreasonable compensation as the result of previous challenges to the compensation levels paid by closely held C corporations, which have an incentive to cause compensation rather than dividends to be paid to shareholder-employees to avoid double taxation. The potential punishment for unreasonable compensation under IRC 4958, however, dwarfs the additional corporate tax burden of such a determination in the for-profit context.

As with the challenges to C corporations, any determination of an excess benefit

A person is considered to be an organization manager if he or she is given one of these designated titles in the organization’s governing documents or if he or she “regularly exercises general authority to make administrative or policy decisions on behalf of the organization.”

Note that decision making, as opposed to recommendation making, is the requisite standard to include a person based on his or her level of responsibility or authority, which will spare advisory committee members from being penalized. Also note that this definition can include members appointed to a compensation committee.

The excise tax on an organization manager will be assessed if the manager knowingly participates by action or silent acquiescence in an excess benefit transaction, unless the participation is not willful (i.e., voluntary, conscious, and intentional) and is due to reasonable cause. A “knowing” manager (1) has actual knowledge of sufficient facts so that, based solely on such facts, the transaction would have excess benefits; (2) is aware that the transaction could violate the prohibition against excess benefit transactions; or (3) either negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction or is already aware of such fact.

The difficulty lies in disproving these criteria. One of the criteria that would otherwise be met may be disregarded by either (1) the reliance on professional advice, or (2) the approval of the transaction under procedures qualifying for the rebuttable presumption of reasonableness.

Excess Benefit Transactions

An excess benefit transaction is one in which the value received from the organization exceeds the value provided to the organization. The primary target is compensation or other payments for services, although all transactions with disqualified persons are included, such as leases and sales of property. The IRS already has the resources to attack unreasonable compensation as the result of previous challenges to the compensation levels paid by closely held C corporations, which have an incentive to cause compensation rather than dividends to be paid to shareholder-employees to avoid double taxation. The potential punishment for unreasonable compensation under IRC 4958, however, dwarfs the additional corporate tax burden of such a determination in the for-profit context.

As with the challenges to C corporations, any determination of an excess benefit
transaction will be a fact-intensive process involving input from competing experts. The IRS has been selecting approximately 2,000 Form 990s filed for the 2002 tax year to test how these examinations have been working and to determine how they will progress in the future.

Currently, the determination of an excess benefit transaction proceeds as follows. The examining agent gathers evidence, likely with a predisposition toward certain audit target issues. If compensation is a target and the evidence does not reasonably support the compensation that was paid, or if the support is of questionable merit, the disqualified person can expect the agent to determine that an excess benefit transaction exists, subject to the 25 percent first-tier excise tax. The first-tier tax may be abated if correction action occurs and the excess benefit transaction was “due to reasonable cause and not to willful neglect.”

However, the disqualified person next needs to reverse the excess benefit on a gross basis, with interest, to avoid being held liable for the 200 percent second-tier excise tax. A disqualified person who decides to challenge the examination report will face many obstacles to a complete reversal.

The following example describes the effects of the correction rules. Ima Dogooder, as president of Charitable Giving, Inc., a 501(c)(3) organization, in year one receives annual compensation of $250,000. During an examination conducted in year three, it is determined that Ima’s salary should have been $100,000 and that the remaining $150,000 was an excess benefit to Ima, resulting in a proposed excise tax assessment of $37,500. Assuming Ima’s effective federal and state personal tax rate on this salary is 29 percent, the net-of-tax salary for year one is $177,500 (without regard to F.I.C.A.). To avoid a second-tier excise tax assessment of $300,000, Ima must pay back the $150,000 plus interest using the applicable federal rate before the earlier of (1) receiving a notice of deficiency, or (2) the date of assessment. This clearly is a financial disaster for Ima and would only be exacerbated by the examination of additional tax years. In addition, Ima is not the only party at risk, as the board or committee that approved this salary could be assessed a 10 percent excise tax of the excess benefit, up to $10,000 per transaction.

The excess transaction rules cover all benefits paid to an employee, with the exception of the following:

1. Nontaxable fringe benefits;
2. Expense-reimbursement payments from accountable plans;
3. Certain economic benefits provided to volunteers;
4. Economic benefits provided to members or donors solely on account of the payment of membership fees or charitable contributions, provided the same benefits are provided to non-qualified persons for the same payment and a significant number of non-disqualified persons make payments or contributions of at least this specified amount.

The rules do include an initial contract exception, based on the logic that a person must have a relationship with an organization to be a disqualified person with respect to such organization. The exception is limited to nondiscretionary payments, whether fixed or by formula. Also, the initial contract must be a written binding contract that cannot be terminated at will by the organization except for a lack of substantial performance. A material change, including a change in amount or renewal (other than an employee option to extend), will constitute a “new contract” not eligible for the initial contract exception.

The rules do provide some leeway for tax-exempts to compete with the for-profit sector for talented employees.

Can Tax-Exempts Compete for Talent?

Because of these rules, it may initially seem like tax-exempts will face extreme difficulties when competing with the for-profit sector for talent. With limited budgets and the goal of serving beneficiaries instead of shareholders, this has historically been the case. However, the rules do provide some leeway for the tax-exempts to compete for talented employees.

First, tax-exempt organizations can pay incentive compensation, so long as such compensation is reasonable. And second, a tax-exempt organization can use comparability data (i.e. salary surveys) for both the non-profit and for-profit sectors.

It remains uncertain, however, what impact that board decisions will have on compensation levels and arrangements in this atmosphere of heightened scrutiny. The impact may have been felt already by those boards that reacted promptly to the passage of intermediate sanctions. Less-diligent organizations may be facing a quandary, as they fear both the sanctions and the loss of talented managers.
Proactive Protection

The enforcement of the excess benefit rules should send chills to those boards, officers, and anyone else involved with a tax-exempt organization. However, for those who wish to protect themselves from the excess benefit scrutiny, there is hope in the form of the rebuttable presumption rules. These rules shift the burden of proof to the IRS by following a road map of approving transactions with disqualified persons. There has been much written recently about the best practices of tax-exempt organizations. The Treasury Department was ahead of the curve with respect to governing these transactions when the Temporary Regulations were adopted in early 2001.17

A rebuttable presumption of reasonableness is created when (1) the transaction is approved in advance by a governing body or committee composed of members who do not have a conflict of interest, (2) the approval of the transaction is made in reliance on appropriate comparability data, and (3) the basis for the determination is adequately and concurrently documented.

The critical issue is the determination of whether a conflict of interest exists. The regulations describe the absence of a conflict of interest, excluding any person who:

1. Is not the disqualified person or a family member;
2. Is not a subordinate of such disqualified person;
3. Is not receiving compensation or other payments subject to the approval of such disqualified person;
4. Has no material financial interest affected by the transaction or arrangement; and
5. Does not approve a transaction providing economic benefits to a disqualified person who has approved, or will approve, a transaction providing economic benefits to the member.

If a member of the board or committee making the determination of the financial arrangements with a disqualified person has a conflict of interest, he or she can help the organization establish the rebuttable presumption by (1) only meeting with the board or committee to answer questions, if at all; (2) recusing himself or herself from the remaining portion of the meeting; and (3) being absent during debate and voting on the transaction or compensation arrangement.19

The decision by the board or committee must be based on comparable data, including records of compensation paid by similarly situated organizations, reports prepared by independent consultants, other written offers to the person, or the availability of similar services in the geographic location of the organization. Small organizations (i.e., those with an average gross of $1 million or less) can simply rely on compensation data from three similarly situated organizations.20

The adequate documentation requirement can be met if the organization has a clear record of the board’s or committee’s evaluation of the proposed transaction or compensation arrangement and the following information is provided:21

1. The terms and approval date of the transaction;
2. The names of the governing body or committee members who were present during the debate and/or voted on the transaction or arrangement;
3. The comparability data the governing body or committee used, and how the data were obtained; and
4. The actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the governing body or committee but who had a conflict of interest with respect to that transaction or arrangement.

The IRS does not require a conflict of interest policy, but it does recommend one and even provided a sample in the instructions to Form 1023. One item on Form 1023 asks whether the applicant has adopted a conflict of interest policy and, if not, how the organization will approve transactions that may be subject to the excess benefit transaction rules. This is another example of the enhanced detection processes being implemented.

Sliding Toward Termination

The death sentence for a tax-exempt organization is the loss of its tax-exempt status, which results not only in new entity-level taxes but also in a loss of funding, since the entity will no longer be able to receive deductible contributions from the public. In addition, many grant providers condition funds on an organization’s tax-exempt status, and governmental agencies require it. In effect, the organization could spiral into

The IRS does not require a conflict of interest policy, but it does recommend one and even provided a sample in the instructions to Form 1023.
financial crisis. Even organizations that could otherwise survive as for-profits may lose customers who thought they were helping a noble cause. Employees also may decide to leave.

A recent termination case highlights this struggle. In *South Community Ass’n v Commissioner*, TC Memo 2005-285, the taxpayer operated an Ohio bingo hall and contributed significant proceeds to charitable organizations that were controlled by petitioner’s president. The founder, meanwhile, sold supplies to petitioner. The tax court upheld the termination of petitioner’s tax-exempt status. The initial question regarding the future viability of petitioner is whether a private enterprise can conduct a bingo operation in Ohio. If so, will the loss of its tax-exempt status have a negative impact on business and employee retention? This seems likely. However, as petitioner contributed significant dollars to charitable organizations, perhaps customers and employees will view petitioner as a victim of excessive governmental intrusion. Regardless, the founder and operator face many uncertainties about the future.

The *South Community* case concerned tax years occurring before the passage of the intermediate sanctions and how these sanctions could lead to termination. The new proposed regulations clarify the separate application of the private inurement rules and the intermediate sanctions while stressing that these are not mutually exclusive. The regulations even provide guidance to tax-exempt organizations regarding the effect that excess benefit transactions will have on their tax-exempt status, including the following factors that will be weighed in totality:

1. The size and scope of the organization’s regular and ongoing activities that further its exempt purposes before and after the excess benefit transaction(s) occurred;
2. The size and scope of the excess benefit transaction(s) (collectively, if more than one) in relation to the size and scope of the organization’s regular and ongoing activities that further exempt purposes;
3. Whether the organization has been involved in repeated excess benefit transactions;
4. Whether the organization has implemented safeguards that are reasonably calculated to prevent future violations; and
5. Whether the excess benefit transaction has been corrected or the organization has made good-faith efforts to seek correction from the disqualified persons who benefited from it.

Although conclusions cannot be drawn from the existence of only some of these characteristics, the safeguards and corrective-action factors (items 4 and 5 above) may be given more weight. The proposed regulations include several examples of how these factors should be weighed and advise that the analysis should be fact intensive.

**Observations and Recommendations**

The proposed regulations under IRC 501(c)(3) increase the punishments that can be unleashed on tax-exempt organizations and, in turn, increase the incentives to comply with the rebuttable presumption rules. These rules certainly belong on any best-practices list for the non-profit community. The excess benefit rules, it should also be noted, will be applied separately and irrespective of the adoption of best practices that may not meet the tough standards set forth by the rules.

The best defense may be a good offense in this arena. Organizations should create the rebuttable presumption to potentially avert an IRS attack on its reasonable compensation or valuation of transactions. An examining agent will be less likely to challenge transactions that were approved in accordance with these rules.

However, the rules potentially discriminate against smaller tax-exempt organizations in several ways. The comparability data exception is of little comfort, and the carve-out for non-highly compensated individuals is available only for subordinate employees. The rebuttable presumption rules may be harder to satisfy, because the people making the decisions are the same as those who founded and are running the organization. Finally, many small organizations will be required to build a good defense to meet the burden of proving the reasonableness of transactions with disqualified persons.

These same small organizations may find it difficult to attract outsiders to serve on their boards due to this intensified enforcement and perceived exposure. It is incumbent upon these organizations to adopt best practices to
operate as an organization separate from the interests of the people who make the organization serve the greater good.

All organizations should consider undertaking a legal review of their governance and operations or a mock audit based on the standards set forth by the intermediate sanctions. Many organizations may be operating in a way that differs from the governing documents adopted years ago, and an update of these may be worthwhile, as outdated documents will not help during an examination. Also, it is better to know that a conflict of interest exists rather than to assume incorrectly that a rebuttable presumption of reasonableness can be sustained. The stakes are too high in this new enforcement environment, and the demands of other interested parties too important, to ignore best practices and the intricacies of the excess benefit excise tax rules.

NOTES
2. IRC 4958 (a)(2), (e), (f)(1).
4. Id.
5. Treas Reg 53.4958-3(d).
6. Treas Reg 53.4958-3(e)(2)(i)–(vii).
8. Treas Reg 53.4958-1(d)(2).
10. Treas Reg 53.4958-1(a).
13. IRC 4958(c); Treas Reg 53.4958-4.
14. IRC 665(a)(1), (2).
19. Treas Reg 53.4958-6(c)(1)(ii).
20. Treas Reg 53.4958-6(c)(2)(ii).
Charitable Property Tax Exemption: Making the Most of Scarce Resources

By Paul V. McCord

Introduction
Many charitable organizations are trying to recover from the negative effects their endowment funds have experienced in recent years due to investment losses and decreased funding. Property tax exemptions may be useful, and attorneys can provide a valuable service to their clients, either as board members or as retained counsel, by educating the boards of charitable organizations on this subject. Familiarity with the law’s requirements also can prevent boards from making decisions that could jeopardize an already-granted exemption or prevent an exemption from being granted in the first place.

A charitable organization may experience financial benefits from purchasing rather than renting property, especially when a real-estate tax exemption is factored in. Not only does property ownership provide an additional asset to leverage, but it also usually results in tax savings. Property that is leased by a charitable organization from a for-profit landlord does not qualify for an exemption, however, and most leases require the tenant to pay its proportionate share of real estate taxes. Therefore, charities that lease property may be paying more than necessary. In contrast, charities that lease property from other nonprofit landlords may continue to qualify for a property tax exemption.

Michigan Property Tax Exemption
Under Michigan law, nonprofit charitable organizations that own and occupy real property are exempt from paying property tax under certain circumstances. Specifically, Michigan’s General Property Tax Act provides that “[r]eal or personal property owned and occupied by a nonprofit charitable institution while occupied by that nonprofit charitable institution solely for the purposes for which it was incorporated is exempt from the collection of taxes under this act.”

To determine whether a nonprofit organization qualifies for a property tax exemption, Michigan courts have long relied on a three-part test. As set forth in Ladies Literary Club v City of Grand Rapids, this test requires that (1) the real estate be owned and occupied by the nonprofit organization claimant; (2) the organization be a library, benevolent, charitable, educational, or scientific charitable institution; and (3) the buildings and other property be occupied by the nonprofit organization claimant solely for the purpose for which it was incorporated. The charity itself faces the burden of proving that it qualifies for the exemption, and it must demonstrate by a preponderance of evidence (i.e., that it is more likely than not) that the exemption it claims was intended by the legislature.

In Michigan, the courts have the authority to determine whether an organization is a “charity.” Charitable status granted by another government body, such as the Internal Revenue Service, is therefore not determinative. The courts will generally resolve any questions about eligibility for an exemption in favor of taxation. Typically, most of the disputes regarding the application of the test focus on its last two criteria, i.e., the organization’s charitable purposes and the exclusive use of its property.

Charitable Ownership
Generally, a nonprofit must “own” a piece of property to qualify for a tax exemption; however, Michigan courts have interpreted ownership in a way that gives nonprofits some flexibility in how they own the property. For example, charities can qualify for an exemption even if they are not the sole owners or owners in fee simple title but instead hold an undivided interest in the property. This assumes, however, that all the co-owners would qualify for an exemption.

Charitable organizations may also take advantage of the protections of placing real property in so-called holding-company or parent-subsidiary structures. For example, in Ann Arbor v University Cellar, the Michigan Supreme Court addressed the issue of whether the personal property of a separately organized corporate entity was the property of the University of Michigan. Although the court, in a 4 to 3 decision, answered the question in the negative, University Cellar nevertheless established the framework for examining the circumstance under which the conduit, or alter ego theory, applies. The
That generate annual revenues of less than $1 million. The vast majority of nonprofits, excluding churches, hospitals, and schools, are groups that generate annual revenues of less than $1 million.

Notwithstanding the bookstore’s separate legal existence from the university, the court’s minority would have held the store’s property to be the property of the university and, thus, tax exempt. To rule otherwise, the minority opinion held, would be to exalt form over substance.

In *Regents of the University of Michigan ex rel M-Care v City of Ann Arbor*, however, the Michigan Tax Tribunal held that the University of Michigan was the equitable owner of underlying property owned by an HMO connected to the university. Again, the test in this situation is whether the nonprofit organization is the equitable owner of the property when it is given managerial and operational control and whether the organization is using the property in furtherance of its charitable purposes.

Under certain circumstances, charitable nonprofits may also lease property to certain other nonprofit organizations or governmental entities without endangering the property’s tax-exempt status. It is not uncommon in Michigan to find nonprofits pooling their resources. For example, a nonprofit health foundation and its subsidiaries may have developed a number of facilities throughout the state that are leased to public health or community mental health agencies, and these facilities may be occupied by a variety of nonprofits and governmental agencies to provide one-stop shopping for patients.

Specifically, MCL 211.7o(3) includes an exemption for property owned by a nonprofit that is leased or otherwise made available to another nonprofit, provided the real or personal property would be exempt from the collection of taxes if it were occupied by the lessor nonprofit charitable institution or charitable trust solely for the purposes for which the institution was organized or the trust was established. Property owned by a nonprofit charitable organization and leased to a governmental entity is also specifically exempt from the tax.

**Nonprofit Joint Ventures — Choice of Entity Issues**

The vast majority of nonprofits, excluding churches, hospitals, and schools, are groups that generate annual revenues of less than $1 million. Consolidation is an option that an increasing number of smaller nonprofits in the arts, public health, and advocacy are pursuing as more and more organizations vie for a diminishing pool of philanthropic and grant dollars. With fewer resources to draw on, joint ventures between nonprofits or between nonprofits and for-profits are one method by which nonprofits can expand their activities and create the opportunity to raise capital outside of individual and corporate giving.

A nonprofit’s participation in a joint venture can be structured in different ways. As long as certain strict organizational and operational requirements are met, a nonprofit may serve as the general partner of a partnership or, as is increasingly the trend, as a managing member of a limited liability company (LLC). Investment through a pass-through entity such as an LLC minimizes the overall tax burden imposed on the investment, since
the LLC is treated as a conduit and its activities are attributed to the nonprofit member both for consideration of tax-exempt status and for possible unrelated business income tax (UBIT)\[18\] from the activity.\[19\] This structure may also be used for non-tax reasons, such as protection from liability or participation in management, or simply to isolate the tax-reporting responsibilities and preserve the non-UBIT filing status of the tax-exempt investor.\[20\]

As a conduit of the nonprofit member, the underlying real and personal property can arguably be viewed as meeting the organizational prong of the Ladies Literary Club test discussed above. Joint ventures structured in accordance with the requirement of Rev Rul 98-15\[21\] are distinguishable from the bookstore at issue in University Cellar by reason that direct control over the joint venture is exercised by the tax-exempt charitable members.\[22\] The members’ active participation in, and domination of, the joint-venture operations should meet the standards of “managerial and operational control” and “management, supervision and control” sufficient enough to render the underlying property, in substance, the property of its nonprofit members. In this regard, the joint venture should be viewed, in effect, as the “functioning arm” of its larger, tax-exempt member.\[23\]

As a result, given a nonprofit’s “managerial and operational control” over the joint venture and the aggregate nature of LLCs, arguably the separate legal existence of the joint venture LLC should be ignored and its underlying property should be viewed as being owned and occupied by its nonprofit member, thus satisfying the organizational test. Assuming that the purposes, activities, and benefits tests are otherwise satisfied, one would think that the underlying property should be exempt.

The Michigan Tax Tribunal has ruled, however, that regardless of whether a joint venture satisfies any of the other tests for exemption, if it is not structured either as a corporate subsidiary of the nonprofit or as a charitable trust, it does not meet the basic requirement of the organizational test.\[24\] As a result, until either the statute is amended to include LLCs as permissible organizations, or subsequent appellate case law recognizes the conduit nature of these arrangements, nonprofit joint ventures organized as LLCs or partnerships simply will not qualify for the property tax exemption.\[25\]

### Exclusive Use

To qualify for a property tax exemption, Michigan law provides that the buildings and other property are to be “occupied” by the nonprofit organization “solely” for the purpose for which it was incorporated. However, Michigan courts have not interpreted this statutory language narrowly but, instead, have construed these requirements to mean that the primary use of the property must be for clearly exempt purposes.

The term “occupied” has been interpreted as being synonymous with the “use” of the subject property.\[26\] In other words, the primary purposes or the use to which the property is put must be charitable. Incidental or secondary purposes, however, will not necessarily bar a finding that the property is exempt. The court of appeals in Lake Louise Christian Community v Township of Hudson\[27\] looked to prior cases granting the charitable-use exemption where there was an incidental use.\[28\] The case law reveals that the use must be incidental or relative to the express purpose of the corporation and that it must be frequent.\[29\] In most instances, this element demands physical use; however, the statute has not been so narrowly construed.\[30\]

In interpreting the word “solely” in the property tax exemption statutes, Michigan case law reveals that “solely” does not literally mean “exclusively.” In Webb Academy v Grand Rapids,\[31\] the city argued that the school property was not “occupied” and used solely for the purposes of its incorporation because some of the property was used as a residence, some was used as a garden, and the barn on the premises was sometimes rented out to store automobiles. The Webb court relied on case law from other jurisdictions favoring a construction of the word “solely” that was “consonant with the spirit which prompted the adoption of the provisions in question” and which “serve[d] a great public use in pursuance of a most beneficial public policy.”\[32\] Similarly, in American Legion Memorial Home Ass’n v Grand Rapids, the court of appeals stated:

> With respect to a statutory requirement that an institution be occupied “solely” for the purposes for which it was incorporated, tax exemption is not lost by virtue of occasional or incidental uses for other purposes. If the primary use of a building is for clearly exempt purposes, the exemption is not lost because on
occasion the building is used for social purposes or is let out to other organizations.

Thus, Michigan courts have concluded that the word “solely” does not mean that the property has to be used “solely” for the purposes for which a nonprofit organization was incorporated. Rather, the test is whether the primary use of the property is for clearly exempt purposes.

Charitable Purposes

Originally, the Michigan Supreme Court simply required that the property being occupied for charitable or benevolent purposes must “benefit the general public without restriction.” In 1982, the court in Retirement Homes of Detroit Annual Conference of the United Methodist Church v Sylvan Township reaffirmed this requirement and introduced a functional test as to whether an organization’s purposes were charitable or benevolent:

[Charity] ... [is] a gift, to be applied consistently with existing laws, for the benefit of an indefinite number of persons, either by bringing their minds or hearts under the influence of education or religion, by relieving their bodies from disease, suffering or constraint, by assisting them to establish themselves for life, or by erecting or maintaining public buildings or works or otherwise lessening the burdens of government.

With this “activities” test, the court concluded that the key issue was whether the organization used the land in such a way that there was a gift for the benefit of the general public without restriction or for the benefit of an indefinite number of persons. Unfortunately for organizations seeking an exemption from property tax, subsequent court decisions appear to have blurred the analysis of whether the nonprofit claimant is a benevolent or charitable institution with whether the property is used for charitable (or other qualifying) purposes.

In Michigan United Conservation Clubs (MUCC) v Lansing Township, the Michigan Supreme Court held that “[t]he proper focus in this case is whether MUCC’s activities, taken as a whole, constitute a charitable gift for the benefit of the general public without restriction or for the benefit of an indefinite number of persons.” This ruling essentially affirmed and restated the holding in American Concrete Institute v State Tax Commission.

As a result, harmonizing the court’s rulings in Ladies Literary Club, Retirement Homes of Detroit, and MUCC, it is clear that in order for the organization to qualify for an exemption as a charitable institution three tests must be met. First, the organization must meet the organizational and charitable-purpose prongs of the Ladies Literary Club test. Second, assuming that those prongs are met, the organization’s activities must be one or more of those described in the Retirement Homes of Detroit “activities” test. Finally, if the organization fulfills both of these requirements, the organization must satisfy the “benefits” test under MUCC, i.e., the organization’s activities, when taken as a whole, must constitute a charitable gift for the benefit of the general public without restriction or for the benefit of an indefinite number of persons. More specifically, under the American Concrete analysis, the organization must be organized chiefly, if not solely, to meet the objective of benevolence, charity, education, or the promotion of science.

Sources of Funding

Charities that get most of their funding from public or private donations are favored for exemption. Occasionally, an organization may realize a significant gain from the appreciation of donated property. Where the organization’s sources of income are derived from public or private donations, courts are likely to classify such donated property as a public or private donation and thus not preclude a determination that the property is exempt.

It should be noted that the source of the funds is less of a factor when an organization establishes that those funds will be put to a charitable use. Organizations that receive their income from dues, fees, or other sources should not consider themselves ineligible for exemption if they use any donated property primarily for charitable purposes and the organization otherwise appears qualified for tax exemption.

Obstacle to Benefits

A charitable organization’s policies may pose an obstacle to property tax exemption. Courts will investigate whether there are any restrictions imposed on who may receive a nonprofit’s services and on how those services are delivered. In Michigan Baptist Homes, the charity was ultimately denied exempt status.
for property tax purposes in part because it required its elderly residents to be in good health and to have the ability to pay. The court found these policies at odds with the requirement that exempt homes for the aged be for the benefit of the elderly in general.

In a similar case, the court in *Retirement Homes of Detroit* found that the nonprofit apartment homes at issue were not for the benefit of the general public because the residents were selected on the basis of their good health, and their abilities to pay and to live independently. The court noted that the organization’s policies and practices demonstrated that any individual who was living in an apartment who became unable to pay the monthly fee was transferred from the apartments; at no time were the fees waived or reduced for these individuals. Conversely, in *Kalamazoo Aviation History Museum v Kalamazoo*, the court found that although the museum charged an admission fee, it waived this fee for those who could not pay. The court acknowledged that had the evidence revealed that the museum did not waive its admission fee for those who could not afford it, the museum probably would not have qualified for a charitable exemption. Similarly, in *Pierce v Baltimore Township*, the court noted that the nonprofit environmental organization offered many of its programs and services for free and that when it did charge a fee, the fee was small and covered only a fraction of the organization’s program costs. In fact, the organization’s expenses significantly exceeded its revenues. As such, the court acknowledged that the charging of a fee did not destroy the charitable nature of the organization, and it concluded that the organization clearly did not profit from the fees it charged.

From all of these cases it seems clear that charging a fee does not impose an obstacle per se if the nonprofit organization also provides a mechanism for fee waivers or reductions. The fee waiver must be truly available. In cases where the organization’s policies provide for fee waivers but the waiver option is never made public, or where fee waivers exist in theory but are never in fact granted, the courts are likely to find the fee an obstacle. This determination is fact intensive. On the other hand, nonprofits should evaluate their operating costs and the sources of funding used to cover them, and they should be able to demonstrate that these costs are mostly covered by sources other than fees, such as charitable contributions, endowed funds, or government grants. If this is not possible, it may be difficult to establish that a “gift” was made and obtain the benefits of a property tax exemption.

**Lessening the Burdens of Government**

Two reasons are often cited to justify state tax exemptions for nonprofits. First, some nonprofits perform services that may be viewed as relieving what would otherwise be a state or local government burden. Second, many nonprofits provide services that confer a benefit on the community as a whole. In both cases, the exemption is based to some degree on the notion that “the social value of the services performed is at least as great as the revenues foregone.” However, relying on this rationale for a Michigan property tax exemption is problematic, as it requires the nonprofit to (1) identify the specific government burden that exists, and (2) demonstrate that its services substantially contribute to lessening this burden.

The first issue to address is what government burdens are lessened by the nonprofit’s activities. This is generally difficult to answer, as it requires one to speculate about the level at which state or local governments would provide the same service in the absence of the nonprofit’s contribution of that service. Nevertheless, Michigan courts have addressed “lessening the burdens of government” as it pertains to scientific institutions, educational institutions, institutions that treat troubled, abused, and neglected youths, and institutions that conserve and promote natural resources and wildlife. To qualify for a property tax exemption under this theory, the nonprofit first must establish that the government has a burden to provide the same service that the nonprofit also provides. In *Moorland Township v Ravenna Conservation Club*, the court held that the Ravenna Conservation Club “lessened an expressly recognized burden of government.” Similarly, in *Huron Residential Services for Youth v Pittsfield Charter Township*, the court found that “if petitioner did not provide the service, the state itself would have been required to care for the youths.”

Next, assuming that the nonprofit establishes that such a burden exists, it then must demonstrate that through its services it has made a “substantial contribution to the relief of the burden of the government.” In American
Charities that get most of their funding from public or private donations are favored for exemption.

Society of Agricultural Engineers v St Joseph,16 for example, the nonprofit demonstrated that “[w]here it not for the existence of the plaintiff institution, it is clear that the burden imposed on the state government would be appreciably increased.”17 While older appellate authority suggests that a charitable institution is not required to show “substantial contribution to the relief of the burdens of governments,”18 more recent case law has held that this “substantial contribution” test is applied in cases where the claimant claims an exemption as an educational or scientific organization.19 For planning purposes, charitable nonprofits should analyze whether their services will meet the “relief of government burdens” rationale under this more stringent “substantial contribution” test in light of the Michigan Supreme Court’s opinion in Retirement Homes of Detroit.20

Conclusion

Attorneys serving charitable organizations should make sure that the charity is taking advantage of the property tax exemption. If the organization owns property, determine whether it is already classified as tax exempt for Michigan property tax purposes. If not, find out whether the organization has sought exemption and, if so, what factors contributed to the denial and whether they can be addressed. For example, perhaps the noncharitable use can be eliminated. Charitable organization boards that review exemption eligibility as part of the capital acquisition analysis are better equipped to make decisions that maximize resources. As a result, they can devote more resources to those in need.

NOTES

1. See MCL 211.7o(3), which provides that “[r]eal or personal property owned by a nonprofit charitable institution or charitable trust that is leased, loaned, or otherwise made available to another nonprofit charitable institution or charitable trust or to a nonprofit hospital, or nonprofit educational institution solely for the purposes for which that nonprofit charitable institution, charitable trust, nonprofit hospital, or nonprofit educational institution was organized or established and that would be exempt from taxes collected under this act if the real or personal property were occupied by the lessor nonprofit charitable institution or charitable trust solely for the purposes for which the lessor charitable nonprofit institution was organized or the charitable trust was established is exempt from the collection of taxes under this act.”

2. MCL 211.7o(1). See also MCL 211.9, which provides an exemption for personal property owned and occupied by a nonprofit charitable institution and which states, “The following personal property is exempt from taxation: (a) The personal property of charitable, educational, and scientific institutions incorporated under the laws of the state of this state. This exemption does not apply to secret or fraternal societies, but the personal property of all charitable homes of secret or fraternal societies and nonprofit corporations that own and operate facilities for the aged and chronically ill in which the net income from the operation of the nonprofit corporations or secret or fraternal societies does not inure to the benefit of a person other than the residents is exempt.”

3. As originally stated, the test for property tax status was four-pronged, with the final requirement being that the nonprofit claimant must have been incorporated under the laws of the State of Michigan. This requirement was found to be unconstitutional because it denied equal protection to organizations incorporated outside of Michigan. See Chauncey & Marion Deering McCormick Found v Wauwatosa Township, 186 Mich App 511, 465 NW2d 14 (1990); see also OCLC Online Computer Library Ctr, Inc v City of Battle Creek, 224 Mich App 608, 569 NW2d 676 (1997).


5. See also Michigan Baptist Homes & Dev Cn v Ann Arbor, 396 Mich 660, 670, 242 NW2d 749 (1976) (relying on the four-part test announced in Engineering Soc’y of Detroit v Detroit, 308 Mich 539, 14 NW2d 79 (1944)). The test originally announced in Engineering Soc’y of Detroit examined the exemption from property taxes under former MCL 211.7(d). Specifically, former MCL 211.7(d) extended an exemption for nonprofit theaters and libraries, as well as benevolent, charitable, educational, or scientific institutions and memorial homes of world war veterans. In 1980, this statute was amended and the exemptions were assigned specific statutory sections. For example, the exemption for libraries, educational, or scientific institutions is now found in MCL 211.7n, while the exemption for charitable institutions is now found in MCL 211.7o.

6. Retirement Homes of Detroit Annual Conference of United Methodist Church, Inc v Sylvan Township, 416 Mich 340, 348, 330 NW2d 682 (1982); ProMed Healthcare v City of Kalamazoo, 249 Mich App 490, 644 NW2d 47 (2002). In ProMed Healthcare, the Michigan Court of Appeals discussed the relevant standard of holding that “[t]he beyond a reasonable doubt standard applied when the petitioner [nonprofit claimant] attempts to establish that an entire class of exemptions was intended by the Legislature.” Id. at 493. However, the preponderance of the evidence standard applies when a petitioner attempts to establish membership in an already exempt class. Charitable institutions have been recognized as an exempt class.


8. Retirement Homes of Detroit, 416 Mich at 348 (exemption statutes are subject to a rule of strict construction in favor of the taxing authority); Michigan Bell Tel Co v Department of Treasury, 229 Mich App 200, 207, 582 NW2d 770 (1998). The rationale of finding in favor of taxation rests on the consideration that tax exemptions shift a burden placed on all landowners to share in support of their local governments from some landowners to others. See, e.g., Michigan Baptist Homes, 396 Mich at 669-670. Practitioners also should note that the General Property Tax Act provides that “all property, real and personal, within the jurisdiction of this state, not expressly exempted, shall be subject to taxation.” MCL 211.1 (emphasis added).


10. Id. at 286-287.
11. Id. at 294 (emphasis added).
12. Id. at 304.
14. The term “governmental entity” means the state or federal government or an agency, department, division, board, bureau, or authority of the state or federal government; a county, city, township, village, local or intermediate school district, or municipal corporation; a public institution of higher education, including a public school academy, community or junior college, or a state four-year institution of higher education; or any other authority or public body created under state law.
15. As amended by 1996 PA 469.
17. The IRS abandoned its per se opposition to the involvement of nonprofits in joint ventures with for-profit entities in 1982, with the issuance of the decision in Plumstead Theatre Soc’y v Commissioner, 675 F.2d 244 (9th Cir 1982), aff’d 74 TC 1324 (1980). In Plumstead, a theater company that was organized to foster the performing arts entered into a limited partnership with three for-profit investors to raise revenue needed to produce a stage play. The IRS denied tax-exempt status to Plumstead on the grounds that it was not operated exclusively for charitable purposes. Based on the safeguards contained in the limited partnership agreement, which served to insulate Plumstead from potential conflicts with its exempt purposes, the Ninth Circuit disagreed, holding that Plumstead was operated exclusively for charitable (and educational) purposes, and therefore was entitled to exemption.
18. Alternatively, a nonprofit may participate through a subsidiary or affiliated organization. Generally, a nonprofit may invest as a limited partner (or a nonmanaging, nonparticipatory member in an LLC) in any prudent investment, although as a passive investor it may be subject to tax on income generated by any activity unrelated to its charitable purposes (i.e., the UBIT). Also, where a nonprofit invests a substantial portion of its assets to a venture that does not meet the IRS’ guidelines for joint ventures as discussed in note 22, the IRS likely will deem the income from the venture as “unrelated” and therefore subject to income tax as UBIT. However, its tax-exempt status will not be jeopardized.
19. See IRC 512.
20. There are two views as to the nature of pass-through entities, such as limited liability companies, that apply for purposes of taxation of these types of entities. The first is that a pass-through entity is simply an aggregation of individuals, each of whom should be treated as the owner of a direct, undivided interest in the pass-through entity’s assets and operations. This is sometimes referred to as the “aggregate” or “conduit” view. The second view is that a pass-through entity is a separate entity, distinct from the individual members. Under this view, a member has no direct interest in the pass-through entity’s assets or operations but only an interest in the entity itself, separate and apart from its assets and operations. It is well settled that for federal income tax purposes the activities of a partnership are considered to be the activities of the partners. See Butler v Commissioner, 36 TC 1097 (1961). In light of the aggregate principle discussed in Butler and reflected in IRC 512(c) (relating to the treatment of partnership income for purposes of the UBIT), the aggregate approach also applies for purposes of the operational test set forth under IRC 501(c)(3), provided that participation in the LLC (cum partnership) furthers a charitable purpose and that the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purposes. Thus, the activities of a limited liability company treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is a member of the LLC when evaluating whether the nonprofit is operated exclusively for exempt purposes within the meaning of IRC 501(c)(3).
21. If an LLC is classified as a partnership for federal tax purposes, it can also hold debt-financed real estate without incurring UBIT as long as it complies with IRC 514(c)(9).
22. Although this topic is beyond the scope of this article, nonprofits should be mindful of the examples outlined in Revenue Ruling 98-15 when structuring joint ventures with both nonprofits and for-profits. The ruling includes examples from the IRS of both “good” and “bad” joint ventures. Inherent control by the exempt organization over the organizational structure of a venture is crucial. To satisfy this requirement, the organizational documents for such ventures should contain legally enforceable provisions that vest the nonprofit with control over the venture. The IRS’s firm position on this issue provides nonprofits with significant leverage when negotiating joint-venture structures with for-profit partners. In addition to drafting operating agreements to vest power in the nonprofit, the venture must actually be operated in such a manner that the nonprofit may exercise its control. The key elements relate to day-to-day activities and include the capacity of the nonprofit, through its voting power in the venture, to commit the venture’s assets for charitable purposes; the term of any management contract executed by the venture and the ability of the venture to terminate the contract for cause; and composition of the venture’s management team, that is, whether the representatives chosen by the for-profit partners were previously employed by the for-profit partners. The IRS’s use of the control test, with its variety of facts and circumstances, has been upheld in Redlands Surgical Servs v Commissioner, 113 TC 47 (1999), where the Tax Court upheld the denial of exempt status to a joint venture formed by for-profit and nonprofit entities. In arriving at its decision that private, rather than charitable, interests were being served, the court examined various factors similar to the factors the IRS enunciated in Rev. Rul. 98-15. The court noted, most significantly, that there was a lack of any express or implied obligation of the for-profit parties to place charitable objectives ahead of for-profit objectives. Moreover, the relevant organizational documents did not include an overriding charitable purpose. The lesson learned from the Redlands case points to a number of critical factors that must be present for the joint venture to be considered tax-exempt. First and foremost, the exempt organization must retain control over the joint venture through voting rights and the language in the Partnership Agreement. Second, the joint venture’s primary motive must be to benefit the community rather than to earn a profit; long-term management contracts with the for-profit partner that include the option of indefinite extensions would indicate the for-profit partner’s motive of profit. Finally, documentation outlining the exempt organization’s purpose and agenda should be kept; the purpose and activities supporting the purpose must be discussed at all board meetings and must outweigh the interest of the for-profit entity. In sum, nonprofits participating in joint ventures with for-profit entities or private investors should carefully structure provisions in the agreements so that they are not deprived of control over the operations of the venture or limited in their ability to ensure that the venture will be operated for charitable purposes.
23. See also Rev Rul 2004-51, in which the IRS provided additional guidance on ancillary joint ventures between nonprofits and for-profit entities. This ruling augments Rev Rul 98-15, which established patterns of good and bad facts for whole hospital joint ventures. Rev Rul 2004-51 described a tax-exempt university that offered summer seminars for grade school teachers for the purpose of increasing their skills. The activity was carried out through an LLC with a 50 percent for-profit member
and with each member appointing an equal number of directors to the LLC's governing board. One significant outcome of this ruling is that it demonstrates that the IRS will consider a joint venture as an exempt activity (under the right circumstances) even where control is held 50/50 with the for-profit (a departure from Rev Rul 98-15, which looked for control by the exempt organization). This ruling also gets away from the "charity care" and "community benefit" standards that were part of the prior analysis of joint ventures in the healthcare arena. Organizations both within and outside the healthcare community should look carefully at both Rev Rul 2004-51 and Rev Rul 98-15 when contemplating for-profit joint ventures.

24. See, e.g., National Music Camp v Green Lake Township, 76 Mich App 608, 614-615, 257 NW2d 188 (1977); see also Regents of the Univ of Michigan ex rel M-Care, 7 MTT at 675.


26. It is interesting to note that the Single Business Tax Act addresses these types of collaborations by extending exempt status to partnerships, LLCs, joint ventures, general partnerships, limited partnerships, unincorporated associations, and other groups or combinations of entities acting as a unit if (1) the entity’s activities are exclusively related to the charitable, educational, or other purpose or function that is the basis for the federal income tax exemption of the partners or members; and (2) all the partners or members are exempt from federal tax. See MCL 208.35(1)(c).


28. Id.

29. Id. at 580.

30. Id.

31. See Kalamazoo Nature Ctr, Inc v Cooper Township, 104 Mich App 657, 305 NW2d 283 (1981) (holding that sound land management policies require that “occupancy” may be visual, educational, or otherwise demonstrative).

32. 209 Mich 523, 532, 177 NW 290 (1920).

33. Id. at 540-541, quoting Bishop of Cathedral of St John the Evangelist v Treasurer of Arapahoe County, 29 Colo 143, 68 P 272 (1901), and Yale Univ v Town of New Haven, 71 Conn 316, 42 A 87 (1899).


35. It is interesting to note that the court in American Legion determined that use of the premises at issue for social purposes or by groups not affiliated with the American Legion did not defeat that organization’s entitlement to a property tax exemption. Id. at 710-711.


38. Id. at 348-349.


40. Id. at 673 (emphasis added).

41. 12 Mich App 595, 608, 163 NW2d 508 (1968). The court of appeals in Comprehensive Health Servs, Inc v City of Oak Park, No 196078, 1998 Mich App LEXIS 2513 (Mar 13, 1998) (unpublished), cited American Concrete, holding that “[t]o qualify for tax exemption as a charitable organization in Michigan it is not enough that one of the organization’s direct or indirect purposes or results is benevolence, charity, education, or the promotion of science. It must be organized chiefly, if not solely, for one or more of these objectives.” *5-6 (emphasis added).

42. The Michigan Supreme Court has repeatedly held that just because a nonprofit charges recipients its costs for the benefits and services it provides, this does not mean that the nonprofit is not providing a gift. Michigan Baptist Homes, 396 Mich at 660; Retirement Homes of Detroit, 416 Mich at 349-50. See also Gall Lake Bible Conference Ass’n v Ross, 351 Mich 269, 88 NW2d 264 (1958) (the fact that a claimant may charge a membership fee does not negate the fact that it is a charitable institution); OCLC Online Computer Library, 224 Mich App at 615 (the fee charged is for benefits conferred, against those who are able to pay, in no way detracts from the charitable character of an organization); American Concrete Inst, 12 Mich App at 609 (holding that “[m]erely because the American Concrete Institute is largely supported by contributions from its members does not disentitle it to a tax exemption to which it otherwise would be entitled”).

43. Michigan Baptist Homes.

44. Retirement Homes of Detroit.

45. Id. at 350.


47. Id. at 718.


52. Id. at 461 (emphasis added).

53. 152 Mich App at 54.

54. Id. at 63.


56. 53 Mich App at 45.

57. Id. at 50.


59. See note 50. In Hospital Purchasing, the court held that the fact that only a small benefit of a charitable corporation’s activities would benefit the taxing authority and its citizens did not preclude the charity’s right to an exemption from taxation. However, Hospital Purchasing was decided in 1968, well before the Michigan Supreme Court issued its opinions in Retirement Homes of Detroit and MUCC.

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Mending SOX: Is Some Relief from the Sarbanes-Oxley Act Coming for Smaller Public Companies?

By Michael K. Molitor

Readers of The Michigan Business Law Journal are certainly familiar with the Sarbanes-Oxley Act of 2002 (SOX), which was enacted after many prominent corporate scandals roiled the securities markets and shook investor confidence. Although the statute was well intentioned, public companies soon realized that it would be difficult and expensive to comply with many of its new requirements, especially the internal controls report mandated by Section 404, as well as with related Securities and Exchange Commission (SEC) rules. Small companies were particularly affected by SOX because they lacked the resources of their larger counterparts.

In December 2004, after more than two years of experience with the statute, the SEC announced its plan to establish the Securities and Exchange Commission Advisory Committee on Smaller Public Companies (the Committee) to examine the impact of federal securities laws, including SOX, on “smaller public companies” and to make recommendations for changes. Specifically, the Committee was charged with examining the requirements for (1) internal control over financial reporting; (2) corporate disclosure, reporting, and governance; (3) accounting standards and financial reporting; and (4) securities offerings. The overall goal was to assess “whether the costs imposed by the current securities regulatory system for smaller public companies are proportionate to the benefits.” The Committee has been hard at work since early last year, and in August 2005 made several well-received interim suggestions. In late February 2006, after this article was written, the Committee released a preliminary report recommending many changes to SEC rules.

This article provides a broad, but necessarily incomplete, overview of the Committee’s work and the changes it may provoke to SEC rules. Although the Committee is only an advisory committee and has no rulemaking power of its own, the SEC likely will adopt many of its recommendations in one form or another, as discussed below. It may be too soon to determine the precise details of the changes ahead, but it appears that some significant relief is in store for smaller public companies.

The Committee and Its Agenda

The Committee has 21 members, primarily business people, lawyers, and accountants, who were chosen to represent a wide array of interests and viewpoints. In addition, representatives of the Financial Accounting Standards Board (FASB), the Public Company Accounting Oversight Board (PCAOB), and the North American Securities Administrators Association (NASAA) are serving as “official observers.” Within the Committee are four standing subcommittees—Internal Control Over Financial Reporting; Corporate Governance and Disclosure; Accounting Standards; and Capital Formation—as well as a special Size Subcommittee, whose purpose was to define “smaller public company,” a term the SEC had left vague.

The Committee has been following a very ambitious agenda. As might be expected, the first item of business was the “smaller public company” definition. The second item, also not surprisingly, concerned internal controls and other related matters under Section 404 of SOX, including the need for changes to SEC rules and PCAOB standards. Many smaller public companies would probably have been satisfied if the Committee had focused solely on Section 404, which is widely viewed as the most onerous provision of SOX. However, the Committee’s agenda also extends into many other securities regulations that affect small companies.

To easily gather public comments, the Committee created a page on the SEC’s Web site, and has received well over 100 letters in response. The Committee also posted online a special questionnaire that asked a series of wide-ranging questions, among them, “Do you believe SOX has enhanced, or diminished, the value of smaller companies? Please explain.” In addition, the Committee held a series of public meetings across the country...
where members could hear testimony from interested citizens, particularly corporate executives.

**Interim Recommendations**

On August 18, 2005, the Committee presented the SEC with interim recommendations that it felt were too important to wait until its final report in April 2006. These early suggestions included:

**Section 404 Implementation Delay**

The Committee’s first recommendation was to delay for an additional year the implementation of SOX Section 404 reporting requirements for companies that are not “accelerated filers.” Accelerated filers have been subject to the SEC’s Section 404 reporting requirements since fiscal years that ended after November 14, 2004. For non-accelerated filers (which are very small companies), the SEC had already twice extended this compliance date, which before the Committee’s recommendation was fiscal years ending after July 14, 2006. In its resolution, the Committee noted that Section 404 costs have been “far more expensive than originally forecasted,” and that efforts by the SEC and the PCAOB to improve the Section 404 process were under way but not expected to come to fruition “for some considerable time.” The SEC quickly acted on this recommendation (although it may have been planning to do so anyway) by issuing a final rule on September 22, 2005, that extended the deadline for internal controls reports by non-accelerated filers for an additional year, i.e., to fiscal years ending after July 14, 2007.

**Moratorium on Acceleration of Exchange Act Reporting Deadlines**

The Committee’s second interim recommendation was that “smaller public companies” should not be subject to any further acceleration of the due dates of periodic reports under the Securities Exchange Act of 1934 (the Exchange Act). Before SOX, a public company had 90 days after the end of a fiscal year to file its annual report (typically on Form 10-K) and 45 days after the end of a fiscal quarter to file its quarterly report (typically on Form 10-Q). However, pursuant to SEC rule amendments adopted in the wake of SOX, accelerated filers were eventually to be given only 60 days to file annual reports and only 35 days to file quarterly reports.

The SEC quickly responded to this recommendation. In September 2005, it proposed rule changes that would separate accelerated filers into two categories: (1) “large accelerated filers,” which are those with a public float of $700 million or more; and (2) “accelerated filers,” which are those with a public float of between $75 million and $700 million. The SEC adopted these changes in December 2005. Under the new rules, only large accelerated filers will be subject to the 60-day annual-report filing deadline, which will apply to reports for fiscal years ending after December 14, 2006; until then, the current 75-day deadline will apply. Regular accelerated filers will continue to face this 75-day deadline for annual reports, and both large and regular accelerated filers will continue to face the current 40-day deadline for quarterly reports.

**Definition of “Smaller Public Company”**

In the process of making the above recommendations, the Committee was also working to define the term “smaller public company.” These companies are obviously the focus of the Committee’s work, as most of its recommendations relate only to them. However, for several months it was unclear exactly what the term meant. Thus, the Size Subcommittee had quickly begun to examine the issue, and at the Committee’s August 10, 2005, meeting it proposed a definition that the full Committee approved. In its resolution, the Committee noted that Section 404 costs have been “far more expensive than originally forecasted.”

The recommended definition essentially provides that the public companies making up the bottom 6 percent of total market capitalization in the United States are “smaller public companies.” To calculate this, one would start by determining the total market capitalization (multiplying the number of shares outstanding by the trading price) of all public companies in the U.S. Next, one would total the market capitalizations of the public companies with the smallest market capitalizations until their combined market capitalizations reached 6 percent of the total market capitalization of U.S. stock markets. The companies gathered up to that point would be “smaller public companies.” Amazingly, the Size Subcommittee estimated that approximately 80 percent of all public companies would be considered smaller public companies under this definition because of the large number of very small companies and their consequently modest contribution to total market capitalization. Less than 20 percent of all public companies (including familiar names like Microsoft and Coca-Cola)
represent approximately 94 percent of the total capitalization of the U.S. stock markets, simply due to their sheer size. The effect is similar to putting a billionaire in a room with 99 average people: the billionaire would likely have more than 94 percent of the combined wealth of the 100 people in that room.

While the Size Subcommittee estimated that, based on current data, companies with a total market capitalization of less than $700 million would be considered smaller public companies, the beauty of the proposed definition is that it would not simply set a dollar figure that would apply each year, as some SEC regulations do. Instead, the SEC would reset the dollar figure annually. For example, assume that in Year 1 the SEC determined that the public companies with market capitalizations of less than $700 million represented, in the aggregate, 6 percent of total U.S. market capitalization. Then assume that in Year 2, an extremely good year for the stock market, the market capitalization of every public company doubled. In Year 2, then, companies with market capitalizations of $1.4 billion or less still would be considered smaller public companies. In this sense, the definition would be self-calibrating.

Another interesting feature of the recommended definition is that it would measure total market capitalization instead of public float. An issuer’s public float can be hard to calculate because it is often unclear which of its shareholders are “affiliates.” Measuring total market capitalization would not involve these uncertainties. The Size Subcommittee also noted that the definition would allow an issuer to determine, as of the first day of a given fiscal year, whether it is a smaller public company. However, the Subcommittee also noted that transition rules should provide that an issuer would not move from one category to another, either up or down, unless it fell within that category for two consecutive years. This would give a small issuer more time to plan for its transition to the requirements for large public companies.

Other Recommendations

As noted above, the Committee held many meetings to hear testimony and debate the issues before preparing the first draft of its report to the SEC, which was released in late February 2006. By the time the Committee held its December 14, 2005, meeting to approve the content of that report, its focus had narrowed from its original agenda, and the four subcommittees had the following preliminary suggestions. Please note that this is not a summary of all of their December 2005 recommendations, but rather a list of those that appear to be the most significant.

Major Recommendations of the Internal Controls Subcommittee

The Internal Controls Subcommittee’s recommendations concerned Section 404 of SOX. Section 404(a) requires that each annual Exchange Act report (e.g., Form 10-K) contain (1) a statement of management’s responsibility for “establishing and maintaining an adequate internal control structure and procedures for financial reporting,” and (2) an assessment, as of the end of the fiscal year, of the effectiveness of the structure and procedures. Section 404(b) requires the issuer’s independent auditors to attest to and report on the issuer’s assessments made under Section 404(a). New Exchange Act Rule 13a-15 requires an issuer to (1) maintain disclosure controls and procedures and internal control over financial reporting (as both are defined in the rule); (2) evaluate the effectiveness of its disclosure controls and procedures as of the end of each fiscal quarter; (3) evaluate the effectiveness of its internal control over financial reporting as of the end of each fiscal year; and (4) evaluate any change in its internal control over financial reporting that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the issuer’s internal control over financial reporting. Disclosure about these items must be included in an issuer’s annual and quarterly reports, pursuant to Items 307 and 308 of Regulation S-K.

To those without an accounting background, these requirements may not seem horribly demanding. However, Section 404 easily generated the most controversy of any provision in SOX, and many studies have documented the enormous cost that compliance with Section 404 entails. As the Internal Controls Subcommittee noted in its written presentation to the Committee at the December 2005 meeting, Section 404 compliance has turned out to be a “significantly more onerous and expensive requirement than anticipated,” in terms of both out-of-pocket costs and the loss of management time devoted to Section 404 compliance. The Subcommittee’s recommendations, if adopted, would spare smaller public companies some of these burdens.
The first recommendation was to exempt micro-cap companies\textsuperscript{20} from Section 404, provided that they comply with either the corporate governance requirements of the stock market on which their securities are listed or, if not listed, the requirements recommended by the Corporate Governance and Disclosure Subcommittee.\textsuperscript{21} The second recommendation was to exempt other smaller public companies from the \textit{external} audit requirements (but no other requirements) of Section 404, provided they comply with these same corporate governance requirements.

Perhaps anticipating that this second recommendation would not be well received by the SEC, the Subcommittee provided an alternative in its third recommendation: in essence, that if the SEC continues to require auditor reporting on the internal controls of smaller public companies under SOX Section 404(b), then it and the PCAOB should change the standard “for the implementation of the external audit requirement of [Section 404(b)] to a cost-effective standard (ASX) providing for an external audit of the design and implementation of internal controls” but no testing of their operating effectiveness.

The Subcommittee’s fourth recommendation was to request additional guidance from the Committee of Sponsoring Organizations of the Treadway Commission (also known as COSO) and the PCAOB to help smaller public companies with their internal controls. As the Subcommittee wrote in its December report, “there is little practical guidance … today for management of smaller companies to establish internal controls.” Specifically, the Subcommittee recommended that the SEC establish, perhaps through a Web site, a “Center of Excellence for Reporting and Corporate Governance for Smaller Public Companies.” It also recommended that the SEC ask the PCAOB to clarify the application of its Auditing Standard No. 2,\textsuperscript{22} which provides the standards for outside auditors completing their Section 404(b) attestation and reporting on management’s assessment of the company’s internal controls—but which gives no guidance to management.\textsuperscript{23}

\textbf{Major Recommendations of the Corporate Governance and Disclosure Subcommittee}

Most of the Corporate Governance and Disclosure Subcommittee’s recommendations were more modest in scope,\textsuperscript{24} but one suggestion could have far-reaching implications for the many issuers that went dark after SOX: that the SEC should count “beneficial” shareholders, rather than only “record” shareholders, toward the 500-shareholder threshold of Section 12(g) of the Exchange Act. Under a rule adopted in 1965 and still in effect today,\textsuperscript{25} an issuer may avoid Section 12(g) registration—and compliance with the Exchange Act and nearly all of SOX—if it has fewer than 500 record shareholders (generally, those that hold actual stock certificates), even if it has thousands of beneficial holders (generally, those who hold their shares through a broker). The effects of this recommendation would be tempered somewhat by a related recommendation to increase the threshold from 500 shareholders to a higher number, perhaps 1,000.\textsuperscript{26}

The Subcommittee also recommended that smaller public companies not be subject to further acceleration of the deadlines for periodic Exchange Act reports; as noted above, however, the SEC has already adopted new rules to this effect. It also suggested that the SEC establish a task force to work with other governmental agencies to reduce duplicative filings for companies required to submit similar reports to multiple agencies. In public testimony before the Committee, many executives of small bank holding companies bemoaned the fact that they are required to file substantially the same information with the SEC and their banking regulators.

Other recommendations included:

- clarifying whether certain transactions violate SOX’s prohibition on loans to insiders;\textsuperscript{27}
- allowing smaller public companies to include in their Exchange Act annual reports only two, instead of three, years of audited statements of income, cash flows, and changes in stockholders’ equity;\textsuperscript{28}
- allowing smaller public companies to use Form S-3 and to incorporate prior SEC filings by reference in Securities Act registration statements; and
- allowing electronic delivery of proxy statements and other filings.\textsuperscript{29}

\textbf{Major Recommendations of the Accounting Standards Subcommittee}

Noting that the FASB often gives private companies extended deadlines to comply with new accounting rules, this Subcommittee recommended that micro-cap companies also be given extra time in these cases. Because of their limited resources, the Subcommittee

\textbf{The beauty of the proposed “smaller public company” definition is that it would not simply set a dollar figure that would apply each year. Instead, the SEC would reset the dollar figure annually.}
felt it was appropriate for micro-caps to also be offered this relief.

The Subcommittee further recommended that the SEC issue guidance concerning materiality thresholds before companies are required to restate previously issued financial statements to correct errors that are subsequently discovered. The subcommittee felt that many “restatements are occurring where the impact of the error is not likely to be meaningful to a reasonable investor.” As an alternative, the Subcommittee recommended that an issuer be allowed in some circumstances to disclose the prior errors in its current quarterly or annual report.

Other recommendations included adding a de minimis exception to the auditor independence rules, pursuing “objectives-based” accounting standards, and increasing the visibility of audit firms that are not among the Big Four.30

Major Recommendations of the Capital Formation Subcommittee

One important recommendation presented by the Capital Formation Subcommittee was that the SEC should adopt a new private offering exemption under Section 4(2) of the Securities Act31 that would allow general advertising and general solicitation,32 provided that all purchasers (as opposed to offerees) meet certain wealth, “sophistication,” or other requirements.

The Subcommittee also recommended that the SEC, in conjunction with the National Association of Securities Dealers (NASD) and state securities regulators, allow “finders” and merger-and-acquisition advisers to register as such, instead of being required to undertake the difficult process of registering as broker-dealers. According to the Subcommittee, there is a large “unregulated underground” of finders who operate without being registered as broker-dealers, even though their activities could require such registration. The Subcommittee believed that providing a streamlined method of registration, along with “regulatory amnesty” for prior activities, would encourage these persons to register, resulting in improved regulatory oversight and issuer protection.33

The Capital Formation Subcommittee also presented additional recommendations relating to:

- trading markets for small-company securities, such as the OTC Bulletin Board and the Pink Sheets;
- amendments to various exemptions from registration under the Securities Act, including Rule 701, which exempts securities issued under certain compensatory arrangements; and
- allowing company-sponsored research on smaller public companies, provided that the researcher makes full disclosure about its relationship with the company.

What’s Next?
The foregoing preliminary recommendations were overwhelmingly approved by the Committee members at their December 14, 2005, meeting and thus were approved for inclusion in the Committee’s February 2006 preliminary report.34 The Committee’s final report is due in April 2006. Assuming that it is not materially different from the recommendations approved at the December 2005 meeting, the final report will include many important recommendations for reform of the federal securities laws, including those discussed above. However, because the Committee is only an advisory committee, its work will all be for naught if the SEC declines to pursue any of its recommendations.

This appears unlikely for several reasons. First, an overwhelming number of small public companies, as well as other commentators, have been asking for some time for some relief from SOX, particularly Section 404. In addition, current SEC Chairperson Christopher Cox noted in an August 15, 2005, press release that “I expect that the SEC and the [PCAOB] will give significant weight to the findings and recommendations of the Advisory Committee.”35 More tellingly, the SEC quickly acted on two of the Committee’s August 2005 interim recommendations, as discussed above. Also, the Committee’s work has been closely followed by interested members of the public, and the Committee (and thus the SEC) has received numerous comment letters. Finally, one must keep in mind that the SEC formed the Committee with the purpose of making recommendations to the SEC—why would the commission go to all that trouble just to ignore the results?

In the end, we will have to wait to see what happens to the Committee’s recommendations. Any recommendations that lead to an SEC rule change still will be subject to the standard public comment process. In any case, this article has hopefully informed readers about the types of relief that might come to smaller public companies and reminded
readers that they will have the chance to comment if and when the SEC proposes changes.36

NOTES
2. 15 USC 7262.
4. The release of the preliminary report was followed by a 30-day public comment period. The Committee’s final report is due April 23, 2006.
5. The Federal Advisory Committee Act (FACA), 5 USC App 1, regulates the manner in which executive branch agencies may establish advisory committees to provide expert advice or recommendations. Unless otherwise provided by statute or presidential directive, advisory committees are just that: advisory. The ultimate decision about whether to take action in response to an advisory committee’s recommendations rests with the agency that established the committee.
6. Available at http://www.sec.gov/info/smallbus/acspc/acspc-ommagenda.pdf. As Herbert S. Wander, Committee co-chairperson, observed at the Committee’s first meeting: “[i]f all of our recommendations are quickly adopted by the SEC, we have probably not been bold enough.”
8. The original deadline was June 15, 2004. However, this date was extended to fiscal years ending after November 14, 2004, in SEC Release No 34-49313, 69 Fed Reg 9,721 (Mar 1, 2004).
9. Before recent amendments, Securities Exchange Act rule 12h-2, 17 CFR 404.12h-2, defined an accelerated filer as an issuer that meets four conditions as of the end of a fiscal year, including the requirement that the aggregate market value of the issuer’s common equity held by non-affiliates total $75 million or more as of the last business day of the second fiscal quarter of that year.
10. SEC Release No 34-52492, 70 Fed Reg 56,825 (Sept 29, 2005). It is important to note that this delay relates only to the reporting requirements relating to Section 404. For example, the conditions of Exchange Act Section 13(b)(2), 15 USC 78m, apply to all public companies, requiring that they each devise and maintain a system of internal controls.
11. One confusing aspect of this recommendation is that some “smaller public companies” are not “accelerated filers” under SEC rules and thus are not subject to any shortened reporting deadlines. However, some smaller public companies nonetheless are accelerated filers because that definition requires only that the market value of shares held by non-affiliates be $75 million or more, which is a very modest figure. See note 9.
13. “Public float” is the market value of shares held by persons who are not affiliates of the issuer.
14. The Size Subcommittee noted in its August 10 presentation that while its purpose was “to provide an umbrella definition,” other subcommittees would not be precluded from using alternative definitions for their own recommendations. But see note 20.
15. Further, the companies that make up the bottom 1 percent of total U.S. market capitalization would be considered micro-cap companies. Some of the Committee’s recommendations concern micro-caps but not other “smaller public companies.”
16. However, in SEC Release No 34-52491 the SEC noted that “[w]e continue to believe that the public float test is an appropriate measure of size and market interest.”
17. Rule 2-02(f) of Regulation S-X now requires such reports, which must appear in Form 10-K, 17 CFR 210.2-02. Meanwhile, new Commission rules adopted pursuant to SOX Section 302 require an issuer’s CEO and CFO to certify in each annual and quarterly Exchange Act report, among other things, that they are responsible for establishing and maintaining the issuer’s disclosure controls and procedures and internal control over financial reporting, that they have evaluated the effectiveness of the disclosure controls and procedures as of the end of the period covered by the report, that they have presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on that evaluation, and that they have disclosed to the issuer’s auditors and audit committee all “significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the [issuer’s] ability to record, process, summarize and report financial information.” See Item 601(b)(31) of Regulation S-K, 17 CFR 229.601; see also Exchange Act Rule 13a-14(a), 17 CFR 240.13a-14.
20. As discussed in note 15, the Size Subcommittee recommended that the companies making up the bottom 1 percent of total market capitalization be considered micro-cap companies. However, the Internal Controls Subcommittee also added to its recommendations a requirement that micro-cap companies be limited to those with annual revenues no greater than $125 million. On a similar note, that subcommittee also suggested that “smaller public companies” be limited to those with annual revenues no greater than $250 million.
21. The Corporate Governance and Disclosure Subcommittee recommended that if the SEC changes its rules to allow smaller public companies to avoid the SOX Section 404 requirement of outside auditor attestation, then the commission should require such companies to make additional disclosures beyond what is currently required under Item 308 of Regulation S-K, which concerns their internal controls. The Subcommittee also suggested that smaller public companies should face requirements “substantially equivalent” to the audit committee requirements of Exchange Act Rule 10A-3, 17 CFR 240.10A-3, even if they are not otherwise subject to those requirements.
23. The Subcommittee’s final recommendation essentially was that the SEC should continue to examine whether some additional relief from Section 404 is appropriate for certain categories of smaller public companies, such as debt-only issuers.
24. In its report, the Subcommittee concluded that many of the corporate governance reforms resulting from SOX were “working well.” Thus, it did not make any recommendations in those areas.
25. 17 CFR 240.12g5-1.
26. Under current rules, an issuer with fewer than 300 record shareholders can in most cases de-register under Section 12(g). The Subcommittee also recommended increasing this number, perhaps to 750.
27. Section 402 of SOX added new Subsection (k) to Section 13 of the Exchange Act, 15 USC 78m, which provides that public companies may not extend or maintain credit in the form of a personal loan to any director or executive officer of the company, subject to limited exceptions. The Subcommittee noted that certain activities in this area need clarification, such as cashless exercises of stock options, indemnity advances, relocation expenses, and split-dollar life insurance policies.

28. The Accounting Standards Subcommittee also made a similar recommendation at the December 14, 2005, meeting.


30. The Accounting Standards Subcommittee also noted that it had considered, but rejected, the idea of “Big GAAP vs. Little GAAP,” i.e., the adoption of two different standards of generally accepted accounting principles for public companies.

31. 15 USC 77d.

32. Many exemptions from registration under the Securities Act, such as Rules 505 and 506 of Regulation D, prohibit the use of general advertising or general solicitation to reach prospective investors. See Securities Act Rule 502(c), 17 CFR 230.502.

33. Similar proposals have been made before, most recently in a report by the ABA’s Section of Business Law. See Task Force on Private Placement Broker-Dealers, American Bar Association Section of Business Law, Report and Recommendations of the Task Force on Private Placement Broker-Dealers, 60 Bus Law 959 (2005).

34. One member of the Internal Controls Subcommittee dissented from that subcommittee’s first and second recommendations, stating that giving smaller public companies “a pass on any verification and oversight of internal controls will come back to haunt us.” The member further noted that “[c]omprehensive, sweeping exemptions from Section 404 may not be possible under the current legislation, which specifically excluded Section 404 from the Securities Exchange Act of 1934…. I expect there will be legal challenges [to] this authority.” CFA Institute press release, Dec 14, 2005, available at http://www.cfainstitute.org/pressroom/05releases/20051214_01.html.


36. Although all proposed SEC rule changes are published in The Federal Register, the SEC also posts them on its Web site as soon as they are released (and often a week before they are actually published in The Federal Register). Interested readers should periodically visit http://www.sec.gov/rules/proposed.shtml to see what rule changes are forthcoming.

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Extending Credit to Automotive Suppliers in the Era of Contractual Termination for Convenience

By Joseph J. DeVito*

Introduction

Background of the Automotive Industry’s Contracting Process

There is a contractual epidemic plaguing the automotive industry. Automobile parts and components suppliers enter into contracts among themselves and with Original Equipment Manufacturers (OEMs)—i.e., General Motors, Ford, and DaimlerChrysler (collectively, the Domestic OEMs)—as well as with the foreign OEMs that produce or assemble automobiles in the U.S., including Toyota, Honda, and BMW—but by their terms these contracts may be terminated at the convenience of the buyer. Having spent a significant portion of my practice representing tier-one, tier-two, and lower-tier automotive suppliers,1 I remain perplexed and troubled by the absence of respect for the accord that this industry calls a “contract.” In fact, much of what this author learned in law school about the contract-formation process proved to be utopian theory in the face of the harsh practices adopted in Greater Metropolitan Detroit and thereafter spread by the Domestic OEMs through much of the automotive industry.

For example, when counsel represents a supplier, he or she may discover that an offer has been formally accepted and performance commenced pursuant to a newly formed contract in accordance with UCC Article 2—but that the contract has suddenly been terminated at the convenience of the buyer without any corresponding breach by the seller. It should be noted that while the majority of the buyers of goods we are discussing are OEMs, generally with vastly superior bargaining power, and the sellers are tier-one suppliers, the same or a similar contracting process necessarily flows downstream and pollutes the contracts by and among the lower tiers of the supply base. In certain circumstances where the terms and conditions of contracts between the suppliers do not match those between the tier-one supplier and the OEM, the tier-one supplier may be caught in a trap that leads to litigation, consequential losses to the tier-one, or both.

This contractual epidemic can be blamed, at least partly, on the adoption by the OEMs of a combination of the following contracting terms and implementation techniques:

- the establishment, use, or threat of use of the termination-for-convenience clause
- the establishment of the long-term supply agreement (LTA), which will often contain a required annual percentage giveback to the buyer
- the inclusion of unfunded, unilateral, and often costly engineering changes, and other contractual modifications that solely benefit the buyer

Convergence of Article 2 and Article 9 of the UCC

Although an exhaustive review of the contracting process in the automotive industry is beyond the scope of this article, the basic legal principles are important to understand in the context of secured lending to suppliers. The contracts formed pursuant to UCC Article 2 provide the collateral that is relied on both directly and indirectly by all types of secured and unsecured lenders extending credit to suppliers. More specifically, the lenders’ credit risk analysis is premised on the integrity of the accounts receivable, inventory, and machinery and equipment that are incident to the purchase orders (POs) and LTAs issued to the supplier, as well as on the expectation that the supplier will realize an ongoing revenue stream from performance under such contracts.

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The views expressed in this article are personal to the author and are not an expression of his present or past employers or partners.
Due to the typically large size of the “programs,” tier-one suppliers often do not possess large enough cash reserves to finance even pre-production, let alone actual high-volume production.

Financing Needs of Auto Suppliers
Because of the burden shifting that has occurred in the automotive industry’s contracting process, automotive suppliers have unique and extraordinary financing needs compared to other types of commercial borrowers. With a reduction in new-vehicle sales by the OEMs, new programs are highly sought after by tier suppliers, almost all of which face both an excess production capacity and a need for high-volume production to cover fixed overhead costs. This gives the OEMs tremendous leverage during the request-for-quotation process and often results in the eventual award of a PO to the lowest-bidding, and sometimes most-qualified, supplier.

The impact on the financing needs of suppliers is multifaceted. Under POs and LTAs, suppliers may be required to finance the development of prototype parts and tooling, and once these prototypes are accepted the suppliers must finance the launch of their production, including any additional engineering, high-volume design, or tooling costs. In addition, the supplier is often required to finance or carry the costs of actual production, as the OEMs demand stretched payment terms and also cause frequent production delays.

Due to the typically large size of the “programs” —i.e., the production of a certain vehicle or platform of vehicles for which the supplier is responsible for contributing a part or component— tier-one suppliers often do not possess large enough cash reserves to finance even pre-production, let alone actual high-volume production. Therefore, they must monetize whatever collateral they have available to meet cash expenditure needs during performance of the LTA or other PO. This collateral is often comprised of the right to receive payment from the OEM buyer under the contract itself. Other common items of collateral available to the supplier are inventory (raw materials, work in process, and finished goods) and machinery and equipment, all of which may be purchased by the supplier from sub-suppliers of raw materials and vendors of machinery, equipment, and tooling on an unsecured basis and on payment terms, such as net 30 days. Further, a supplier may have special assets, such as proprietary software, copyrights, or patented technology, that has intrinsic commercial value or an income stream tied to it by way of a license agreement that produces royalties.

Types of Creditors and Credit
Assume for the purposes of this article that the suppliers do not possess sufficient cash reserves to self-finance their performance obligations. They would then consider the types of creditors or lenders that are available as sources of cash or other credit. These different types will be discussed next in the order of their importance to the entire industry of suppliers. However, it should be noted that for any one supplier a certain creditor, such as a sub-supplier of raw materials that sells to the supplier on favorable terms, may be more important than a commercial bank.

Banks and Commercial Financial Institutions
In this author’s opinion and experience, state and federally chartered banks and financing companies are the single most important source of financing available to suppliers. To fully understand the types and amount of credit that banks will extend to suppliers, the reader must understand that banks are very extensively regulated by state and federal government agencies, including the Office of the Comptroller of the Currency, because they use depository accounts or federally borrowed funds to issue loans. The overriding requirement for banks extending commercial credit is that they use “safe and sound” lending practices. In other words, banks must establish that the creditworthiness of the prospective borrower is such that the bank, with a high degree of probability, realize not only a repayment of the loan in accordance with its terms but also a return on the loan, i.e., the payment of interest by the borrower. Accordingly, when determining how much credit to extend to a borrower, the bank will employ formulas that are tied to the borrower’s assets or sources or rate of income. Typical formulas consist of an advance rate on accounts receivable plus some percentage of the fair market (or, alternatively, liquidation) value of machinery, equipment, and inventory. In turn, and more importantly, the formulas are all based on the bank’s presumption that the loan will
be secured by certain collateral and that the security interest of the bank will have the priority it expects in reliance on the secured lending regime set forth in UCC Article 9.

For example, a bank may extend a commercial line of credit to an automotive supplier on a revolving basis to provide the working capital necessary to perform under a contract with an OEM. That performance will include purchasing and processing the raw materials and using the labor of the supplier’s employees to produce the finished goods for delivery to the supplier’s customer. Assuming that the goods are not rejected as nonconforming, the supplier’s performance is at least partly complete when the goods are shipped, giving rise to a right to receive payment from the OEM (in this case the buyer). The supplier then invoices the buyer and enters the amount owing in its accounts receivable ledger. This account receivable, included in the definition of “account” in Article 9 of the UCC, will serve as the collateral base for the line of credit pursuant to which funds will be advanced in an amount established by application of the bank’s “advance rate” to the amount of the supplier’s “eligible receivables.” The bank also may extend credit to the supplier under the line of credit at a lower advance rate on the supplier’s inventory. Once the inventory is shipped to the OEM, it is removed from the collateral base and replaced with the newly formed account receivable. After the OEM pays, the supplier will use those proceeds to pay down its line of credit—typically only to re-borrow on that line shortly thereafter, thus the “revolving” nature of this line of credit.

The bank also may extend credit to the supplier for a certain period of time to finance the purchase of capital machinery or equipment needed for performance under the PO. In most cases, the bank will advance a percentage of the purchase price or fair market value of the machinery or equipment, commonly referred to as the loan-to-value ratio. The term of the equipment loan is usually for a period of one to five years. This loan is called a “term loan” because it is normally advanced in one lump sum, with the supplier required to make regular monthly payments of principal plus outstanding interest over the term of the loan until the fixed-term maturity date, when any amount outstanding must be paid in full.

As with a line of credit, the term loan is extended to the automotive supplier based on a formula tied to some collateral, from which the bank will receive a security interest from the borrower under UCC Article 9. The specific method employed by the banks to secure their extension of credit is discussed in greater detail below; the point here is that without this expectancy that a secured position in the collateral base will be established simultaneously with the extension of, or commitment to extend, credit, the banks would not lend to the suppliers and the suppliers would either be unable to fulfill the LTAs and POs or would have to seek alternative sources of financing. The hesitation on the part of the banks to lend funds to automotive suppliers at normal advance rates is justified: banks frequently experience a “hair cut” or reduced payment on a default by the automotive supplier when the bank fails to realize the expected value of collateral. This, in turn, is often due to some setoff or debit back to the account receivable by the OEM for a claimed nonconformity or other alleged breach of contract that it uses to justify refusal of payment for the suppliers’ performance under the LTA or PO. To safeguard their extension of credit, banks may offer a normal advance rate in conjunction with the cross-collateralization of the loan with unrelated collateral, such as real estate or personal guaranties of the supplier’s primary owners. Banks will almost always require a first-priority security interest in the primary collateral for the extension of credit, though they may be willing to accept a position second to another creditor with respect to ancillary collateral having excess equity.

**Financing and Leasing Companies**

As a result of deregulation as well as new regulations, many insurance companies and other non-bank lenders have formed financial holding companies, specialized lending entities, or subsidiaries for extending credit to borrowers such as automotive suppliers. These entities exist in part because of the historic demand by automotive suppliers for capital equipment and, more recently, infrastructure such as hardware and software. These financial entities tend to extend credit for a specific piece of equipment in the amount of that item’s purchase price. In exchange, they will take what they expect to be a first priority, purchase money security interest (PMSI) in the purchased item(s), sometimes with additional and different collateral as a credit enhancer. These lenders may be less...
familiar with the risks of the supplier/OEM contracting process and thus more willing to advance a loan at a greater rate, making them a viable alternative to banks for some of the suppliers’ credit needs.

**Mezzanine Lenders**
Extending credit to bridge the gap between the supplier’s need for cash and the formulaic and first-priority approach of the banks and financing companies are the mezzanine lenders. These may be subdivisions of banks or some other type of financial institution, and they lend funds on a secured but second or junior position relative to the primary lenders of the automotive supplier. Because of the increased risk caused by having their interest in the collateral placed second or subordinate to that of the primary lenders, mezzanine lenders will require a higher rate of interest to be paid on their extension of credit. This subordinate nature is often the subject of not only statutory-filing priority but an inter-creditor agreement demanded by the supplier’s primary lender to safeguard against any errors in perfecting the primary security interest.

**Equipment and Tooling Vendors**
The automotive industry and the production of its parts, components, and final assemblies is very capital intensive in terms of the equipment and tooling necessary for the suppliers to fulfill their obligations under the LTAs and POs. An important source of credit for automotive suppliers, therefore, is the sub-supplier or vendor of the equipment or tooling (E&T Vendor), which may extend credit to the supplier by way of agreed-to payment terms. Whether these terms call for payment 30 days from the date of invoice or progress payment on completion of each phase of the equipment or tooling, the supplier is usually willing to accept this extension of credit. Although this would seemingly shift the risk of default to the E&T Vendors, these vendors are sometimes secured lenders as the result of a contractual PMSI or statutory lien.¹³

**Unsecured Sub-Suppliers and Vendors**
The best form of credit that a supplier can hope for is the extension of payment terms from a sub-supplier or vendor. This type of credit generally is not secured and does not bear interest. In addition, paying the account to the vendor within the set terms often allows the supplier to take a discount. This obviously presents risks to the lenders of the sub-suppliers and vendors, and a bank that lends to the OEM’s primary supplier will be cautious about also lending to its tier-two and tier-three sub-suppliers. Again, the presence of reliable and predictable contracting (UCC Article 2) and secured lending (UCC Article 9) regimes is critical both to the financing of suppliers as well as to preventing the domino credit effect that can occur if there is instability in either of these two interrelated regimes.

**Methods of Securing Credit**
The previous section discussed the types of a supplier’s assets that can be used as collateral for the extension of credit by lenders and other secured creditors. This section will briefly examine the methods by which those secured creditors create and perfect their security interests in the suppliers’ collateral, with the type of collateral determining the method for securing the credit.

**UCC Article 9**

1. **In General**
Michigan’s current version of Article 9 of the Uniform Commercial Code began as a statute that took effect January 1, 1964. Later amendments became effective January 1, 1979, and further and more significant amendments became effective July 1, 2001. The primary purpose of the original Code was to provide for a method to obtain, perfect, prioritize, and enforce security interests.¹⁴ The most recent revision to Article 9 had the purpose of simplifying the creation, perfection, prioritization, and enforcement of security interests. It also added e-commerce terms to update the methods by which parties conclude contracts for attachment and perfection of security interests.¹⁵

In this author’s opinion and experience, the revised Article 9 was most beneficial to primary commercial lenders like banks. Necessarily, this revision was also critical to suppliers at the tier-one and sub-tier levels, since the primary financing sources for suppliers are banks and their affiliates. The revised Article 9, in short, provides more security for a bank and more stability in the Article 9 secured lending regime and, therefore, should have the tendency to encourage lenders to extend credit on more favorable terms and formulas to suppliers. However, the revisions to Article 9 do not entirely compensate for or correct the failings of the Article 2
contracting process by and among suppliers and OEMs.

2. Attachment of Security Interests

To have a perfected security interest, a creditor must first obtain the debtor’s agreement to grant this security interest. This is called “attachment” with respect to the collateral. Section 9203(1) of UCC Article 9 explains that a security interest “attaches” to collateral when it becomes “enforceable” against the debtor (with the agreement of the debtor). The statute further provides that attachment requires all of the following:

1. A value must be given for the security interest (in most cases, these are the funds lent by the lender to the debtor);
2. The debtor receiving the funds referred to in item 1 must have rights in the collateral with respect to which it is granting a security interest to the lender; and
3. The borrower must authenticate a security agreement in favor of the secured lender. The revisions to Article 9, including the use of the word “authentication,” allow for e-mail and other electronic means to constitute authentication of the security agreement and to complete the third and final element of attachment.17

A subset requirement of the third element is that the collateral in which the debtor is granting rights to the secured lender must be described so that it can be reasonably identified by other parties. A generic description of collateral, therefore, is not advisable. For example, secured lenders like banks often require in their loan documents an “all asset” filing. Although this generic description method is very typical in lending across all industries, it can be problematic with respect to later attachment disputes between the borrower and the secured lender or any third parties also claiming a security interest (this will be discussed in more detail below). UCC Article 9, however, does allow for more generic descriptions in financing statements to perfect an otherwise-attached security interest.18 Security agreements also normally identify the debtor as the specific supplier with which the bank is dealing at the time of the contract; however, they also include the debtor’s assignees and successors. Under UCC § 9-203(4)(a), assignees and successors in interest to the assets of the debtor “by operation of law other than [Article 9] or by contract” are also bound by the same security agreement.20

There are two additional components of Article 9 that are important to banks lending to suppliers: (1) after-acquired property is secured and attached pursuant to UCC § 9-204(1),21 and (2) future advances made by the same lender to the same automotive supplier can be secured by the collateral given under the original loan, provided the original security agreement contained language specifying that the value for the attachment included future advances. These aspects of revised Article 9 are significant to lines of credit from banks to suppliers insofar as they may be cross-collateralized with other types of loans, such as the term loans discussed above. Moreover, credit may be more readily advanced in reliance on previously executed security agreements, thus reducing the amount of time necessary to consummate a loan transaction. Finally, commercial lenders such as banks are the beneficiaries of UCC § 9-315, which provides for automatic “rights to proceeds provided by section [9-315]” and its supporting obligations. Thus, a security agreement that may be deficient because it does not specify proceeds and supporting obligations will still be collateralized by proceeds and supporting obligations relating to the collateral described in the security agreement.22

3. Perfection of Security Interests

In the normal course of business, a secured lender such as a bank will usually obtain attachment through execution of a security agreement and then perfect the security interest pursuant to UCC Article 9. If attachment is achieved after the perfection method is established, the priority of the security interest will date back only to the date of both attachment and perfection. Article 9 provides three methods relevant to this article by which a secured creditor of a supplier may perfect its security interest in the supplier’s personal property:

1. Filing a financing statement with the appropriate governmental authority23
2. Taking possession of the collateral24
3. Obtaining control over the collateral25

Contrary to what is required in a security agreement for attachment, the financing statement may contain generic rather than specific language.26 Given the nature of the assets that comprise the collateral available for suppliers to use in borrowing funds from automotive suppliers, the financing statement will be the method most often used for perfecting security interests.

Given the nature of the assets comprising the collateral available for suppliers to use in borrowing funds from secured creditors, the financing statement will be the method most often used for perfecting security interests.
secured creditors, this will be the method most often used for perfecting security interests.\textsuperscript{28} The supplier’s most common collateral available to grant to secured parties will be its accounts receivable due from the OEMs; the machinery and equipment it uses to manufacture parts and components pursuant to the LTAs or POs; and its intellectual property. A security interest in all of these items of collateral is perfected by filing a financing statement with the Michigan Secretary of State’s UCC Division. The financing or leasing companies and mezzanine lenders discussed above also can use the financing statement method to perfect their security interest granted by the supplier. Those creditors claiming a purchase money security interest in collateral of the supplier must file a financing statement within 20 days of the advance of funds to the supplier or before advancing funds with respect to inventory.\textsuperscript{29}

The second and third methods for perfection—possessing and controlling the collateral—may prove to be equally important in the case of a liquidation of a supplier. With respect to possession, cash collateral in the possession of a secured lender like a bank is only perfected by possession in an actual depository account at the lender’s institution. As for the control method, a bank may require the owner of a supplier to provide a personal guaranty or some additional collateral. In turn, some guaranties are secured by a grant of a security interest in marketable securities held in a brokerage account of the guarantor. The lender obtains perfection over the pledged marketable securities by way of an account control agreement entered into between the lender, the guarantor, and the securities brokerage firm possessing the marketable securities.\textsuperscript{30}

\textbf{Special Statutes: Molders, Tool Builders, and Judgment Creditors}

Suppliers such as molders, tool builders, and otherwise unsecured creditors that have a judgment may obtain a perfected security interest in the assets and collateral of a supplier. For example, the builder of a mold used by a supplier in the production process receives attachment of a lien to the actual mold when the mold builder provides actual or constructive notice pursuant to MCL 445.619. More specifically, the mold builder must permanently record its name and mailing address on every die, mold, or form that it fabricates, repairs, or modifies. Further, the mold builder is then required to file a financing statement in accordance with the requirements of UCC § 9-502.\textsuperscript{31} The fulfillment of these two obligations perfects the mold builder’s lien on the item at issue; the lien is retained under MCL 445.619(3) even if the mold builder is not in physical possession of that die or mold. Further, a sub-supplier that actually uses the mold or die to create a part or component also has a lien (i.e., a perfected security interest) in the mold or die while it is in the possession of the molder, to the extent that the work is performed for the supplier.

A sub-supplier or vendor to a supplier that designs, develops, manufactures, or assembles special tools (i.e., dies, jigs, gauges, gauging fixtures, special machinery, cutting tools, or metal casting fabricated by a special tool builder) enjoys a perfected lien in those special tools pursuant to MCL 570.541 et seq., the Special Tools Lien Act. Finally, under Michigan’s judgment lien law,\textsuperscript{32} sub-suppliers and vendors of the supplier that were otherwise unsecured creditors of the supplier may obtain liens in certain assets of the supplier in an expedited manner.

The special statutes are important for counsel to recognize, as they are critical to analyzing the priorities of a supplier’s secured and unsecured lenders. Depending on the time of attachment and perfection of these statutory liens, a bank or other financial institution in a traditional security agreement and financing statement perfection method may find itself second in position to a statutory lien holder if it has not done a lien search before extending credit to the supplier. This, in turn, will render the supplier in breach of its loan agreements, including its security agreement with the bank, as these agreements customarily require the bank to maintain a first-priority security interest in the collateral described in the security agreement at all times during its extension of credit to the supplier.

\textbf{Possessory Liens}

For the purposes of this article, the most important possessory lien is that of the cash collateral held at an account of a bank. More specifically, the supplier’s funds held in a depository account at the same financial institution that extends commercial credit to the supplier are the subject of a perfected security interest of the bank. Furthermore, proceeds of collateral that are otherwise not the subject of a security interest of such lender but that
find their way into the depository account of the supplier will be the subject of a perfected security interest of the bank if it has a security interest in the supplier’s cash.\textsuperscript{35}

**Competing Priorities and Claims**

**Default of Supplier**

What are the relative priorities of a supplier’s creditors in a default situation? In particular, assuming that an OEM exercises its contractual rights or power to terminate or modify an LTA or PO, what are the consequences for the banks and other secured lenders under UCC Article 9? The general rule of law in Michigan is that the first secured party to file an effective financing statement has the first priority security interest in the collateral.\textsuperscript{34} There are, however, a few very important exceptions to this general rule as it applies to the supplier situation.

First, the so-called purchase money security interest or “PMSI” will have priority over a preexisting “all asset” filing covering the same type of collateral, provided (1) the PMSI-lender advances the funds for the purchase of the collateral; (2) the auto supplier has rights in (i.e., takes title to) the collateral; and (3) the PMSI-lender files a financing statement within 20 days.\textsuperscript{35}

Another special rule applies to consignments of inventory, a common clause in automotive supply agreements. Suppose that inventory held by a supplier was not paid for but instead was held at its plant on consignment from a sub-supplier or vendor. This sub-supplier or vendor would be the recipient of an automatic PMSI pursuant to UCC § 9-103(4),\textsuperscript{36} and so long as such sub-supplier or vendor followed the 20-day filing rule in UCC § 9-324(1)\textsuperscript{37} it would have a priority security interest above the banks in the consigned inventory. If the sub-supplier or vendor fails to file a financing statement within such 20-day period, it may be subordinate in interest to the banks.

There are also exceptions to the normal priority rules that apply to proceeds in bank depository accounts. Assume that the supplier does most of its banking with Bank A, where it has its checking and depository accounts. Bank B, meanwhile, has a prior filing with respect to the proceeds of the collateral securing its loan. However, if the supplier sells any of its assets that serve as collateral for its Bank B revolving line of credit and the cash proceeds of this sale end up in its accounts at Bank A, Bank A will have a priority interest superior to Bank B’s perfected interest in those proceeds.\textsuperscript{38}

An exhaustive examination of the hypothetical scenarios and applicable priority rules that could actually exist among a supplier, its banks, and other secured lenders is beyond the scope of this article. These few preceding examples, however, highlight the complexity of the exception-laden priority rules and should make it clear that when the supplier’s collateral base is shaken by sinkholes in the OEM-supplier contract process, secured lending to suppliers is anything but secure.

Further, this raises issues of banking regulatory law, as banks and other similarly regulated lenders are required to adhere to “safe and sound” lending practices that may be ineffective or unattainable in the automotive industry lending regime.

**Conclusions**

Without the integrity of the contracting process under Article 2 of the UCC and other generally applicable rules of law governing contracts, the collateral relied on by secured lenders in advancing credit to a supplier may be rendered worthless. All types of parties extend credit to suppliers based on not only the intrinsic value of the collateral but also, more importantly, on the income stream that flows from the production supply contracts with the OEMs and the resulting accounts receivable and eventual payments. Further, many creditors extend credit on a long-term basis in reliance on the supplier’s long-term contracts, but when the LTA contains a termination-for-convenience clause the integrity of any long-term income stream is threatened. As a result, secured commercial lenders such as banks, mezzanine lenders, commercial leasing companies, and other secured lenders are tightening credit facilities by lowering the formula borrowing base of suppliers and requiring that the supplier pledge more collateral than the credit facility might ordinarily require. This weakening in the secured lenders’ collateral position, combined with the overall loss of integrity in the contracting process, has had a trickle-down effect on other secured lien holders, including mold builders and special tool builders, as well as on unsecured vendors and creditors. More specifically, these factors have a negative effect on the accounts receivable of the latter groups, which, in turn, begin to default on their credit facilities, causing the domino

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**When the supplier’s collateral base is shaken by sinkholes in the OEM-supplier contract process, secured lending to suppliers is anything but secure.**
effect that we are seeing in the automotive industry today.

Reestablishing the integrity of the contracting process would help resolve the issues facing secured lenders extending credit to suppliers. To shorten payments and stabilize the dollar value of accounts receivable, long-term agreements must be reestablished. This would prevent any further erosion of the supply base and reduce the hesitation of lenders in entering into or further extending themselves in the automotive industry. Although market conditions and poor sales cannot be overlooked, the integrity of contracts is critical to this industry, providing stability not only to suppliers and sub-suppliers but, more importantly, to secured commercial lenders. If banks and other secured lenders are to continue to play a role in the automotive industry, the termination-for-convenience clause and other similar contracting techniques must be eradicated from LTAs, POs, and OEM terms and conditions.

NOTES

1. Tier suppliers supply parts directly or indirectly through other suppliers or through their sub-suppliers and other OEMs.
2. MCL 440.2101 et seq.
3. “Collateral” means assets to support obligations to lenders or creditors.
4. This expectancy right to receive payment for goods delivered to the buyer on extended-payment terms (other than C.O.D.) is called an “account receivable.” The UCC refers to accounts in general. See 440.9102(1)(b), which includes accounts receivable.
5. Except for certain suppliers like tool builders, which are granted lien rights under special Michigan statutes. See MCL 570.541 et seq.
6. See generally MCL 440.9102 and MCL 440.9109.
7. MCL 440.9101 et seq.
8. MCL 440.9102(1)(b).
9. “Advance rate” typically means the percent (typically 80 percent) applied to the outstanding accounts receivable balance.
10. At times, accounts receivable are no longer eligible to be applied to the advance rate. It is customary in the automotive industry to allow OEM accounts receivable to extend to 180 days rather than the customary 90 days.
11. Suppliers often seek alternative sources of financing anyway, because of the banks’ tendency to lower their advance rates or to otherwise deem collateral ineligible due to the uncertainty in the supplier/OEM contract enforcement discussed above, which leaves banks exposed to higher rates of defaults among its automotive supplier borrowers.
12. The enforceability of any additional collateral taken in conjunction with the PMSI may be challenged, but the actual collateral purchased is safe. MCL 440.9103(1)(b) and (6).
13. The statutory liens include the one protecting mold builders and molders. MCL 445.617 et seq.

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“And” to “Or” Means Preference No More: The Expansion of the “Ordinary Course” Bankruptcy Preference Defense

By Scott A. Wolfson

Being sued to recover a preference can drive home the financial impact of bankruptcy to a creditor client. In addition to the loss the creditor will likely sustain on the amounts owed by the debtor when the debtor filed for bankruptcy, the creditor may be forced to return any preferential payments it received before the bankruptcy. There are several defenses to a preference action, the most common of which is the “ordinary course of business” defense.\(^1\) Congress changed only one word of the elements of this defense—substituting an “and” for an “or”—in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005\(^2\) (the “Reform Act”), its recent amendments to the Bankruptcy Code.\(^3\) That change, however, should significantly help the typical unsecured creditor defeat a preference claim.

**Definition of a “Preference” and Purposes of Avoidance**

Preferences are payments that favor certain creditors over others.\(^4\) A debtor, or the trustee of a debtor, may avoid any transfer\(^5\) of an interest of the debtor in property:

1. to or for the benefit of a creditor;
2. for or on account of an antecedent debt owed by the debtor before such transfer was made;
3. made while the debtor was insolvent;
4. made—
   1. on or within 90 days before the date of the filing of the petition; or
   2. between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider;\(^6\) and
5. that enables such creditor to receive more than such creditor would receive if—

   (A) the case were a case under chapter 7 of this title;
   (B) the transfer had not been made;
   and
   (C) such creditor received payment of such debt to the extent provided by the provisions of this title.\(^7\)

Outside the confines of bankruptcy, a company is generally free to pay its creditors in any order of priority. For example, if a company owes unsecured creditors A, B, and C $100 each, the company could pay C in full before paying any amount to A or B. However, if the company were to subsequently file for bankruptcy, transfers meeting the elements set forth above could be set aside. A preferential payment that is avoided becomes part of the common pool of assets, known as the “bankruptcy estate,”\(^8\) for distribution to creditors under the Bankruptcy Code’s priority scheme.\(^9\)

Congress described the purpose of the preference-avoidance power as twofold: first, to discourage creditors “from racing to the courthouse to dismember the debtor during [its] slide into bankruptcy;”\(^10\) and second, to “facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor.”\(^11\) Thus, if the $100 payment to C constituted a preference, the debtor could recover the $100 from C for distribution pro rata to A, B, and C.\(^12\)

**Defenses to Preferences**

Section 547(c) of the Bankruptcy Code excepts certain transfers from being avoided as preferences even though they meet all of the elements of a preference under section 547(b). The exceptions include payments in the ordinary course of business;\(^13\) contemporaneous exchanges for new value;\(^14\) purchase money security interests, or “enabling loans;”\(^15\) and preferences subsequently offset by unsecured credit, or “new value.”\(^16\) The ordinary
course of business defense, already the most common preference defense, should become even more prevalent with the Reform Act.

**Ordinary Course of Business Defense**

The legislative history behind the ordinary course of business defense states that its purpose “is to leave undisturbed normal financing relations because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or [its] creditors during the debtor’s slide into bankruptcy.” The defense, as amended by the Reform Act, provides that a transfer may not be avoided to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or

(B) made according to ordinary business terms.

Like prior law, the Reform Act continues the requirement that the debt be incurred in the ordinary course of business of the debtor and the transferee. However, the amended language now stipulates that the requirements of either subsection (A) or subsection (B) be met. Courts have interpreted the requirements of (A) to be a subjective test—i.e., that the transfer be ordinary in relation to the other business dealings between that creditor and that debtor. Courts have interpreted the requirements of (B) to be an objective test—i.e., that the transfer be ordinary in relation to the prevailing standards in the relevant industry. Prior to the Reform Act, the ordinary-course defense was written in the conjunctive; a creditor had to show that the transaction was ordinary both subjectively and objectively. The Reform Act’s one-word change significantly relaxes the standard for a transfer to be considered ordinary course because a transfer now need only be subjectively or objectively ordinary course to qualify for the defense.

The Reform Act’s changes to the ordinary-course defense apply to bankruptcy cases commenced on or after October 17, 2005. Thus, conduct today will be subject to the amended statute.

### Examples of the Amendment’s Potential Benefits to Creditors

**Tightening Credit to Industry Standards**

A company’s financial problems are sometimes well known, and some bankruptcies are highly anticipated. In such circumstances, diligent creditors typically begin to shorten the time within which they require payments from the financially troubled debtor to avoid a large outstanding receivable upon a bankruptcy filing. However, there are circumstances under the new ordinary-course defense in which the creditor’s demand for an earlier payment may not be considered a preference. This would be true where the new, shorter payment terms, although not subjectively ordinary course between the creditor and the company, are ordinary course in the industry. This result seems contrary to the congressionally espoused purpose of the ordinary course of business preference defense of maintaining “normal financing relations,” but it appears to be required by the unambiguous language of the statute. Furthermore, a creditor could argue that a change in terms to allow the creditor to be paid in line with its industry peers furthers the preference policy of equality of distribution.

For example, Creditor supplies BrokeCo. with goods under a contract that gives BrokeCo. 60 days to pay—a more generous payment term than the 30-day industry standard. Creditor then learns of BrokeCo.’s financial problems, deems itself insecure, and begins requiring payment within 30 days. BrokeCo. files for bankruptcy several months after this.

Assume that during the 90-day preference period preceding BrokeCo.’s bankruptcy Creditor received payments from BrokeCo. an average of 33 days after invoice, 30 days sooner than the average 63 days within which Creditor had received payment from BrokeCo. before the preference period. BrokeCo., or the trustee representing BrokeCo. in bankruptcy, then sues Creditor to recover as preferential the payments made during the 90 days preceding BrokeCo.’s bankruptcy.

The expedited payments would likely be preferential under the old law because the payments were not subjectively ordinary course—that is, not ordinary course between BrokeCo. and Creditor. The fact that the 33-day payment terms are objectively ordinary course—that is, standard in the industry—would not be dispositive. However, under the new law these payments should not be
preferential because they meet the objective standard.

**Tightening Credit Early to Establish a Course of Dealing**

The changes to the ordinary-course defense may also encourage getting tough early with a problem customer. Under the new law, any payment terms, regardless of how onerous or in line with industry standards, would appear to insulate a creditor from preference exposure provided they have been in existence long enough to be deemed subjectively ordinary course between the creditor and potential debtor.  

For example, what if Creditor had been more aggressive with BrokeCo. and required cash on delivery or net immediate payment terms and BrokeCo. did not file for bankruptcy until 18 months later? In that case, Creditor should have a valid ordinary course of business defense under the new law because the immediate payment terms, in effect for a year and a half, were subjectively ordinary course. This is true despite the fact that Creditor obtained payment over 30 days earlier than is standard in the industry, which would have proved fatal pre-Reform Act, because the Reform Act eliminates the objective component. This result is also contrary to the preference law’s intention of encouraging creditors to work with a struggling company to perhaps make a bankruptcy filing unnecessary. The new law is clear, however, on the fact that payments made to a creditor in the ordinary course of its business with the debtor are protected.

**Conclusion**

The recent one-word change to the ordinary course of business defense to a bankruptcy preference action significantly expands the defense’s utility to the typical unsecured creditor. Attorneys must understand the new law to properly advise a client whose customer may file for bankruptcy or to advise a client who is a defendant in a preference lawsuit.

**NOTES**

1. “The most commonly raised defense by far, to the surprise of no one, is the ordinary course of business defense under § 547(c)(2) (73.4 percent).” ABI Preference Survey, Bankruptcy Reform Study Project, Task Force on Preferences, American Bankruptcy Institute (1997).


3. 11 USC 101-1532.

4. “In general, a ‘preference’ exists when a debtor makes payment or other transfer to a certain creditor or creditors, and not to others. Such favoritism is prohibited by 11 USC 547(b) when a debtor is in bankruptcy.” Kenan v Fort Worth Pipe Co (In re George Rodman, Inc), 792 F2d 125, 127 (10th Cir 1986) (citation omitted).

5. A "transfer" is broadly defined by the Bankruptcy Code as "(A) the creation of a lien; (B) the retention of title as a security interest; (C) the foreclosure of a debtor’s equity of redemption; or (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—(i) property; or (ii) an interest in property.” 11 USC 101(54).

6. See 11 USC 101(31) for the definition of an “insider.”

7. 11 USC 547(b) (citations omitted).

8. See 11 USC 541 for a description of assets that constitute a bankruptcy estate.


10. HR Rep No 95-595 at 177 (1977), as reprinted in 1978 USCCAN 5963; see also In re Tolona Pizza Prods Corp, 3 F3d 1029, 1032 (7th Cir 1993): “Unless the favoring of particular creditors is outlawed, the mass of creditors of a shaky firm will be nervous, fearing that one or a few of their number are going to walk away with all the firm’s assets; and this fear may precipitate debtors into bankruptcy earlier than is socially desirable.”

11. HR Rep No 95-595 at 177-78 (1977), as reprinted in 1978 USCCAN 5963; see also Warco v Preferred Technical Group, 258 F3d 557, 564 (7th Cir 2001) (“Trustee’s power to avoid preferential transfers is designed to further the Bankruptcy Code’s central policy of equality of distribution: ‘Creditors of equal priority should receive pro rata shares of the debtor’s property.’”) (quoting Begier v IRS, 496 US 53, 58 (1990)).

12. Assuming, simplistically, that A, B, and C are the only creditors of the debtor and that there are no administrative expenses.

13. 11 USC 547(c)(2).

14. 11 USC 547(c)(1).

15. 11 USC 547(c)(3).

16. 11 USC 547(c)(4).

17. HR Rep No 95-595 at 373-74 (1977), as reprinted in 1978 USCCAN 5963.

18. 11 USC 547(c)(2) (emphasis denotes new language).


20. Id. at 243-44, 245.

21. “[I]n all cases involving statutory construction, our starting point must be the language employed by Congress . . . and we assume that the legislative purpose is expressed by the ordinary meaning of the words used.” INS v Phinpathya, 464 US 183, 189 (1984) (interpreting a statute according to its “plain meaning . . . however severe the consequences”) (internal quotations and citations omitted).

22. There is no precise legal test to determine whether payments are subjectively ordinary course between parties; rather, courts “engage in a fact-specific analysis.”

The changes to the ordinary-course defense may also encourage getting tough early with a problem customer.
Fred Hawes, 957 F2d at 244.

23. The risk is that the debtor may file for bankruptcy before a new course of dealing can be established, in which case the shorter payment terms would not meet the subjective component of the ordinary-course defense.

24. See, eg, Cage v Wyo-Ben, Inc (In re Ramba, Inc), No 04-20752, 2006 US App LEXIS 1653 at *14 (5th Cir Jan 23, 2006) (pre-Reform Act decision vacating finding of ordinary-course defense where court considered only payment history between the parties and failed to address whether payments were “out of line with what others do”).

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Case Digests
Prepared by Jason D. Glenn*

Diversity Jurisdiction – Access of National Banks to Federal Courts
In Wachovia Bank, NA v Schmidt, ___ US ___, 126 S Ct 941 (2006), respondents, South Carolina citizens, sued Wachovia in South Carolina state court, alleging that they had been fraudulently induced to participate in an illegitimate tax shelter. Wachovia then filed a petition in federal district court to compel arbitration of the claims, alleging diversity as its basis for federal jurisdiction. The district court denied the petition on the merits. On appeal, the Fourth Circuit determined that the district court lacked subject-matter jurisdiction over the suit. The Fourth Circuit interpreted the jurisdiction-granting statute (28 USC 1348), which states that national banks are citizens of every state in which they do business, to mean that there was no diversity of citizenship since Wachovia does business in South Carolina, the home state of the respondents.

The Supreme Court unanimously reversed the Fourth Circuit’s ruling and held that, for the purposes of the jurisdiction-granting statute, a national bank is a citizen of the state in which its main office sits. Thus, Wachovia’s petition to compel arbitration could go forward. The Fourth Circuit had interpreted the usage of the word “located” in 28 USC 1348 to mean having established branches, but the Supreme Court noted that this term does not have a consistent meaning as used in the statute. In the series of statutes and amendments leading to the current conception of section 1348, the term “located” almost always meant “established,” or where the bank’s principal offices were located.

The Supreme Court further alluded to the restriction that the Fourth Circuit’s holding would place on the access of national banks to federal courts. Under the Fourth Circuit’s holding, the ability of many national banks to come to federal courts based on diversity jurisdiction would be frustrated, since national banks tend to be located in most states. This would unreasonably distinguish national banks from most corporations, which ordinarily are deemed to be citizens only of the state in which they are incorporated or maintain their principal place of business.

Antitrust – Discriminatory Pricing Under Robinson-Patman Act
In Volvo Trucks North America, Inc v Reeder-Simco GMC, Inc, ___ US ___, 126 S Ct 860 (2006), respondent Reeder, a Volvo dealer that placed bids on trucks manufactured by petitioner Volvo, filed an antitrust claim under section 2 of the Clayton Act, as amended by the Robinson-Patman Act, 15 USC 13, after it discovered that Volvo had been offering other bidders more favorable price concessions. Suspecting that Volvo wanted to eliminate Reeder from the bidding process, Reeder alleged in its antitrust suit that its sales and profits declined because of Volvo’s favorable price concessions to other dealers. At trial, the jury found, and the Eighth Circuit affirmed, that Volvo had engaged in discriminatory pricing. Reeder was awarded treble damages on its antitrust claim.

The Supreme Court held that Reeder had not satisfied the requirements of a discriminatory pricing claim under the antitrust laws. Specifically, the Court held that while Reeder had satisfied the first two requirements—that the Volvo truck sales were in interstate commerce and that the trucks were of similar grade and quality—it had not satisfied the final two: that Volvo had discriminated in price between Reeder and another purchaser of the same products, and that the effect of the discrimination would be an actual injury to competition.

As evidence of discriminatory pricing, Reeder offered different pricing comparisons that the Court categorized as “purchase-to-purchase,” “offer-to-purchase,” and “head-to-head.” The Court found that the first two categories of comparisons in prices Reeder had offered did not demonstrate the injury to competition required by the statute because in none of the instances that Reeder alleged violated the antitrust laws did Reeder compete with beneficiaries of the alleged discrimination for the same customer. In the final category of comparisons (head-to-head), the Court also found no antitrust violation because Reeder did not establish that it was disfavored with respect to other Volvo dealers in rare cases in which they competed for the same sale. The Court noted that even if there had been some evidence of discriminatory pricing in the few instances in which Reeder had actually competed with other dealers for the same sale, it would not have had the significant impact on competition that the antitrust laws require to establish a violation.

Labor & Employment – Compensable Time Under the FLSA
In IBP, Inc v Alvarez, ___ US ___, 126 S Ct 514 (2005), a consolidation of two separate cases, respondent employees filed a class action seeking compensation under the Fair Labor Standards Act (FLSA), 29 USC 201 et seq., for time spent putting on and taking off required protective gear and walking between the locker rooms and the production floor of the meat processing facilities at which they worked (IBP and Barber Foods). In the IBP case, both lower courts held that the time was compensable, and the Supreme Court affirmed. In the Barber Foods case, the employees sought compensation under the Portal-to-Portal Act, 29 USC 251 et seq., in addition to the FLSA. The lower courts in Barber both held for the employer, and the Supreme Court affirmed with respect to the Portal-to-Portal Act claims, but reversed with respect to the FLSA.

With respect to the FLSA claims in both cases, the Court reasoned that the text of the statute does not specifically exclude the activity for which the employees sought to be

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compensated. IBP argued that, because putting on or taking off protective clothing is not a “principal activity” under the statute, any walking that occurs directly after or before putting on or taking off protective clothing should not be compensable. However, the Court rejected that argument on the ground that its previous ruling in Steiner v Mitchell, 350 US 247 (1956), made clear that any such preparatory activities that are “integral and indispensable” to principal activities are themselves principal activities. The Court also relied on the relevant federal regulations promulgated under the FLSA (see 29 CFR 790.6, .7(g)), reasoning that these could be interpreted to mean that the working time in question is compensable.

**Single Business Tax – Voluntary Disclosure Agreements and the Definition of “Nonfiler”**

In Trostel, Ltd v Department of Treasury, No 255630, 2006 Mich App LEXIS 130 (Jan 17, 2006), plaintiff, a Wisconsin business, filed suit against the Michigan Department of Treasury, seeking to enforce a Voluntary Disclosure Agreement (VDA) with the Department. This action stemmed in part from the 1998 enactment and 2001 amendments of MCL 205.30c, which established a voluntary disclosure program for taxpayers that had not filed single business tax (SBT) returns but that should have according to a change in standards set by the Department of Treasury. By entering into a VDA, a taxpayer could be relieved of any taxes and penalties it might otherwise have had to pay. Plaintiff entered into such an agreement, but the Department of Treasury subsequently terminated it after discovering that plaintiff had filed SBT returns some 20 years earlier. The Department ordered plaintiff to pay back taxes plus penalties and interest. Plaintiff filed returns and paid the taxes under protest but then commenced this suit to recover what it had paid and to enforce the VDA. The Court of Claims found in plaintiff’s favor.

On appeal, the judgment was affirmed. The court noted that, as originally set forth in the 1998 amendment to MCL 205.30c, the voluntary disclosure program limited participation only to a “nonfiler,” which was originally defined as “a person that has never filed a return for the particular tax being disclosed.” In 2001, the legislature revised this definition to mean “a person that has not filed a return for the particular tax being disclosed for periods beginning after December 31, 1988.” The court held that the 2001 amendment to this definition was meant to apply retroactively to the original 1998 enactment of the voluntary disclosure program. Under the amended definition of “nonfiler,” plaintiff qualified to participate in the voluntary disclosure program and should not have had to pay taxes or penalties after entering into the VDA.

**Contracts – Amended Agreements and Consideration**

In Adell Broad Corp v Apex Media Sales, Inc, 269 Mich App 6, 708 NW2d 778 (2005), plaintiff used defendant as its exclusive media representative for national religious and secular broadcast sales. Plaintiff became dissatisfied with defendant’s service, and defendant likewise became dissatisfied with the relationship because plaintiff owed defendant outstanding commission payments. The parties amended their agreement on February 26, 2002, agreeing to a sum that plaintiff owed defendant in commissions ($568,461) and further agreeing that plaintiff’s tendered payment of $370,000 fully satisfied commissions owed through December 2001. The parties also agreed to alterations in the rate of commissions and payment terms. This agreement did not resolve their differences, however, and the relationship was terminated in April 2002. Plaintiff filed suit against defendant, and defendant counterclaimed, seeking rescission of the amended agreement. Plaintiff sought summary judgment on the counterclaim on the basis that defendant could not seek rescission of the agreement because it had not returned the $370,000. The trial court concluded that the $370,000 was partial satisfaction of an undisputed debt, so defendant did not have to tender it back. Defendant then moved for partial summary judgment on its counterclaim, which the trial court granted.

On appeal, plaintiff argued that the trial court should have applied MCL 566.1 to the amended agreement. MCL 566.1 provides that an amended agreement is not invalid because of the absence of consideration as long as the agreement is in writing and signed by the party against whom the change shall be enforced. The court of appeals agreed with plaintiff’s reading of the statute and reversed the trial court’s holding, noting that it is axiomatic that parties to a contract may contract to modify the contract by later agreement, so long as there is mutual agreement expressed in writing. The court further noted that the $370,000 may have satisfied the entire debt on valid consideration, which the court found was present in the form of the parties’ continuation of their business relationship after the amended agreement was entered into. Since valid consideration was present, the partial payment may have satisfied the entire debt. The court remanded to the trial court for a finding on this issue.

**Motor Fuel Tax Act – Refunds for Gasoline Shipped Out of State by Auto Manufacturer**

In DaimlerChrysler Corp v Michigan Dep’t of Treasury, 269 Mich App 528, 708 NW2d 461 (2005), plaintiff sought a refund of the state motor fuel tax it paid pursuant to the Motor Fuel Tax Act (MFTA), MCL 207.1101 et seq., on fuel it had purchased and placed in the fuel tanks of newly made vehicles sold to out-of-state dealers. The refund was sought specifically under MFTA section 47, MCL 207.1047. Plaintiff argued that the stated intent of the MFTA is to require persons using state roads to pay for that privilege. Since the gas placed in the vehicles that were shipped out of state was never used to power the vehicles in Michigan, plaintiff contended that there should be no tax on that gas under the statute. Alternatively, plaintiff argued that it was entitled to a refund under MFTA sections 33 and
that no state tax had to be paid. After federal statute applied to Michigan’s SBT and, therefore, Department of Treasury had taken the position that the tax but rather a value-added tax (VAT) and that the fed

gasoline may obtain a refund on any gasoline purchased and used for non-highway purposes. The Tax Tribunal

In re D’Amico Estate, 435 Mich 551, 460 NW2d 198 (1990), which held that the Department of Treasury was bound by its interpretation of section 34 of the Lottery Act, MCL 432.34, exempting state lottery prizes from the inheritance tax, the court of appeals concluded that the Department of Treasury was bound by the position it adopted before Gillette. The court held that plaintiffs had to pay taxes only for revenues collected after the date of the Gillette decision.

**Title VII – Transfer of Employee after Alleged Sexual Harassment Constitutes “Tangible Employment Action”**

In Keeton v Flying J, Inc, 429 F3d 259 (6th Cir 2005), plaintiff worked as an assistant manager at a Flying J store in Kentucky, where his supervisor began making sexual advances toward him. Plaintiff rejected these advances, until one day his supervisor telephoned him at home requesting that he come to the store. When he arrived, the supervisor told him that he was fired, despite the fact that he had never been formally or informally disciplined. After appealing informally to a regional manager, plaintiff was reassigned to another store, but plaintiff’s wife was unable to move with him due to health problems, and plaintiff was forced to maintain two residences. After leaving Flying J for another chain, plaintiff filed this sexual harassment suit under Title VII, alleging that he had been subject to a hostile work environment and that he had been constructively discharged. At trial, the jury found Flying J liable only for sexual harassment resulting in tangible employment action and awarded plaintiff $15,000. The jury found that plaintiff had not been constructively discharged and awarded no back pay. Flying J filed for judgment as a matter of law, which the district court denied.

Flying J appealed the district court’s denial of judgment as a matter of law, and the Sixth Circuit affirmed. The issue on appeal was whether plaintiff’s transfer could be considered a tangible employment action, which is generally defined as a change in the terms and conditions of employment. Flying J argued that the transfer did not rise to that level because plaintiff retained the same benefits and salary when he was transferred to another store following his “termination.” The Sixth Circuit determined that the transfer could reasonably be interpreted by a jury as a tangible employment action (also labeled an “adverse employment action”). As a result of his transfer, plaintiff had to choose between engaging in a tremendously long commute every day and relocating altogether. The court held that this was within the jury’s reasonable discretion to conclude that a tangible employment action existed.

**Single Business Tax – Retroactive Applicability**

In International Home Foods, Inc v Department of Treasury, 268 Mich App 356, 708 NW2d 711 (2005), plaintiffs were businesses based outside Michigan whose sole presence in Michigan was a sales force that called on Michigan businesses, encouraging them to place orders with plaintiffs’ out-of-state offices. A federal statute, 15 USC 381, prevents states from imposing income tax on plaintiffs’ activities in their respective jurisdictions since all revenue is collected in states outside their jurisdictions. In 1993, the Michigan Court of Appeals decided Gillette Co v Department of Treasury, 198 Mich App 303, 497 NW2d 595, which held that Michigan’s single business tax (SBT) is not an income tax but rather a value-added tax (VAT) and that the federal statute is inapplicable to a VAT. Before Gillette, the Department of Treasury had taken the position that the federal statute applied to Michigan’s SBT and, therefore, that no state tax had to be paid. After Gillette, however, the Department of Treasury assessed SBT liability against plaintiffs not only for the tax years after Gillette but also for prior years still regarded as “open” at the time of the Gillette decision.

39 (MCL 207.1033, 1039), which state that an end user of gasoline may obtain a refund on any gasoline purchased and used for non-highway purposes. The Tax Tribunal issued a decision in favor of the Department of Treasury, holding that plaintiff was neither the “exporter” of the fuel in question nor an “end user” within the purview of the MFTA.

On appeal, the court of appeals affirmed the rulings of the Tax Tribunal on both issues. On the issue of whether plaintiff could be viewed as an “end user” under sections 33 and 39, the court noted that the statutes did not define the term “end user,” giving the term its plain meaning, the court held that “end user” means the ultimate user for whom a product is designed. For purposes of gasoline, the “end user” is the party who uses the fuel to power the motor vehicle into which the fuel is placed. Plaintiff could not be included under that definition because it never used the fuel to power the vehicles. Plaintiff’s sole purpose in purchasing the gasoline was to ensure that there was fuel in the tank when the cars arrived at the dealers. The court similarly dismissed plaintiff’s second argument that it was entitled to a refund based on MFTA section 47. The court concluded that plaintiff mistakenly relied on the stated purpose of the MFTA—i.e., to impose gasoline taxes on persons who use state roads. While the court acknowledged this as the general intent of the MFTA, it stated that the act does not provide that a refund is always appropriate whenever motor fuel tax is paid on gasoline that is not used by cars on Michigan roads. Rather, a refund is appropriate only when the MFTA so provides. Since the MFTA did not provide for a refund in this context, the court affirmed the ruling of the Tax Tribunal that plaintiff could not claim a tax refund.
FMLA – Termination of Leave and Fitness-for-Duty Verification

In Brumbalough v Camelot Care Ctrs, Inc, 427 F3d 996 (6th Cir 2005), plaintiff was a former employee who took FMLA medical leave from her position as state clinical director for the employer, which provided placement for abused and neglected children. Two months into the leave, plaintiff notified the employer of her intent to return to work, but she was terminated when the employer determined that she had failed to timely submit a proper “fitness-for-duty” verification under 29 CFR 825.311(c). Plaintiff filed suit against the employer, alleging that it had interfered with her FMLA rights by terminating her while she was on leave. The district court denied plaintiff’s motion for summary judgment on the issue of liability and granted the employer’s motion for summary judgment.

On appeal, the Sixth Circuit affirmed the denial of the employee’s motion because the trial court properly concluded that the employee was not on FMLA leave at the time she was terminated. The employee’s leave ended when she notified the employer of her intent to return to work. Although the employer may require more information, 29 CFR 825.310(c) clearly provides that the employer cannot delay reinstating an employee simply because the employer is obtaining clarification or more information from the employee’s health care provider. Once an employee submits a statement from a health care provider that indicates that he or she may return to work, the employer’s duty to reinstate under the FMLA is triggered. Although the district court found that plaintiff’s work restrictions of 40 to 45 hours a week would leave her unable to meet the alleged requirement that she be on call 24 hours a day, plaintiff showed a genuine issue of material fact by (1) testifying that, given her knowledge of the position, she could meet her responsibilities by working 45 hours a week; (2) presenting the letter her employer wrote to her doctor, which did not state that she needed to work 60 to 70 hours a week; and (3) presenting the written job description, which did not state precisely the amount of time over 40 hours a week that she needed to work.
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