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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.

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BUSINESS LAW SECTION

November, 2005

Dear Business Law Section Member:

Welcome to another outstanding issue of the *Michigan Business Law Journal*. We are very proud of this publication and thankful to our authors for their efforts. This issue features terrific articles written and solicited by the Section's Commercial Litigation Committee, including informative pieces on the proposed Michigan Business Court, the Class Action Fairness Act of 2005, the Business Judgment Rule, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, judicial dissolution of LLCs and best practices for letters of intent. Our regular columns also feature useful and up-to-date information on special-entity acts and proposed fee changes, S corporations, and more.

It is my sincere hope that you will participate in Section programs and become involved in Section activities. The upcoming year promises to be an exciting one, and some of the activities the Section is planning are described below. Feel free to contact any of the Section leaders listed on the website for more information. The Section has a number of active committees and directorships that are always looking for new members. Please contact any of the Committee or Directorship Chairpersons listed on our website if you are interested in becoming involved.

Mid-Year Meeting and Business Law Institute. The Section's 18th Annual Mid-Year Meeting and Business Law Institute is scheduled for June 2 and 3, 2006, at Soaring Eagle Casino & Resort in Mt. Pleasant, Michigan. This is the third consecutive year the central Michigan location has been selected, in an effort to provide a convenient location for our members. The Mid-Year Meeting provides an excellent opportunity for Section members to network at social events, while keeping abreast of developments in business law through participation in the ICLE-sponsored Business Law Institute. Details regarding these programs and events will be posted on our website as they develop. Please mark your calendars now and plan to attend the Mid-Year Meeting. It promises to be an informative and worthwhile experience.

Annual Meeting. The Section will hold its 2006 Annual Meeting in Southeastern Michigan in September. Details of the activities for the Annual Meeting event will be posted on our website as they develop.

Council Meetings. A good way to become more involved in Section activities is to participate in quarterly Council meetings. In addition to the Annual Meeting next September, our meetings for the upcoming year are scheduled for December 3, March 9, and June 3. Please contact any of the Section's officers if you would like to attend a meeting and become more involved in the Section.

Annual Scholarship Award. The Section will sponsor its Third Annual Scholarship Award in 2006. Last year's contest winner was Damien Weiss of the University of Michigan Law School, who won with an article entitled *Analyzing Disney in the Context of the Business Judgment Rule*. You can read Damien's article in the Summer 2005 issue of the *Journal*. The award is open to all law students enrolled in an ABA accredited law school in Michigan. The purpose of the award is to promote law student involvement with and knowledge about the Section, as well as law student interest in business-related topics. A monetary prize of $2,500 will be awarded during the Section's Mid-Year Meeting to the student penning the best article. The winner will additionally have his or her article published in the *Business Law Journal*.

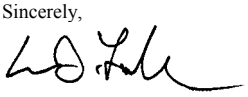
Business Boot Camp: Basic Training for Every Business Lawyer. The Section's Business Boot Camp program was chosen from hundreds of submissions as the 2005 winner of the ACLEA's prestigious Outstanding Achievement Award for seminars. The 9-session program, co-sponsored with ICLE, is being conducted from September, 2005–May, 2006 in both Grand Rapids and Beverly Hills. Further information regarding Boot Camp is available at www.icle.org.

Business Law Journal. The *Business Law Journal* is published three times a year in conjunction with ICLE. As a Section member, you will receive the *Journal* by mail, and it is also available on our website. 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.

Annual Recognition Award. One of my main initiatives involves establishing an annual award (yet unnamed) to be presented to the Michigan business lawyer who has made outstanding contributions to the Section and its members over time. Look for a major announcement on the award prior to 2006.

The Section is privileged to have dedicated and talented members who are willing to devote their time and energy to ensure its success. I'd like to take this opportunity to thank the Section's outgoing Chairperson, David Foltyn, for his outstanding work and commitment to the Section. I'd also like to thank our officers, Michael Khoury, Mark High, and Diane Akers, and our members who have agreed to serve on council, committees and directorships, for their tireless efforts on behalf of the Section. I'd lastly like to thank our Section Administrator, Terri Shoop, who is essential to the Section's success. I welcome the opportunity to serve as Chairperson of the Business Law Section and look forward to an exciting year. I encourage your participation and hope you will accept my invitation to become more involved and take advantage of all the Section has to offer!

Sincerely,



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Special-Entity Acts

The Business Corporation Act,[1] Nonprofit Corporation Act,[2] Michigan Limited Liability Company Act,[3] and Michigan Revised Uniform Limited Partnership Act[4] all are familiar statutes. However, there is a wide variety of less-familiar special statutes under which entities may be formed in Michigan. Entities formed under these special acts may also be subject to the Business Corporation Act or the Nonprofit Corporation Act, but if there is a conflict between the two statutes, the special act under which the entity is formed will control. Currently, summer resort and park association statutes are receiving some attention in the legislature, with Senate Bill 658 to amend the Summer Resort and Assembly Associations Act, 1889 PA 39, and Senate Bill 751 to amend the Incorporation of Summer Resort Owners Act, 1929 PA 137.

Senator Jason Allen introduced Senate Bill 658 on June 29, 2005. It amends Section 4 of the Summer Resort and Assembly Associations Act, MCL 455.54, to increase from 350 acres to 1,000 acres the amount of land a corporation is permitted to own. The Bay View Association of the United Methodist Church, located in Emmet County, was incorporated under 1889 PA 39 in 1920. The Senate fiscal analysis of the bill, dated July 12, 2005, states, "Some people are concerned that the 350-acre limit could inhibit the Bay View Association's ability to obtain additional land to shield the colony from future development nearby, and have suggested that the maximum acreage be raised." SB 658 passed the Senate on September 8, 2005, and the House referred it that day to the Committee on Commerce.

Senate Bill 751, sponsored by Senator Allen, along with Senators Mike Bishop, Mike Goschka, and Patricia Birkholz, was introduced on September 13, 2005. It amends Section 19 of the Incorporation of Summer Resort Owners Act, MCL 455.219, to change the vote necessary to approve annual dues and assessments. Currently, a majority of resort members must approve dues and assessments; the bill, as introduced, would allow the board to require members, with their approval, to pay annual dues or special assessments. The bill passed the Senate on October 12 and was referred in the House to the Committee on Commerce.

The attorney general discussed this act in opinion number 7164, issued October 7, 2004. As noted in the opinion, Section 19 of the Incorporation of Summer Resort Owners Act requires an affirmative vote by a majority of all corporation members to approve dues and assessments, while a bylaw authorizing assessment of annual dues by a vote of less than a majority of all members is unenforceable. SB 751 would change the act to permit a corporation's bylaws to provide for approval by a majority of votes cast rather than by a majority of members.

Currently, summer resort and park association statutes are receiving some attention in the legislature.

The attorney general has issued three other opinions regarding summer resorts. Issued May 12, 1981, OAG No. 5899 concluded that the Subdivision Control Act[5] applies to summer resorts. OAG No. 6942, issued July 3, 1997, concluded that a corporation formed under the Incorporation of Summer Resort Owners Act is a "public body" for purposes of the Open Meetings Act[6] and the Freedom of Information Act.[7] OAG No. 6371, issued June 12, 1986, addressed the authority of the corporation to levy assessments of land within the incorporated territory.

OAG No. 5899 reviewed four incorporation acts: (1) 1889 PA 39, which provides for summer resort and assembly associations; (2) 1929 PA 137, which provides for summer resort owners; (3) 1887 PA 69, which covers suburban homestead, villa park and summer resort associations; and (4) 1897 PA 230, which covers summer resort associations. The opinion concluded that corporations formed under 1887 PA 69 and 1897 PA 230 have express authority to subdivide their land, and that corporations formed under those two acts and 1929 PA 137 must take and record a plat in accordance with the Subdivision Control Act.

OAG No. 6942 likened the authority of a summer resort owners' corporation to that of a governmental power. Section 4 of the Incorporation of Summer Resort Owners Act, MCL 455.204, provides that the summer resort owners' association "shall have and possess all the general powers and privileges and be subject to all the liabilities of a municipal corporation and become the local governing body." The corporation has authority to preserve water quality, control sanitary conditions, provide fire protection and electrical service, and regulate bowling alleys, dance halls, meat markets, and butcher shops. It is further authorized to prevent disorderly assemblies and to adopt bylaws, a violation of which is a misdemeanor punishable by a fine or up to 30 days in jail. To enforce those bylaws, the corporation should appoint a marshal with the authority of a deputy sheriff. The opinion concluded that, because of its "substantial authority[,] which is governmental in character and which clearly may affect the rights of the public," a corporation formed under this act is subject to the Open Meetings and the Freedom of Information Acts.

OAG No. 6371 also interpreted the Incorporation of Summer Resort Owners Act. According to the opinion, if a favorable election is held under Section 6, MCL 455.206, to incorporate the territory of the summer resort, "the owners of land within the incorporated territory of the association may be assessed dues and special assessments which, if unpaid, become a lien upon the land of the owner who is neither a member of the corporation nor has voluntarily aligned himself or herself with the corporation by signing a grant of authority." This is

the case even when an owner is not a member of the corporation and has not signed a grant of authority to it. The opinion concluded that, if the territory is incorporated, the power of the corporation extends across the entire territory and includes any residents who did not voluntarily associate with the summer resort.

In *Whitman v Lake Diane Corp,*[8] the Michigan Court of Appeals examined whether the election provisions in the Incorporation of Summer Resort Owners Act are unconstitutional. The court noted that the basic constitutionality of the act had been called into question in *Baldwin v North Shore Estates Ass'n;*[9] while that case was disposed of on other grounds, the *Baldwin* court indicated that the act itself "borders on unconstitutionality by reason of its vagueness." The court of appeals upheld the permanent injunction enjoining Lake Diane Corporation from conducting an election under MCL 455.206 to expand its territory, holding that the election under that statute for annexation of property to the summer resort violates due process. The appeals court also found that election provisions in MCL 455.206c and MCL 450.206d are constitutionally invalid.

Proposed Fee Changes for Authorized Shares of Corporations and Expedited Document Filing

Senate Bill 298, introduced in March 2005, and Senate Bills 664 through 667, introduced in June 2005, are expected to pass. SB 298 is tie-barred to several bills in a package of bills related to the securitization of tobacco monies, and SBs 664-667 are tie-barred to SB 298.

I. Changes for Fee Requirements for Authorized Shares of Domestic and Foreign Corporations

Senate Bill 298 amends Section 1062 of the Business Corporation Act, MCL 450.2062, and adopts new fees for shares of a domestic corporation and for shares attributable to Michigan for a foreign corporation. Under the bill, the new fee structure will be:

- $50 for 60,000 or fewer authorized shares
- $100 for 60,001–1,000,000 authorized shares
- $300 for 1,000,001–5,000,000 authorized shares
- $500 for 5,000,001–10,000,001 authorized shares
- $1,000 for each additional 10 million, or portion of 10 million, in excess of 10 million authorized shares

For foreign corporations, 60,000 shares initially will be considered attributable to Michigan and the initial fee will continue to be $50. For increases in shares attributable to Michigan, the new fees will be:

- $50 for an increase of 60,000 or fewer authorized shares attributable
- $100 for an increase of 60,001–1,000,000 authorized shares attributable
- $300 for an increase of 1,000,001–5,000,000 authorized shares attributable
- $500 for an increase of 5,000,001–10,000,001 authorized shares attributable
- $500 for an increase of more than 10 million authorized shares, plus an additional $1,000 for each 10 million authorized shares

II. Proposed Electronic Filing and Fees for Expedited Service

Senate Bills 664 through 667 amend the Business Corporation Act, the Michigan Limited Liability Company Act, the Nonprofit Corporation Act, and the Michigan Revised Uniform Limited Partnership Act to require the Department of Labor and Economic Growth to establish by December 31, 2006, a procedure for accepting delivery of documents by electronic mail or over the Internet and to begin accepting delivery of documents in that manner by January 1, 2007. In addition, SBs 664-667 add fees for expedited service, to be used by the department to carry out its duties, as required by law. Under the bills, the new expedited fees will be:

- 1 hour on the same day: $1,000
- 2 hours on the same day: $500
- Same-day formation or qualification document, other than for 1- or 2-hour service: $100
- Same-day for document for existing domestic or qualified foreign entity, other than for 1- or 2-hour service: $200
- 24-hour formation or qualification document: $50
- 24-hour for document for existing domestic or qualified foreign entity: $100

NOTES

1. 1972 PA 284, MCL 450.1101 et seq.
2. 1982 PA 162, MCL 450.2101 et seq.
3. 1993 PA 23, MCL 450.4101 et seq.
4. 1982 PA 213, MCL 449.1101 et seq.
5. 1967 PA 288, MCL 560.101 et seq.
6. 1976 PA 267, MCL 15.261 et seq.
7. 1976 PA 442, MCL 15.231 et seq.
8. 267 Mich App 176, 704 NW2d 468 (2005).
9. 384 Mich 42, 49, 179 NW2d 398 (1970).

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.

S Corporations–New, Enlarged Audit Targets

The tax-controversy community has believed for years that S corporations were audited less frequently than other enterprises. This will soon change.

Why Are Congress and the IRS Doing This?

With record annual federal budget deficits, Congress is under considerable pressure to make ends meet. Since cutting programs is politically unpopular, lawmakers have been forced to look for other solutions and have been approving tax-enforcement budget increases aimed at closing the tax gap.

The tax gap is the difference between (1) what would be collected if everyone properly reported and paid all federal taxes in full *and* there were full enforcement under the current tax laws, and (2) actual tax collections. Currently, the tax gap is estimated at around $350 billion each year. IRS enforcement recovers about $50 billion per year. Thus, the system is annually losing approximately $300 billion in revenue.

Post-Katrina words of caution are appropriate. As this column was being written, Congress was still considering the particulars of Hurricane Katrina rebuilding and relief efforts. Whatever the final price tag may be, it will be staggering—and on top of the current record deficit levels. At the just-concluded ABA Taxation Section meeting, it was quite clear that Congress would look to "enhanced tax enforcement" to pay some of the Katrina costs. Tax enforcement-wise, we are entering new territory.

Congress has found a proven formula for increasing IRS enforcement revenues: more effectively selecting the institutional areas the IRS will target for intense enforcement. First, the government performs a national research project to gather valuable information, then the IRS uses the results to target for examination a large number of returns "with greater compliance risk."[1] Large nonprofit institutions, for example, have recently, and in many cases painfully, become familiar with this approach. From the government's perspective, this restructuring of audit priorities has fruitfully resulted in increased revenues.

S Corporations Will Now Be Targeted for Examinations

S corporations are the next target for audit attention—but why? According to IRS Commissioner Mark W. Everson, "The use of S corporations has exploded."[2] Statistics indicate that S corporations now are the most common corporate entity. In 2002, the last year for which such data are available, the over 3.1 million S corporations in the United States comprised 59% of the country's corporate tax base. About 2 million S corporations reported net income of $248 billion that year, while 1.2 million reported net losses of $63 billion. The last time there was a scientific study of tax compliance by S corporations was an in-depth audit process of about 10,000 returns for the tax year 1984.[3] That was prior to the 1986 Tax Act that spurred the growth of S corporations.

The Government's Plan for S Corporations

The IRS is introducing a pilot project that will start with very detailed examinations, conducted by its National Research Program, of selected S-corporation returns for the tax years 2003 and 2004. The resulting information will be used to conduct large-scale examinations of S corporations' items of income, deductions, and credits for the best audit potential (i.e., the most bang per IRS audit dollar). As Commissioner Everson stated, "The IRS needs a better understanding of what this means for tax compliance. This research is critical for achieving our strategic goal of ensuring that corporations and high-income individuals are paying their fair share."[4]

In plain English, the IRS will (1) audit more and more S corporations, and (2) select the corporate returns to examine and the issues to scrutinize based on what will be most effective from the government's revenue-enhancement perspective. Once the study of the 2003 and 2004 returns is complete, the IRS will mesh the results with sophisticated computer scanning to select S-corporation returns with high-audit potential for 2005 and subsequent years. This means that the 2005 returns filed in 2006 will face a level of examination never before seen in the S-corporation community.

Forewarned is Forearmed!

S-corporation clients taking "aggressive positions" should be counseled that Congress and the IRS are targeting them. The returns for 2005 will be the first audited in large numbers based on the results of the 2003-2004 research project. Tax history shows that when the IRS begins to pay serious audit attention to an area it previously neglected, the government finds numerous situations that leave the tax practitioner asking in retrospect, "What was the taxpayer thinking?" Forewarned is forearmed!

NOTES

1. *IRS Launches Study of S Corporation Reporting Compliance,* Internal Revenue Service News Release, IR-2005-76 (July 25, 2005).
2. *Id.*
3. *Id.*
4. *Id.*

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Malware Grows Up: Be Very Afraid!

"Malware," short for malicious software, is the general term used for software that circulates among computer systems on the Internet with the goal of harming your personal computer. It includes viruses, worms, spam, "Trojan horses," and other exotic beasts that can be used to overload your networks, try to get you to disclose your personal information to a bad guy (called "phishing"), or surreptitiously collect information from your system. Malware also can be used to hijack someone else's computer to disseminate spam or other malware.

This column discusses some of the legal and technical developments that are addressing the spam and malware problem, as well as some of the actions that a business can take to protect itself.

The Truth about Spam

Recently, an acquaintance who is the president of an Internet service provider succinctly summed up the issues we are facing with spam: "It's scary." Spam costs U.S. businesses billions of dollars in lost productivity and resources each year and currently accounts for over 80 percent of all e-mail sent in the United States That percentage has more than doubled in the last two years.

Congress attempted to address the problems through the Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (CAN-SPAM),[1] but the legislation has proven to be worthless. This country is the top producer of spam in the world, but spammers typically route their products through servers outside the U.S. (typically in Eastern Europe and China) to try to hide the sources.

One of the surprising provisions of the CAN-SPAM Act is a safe harbor for spammers. The advertising community is protected under the Act if an e-mail solicitation is identified in a specific way and the sender's identity is not hidden. Additionally, marketers do not have to identify advertising e-mail as such if the user has given "affirmative consent" to receiving the information. That consent, however, typically is buried in a Web site's terms of use.

The Techniques and Goals of Malware

Industry observers have had a field day naming the different kinds of malware that have propagated in the last few years. Here are some of the terms you might hear:

- *Spoofing*. This type of e-mail uses false information to try to trick people into thinking a message is coming from a legitimate source. Common spoofing e-mails look like notices from financial institutions or companies like eBay and ask you to "verify" your account information. When you click on the link and confirm the information, you subject yourself to an identity-theft scam.
- *Trojan Horse*. This is a fairly innocent-looking program or file that encourages users to download some software or a picture. Unsuspecting users may think they are downloading an interesting photograph when they may in fact be downloading spam software to their computers.
- *Spyware*. Spyware is a type of software designed to track your computer usage or Internet activity and send that information—plus any personal information it can find—to a third-party source. This software may be used for spam, identity theft, or other purposes.
- *Zombie*. A zombie is an infected computer used to send spam without the owner's knowledge. If a spammer can infect several computers to create a series of zombies, small amounts of spam can be sent from a variety of sources and the spammer can better cover his or her tracks.

Anti-Spyware Legislation

Recent moves have been made to introduce and enact legislation prohibiting spyware. In my humble and somewhat cynical opinion, however, this legislation should not be expected to produce results that are any better than the legislation prohibiting spam.

What Can You Do?

Your IT department has probably been telling you that the requested budget increase for system security is essential, but it never seems to get enough funding to really protect your networks. It is time to take a closer look at your security plans and strategies and to focus on the deployment of up-to-date technologies to protect your business from malware.

For spam and similar advertising e-mail, spam filters are becoming better and better. The cooperation and participation of each user, however, is absolutely necessary. Unfortunately, some legitimate services are on marketing blacklists, so your server may try to block certain safe addresses or domains.

While intelligent filtering software is becoming more mature, there is no single solution that will protect your environment from malware. This will be an ongoing battle for years to come, and I wish you safety and luck in dealing with this vexing problem.

NOTES

1. Pub L No 108-187, 117 Stat 2699.

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A Business Court in Michigan

By Diane L. Akers

Introduction

Over the last decade in this country, courts specializing in handling business or commercial cases have increased dramatically in number and now exist in Delaware, Florida, Illinois, Maryland, Massachusetts, Nevada, New Jersey, New York, North Carolina, Oklahoma, Pennsylvania, and Rhode Island. The original business courts have expanded in size and been praised for their successes. Now, several other jurisdictions, including Michigan, are considering establishing their own business courts.

A "business court" is generally a business docket, division, or program within an existing trial court. It is not a separate court, but is more like the civil, criminal, family, or other divisions that exist in some of Michigan's circuit courts.

A business court does not require the creation of a new judiciary. Rather, cases are reallocated among existing judges, making business courts a low-cost and highly effective way to enhance the quality of decisions in business cases and the efficiency of overall dispute resolution. Business courts strive to assign business or commercial litigation to judges who have a particular interest, experience, or skill at deciding business issues and at managing large, complex business litigation. Over time, the business court's decisions will provide guidance to litigants and the business community. Business courts also focus on aggressive case management and early alternative dispute resolution (ADR) efforts, which may be particularly well suited to business cases.

For several years, the State Bar of Michigan's Business Law Section explored the possibility of a business court in this state and in late 2001 created the Business Court Ad Hoc Committee to study the issues and make recommendations. When the committee e-mailed section members in early 2002 to gauge their interest in the project, the response was overwhelming. Within forty-eight hours, over 170 members had volunteered to play a role in or to support the project, and some took the opportunity to express their views and the views of their business clients on how the resolution of business disputes could be improved.

The committee reviewed the various forms of business courts across the country, consulted experts, legislators, and business court judges in other jurisdictions, and issued periodic written reports. Most importantly, the committee asked lawyers, judges, court administrators, businesses, chambers of commerce, industry and trade organizations, and others for their views on court litigation and other ways of resolving business disputes.

The message was clear and strong. Many members of the business and legal communities believe that court litigation of business disputes takes too long, is too expensive, and all too frequently damages or even destroys the relationships between businesses. With limited resources, particularly when the economy is down, businesses do not want to spend their resources on litigation counsel and costly discovery proceedings that can drag on for months and significantly disrupt operations.

A bill that will attempt to address these issues by creating a business court is being drafted by Michigan House of Representatives Majority Whip Brian P. Palmer (R-Romeo). The statute would create a business court in each circuit, with many of the details, rules, and procedures to be determined by the Michigan Supreme Court.

This article will review the background and advantages of business courts and examine some of the important issues that must be considered before a business court can be established in Michigan.

The Background of Business Courts

Many businesses and their litigation counsel traditionally have considered litigation of business disputes in the state courts (outside of Delaware) to be undesirable. If they can find any basis whatsoever to assert federal jurisdiction, these parties will commence suit in or remove state court actions to federal court. Rightly or wrongly, federal judges sometimes are perceived as having a superior understanding of business issues. Typically, they also have greater resources at their disposal than state circuit court judges and, therefore, may be better able to devote the time and attention necessary to adjudicating complicated and cumbersome cases

that involve voluminous document production and extensive written motion practice.

Business courts grew out of each enacting state's desire to strengthen its economy by encouraging businesses to locate and continue to do business in that state. Establishing and operating a business court allows states to demonstrate a favorable economic climate for businesses and to compete effectively with states that are perceived as being less business friendly.

Many people consider Delaware's Court of Chancery to be the first—and by far the most esteemed—business court, although it was not created for that purpose. Other states have followed suit:

- New York was the first jurisdiction to create a specialized business court and has since expanded this significantly. According to the New York Council on Judicial Administration, the business court "helped to stem the flight of commercial litigants from New York's courts, and to maintain New York's status as the premier state for the conduct of business."[1]
- In North Carolina, the governor created a special Commission on Business Laws and the Economy to recommend statutory and regulatory changes to help create a legal environment that would attract businesses and provide them with the flexibility and support necessary to operate successfully.[2] The state created its one-judge business court in 1995 and has subsequently expanded this to three judges, reporting that the business court has helped establish North Carolina as a favorable state for businesses.[3]
- Massachusetts created its business court at least partly to address a "concern tied into the general perception … that businesses were fleeing Massachusetts' state courts because of a belief that generalized courts could not handle specialized matters."[4]
- Maryland's Business and Technology Court was established as "part of an effort to overcome the perception that Maryland was anti-business, in the hope of encouraging technology companies to locate in Maryland."[5]
- In Orange County, Florida, the order creating a business court cites as one of its purposes "helping our community to attract new businesses that are looking to relocate."[6]
- Colorado's Task Force on Civil Justice Reform recommended a business court "to help Colorado attract and retain world-class employers and employees alike."[7]

Establishing and operating a business court allows states to demonstrate a favorable economic climate for businesses.

Michigan already has a precedent of encouraging businesses to locate and remain in the state through legal structures that specialize in resolving business or commercial disputes. In late 2001, the legislature passed the cyber court statute,[8] creating a specialized court that incorporates technological processes to expedite resolution of any case that is "primarily a commercial or business dispute."[9] The statute's objectives were to improve Michigan's economy and encourage businesses to locate here.[10] Thus, the state already has recognized the importance of a legal system that addresses the unique features of disputes between businesses.

In today's economy, states must actively court businesses and offer various incentives for these businesses to locate and remain there. A business court can be a low- or even no-cost, yet highly effective, technique for accomplishing this goal.

Features of Business Courts

Specialized Features of Business Litigation

Business courts aim to assign business and commercial cases to judges experienced in this area because of the specialized features of business litigation. Disputes between businesses over commercial transactions, for example, often are governed by the Uniform Commercial Code, and familiarity with Michigan and foreign-state opinions interpreting the UCC is invaluable in business litigation. Business disputes also may involve commercial-financing issues and the transfer of interests in commercial real estate, or intellectual-property issues and noncompete and nonsolicitation agreements. Courts resolving business disputes also frequently deal with the formation, governance, powers, duties, and ownership of interests in corporations, partnerships, limited-liability companies, and other business entities.

In dealing exclusively with business cases, over time the business court judge will further develop his or her expertise in business law, which will lead to a greater efficiency and accuracy in resolving business cases. An improved understanding of the applicable legal principles will in turn lead to more consistent rulings on similar issues. Eventually, a body of law will develop that

future litigants, lawyers, and businesses can look to for guidance. Some jurisdictions encourage or even require the business court judge to issue written opinions that are available to the public; in North Carolina, for example, business court judges issue written opinions on matters that are novel and where a ruling would be helpful to litigants and the general business community.[11]

Some of the factual matters that are prevalent in business litigation can be highly technical. For example, a court deciding a business case often must analyze financial statements, profit and loss projections, audits, accounting reviews and procedures, market analyses, and other financial or economic information. Cases arising from intellectual-property disputes may require the judge to analyze engineering or other scientific information. While some judges enjoy working with such matters, others consider it burdensome, particularly because such analyses can be extremely time consuming.[12]

Because business cases so frequently involve written contracts or other documents, they may be particularly suited to at least partial resolution on motion. As long as a contract is not ambiguous, the court interprets the contract language based on its plain meaning, and extrinsic evidence (e.g., testimony of witnesses, other documents, course of performance, and industry practice) is neither relevant nor admissible.[13] Some judges enjoy a heavy schedule of written motion practice, while others prefer cases that involve more trials or courtroom proceedings.

Business cases can be particularly unwieldy and, especially when involving written motions, can demand a great deal of a trial judge's time, possibly to the detriment of other cases. For instance, a large commercial case involving complex issues, many parties, and multiple motions and cross-motions, may require a great deal of the court's attention on any particular motion day—and on those days, all other parties with pending motions simply must wait. Removing such a business case from the general docket and assigning it to a business court judge can increase the efficiency with which all cases, not just business cases, are resolved.

Requests for Injunctive Relief

Business disputes also often involve urgent requests for injunctive relief at the outset, and this may require the judge to evaluate extensive technical, competitive, and financial information in very short order. For instance, a business asserting that its trade secrets have been misappropriated by a competing business may file suit seeking an immediate injunction prohibiting such use until the litigation is concluded. The plaintiff-business will argue that secret information, once disclosed, loses some or even all of its benefit to that business, so that failure to grant injunctive relief would cause irreparable harm that could never be remedied through money. The defendant-business will argue just as vehemently that such an order would interfere with its legitimate use of information that it contends is either not a trade secret or not the property of the plaintiff-business and that the requested injunction, if entered, would irreparably harm its business in ways that could never be remedied by money. In deciding whether to grant injunctive relief, and what form this should take, the judge must consider the factual background in detail in order to balance the possible harm to the litigants or to the public from either decision.[14] This may require the judge to master a complicated and extensive factual record within a few days or even hours.

Parties to other kinds of litigation also may urgently seek injunctive relief, will press their respective positions just as vehemently, and are equally deserving of the court's careful and timely attention. However, the subject matter of these other kinds of cases may be less technical and may not require the same extensive document review before the judge can determine whether to grant the relief.

Relationship Between Parties

Another unique aspect of business cases is that the litigants may want to continue their business relationship both during and after the adjudication. Of course, the litigation process rarely, if ever, enhances this relationship, but to preserve and encourage the continuation of otherwise-satisfactory business dealings, the litigation should be brought to the speediest possible resolution.

Especially when businesses want to continue their relationship, they may have exchanged information and even made settlement proposals and counterproposals before litigation attorneys were brought in. In general, when a business case is filed, its factual background may be more fully developed than when other kinds of cases are commenced. Because of this, a business case may be ready

Business cases can be particularly unwieldy and, especially when involving written motions, can demand a great deal of a trial judge's time, possibly to the detriment of other cases.

for some form of ADR from the outset or much earlier than other kinds of cases would be.

Damages

Business cases also can be easier to settle because the damages may be more readily defined. In a personal injury case, for instance, the plaintiff will seek recovery for physical and/or mental distress, both of which are notoriously difficult to gauge. The plaintiff may envision an award of many millions of dollars—an unlikely but still plausible outcome, the possibility of which can be a powerful incentive not to settle. In business cases, however, the parties generally are able to assess with greater accuracy what incidental and even consequential damages may be awarded. Business disputes still can involve damages, such as lost profits, that are difficult to measure, but even then the range of outcomes may still be more confined than in a personal injury case.

One of the most important features of all business courts is an emphasis on highly directed and active case management.

Directed Case Management and ADR

One of the most important features of all business courts is an emphasis on highly directed and active case management. The business court judge becomes familiar with the facts and legal issues in detail at the beginning of the case, especially if there has been a request for immediate injunctive relief. The judge's expertise in business issues, as well as the availability of other relevant opinions from similar cases, allows both the judge and the parties to narrow the issues at the outset.

Further, the parties and the business court judge can assess whether some form of very early ADR would be appropriate, with the goal of avoiding significant and costly discovery proceedings. In fact, many people consider business courts to be a form of ADR, and very early ADR saves time, money, and relationships. Business court judges should seek other creative ways to lead the parties to resolution.

Other kinds of cases can also benefit from ADR and also are deserving of resolution as rapidly as possible. Assigning business litigation to a business court does not imply that business cases are more important or that a business litigant is entitled to a better quality of justice. Rather, because of some of the unique features identified above, business cases simply may be ready for early ADR, while other cases may require more factual development before ADR can have much of an impact.

A business court also can benefit smaller businesses with smaller cases. While litigation costs are unpleasant for a large business, they can be prohibitive or fatal for a small business. In a business court, however, a small case can enjoy the same interest, expertise, and experience that allows the business court judge to narrow issues, encourage settlement, and render a decision in large cases.

Business courts provide all of these benefits without significant cost. Although some business courts have created new judicial positions and so have required new funding, many business courts have avoided this. Massachusetts, for example, reports that its business court is "cost neutral" and has required no new budgetary expenses.[15]

Issues for a Business Court in Michigan

Definition

The definition of a business or commercial case must be established before a business court can begin adjudicating cases. A Michigan business court could borrow the definition of a "business or commercial dispute" from the cyber court statute[16] and include the following:

- disputes between business entities
- disputes arising from commercial contracts and intellectual property rights
- disputes involving the internal governance, powers, duties, and obligations of business entities
- disputes involving commercial financing or real estate transactions

A definition based on the statute would generally exclude the following:

- criminal cases
- personal injury cases, including product liability and malpractice
- family law and probate court matters
- employment cases
- consumer transactions
- other matters specifically addressed by a statute, e.g., landlord-tenant matters

Assignment

The process for lodging cases in the business court also must be determined, particularly the issue of whether assignment to the business court will be voluntary. Given the adversarial nature of litigation (and litigators), a business court that requires the consent of all parties may not have many cases at all. If one litigant can veto assignment to the business court, even if all other parties

agree, then litigation strategy could become a factor in the assignment process.

Alternatively, assignment to the business court could be entirely a matter of judicial determination, with no input from the litigants. One administrative difficulty with this approach, however, is that the only way now for a judge or court administrator to determine which cases belong in the business court is the current case-code system. When lawsuits are filed, the plaintiff must include in the case caption one of the case-type codes provided by the State Court Administrative Office.[17] Unfortunately, a number of existing case codes could indicate that a case is appropriate for assignment to a business court,[18] while many current codes encompass matters that are not business or commercial disputes. Certainly, a separate case code for the business court could be established, but reliance on that code alone would mean that assignment to the business court would be determined solely by the plaintiff, without input from defendants or third-party defendants.

The cyber court statute permits a plaintiff to commence an action in the cyber court. Proposed rules for the cyber court[19] would have allowed a defendant to remove a case from the cyber court to circuit court on a motion filed within 14 days after the deadline for responding to the complaint. The business court could consider similar provisions.

ADR

ADR is a very important part of all business courts, and the Michigan Court Rules already provide a number of ADR alternatives, including case evaluation[20] and mediation,[21] and all civil cases are subject to some form of ADR.[22] For a number of years, some circuit courts have offered other creative approaches to dispute resolution, including voluntary facilitative mediation and many forms of settlement conferences.

Business court cases also could use ADR alternatives provided by private individuals or entities, including the American Arbitration Association. The Dispute Resolution Association of Michigan also offers a variety of services, including a new Business-to-Business Mediation program.[23] In addition, there are many former judges and experienced litigation attorneys who offer their services as arbitrators, facilitators, and mediators. In general, courts have been quite flexible in permitting litigants to tailor ADR processes to their disputes, and such flexibility would be well suited to the business court.

Funding and Fees

Funding and fees also must be considered. Business courts not creating new judgeships have gained wide acceptance in part because they do not need additional funding. Some jurisdictions do provide business court judges with additional law clerk assistance if he or she is expected to issue more written opinions than in a general civil trial court, but business court judges generally carry full case loads, even if only a portion of their cases are business court cases.

Assignment to the business court could require some form of administrative oversight, either as cases are lodged in or removed from the business court. The cyber court statute requires a $200 filing fee; for other types of cases, this fee is $150. The business court could implement a similar approach.

Selection of Judges and Other Issues

The selection process and term length for business court judges also will have to be established. Because of the importance of the business court judge's specific interest and expertise in business issues, longer terms would be more appropriate than shorter terms or rotating assignments to the business court.

Other issues that remain to be considered include whether juries should be available in the business court and where appeals of right would be heard. If the business court is established as part of the circuit-court system, juries would be available to the same extent as in other cases, and appeals would go to the Michigan Court of Appeals.

Conclusion

A business court offers many advantages for businesses, litigants, and the entire state—without significant expense. While some aspects of a business court still require further study and evaluation, the passage of a business court statute would go a long way toward achieving these advantages for Michigan.

A business court offers many advantages for businesses, litigants, and the entire state—without significant expense.

NOTES

1. Mitchell L. Bach & Lee Applebaum, *A History of the Creation and Jurisdiction of Business Courts in the Last Decade*, 60 Bus Law 147, § II (2004).
2. *Id.* at § IV.
3. *Id.*
4. *Id.* at § VIII.
5. *Id.* at § X.
6. *Id.* at § XI.

7. *Id.* at § XIV.

8. MCL 600.8001 et seq.

9. MCL 600.8011. *See also* Douglas L. Toering, *Online Lawsuits: The Proposed Michigan Cyber Court and How to Plan for It,* 21 Mich Bus LJ 54 (2001).

10. MCL 600.8001(2). The cyber court remains unfunded.

11. Bach & Applebaum at § IV.

12. Circuit court judges also deal with expert or technical analyses in other areas and may develop expertise in evaluating, for instance, medical reports. That kind of expertise, however, is rarely if ever relevant in a business dispute.

13. *See, e.g., Rory v. Continental Ins Co,* 473 Mich 457, 703 NW2d 23 (2005).

14. *See, e.g., Alliance for Mentally Ill v Department of Cmty Health,* 231 Mich App 647, 588 NW2d 133 (1998).

15. Bach & Applebaum at § X.

16. MCL 600.8005.

17. MCR 2.113(C)(1)(b); MCR 8.117.

18. This includes cases coded CB ("all claims involving partnership termination and other business accountings"), CH ("all housing, real estate, foreclosure, land contracts, and other property proceedings (except landlord-tenant and land contract summary proceedings)"), CK ("all proceedings involving contractual obligations not otherwise coded"), CP ("all complaints regarding unlawful trade practices"), CR ("all corporate receivership proceedings"), CZ ("all other civil actions not otherwise coded") and PD ("all complaints to recover personal property which are assigned a new case number").

19. MCL 600.8007(1) and MCR 2.712(A) (proposed).

20. MCR 2.403.

21. MCR 2.411.

22. MCR 2.410.

23. The Business-to-Business Mediation program is offered by the Dispute Resolution Association of Michigan (DRAM), a nonprofit organization whose mission is to increase public knowledge and use of alternative dispute resolution. DRAM works with a variety of practitioners to provide efficient conflict resolution services to businesses, the government, and the nonprofit sector. For more information, contact Diane L. Akers, Bodman LLP, 100 Renaissance Center, Detroit, MI 48243, 313-259-7777, dakers@bodmanllp.com.

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The Class Action Fairness Act of 2005: Sensible Reform or Orwellian Title?

By Daniel N. Sharkey[1]

Introduction

On February 18, 2005, President Bush signed into law the Class Action Fairness Act (CAFA) of 2005. CAFA dramatically expands federal jurisdiction over class actions in several ways, most prominently by allowing removal of class actions with even "minimal" diversity.[2] CAFA also sharply limits fees in "coupon" settlements and mandates that federal and state officials be allowed to review notice and settlement documents. Understanding CAFA is therefore imperative for all involved in class-action litigation, be it state or federal. The purpose of this article is to highlight CAFA's most important changes to class-action practice.

Background to Passage of CAFA

CAFA was enacted amid a growing perception that abuses of the class-action device undermined public respect for the judicial system.[3] President Bush called CAFA "a critical step toward ending the lawsuit culture in our country" and claimed that its enactment "will ease the needless burden of litigation on every American worker, business, and family."[4]

CAFA attempts to ameliorate the widely held perception that forum shopping has run amok. In response to the U.S. Supreme Court making it increasingly difficult for plaintiffs to certify classes and prevail in class actions in federal courts, plaintiffs' counsel began seeking the friendlier confines of state courts.[5]

When he signed CAFA into law, President Bush pointed out that the number of class actions filed in Madison County, Illinois, had increased from 2 in 1998 to 82 in 2004 and that 24 were filed in the first six weeks of 2005.[6] Senator Arlen Specter (R-Pa), chairperson of the Senate Judiciary Committee, explained that CAFA's purpose was to "prevent judge shopping to [s]tates and even counties where courts and judges have a prejudicial predisposition on cases."[7]

Indeed, CAFA's preface openly criticizes state and local courts for "acting in ways that demonstrate bias against out-of-[s]tate defendants" and "making judgments that impose their view of the law on other [s]tates and bind the rights of the residents of those [s]tates."[8] In state courts, jury pools are known for big verdicts and judges are known to grant plaintiffs' attorneys large shares as fees. Depending on one's perspective, these courts are either "magic magnet jurisdictions" or "judicial hellholes."

Before CAFA, it had become routine practice for plaintiffs to prevent removal by either naming a non-diverse defendant or claiming an amount less than $75,000, the federal jurisdiction threshold for amount in controversy.[9] CAFA obviates this tactic by allowing the aggregation of claims over certain amounts and by allowing federal jurisdiction, even with minimal diversity, thereby keeping many more class actions in federal court.[10]

CAFA also changes the rules regarding coupon settlements.[11] Class actions are a procedural device originally created to efficiently address a large number of similar claims by people suffering small harms. Critics contended, however, that the primary beneficiaries of class actions were lawyers receiving exorbitant fees, leaving class members with coupons or other awards of nominal value.[12] CAFA significantly increases the required level of judicial scrutiny of coupon settlement and attorney fee awards.[13]

Summary of CAFA Provisions

Overview

CAFA applies only to actions commenced on or after February 18, 2005.[14] One federal appellate court has already held that CAFA does not permit removal of class actions pending in state court on its effective date. [15]

The act introduces three primary changes to class-action litigation:

1. Expanded federal jurisdiction over interstate class actions
2. New mandatory notice procedures requiring the mailing of notice and related settlement documents to the "appropriate" federal and state officials for review
3. Limited attorney fee awards in coupon class-action settlements[16]

CAFA facilitates the removal to federal court of claims initially filed in state court.

Federal Jurisdiction Expanded

CAFA establishes broad federal jurisdiction over multistate class actions but preserves state jurisdiction in class actions between plaintiffs and defendants in the same state. Before CAFA, federal diversity jurisdiction in class actions existed only as it did for every other case, when diversity was complete.[17]

CAFA expands federal subject-matter jurisdiction for cases with "minimal" diversity, that is, when *any* class member is diverse from *any* defendant. There must be more than $5 million in controversy, but the claims of all of the class members may be aggregated to meet the $5-million requirement.[18] It was recently held that CAFA's amount-in-controversy requirement may be measured by either the aggregate benefit of injunctive relief to class members or the aggregate cost to defendants.[19]

CAFA also provides for federal jurisdiction over "mass actions," those defined as any action involving 100 or more members whose claims "are proposed to be tried jointly on the ground that [they] involve common questions of law or fact."[20] Unlike class actions, mass actions are not subject to the $5-million amount-in-controversy requirement and remain subject to traditional diversity requirements. Excluded from the definition of mass actions are claims that Congress presumably viewed as local disputes, i.e., those arising from an occurrence within the forum state that allegedly results in injuries only in the forum or contiguous states.[21]

From its broad jurisdictional grant, CAFA also carves out several categories of cases: those against governmental defendants, those with small classes of fewer than 100 members, securities and related fiduciary-duty cases, and internal corporate-affairs cases.[22]

Removal Restrictions Lifted

In several ways, CAFA facilitates the removal to federal court of claims initially filed in state court. First, as stated above, it allows removal even with "minimal" diversity.[23] Second, CAFA eliminates the unanimous defendant consent requirement, so that any defendant can now remove without the consent of other defendants.[24] Third, it eliminates the one-year time bar for removal under 28 USC 1446(b). Last, and perhaps most surprisingly, CAFA carves out an exception to the familiar rule that remand orders are not appealable. Under CAFA, a federal appellate court may entertain an appeal of a remand, provided that the application for leave is filed within seven days of the order. The appellate court must then resolve the appeal extremely expeditiously, within only sixty days of the filing.[25]

Together, these changes greatly aid defendants in removing class actions to federal court and in keeping them there. Indeed, one court recently held that, under CAFA, plaintiffs bear the burden on a remand petition to demonstrate that federal subject-matter jurisdiction is lacking.[26]

The Rule of Thirds

Critics have noted that, by facilitating removal from state courts, CAFA undermines federalism concerns, an odd result given the political orientation of the bill's progenitors.[27] But CAFA does provide some important limits on federal jurisdiction over class actions. It sets forth guidelines to determine when the court must decline jurisdiction, when the court must exercise jurisdiction, and when the court has discretion to either exercise or decline jurisdiction.[28]

CAFA's "Rule of Thirds" examines how many of the proposed class members are citizens of the forum state. If one-third or fewer of putative class members are citizens of the forum state, there is mandatory federal jurisdiction, presumably because it is truly an "interstate" class action.[29] If two-thirds or more of proposed class members are citizens of the forum state and the "primary defendants" also are citizens of that state, a district court *must* decline to exercise jurisdiction. The Senate report on CAFA labels this the "Home State" exception.[30]

Under what is called the "Local Controversy" exception, CAFA also requires remand to state court if any of the following apply:

1. Two-thirds or more members are citizens of the forum state
2. At least one defendant from whom "significant relief" is sought is a citizen of the forum state
3. The "principal injuries" alleged were incurred in the forum state
4. No other class action asserting the same or similar factual allegations was filed during the preceding three-year period[31]

If between one-third and two-thirds of proposed class members and the "primary defendants" are citizens of the forum state, federal courts *may,* at their discretion, decline to exercise jurisdiction.[32] Courts must consider the following factors, many of

which are aimed at forum shopping, when deciding whether to exercise jurisdiction:

1. Do the claims involve matters of national or interstate interest?
2. Will the claims be governed by laws of the forum state or of other states?
3. Was the class action pleaded to avoid federal jurisdiction?
4. Was the action brought in a forum with a "distinct nexus" with the class members, the alleged harm, or the defendants?
5. Is the number of class members who are citizens of the forum state "substantially larger" than the number of citizens from any other state?
6. Have any similar class actions been filed in the past three years?[33]

In short, whether the federal court will exercise jurisdiction depends in large part on its application of the "Rule of Thirds." CAFA, therefore, sets up some interesting battles over counting class members. What corporate defendant knows how many of its consumers are in the forum state versus in other states? Customer lists will likely play an important role early in discovery, and one can easily imagine marketing experts dueling over how many class members are in Michigan versus in Ohio and Indiana. To the extent that the fraction of class members in the proposed class appears to be between one-third and two-thirds, the federal court will examine the six factors above, many of which appear intended to deter forum shopping.

Settlement Notices: Yes, You Have to Tell the Government

CAFA considerably beefs up settlement notice requirements. Since December 1, 2003, Rule 23 has required "the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort."[34] Under CAFA, however, "*each* settling defendant" must now send a substantial notice packet, including several categories of pleadings and other information, to the "appropriate federal official" and to the "appropriate state official" of *each state* in which a class member resides.[35] With a few exceptions, CAFA designates the U.S. Attorney General and the states' attorneys general as such "appropriate officials."[36]

While CAFA creates no causes of action for the government, it affords officials 90 days to review the proposed settlement and presumably to decide whether to become involved. If a defendant fails to comply with the notice provision, members may refuse to be bound by the settlement.[37]

Coupons: I Was a Class Member and All I Got Was This Lousy . . .

Coupon class-action settlements have long been criticized for providing members little real value because they awarded plaintiffs' counsel large fees. Moreover, there has been historically little oversight of redemption rates following court approval of the settlement. Many class members receive settlement coupons they consider much smaller than the value of their damages, while counsel receive "fees based on a percentage of a theoretical settlement value regardless of actual consideration paid by the defendant to class members."[38] The fees awarded have not depended on coupon redemption rates.

Provisions of CAFA labeled the "Consumer Class Action Bill of Rights" attempt to address this perceived inequity by requiring that class members be the "primary beneficiaries" of any coupon settlement.[39] CAFA also requires that the portion of fees awarded to class counsel be based on the value to class members of the coupons that are actually redeemed.[40]

All fees from coupon settlements are subject to court approval, including several conditions.[41] Apart from the familiar requirement that a settlement be "fair, reasonable, and adequate," the court may take expert testimony on the actual value rendered to the class members.[42] Moreover, settlements may not provide greater rewards to some members solely because they are located closer to the forum court.

Overall, CAFA is a watershed change for coupon class-action settlements and attorney fees awarded from them.

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The One-Year Report Card

CAFA directs the U.S. Judicial Conference to provide a report on class-action settlements within a year of CAFA's enactment to ensure that it is accomplishing its stated objectives.[43] The Judicial Conference must also detail a plan to implement any recommended tweaking of the act.[44]

Conclusion

Courts are only starting to grapple with CAFA's attempt to chain the class-action beast. Commentators differ on whether CAFA will increase traffic in federal district

courts or simply result in plaintiffs' counsel filing carefully crafted statewide class actions. It is beyond the scope of this article to debate whether CAFA goes too far and stacks the deck against plaintiffs with valid claims. What appears certain is that CAFA's assortment of notice requirements, member ratio guidelines, and other procedural hoops will result in litigation about CAFA itself.

NOTES

1. The author thanks Maya K. Watson, a third-year law student at Wayne State University and summer associate at Butzel Long, for her invaluable assistance, and his partner Dennis Egan, co-chairperson of the State Laws Subcommittee of the ABA Litigation Section's Class Actions and Derivative Suits Committee, for his helpful comments.

2. 28 USC 1332(d)(2)(A).

3. Pub L No 119-2, 119 Stat 4 (2005), § 2.

4. http://www.whitehouse.gov/news/releases/2005/02/.

5. Georgene M. Vairo, *The Class Action Fairness Act of 2005: A Review and Preliminary Analysis,* In the Know (LexisNexis, Dayton, OH), Mar 2005, at 2 (discussing *Amchem Prods, Inc v Windsor,* 521 US 591 (1997); the 1986 Trilogy of Summary Judgment cases; and *Daubert v Merrell Dow Pharms,* 509 US 579 (1993)).

6. Vairo at 4.

7. 151 Cong Rec S999 (daily ed Feb 7, 2005).

8. Class Action Fairness Act of 2005, Pub L No 109-2, 119 Stat 4 (2005), § 2(a)(4).

9. Vairo at 3.

10. 28 USC 1332(d).

11. 28 USC 1712.

12. *Fears v Wilhelmina Model Agency, Inc,* No 02 Civ 4911, 2005 US Dist LEXIS 7961, at *15 (SDNY May, 5 2005).

13. 28 USC 1712.

14. 28 USC 1332.

15. *Pritchett v Office Depot, Inc,* 420 F3d 1090 (10th Cir 2005).

16. Callow, *The Class Action Fairness Act of 2005: Overview and Analysis,* Fed Law, May 2005, at 26.

17. *Snyder v Harris,* 394 US 332, 340 (1969); *Strawbridge v Curtiss,* 7 US 267 (1806).

18. 28 USC 1332(d)(6); *see also Exxon Mobil Corp v Allapattah Servs, Inc,* ___ US ___, 125 S Ct 2611 (2005), in which the Court resolved a split among the circuits by holding that diversity jurisdiction applies to all members of a class as long as one of them claims more than the $75,000 statutory threshold.

19. *Berry v American Express Publ'g Corp,* 381 F Supp 2d 1118 (CDCA 2005).

20. 28 USC 1332(d)(11).

21. 28 USC 1332(d)(2)(A).

22. 28 USC 1332(d)(5) and (9).

23. 28 USC 1453(b).

24. 28 USC 1453(b).

25. 28 USC 1453(c).

26. *Berry.*

27. Vairo at 3.

28. *Id.* at 25.

29. 28 USC 1332(d)(9).

30. Knight, *The Class Action Fairness Act of 2005: A Perspective,* Fed Law, June 2005, at 46.

31. 28 USC 1332(d)(4).

32. Callow at 26.

33. *Id.* at 26, 29.

34. Fed R Civ P 23(c)(2)(B).

35. 28 USC 1715(b) (emphasis added).

36. 28 USC 1715(a).

37. *Id.*

38. Vairo at 17.

39. 28 USC 1712(a).

40. Vairo at 17.

41. 28 USC 1712(e).

42. 28 USC 1712(d).

43. Class Action Fairness Act of 2005, Pub L No 109-2, 119 Stat 13 (2005), § 6(a).

44. *Id.* at § 6(b).

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In the Shadows: The Business Judgment Rule Amid the Recent Corporate Scandals

By Ashish S. Joshi

Introduction

Sometime in March 2005, when American International Group (AIG) independent directors met to determine the fate of Chairman Maurice R. "Hank" Greenberg, many had an unusual question: Could they bring their own counsel along? Of course, the directors' personal lawyers were not allowed into the meeting—only counsel retained for the group as a whole.[1] But the AIG directors' wish for individual counsel during a critical decision reflects a new level of anxiety over legal liability in corporate boardrooms: an increased sense among directors that they need to worry about their own performance and liabilities.

Although directors theoretically can be held liable for any mistakes made on their watch, there is a high legal standard for proving individual liability. To successfully defend themselves, directors need only show that their decisions were "business judgment," made in good faith and not recklessly.[2] Nevertheless, many directors have been scrambling to their lawyers for advice since former Enron and WorldCom directors agreed to pay millions to personally settle shareholder suits.[3] Such payments are rare because company charters often include provisions that make the corporation responsible for judgments against directors, and directors are further protected by insurance.[4] Nevertheless, the WorldCom and Enron settlements were a wake-up call in boardrooms across the country that the days of the rubber-stamping, old-boy-network board of directors were gone. Today's boards are feeling the heat and, unlike in the past, *they have begun to respond*.[5] Heads have been rolling: Franklin Raines from Fannie Mae, Carly Fiorina from Hewlett-Packard, Harry Stonecipher from Boeing, Michael Eisner from Disney, Hank Greenberg from AIG, Christopher Milliken from OfficeMax, and Scott Livengood from Krispy Kreme—all cut down by boards that had recently been subjected to a great deal of pressure, in AIG's case from New York Attorney General Eliot Spitzer and in Disney's case from institutional shareholders. As the *Wall Street Journal* put it: "There seems to be a sea change going on here—a kind of maturation of American corporate governance. The king now has a parliament, which in turn answers to powerful constituents."[6] During the '90s bull market, buoyed by lax "race-to-the-bottom"[7] case law and statutory amendments after the *Van Gorkom* decision,[8] fear was forgotten. But now it's back. Directors are afraid of losing their money, and in the corporate world that is simply not supposed to happen.[9]

The Business Judgment Rule[10]

Historically, the business judgment rule, as interpreted by state and federal courts, presumed that directors of corporations making decisions on behalf of shareholders were correct if they acted (1) in good faith, (2) on an informed basis, (3) in a disinterested manner, (4) with due care, and (5) without discretion or waste.[11] If these criteria were met, directors' fiduciary obligations were satisfied. To overcome this presumption, challengers were forced to show that a director had acted in a grossly negligent manner or had had a conflict of interest, but directors could overcome the latter charge by showing that they had informed the board of their interest and that their actions had served the best interests of the shareholders. This unwillingness of courts to intervene and overturn the decisions of private boards of directors can be traced in English common law as far back as 1742.[12]

In the United States, the business judgment rule as a principle of corporate law was first established in 1829 by the Louisiana Supreme Court.[13] In 1853, the Rhode Island Supreme Court stated the rule succinctly: "We think a board of [d]irectors acting in good faith and with reasonable care and diligence, who nevertheless falls into a mistake, either as to law or fact, [is] not liable for the consequences of such mistake."[14] It appears that the major rationales underscoring the validity of the business judgment rule are (1) that people make mistakes, and that they should be encouraged to assume directorships without fear of failure; (2) that the directors need wide discretion in setting policy

and making decisions; (3) that courts should be kept out of boardrooms where they have little expertise; and (4) that all parties concerned should be assured that directors, not shareholders, will set policy and be accountable to all present and future investors.[15]

The corporate law doctrine of the business judgment rule is curiously protean in judicial interpretation. During "good" times, courts typically adopt a robust vision of the business judgment rule and pay maximum respect to the principle of board authority. During periods of market decline, however, and with the emergence of highly publicized corporate scandals and their resultant extralegal pressures, judicial review of board decision making increases.[16] However, once the crisis defuses and the pressure recedes, courts return to their position of board deference. In a nutshell: board accountability increases during periods of scandal and crisis and decreases when the crisis blows over.[17]

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The Watershed Year

The corporate law jurisprudence that emerged in Delaware in the mid-1980s was, like the recent post-Enron decisions, a result of crisis and controversy. With hostile takeover activity exploding, takeover battles were drawing wide public attention. The financiers who engineered the acquisitions were vilified for getting wildly rich while the deals they made resulted in plant closures, asset sales, and layoffs.[18] On one side were the public and corporate managers who were largely opposed to the takeovers; on the other side were the academics and shareholder-rights activists who argued that takeover defenses obstruct the efficient transfer of resources and hinder the ability of shareholders to sell their interests at a premium. In response, the Delaware courts handed down a monumental set of fiduciary-duty decisions by modifying or inventing doctrines which tipped the balance in favor of greater board accountability. In a single year, the Delaware Supreme Court (1) reset the standard of gross negligence in *Smith v Van Gorkom*[19] in an unprecedented manner, (2) restricted the ability of an incumbent board of directors to resist an unwanted takeover offer in *Unocal Corp v Mesa Petroleum Co,*[20] and (3) set limits on when a target board could favor one buyer over another in *Revlon Inc v MacAndrews, Inc & Forbes Holdings, Inc*.[21] Each of these decisions was a reaction by Delaware courts to a climate of controversy and crisis.

The Waters Recede: Resumption of the "Race to the Bottom"

This narrowing of the business-judgment-rule doctrine did not last long. The ultimate impact of each of the "watershed decisions" has either been eliminated or substantially reduced: *Van Gorkom* was reversed by the Delaware Legislature, *Unocal* was slowly eroded by lax application, and *Revlon* was expressly narrowed. Once again, the "race to the bottom" continued.[22]

Perhaps the most important decision pertaining to the business judgment rule's expansion and subsequent contraction is *Smith v Van Gorkom*.[23] The chancery court imposed individual liability on Trans Union's directors for gross negligence in approving the acquisition of their company, which board members did after a twenty-minute oral presentation by Jerome Van Gorkom, Trans Union's CEO. Van Gorkom presented his understanding of the offer, which he had singly negotiated, and after two hours of discussion the board accepted the offer price of $55 per share. The directors were held personally liable for the fair value of Trans Union stock exceeding $55 per share because they were "grossly negligent" in failing to inform themselves of the market value of the stock in a competitive-buyout environment. The court noted that none of the board members was an investment banker or financial analyst, that no valuation report existed, and that it was clear that the directors had merely "rubber stamped" the fair price set by the CEO. The Delaware Supreme Court reviewed the case to determine the fair value of Trans Union shares at the time of the board's decision and for an amount of damages to the extent that fair value exceeded $55 per share.[24] Before the court determination, a settlement was reached for $23.5 million.[25]

Despite the hue and cry that followed the *Van Gorkom* decision, Delaware Supreme Court Justice Andrew G. T. Moore, who voted in the majority, stated that the case "[did not] stand for new law. The Court was just applying old law to egregious facts."[26] It was apparent that the Delaware Supreme Court's objection to the board action was because of the board's failure to follow a process that would have made it informed about significant matters involving the corporation and its shareholders.

Following the *Van Gorkom* decision, and reacting to a director's liability insurance crisis,[27] the Delaware Legislature enacted a stat-

ute that sought to immunize directors from damages for breaches of a duty of care.[28] The amended statute permits a corporation to eliminate or limit personal liability of directors and shareholders for money damages for violations of the traditional business judgment rule's obligation of a duty of care in certain circumstances. However, Section 102(b)(7) does not eliminate or limit the liability of a director for (1) breach of the duty of loyalty, (2) acts or omissions that are not in good faith or that involve intentional misconduct, and (3) any transaction for which the director derived an improper personal benefit.[29] Section 102(b)(7) also does not eliminate the duty of care; it merely permits shareholders to limit or eliminate a director's *liability* for monetary damages for violations of such a duty, which still may be enforced through equitable remedies like injunctive relief or rescission.[30] The liability is limited only when actions are instituted by shareholders or on behalf of the corporation; directors will still be held monetarily liable for a breach of a duty of care in third-party actions. Further, the amendment covers directors only, not officers, and thus director-officers are covered only when they act as directors. Lastly, Section 102(b)(7) does not allow elimination or limitation of liability arising under other state or federal laws such as federal securities laws and the Racketeer Influenced and Corrupt Organizations Act.[31]

Despite the legislative frenzy to limit or eliminate personal liability for a director's breach of fiduciary duties, there are few cases where directors have personally paid damages for violations of a duty of care.[32] Some academics believe that Section 102(b)(7) was a response to a "manufactured" insurance crisis and to *Van Gorkom,* even though that case was a mainstream decision based on egregious facts resulting in gross negligence.[33] Interestingly, since *Van Gorkom*, Delaware courts have repeatedly rejected challenges to boards' decisions where a conflict of interest or gross negligence resulting in a violation of the duties of loyalty and good faith have not been shown.[34]

The "race to the bottom" theorists claim that this race has been exacerbated by Delaware courts' pro-management rulings on the business judgment rule. The amendment of Delaware statutory law to permit Delaware corporations (and those states that have passed similar law) to limit or eliminate the personal liability of directors for money damages for violations of the traditional business judgment rule's obligation of the duty of care has also contributed to decreased standards.

Arguably, judicial decisions played, if not an important, then at least a non-trivial role in sowing the seeds of recent corporate scandals. The New York court's decision in *Kamin v American Express Co,*[35] which takes an extremely lax approach to interpreting the business judgment rule, is another example of the "race to the bottom" theory.[36] In *Kamin*, the court held that, under the business judgment rule, it was entirely appropriate for the directors of American Express "to cause the company to lose millions of dollars for the sole purpose of improving reported earnings and thereby maintaining the price at which the company's stock traded."[37] With courts giving such carte blanche to directors to engage in transactions lacking real substance and designed simply to improve reported earnings, the recent "cascade of scandals" should not be a surprise.[38] *Kamin* joins other decisions that place beyond challenge nearly any director's action, no matter how ill-conceived, if it is made without a conflict of interest and if the director thought it was in the corporation's best interest.[39]

Arguably, judicial decisions played a role in sowing the seeds of recent corporate scandals.

With the benefit of hindsight, it is eerily interesting to note how the arguments of plaintiffs in *Kamin* foreshadowed the scandals of 2002. Plaintiffs argued that, coupled with the aggressive accounting approach of American Express, some of the directors had had a conflict of interest in voting for the dividend because these directors were officers and employees of American Express and their compensation depended on the level of reported earnings. Finding no showing that the four insiders had dominated or controlled the sixteen outside directors, the trial court rejected this argument.[40] In Enron and the other scandals of 2002, the corporations pursued "aggressive accounting" in search of higher reported earnings and higher stock prices which benefited management, much of whose compensation was in the form of stock options.[41] These decisions sent an unfortunate message to future corporate leaders and their attorneys: the doctrine of the business judgment rule would protect management if it pursued more aggressive "earnings management" techniques, even when the actions were designed to pull reported earnings up from low levels without any increase in real earnings.[42]

Have the Rules Changed?

After the recent spate of corporate scandals, courts have subjected directors' conduct to increased scrutiny. Several recent Delaware decisions call into question the extent of judicial deference to the business judgment of directors. In *Brehm v Eisner*, a case involving Disney's large severance payment to its former president, Michael Ovitz, the Delaware Supreme Court reiterated the traditional formulation of the business judgment rule.[43] Later, the Delaware Chancery Court on May 28, 2003, denied a motion to dismiss an amended complaint against Disney directors arising from the same severance payments paid to Ovitz that underlay the Delaware Supreme Court's broad reading of the business judgment rule in *Brehm*.[44] Plaintiffs alleged that the directors did not investigate basic information about the Ovitz contract, including the cost of termination, and allowed Disney's CEO Michael Eisner to arrange termination payments to his long-time friend Ovitz well beyond what was called for in Ovitz's employment contract.[45] Plaintiffs alleged that the Disney directors "failed to exercise *any* business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders."[46] They further alleged that the defendant-directors "*consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."[47] The alleged facts implied that the directors "*knew* that they were making material decisions without adequate information … and they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss."[48] The chancellor held that the complaint was sufficient to withstand a motion to dismiss: "Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director's actions are either 'not in good faith' or 'involve intentional misconduct,'" and the allegations accordingly supported claims that fell outside the liability waiver provision in Disney's certificate of incorporation.[49]

Several recent Delaware decisions call into question the extent of judicial deference to the business judgment of directors.

Months before the *Disney I* decision, the Seventh Circuit in March 2003, applying Illinois law (which closely tracks Delaware law in this area), held that plaintiffs' complaint stated a claim by alleging that the directors of Abbott Laboratories had known of significant problems but decided that no action was required and that the allegations, if proved, showed a "systematic failure of the board to exercise oversight."[50] The court held that the directors' decision not to act was not made in good faith and that plaintiffs' claims were not precluded by a charter provision under the Illinois law analogous to Delaware's Section 102(b)(7). The board's failure to act was not a business decision and, accordingly, was not protected under the business judgment rule.[51]

Apparently, it has become harder for defendant-directors to dispose of litigation by preliminary motion without discovery. In the last two years, the Delaware Supreme Court has reversed several chancery court decisions in favor of defendant-directors, thereby heightening its review of director conduct and reflecting a different judicial attitude toward directors' decisions and liability.[52] Courts, perhaps acutely aware of the corporate scandals and excesses of recent years, are more willing than before to find charter protections against director liability inapplicable because of the exception for actions not in good faith or involving intentional misconduct.[53]

The "Good Faith" Conundrum

Delaware cases refer to a "triad" of fiduciary duties: duty of care, duty of loyalty, and duty to act in good faith.[54] The Delaware Supreme Court, by acknowledging in its opinions the duty to act in good faith, and in ranking this side by side with the traditional fiduciary duties of care and loyalty, implies that good faith is to be given a role in any fiduciary duty analysis equal to the other two duties.[55] However, without a general meaning of its own, good faith is an amorphous principle whose meaning "varies somewhat with the context."[56] Though it is difficult to give good faith any meaning or substance without restating either the duty of care or the duty of loyalty, an emerging line of cases rejects a vision of good faith as "mere shorthand for the duties of care and loyalty and establishes it, instead, as an independent basis for decision."[57] These cases suggest that good faith is not merely a new spin on old dicta but a *ratio decidendi*.[58] This, in turn, allows courts to review corporate governance decisions outside the confines of care and loyalty.

To gauge the importance of the duty to act in good faith as an independent basis for a court's decision making, consider a complaint against a board of directors in which the facts do *not* rise to the occasion of a clear breach of loyalty. In order to overcome the business judgment presumption, plaintiffs

would have to argue a breach of the duty of care, the duty of loyalty, or the duty to act in good faith. Without an argument under the duty of loyalty, the plaintiff would be left with only a duty of care claim. If the defendant corporation has adopted Section 102(b)(7) or a similar provision entitling the board to dismissal of claims arising exclusively under the duty of care, the plaintiff's case for monetary damages would be doomed—*unless* the complaint alleges a breach of the duty to act in good faith.[59] In such a scenario, good faith may prove to be the silver bullet. The plaintiff first would recite facts drawing both the duty of care and the duty of loyalty into question. However, rather than pursuing either of the two traditional fiduciary duties through to its logical conclusion, the plaintiff would alternate between the two and, in so doing, blend the issues raising doubts concerning the good faith of the defendant-directors.[60]

It is no accident that the issue of good faith reemerged during a period of scandal and crisis in American corporate governance. After the likes of Enron, WorldCom, Tyco, etc., the Delaware judiciary faced a heightened threat of federal preemption and responded by modifying or creatively interpreting corporate doctrines.[61] However, judging from the past, this shift toward accountability brought by good-faith interpretations will not be permanent.

The *Disney II* Decision

Two years after denying summary disposition in favor of the defendant-directors,[62] the Delaware Chancery Court concluded that defendant-directors did not breach their fiduciary duties or commit waste.[63] The court made pertinent rulings regarding the business judgment rule and held that the rule's protections will not apply if the directors have made an "unintelligent or unadvised judgment."[64] The court further held that in instances where directors have *failed* to exercise business judgment, that is, in the event of director inaction, the protections of the business judgment rule do not apply.[65] The court made a distinction between directorial inaction and a director's conscious decision not to act.[66] An informed and conscious decision to refrain from acting may be a valid exercise of business judgment and will, accordingly, enjoy the protections of the rule. However, the rule has no role to play where directors have either abdicated their functions or failed to act—clearly, dereliction of duty is not protected. In these circumstances, the appropriate standard for determining liability is widely believed to be "gross negligence."[67]

The *Disney II* decision also seeks to unravel the mysterious role that good faith plays; however, it does not quite succeed in doing so. To begin with, Delaware decisions are not clear about whether there is a separate fiduciary duty of good faith. Good faith has been said to require an "honesty of purpose" and a genuine care for the fiduciary's constituents.[68] Since the law *presumes* that directors act in good faith when making business judgments, it is probably easier to define bad faith than good faith. Bad faith has been defined as authorizing a transaction for some purpose other than a genuine attempt to advance corporate welfare or when the transaction is known to constitute a violation of applicable positive law.[69] The *Disney II* decision states that bad faith also can be a systematic or sustained shirking of duty:

> Bad faith can be the result of 'any emotion [that] may cause a director to [intentionally] place his own interests, preferences or appetites before the welfare of the corporation,' including greed, 'hatred, lust, envy, revenge, … shame or pride.' Sloth could certainly be an appropriate addition to that incomplete list if it constitutes a *systematic* or *sustained* shirking of duty.[70]

Accordingly, though mere ignorance, in and of itself, probably will not constitute bad faith, a *systematic* or *sustained* shirking of duty will. Directorial inaction will not be given the protection of the business judgment rule unless it is a reasoned and conscious decision not to act. However, even though plaintiffs may be able to demonstrate that directorial inaction is a breach of the duty of care and should not be afforded the protection of the business judgment rule, to get monetary damages they will need to get past the protection afforded by Section 102(b)(7). A single and isolated failure to act, though not covered under the business judgment rule, may not be enough to constitute bad faith. As the *Disney II* decision puts it, only a *systematic* or *sustained* shirking of duty will constitute bad faith.

Interestingly, Chancellor Chandler further held:

> [T]he concept of *intentional dereliction of duty*, a *conscious disregard for one's responsibilities*, is an appropri-

Delaware decisions are not clear about whether there is a separate fiduciary duty of good faith.

> ate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction *in the face of a duty to act* is … conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct. To act in good faith, a director must act at all times with an honesty of purpose and in the best interest and welfare of the corporation.[71]

Here the court does *not* require *systematic* or *sustained* inaction, merely holding that "inaction *in the face of a duty to act* …. [would be held] disloyal to the corporation."[72] So, what would constitute bad faith (or not be considered an action in good faith): a systematic or sustained shirking of duty or a few moments of inaction in the face of a duty to act? Would the magnitude or repercussion of that inaction be a deciding factor? How many inactions or failures to act would constitute a systematic or sustained shirking of duty? Apparently, the Delaware Chancery Court leaves many gray areas which invite further litigation.

"To act in good faith, a director must act at all times with an honesty of purpose and in the best interest and welfare of the corporation."

Disney II leaves us with an impression that to create a definitive and categorical definition of the universe of acts that would constitute bad faith would be difficult if not impossible. The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty but all the actions required by a true, faithful steward of the interests of the corporation and its shareholders. The three most salient examples of bad faith are (1) where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, (2) where the fiduciary acts with the intent to violate applicable positive law, or (3) where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proved or alleged.

Conclusion

To sum up, the pendulum on the business judgment rule has once again swung toward directors' accountability. Courts are more willing, at least in principle, to find charter protections against director liability inapplicable because of the exception for actions not in good faith or involving intentional misconduct. This emphasizes the need for corporate attorneys to counsel directors on how to demonstrate good faith and informed decision making. The better the process,[73] the less likely the courts will be to second-guess director action.

The prescriptions are not new, but they must be taken, recorded, and reflected in making a business decision.[74] They include the following:

- *Focusing on and deciding important matters*. Courts will defer to directors' business judgment only if the directors have looked at the question and used their business judgment in deciding it. It does not help (*see Disney I* and *Abbott*) if directors close their eyes to, rather than trying to wrestle with, a major issue they know about.
- *Seeking information*. In order to make an informed decision in good faith, the directors should probe to obtain the requisite information and assure themselves that the officers have done their homework to ground their recommendation. The board should actively do this and create a clear evidentiary trail of that effort.
- *Acting on an informed basis*. As the Delaware courts put it, a director must act after considering the material facts that are reasonably available.[75] Care should be taken so that pertinent reports are disseminated to the board well before a decision is made. It did not help in the *Disney* case that the compensation committee had not bothered to read the draft employment contract or the termination agreement.
- *Relying on experts when appropriate*. Corporation statutes protect directors who, in discharging their duties, rely in good faith on information presented to the company by a professional about matters the directors reasonably believe are within that person's professional competence. Directors should have the intricate or technical matters explained to them by a knowledgeable expert, and the minutes or other record should indicate this.
- *Identifying and minimizing conflicts of interest*. The directors should not have material interests that conflict with those of the company. Conflicts must be identified fully and addressed by directors who are fully independent. As the *Oracle Corp Derivative Litigation* case[76] makes clear, appearances count.
- *Acting in the best interest of the corporation*. The directors' basic duty is to maximize the shareholders' return and advance the best interests of the corporation. The

board must make a real effort to do this and should keep a record of those efforts.

NOTES

1. *See* Kara Scannell, *AIG Considers Cutting Greenberg Ties,* Wall St J, Mar 16, 2005, at C1.

2. *Id.*

3. *Id.* ("Outside board members increasingly are being targeted in shareholder litigation. Ten former Enron directors agreed to personally pay $13 million to settle civil litigation, while 10 WorldCom former outside directors agreed to pay $18 million from their own pockets to settle a shareholder suit before that agreement fell apart.")

4. Also, since the decision in *Smith v Van Gorkom,* 488 A2d 858 (Del 1985), Delaware and over 30 other states have passed statutes allowing company charters to eliminate or limit directors' individual monetary liability absent certain prohibited conduct.

5. *See* Alan Murray, *Emboldened Boards Tackle Imperial CEOs,* Wall St J, Mar 16, 2005, at A2.

6. *Id.*

7. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 Yale LJ 663, 666 (1974). The phrase "race for the bottom" was coined by Professor William Cary of Columbia University. It is derived from the dissenting opinion of Justice Brandeis in *Louis K Liggett Co v Lee*, 288 US 517, 559 (1933), describing competition among states for corporate chartering revenues as a race "not of diligence but of laxity." *See also* Bartley A. Brennan, *Current Developments Surrounding the Business Judgment Rule: A "Race to the Bottom" Theory of Corporate Law Revived*, 12 Whittier L Rev 299, 303 n13 (1991). Cary goes on to observe that "Delaware courts have contributed to shrinking the concept of fiduciary responsibility and fairness, and indeed have followed the lead of the Delaware legislature in watering down shareholders' rights." 83 Yale LJ at 696.

8. 488 A2d at 858.

9. *See* Geoffrey Colvin, *CEO Knockdown,* Fortune, Apr 4, 2005, at 19.

10. The number of major companies incorporating in Delaware, and the willingness of other states to be guided by Delaware, has established Delaware law as de facto national corporate law. *See* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 Am J Comp L 329 (2001). Accordingly, this article focuses largely on Delaware decisions and statutes.

11. *See Aronson v Lewis*, 473 A2d 805, 812 (Del 1984), *overruled in part on other grounds by Brehm v Eisner*, 746 A2d 244 (Del 2000). The rule is embodied in statutory form in the General Corporation Laws of Delaware (DGCL), which state that "[t]he business and affairs of every corporation … shall be managed by or under the direction of a board of directors." Del Code Ann tit 8, § 141(a).

12. *Charitable Corp v Sutton,* 2 Eng Rep 400, 404 (1742).

13. *Id. See also Percy v Millaudon*, 8 Mart (ns) 68 (La 1829).

14. *Hodges v New England Screw Co*, 3 RI 9, 18 (1853).

15. Brennan, 12 Whittier L Rev at 302. *See also Reading Co v Trailer Train Co*, 9 Del J Corp L 223, 229 (Del Ch 1984) (unreported).

16. *See generally* S. Griffith, G*ood Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 Duke L J (forthcoming 2005).

17. *Id; see also* Mark J. Roe, *Delaware's Competition,* 117 Harv L Rev 588, 641–643 (2003).

18. *See generally* Connie Bruck, *Predator's Ball* (1988); Bryan Burrough & John Helyar, *Barbarians at the Gate: The Fall of RJR Nabisco* (1990).

19. 488 A2d at 858.

20. 493 A2d 946 (Del 1985).

21. 506 A2d 173 (Del 1986). *See also Griffith* at 59.

22. *See* note 7.

23. 488 A2d 858 (Del 1985).

24. *Id.* at 893.

25. Brennan at 309 n39.

26. Kirk Victor, *Rhetoric is Hot When the Topic is Takeovers*, Legal Times, Dec 23, 1985, at 2.

27. *See* Synopsis to Del Code Ann tit 8, § 102(b)(7) (Supp 1986).

28. Del Code Ann tit 8, § 102(b)(7) (Supp 1986). Many other states, including Michigan, have enacted similar statutes that seek to immunize directors from damages for breaches of the duty of care. *See* the Michigan Business Corporation Act, MCL 450.1209(c).

29. *See Unocal Corp*, 493 A2d at 946.

30. Brennan at 322.

31. 18 USC 1961 et seq.

32. *See* Brennan at 323; *see also* Tamar Frankel, *Corporate Director's Duty of Care: The American Law Institute's Project on Corporate Governance*, 52 Geo Wash L Rev 705, 715 (1984).

33. *Id.*

34. *See* Stephen A. Radin, *Director's Duty of Care Three Years After Smith v Van Gorkom*, 39 Hastings LJ 707, 721-28 (1988).

35. 383 NYS2d 807 (NY Sup Ct 1976), *aff'd*, 387 NYS2d 993 (NY App Div 1976).

36. *See generally* Franklin A. Gevurtz, *Earnings Management and the Business Judgment Rule: An Essay on Recent Corporate Scandals*, 30 Wm Mitchell L Rev 1261 (2004).

37. *Kamin* involved a shareholders' derivative complaint against the directors of American Express who had approved distributing an in-kind dividend consisting of shares of stock in another company which American Express had bought some years earlier and which had substantially declined in value. Plaintiffs argued that directors should have sold the shares at a loss and obtained a capital-loss deduction, thereby saving American Express around $8 million in taxes. The board's rationale for the in-kind dividend lay in the accounting treatment of the transaction, which would have avoided recognizing a loss that would have lowered the income reported in the corporation's published financial statements.

38. Gevurtz at 1262.

39. *See, e.g., Shlensky v Wrigley*, 95 Ill App 2d 173, 176, 237 NE2d 776 (1968).

40. *Kamin,* 383 NYS2d at 811.

41. *See* Bethany McLean & Peter Elkind, *Partners in Crime,* Fortune, Oct 13, 2003, at 78.

42. Gevurtz at 1275.

43. *Brehm v Eisner*, 746 A2d 244, 264 n66 (Del 2000), quoting *Aronson v Lewis,* 473 A2d 805 (Del 1984) ("a presumption that in making a business decision the directors…acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation").

44. *In re Walt Disney Co Derivative Litig*, 825 A2d 275 (Del Ch 2003) (*"Disney I"*). However, on August 9, 2005, the Delaware Chancery Court, after conducting the trial, concluded that the defendant-directors did not breach their fiduciary duties or commit waste.

45. *See* Meredith M. Brown & William D. Regner, *What's Happening to the Business Judgment Rule?,* 17 Insights No 8, at 2.

46. *Disney I*, 825 A2d at 278.

47. *Id.* at 289.

48. *Id.* at 290.

49. *Id.* at 289-290.

50. *In re Abbott Labs Derivative S'holder Litig*, 325 F3d 795, 809 (7th Cir 2003) (directors knew of the FDA notices of safety violations and did nothing for six years).

51. *Id.*

52. *See Krasner v Moffett,* 826 A2d 277 (Del 2003), citing *Emerald Partners v Berlin*, 726 A2d 1215, 1222-1223 (Del 1999); *MM Cos v Liquid Audio, Inc*, 813 A2d 1118 (Del 2003); *Omnicare, Inc v NCS Healthcare, Inc*, 818 A2d 914 (Del 2003); *Levco Alternative Fund Ltd v Reader's Digest Ass'n*, 803 A2d 428 (Del 2002); *Saito v McKesson HBO, Inc*, 806 A2d 113 (Del. 2002) (unpublished); *Telxon Corp v Meyerson*, 802 A2d 257 (Del 2002) (unpublished).

53. *See* Brown & Regner at 5.

54. *Emerald Partners v Berlin*, 787 A2d 85, 90 (Del 2001) (unpublished); *McMullin v Beran*, 765 A2d 910, 920 (Del 2000).

55. *Cede & Co v Technicolor, Inc*, 634 A2d 345, 361 (Del 1993).

56. *EI DuPont de Nemours & Co v Pressman*, 679 A2d 436, 443 (Del. 1996), quoting *Restatement (Second) of Contracts* § 205 comment a.

57. Griffith. Professor Griffith's brilliant article argues that good faith is simply the application of the thaumatrope to the duties of care and loyalty.

58. *See generally Disney I*; *Official Comm of Unsecured Creditors of Integrated Health Servs, Inc v Elkins*, CA No 20228-NC, 2004 Del Ch LEXIS 122 (Aug 24, 2004) (unpublished); *Levco Alternative Fund Ltd v Reader's Digest Ass'n*, 803 A2d 428 (Del 2002).

59. *See In re Abbott Labs Derivative S'holder Litig* at 809 (7th Cir 2003) (invoking good faith as one of the exceptions to the corporation's Section 102(b)(7) provision).

60. *See* Griffith and *Disney I.*

61. Griffith.

62. *See* Brown & Regner.

63. *In re Walt Disney Co Derivative Litig*, 2005 Del Ch LEXIS 113(Aug 9, 2005)(unpublished)(*"Disney II"*).

64. *Id.* at *32. *See also Mitchell v Highland-Western Glass Co,* 19 Del Ch 326, 329, 167 A 831(1933).

65. *Id. See also Aronson v Lewis,* 473 A2d 805, 813 (Del 1984), *overruled on other grounds by Brehm v Eisner,* 746 A2d 244 (Del 2000) ("a *conscious* decision to refrain from acting may nonetheless be a valid exercise of business judgment" (emphasis added)).

66. *See also Hanson Trust PLC v ML SCM Acquisition Inc,* 781 F2d 264, 275 (2d Cir 1986); *Kaplan v Centex Corp*, 284 A2d 119, 124 (Del Ch 1971).

67. *See Seminaris v Landa*, 662 A2d 1350 (Del Ch 1995); *In re Baxter Int'l*, 654 A2d 1268 (Del Ch 1995). However, a single Delaware case has held that ordinary negligence would be the appropriate standard. *See Rabkin v Philip A Hunt Chem Corp*, 1987 Del Ch LEXIS 522, *1-3 (Dec 17, 1987) (unpublished), *later proceeding, Rabkin v Olin Corp,* 1990 Del Ch LEXIS 50, *aff'd,* 1990 Del LEXIS 405 (Dec 20, 1990).

68. *Disney II* at *35.

69. *See Gagliardi v TriFoods Int'l Inc*, 683 A2d 1049, 1052 (Del Ch 1996).

70. *Disney II* at *37 (emphasis added, citations omitted).

71. *Id.* at *36 (citations omitted).

72. *Id.*

73. *See Brehm v Eisner,* 746 A2d at 264 ("due care in the decision making context is *process* due care only").

74. *See* Meredith M. Brown & William D. Regner at 5.

75. *Brehm v Eisner,* 746 A2d at 264 n66.

76. *In re Oracle Corp Derivative Litig*, 824 A2d 917 (Del Ch 2003).

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The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Significant Business Bankruptcy Changes

By Patrick E. Mears and John T. Gregg

Introduction

On April 20, 2005, President George W. Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act"). The Act clarifies, expands, and revises a number of provisions to Title 11 of the United States Code (the "Bankruptcy Code") that are likely to have a significant impact on business bankruptcies. This article addresses, among other things, the general provisions pertinent to business bankruptcy cases.[1]

General Provisions

***Preferential Transfers*[2]**

1. Transfers to Non-Insiders for the Benefit of Insiders

Section 547 of the Bankruptcy Code permits the avoidance of preferential transfers made to or for the benefit of creditors during the 90 days immediately preceding the petition date, subject to certain limitations and defenses.[3] If the creditor is an "insider" of the debtor, as that term is defined by Section 101(31), preferential transfers made within the one year preceding the petition date may be avoided.[4] In 1989, the Seventh Circuit Court of Appeals held that transfers made during the one-year insider period to non-insider lenders on account of a loan guaranteed by insiders constituted avoidable transfers, because such payments benefited the insider-guarantors by reducing their contingent liability on underlying obligations.[5]

In 1994, Congress attempted to overrule *Levit v Ingersoll Rand Financial Corp (In re Deprizio)*, 874 F2d 1186 (7th Cir 1989), by amending the Bankruptcy Code to provide that transfers made to non-insider creditors during the one-year period were not recoverable. However, some courts interpreted the amendment to apply only to payments made to non-insider creditors and not to other transfers, most notably liens granted on property of the debtor during the one-year period. Under the Act, Congress has again attempted to overrule *Deprizio*. The Act amends Section 547 so that any preferential transfer made to a non-insider creditor between the ninety-day non-insider period and the one-year insider period may not be avoided.[6]

Section 547(i) became effective on April 20, 2005, and applies to all cases, whether pending or commenced on or after that date.

2. Ordinary Course of Business Defense

The Bankruptcy Code before the Act provided that a creditor asserting the ordinary course of business defense had to prove that the transfer at issue was: (1) in payment of a debt incurred in the ordinary course of business between the debtor and the creditor, (2) made in the ordinary course of business between the debtor and creditor, *and* (3) made according to ordinary business terms within the industry.[7]

The Act no longer requires that the creditor prove that the transfer was made both in the ordinary course of business between the debtor and the creditor (i.e., the subjective component) *and* that the transfer was made according to ordinary business terms within the industry (i.e., the objective component).[8] Instead, the creditor now must demonstrate that the transfer was made in payment of a debt incurred in the ordinary course of business between the debtor and the creditor and that the transfer satisfies *either* the subjective *or* the objective component.[9]

3. Extensions of Time to Perfect Security Interests

A creditor generally has a defense to a preferential transfer if it can establish that the challenged transfer was a contemporaneous exchange for new value given to the debtor.[10] Under the Bankruptcy Code before the Act, perfection of a security interest within 10 days after the interest was granted was deemed contemporaneous. The Act extends the grace period for perfection to 30 days.[11] It also permits a purchase money security interest to be perfected on or within 30 days after the debtor received possession of the property, as opposed to the 20 days permitted under the former Bankruptcy Code.[12]

4. Transfer Amount Thresholds

The Act provides a complete defense to a preference action brought in a business bankruptcy (i.e., a case of a debtor whose debts are primarily non-consumer debts) if the aggregate value of the property transferred is less than $5,000.[13] In addition, an action to recover a non-consumer debt of less than $10,000 must be commenced in the district in which the defendant resides.[14]

Post-Petition Transfers

Under Section 549 of the Bankruptcy Code before the Act, a trustee could generally avoid certain post-petition transfers of estate property. However, a post-petition transfer of real property for present fair equivalent value to a good faith purchaser who did not have knowledge of the filing did not constitute an avoidable transfer.[15] Some courts limited this exception to actual transfers of real property, thus excluding from protection the creation of a lien on real property. The Act amends Section 549(c) and the definition of "transfer" to extend the exception to "a transfer of an interest in real property," such as the creation of a lien.[16]

Fraudulent Transfers

The Bankruptcy Code formerly provided that a fraudulent transfer or obligation made or incurred within one year before the petition date could be avoided without applying state law.[17] Under the Act, the reach-back period has been expanded to two years.[18] This change will not become effective until April 20, 2006.

The Act also permits avoidance of a pre-petition transfer or obligation to or for the benefit of an insider "under an employment contract and not in the ordinary course of business" if the debtor received less than the reasonably equivalent value.[19] Under new sub-clause IV of Section 548(a)(1)(B)(ii), it is likely not necessary to prove either actual fraudulent intent or any of the criteria for a constructive fraud, i.e., insolvency or unreasonably small capital.[20] It should be noted that this change became effective April 20, 2005.

Reclamation Claims[21]

Under Section 546 of the Bankruptcy Code before the Act, reclamation rights under the Uniform Commercial Code were recognized if written notice was provided to the seller 10 days after receipt of the goods; if the 10-day period came after the bankruptcy petition date, the written notice had to be provided within the 20 days following the receipt of the goods.[22] Because a seller's right of reclamation is subject to the rights of a buyer or other good-faith purchaser, a valid reclamation claim may be subordinated to the rights of a good-faith purchaser (i.e., a creditor holding a security interest or lien).[23] If the secured creditor was undersecured, the valid reclamation claim could be subordinated and, in some instances, rendered worthless.

Under the Act, sellers will be able to reclaim goods sold on credit for a 45-day period before bankruptcy, so long as written notice is provided to the buyer within 45 days of receipt of the goods.[24] The Act also grants reclaiming creditors administrative expense claims for the goods delivered within the 20 days preceding the commencement of the case, provided the goods were sold in the ordinary course of the debtor's business.[25] The seller holding an administrative claim will not need to provide written notice and will have an administrative claim entitled to payment before any unsecured creditors receiving distribution under a plan. The reclaiming seller need not prove that the goods are still in the possession of the buyer/debtor or that the goods have not been consumed. Rather, the reclaiming seller merely must show that goods were delivered within the 20 days before the petition date. It should be noted, however, that the reclaiming seller's administrative claim does not arise automatically, and the reclaiming seller should be proactive by filing an administrative claim and seeking payment immediately.

Under the Act, sellers will be able to reclaim goods sold on credit for a 45-day period before bankruptcy, so long as written notice is provided to the buyer within 45 days of receipt of the goods.

Wage and Benefit Priority

Section 507(a) of the Bankruptcy Code formerly provided that employee wage and benefit claims were entitled to priority to the extent that such claims were (1) earned within a specified time period before the petition date or cessation of the debtor's business, and (2) subject to a monetary cap.[26] The Act now expands both the statutory look-back period and the monetary cap on priority wage and benefit claims.[27] The look-back period for wage claims is now 180 days, up from 90, which matches the period for benefit claims,[28] and the monetary cap on priority wage and benefit claims for each employee has been increased from $4,925 to $10,000, subject to annual increases.[29] Effective April 20, 2005, these changes apply to all cases filed on or after that date.

Exceptions to Corporate Discharge

Under the Act, confirmation of a Chapter 11 plan will not discharge a corporate debtor from debts arising from a tax or customs duty the debtor attempted in any manner to evade or defeat or for which the debtor made a fraudulent return.[30] Furthermore, confirmation will not discharge a corporate debtor from debts owed to a domestic governmental unit that is of the kind not excepted from discharge pursuant to section 523(a)(2)(A) or (B) (i.e., certain types of fraud).

Prepackaged Bankruptcies

The Act expressly permits a debtor to continue soliciting acceptances of a prepackaged plan after the petition has been filed, notwithstanding the absence of a court-approved disclosure statement, so long as the solicitation complies with applicable non-bankruptcy laws and the claim holder was solicited before the commencement of the case.[31] In addition, if solicitation does occur before the commencement of the case, the Act provides that the bankruptcy court may order the United States Trustee (UST) to dispense with the meeting of the creditors under Section 341.[32]

Consumer Privacy

The Act includes provisions that are designed to protect the privacy of "personally identifiable information" (i.e., the name, contact information, social security number, and account number) of individuals who were customers of the debtor. Under the Act, Section 363(b)(1) requires that any sale or lease of property of the estate be either consistent with the debtor's pre-petition privacy policy or be approved by the bankruptcy court. Any such approval must consider "the facts, circumstances, and conditions of such sale or lease" and find "that no showing was made that such sale or lease would violate applicable nonbankruptcy law."[33] If the proposed transaction would be inconsistent with the privacy policy, the court must order the UST to appoint a "consumer privacy ombudsman," to be compensated by the estate, to assist the court in considering the proposed transaction.[34]

Utilities

Section 366 of the Bankruptcy Code formerly allowed a utility to alter, refuse, or discontinue service to a debtor if it did not receive timely and adequate assurance of payment.[35] Under the Act, a utility may still alter, refuse, or discontinue service,[36] but only if it has not received adequate assurance that is subjectively satisfactory to the utility within 20 or 30 days of the petition date.[37] The bankruptcy court may modify the amount of assurance required, but it is precluded from reviewing pre-Act factors, including (1) pre-petition security, (2) timeliness of pre-petition payments, or (3) the availability of an administrative expense priority.[38] Rather, assurance of payment constitutes, among other things, a cash deposit, a letter of credit, a certificate of deposit, a surety bond, or a prepayment.[39] Furthermore, Section 366 expressly states that an administrative expense priority does not constitute adequate assurance.[40] Finally, the Act allows utilities to recover or set off against a pre-petition security deposit without notice or court approval.[41]

Single-Asset Real Estate Debtors

The Bankruptcy Code previously provided that, in order to qualify as a single-asset real estate debtor, the debtor had to have "aggregate noncontingent, liquidated secured debts" not exceeding $4 million. The Act removes this monetary threshold and now seemingly extends single-asset real estate status to all debtors owning real property by defining real property as

> constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental [thereto].[42]

Moreover, unless the debtor has filed a plan that has a reasonable possibility of being confirmed within a reasonable amount of time, a single-asset real estate debtor must make monthly payments to creditors secured by such real estate in an amount equal to interest at the then-applicable default contract rate on the value of the creditor's interest in the property. If the debtor fails to make such payments, the debtor risks losing the protection of the automatic stay.[43] Such payments must commence by the later of (1) 90 days after the entry of the order for relief, or such later date as the court may determine for cause; or (2) 30 days after the court determines that the case involves "single asset real estate."[44] Pay-

The Act includes provisions that are designed to protect the privacy of "personally identifiable information" of individuals who were customers of the debtor.

ments may be made from the rents or other income generated from the real property.[45]

Personal Property Leases

Under the Act, if a lease of personal property is rejected or not timely assumed, the leased property is no longer considered to be property of the estate and the stay is automatically terminated.[46] New subsection (p) of Section 365 will allow a lessor of personal property to repossess such property on rejection or non-assumption, without the need for court approval.

Real Property Considerations

The Act provides that unexpired leases of commercial real estate will automatically be deemed rejected if they are not assumed by the earlier of the following periods: (1) 120 days after the petition date, or (2) the date on which a plan of reorganization is confirmed by the bankruptcy court.[47] The initial 120-day period can be extended by the bankruptcy court for cause, but only for an additional 90 days.[48] At the end of these additional 90 days, the lessor must consent to any additional extensions; without consent, the lease is automatically deemed rejected, and the leased premises must be surrendered to the landlord.[49]

Unexpired commercial real estate leases will automatically be deemed rejected if not assumed by the earlier of the following: (1) 120 days after the petition date, or (2) the date on which a plan of reorganization is confirmed by the bankruptcy court.

Under the Bankruptcy Code before the Act, case law was split on the issue of whether a debtor (or trustee) was required to cure all monetary defaults in an unexpired lease of real property before it could be assumed under Section 365(b). The Act amends this provision to provide that non-monetary defaults (other than defaults arising from the debtor's failure to operate in accordance with the terms of a lease of nonresidential real property) that are "impossible" for the debtor to cure will not bar assumption and assignment of the lease.[50] These defaults will be deemed cured upon the assumption of the lease.[51] Defaults that require the payment of money must still be cured by payment of money.

Additionally, under the Bankruptcy Code before the 2005 amendments, many courts held that once a debtor assumed an unexpired lease of real property but thereafter rejected the lease, all resulting damages determined under applicable bankruptcy law would be categorized as administrative claims. The substantial claims resulting from this could effectively prohibit confirmation of many plans because, without the consent of the lessor, all damages would need to be paid in full and in cash upon confirmation (or shortly thereafter). The Act revises Section 503(b) to limit the lessor's administrative claim under these circumstances to a maximum of two years of rent and other lease obligations, less amounts received from other sources.[52]

Section 365(f)(1) under the Act now clarifies that the special requirements of adequate assurance that a debtor must provide to the lessor of a shopping center lease upon assumption must also be given upon the attempted assignment of that lease.[53]

A lessor of residential real property to an individual lessor holding a judgment for possession of the premises entered before an *individual* debtor's bankruptcy filing may proceed to complete those eviction proceedings unless the debtor certifies to the bankruptcy court that he or she can cure the lease default and thereafter pays the amount of the default to the lessor.[54] The lessor, of course, can dispute any such representations.

Under the Bankruptcy Code before the Act, debtors who defaulted on real estate mortgage loans would often file successive bankruptcy petitions to stop foreclosure proceedings by mortgagees. Under Section 362(c)(3), the Act now protects mortgagees from these serial filers so that foreclosure can be completed.

Finally, the Act provides that, under Section 362(j), upon the request of a party in interest, the bankruptcy court may enter an order confirming that the stay has been terminated.[55]

Tax Considerations

1. Taxes Paid Pursuant to a Plan

Section 1129(a)(9) expresses the required treatment of priority tax claims in a Chapter 11 plan where there has been no agreement for different treatment.[56] Before the 2005 amendments, the Bankruptcy Code permitted such claims to be paid in deferred cash payments with a present value equal to the allowed amount of the claim over a period not exceeding six years after the date of assessment. After the amendments, the Code requires "regular installment payments in cash" over a period not exceeding five years after the date of the order for relief.[57] Moreover, the claim must be paid "in a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan," other than convenience class claims.[58] Finally, the Act resolves a split in authority and provides that secured claims that would be priority tax claims if they were not secured are entitled to the same treatment in a plan as priority tax claims.[59]

2. Interest

The Act added to the Bankruptcy Code Section 511, which provides that, in the event that the Code requires (1) payment of interest on a tax claim or an administrative expense tax, or (2) that a creditor receive the present value of its allowed claim (i.e., USC 1129(a)(9)(C)), the rate of interest[60] must be calculated under applicable non-bankruptcy law.[61] For taxes paid under a confirmed plan, the rate must be determined as of the calendar month in which the plan is confirmed.

3. Priority Property Tax Claims

The Bankruptcy Code before the Act entitled an unsecured property tax claim to priority if it was assessed before the petition date and was last payable without penalty within the year before the petition date.[62] The Act, however, alters the date when the tax was actually incurred so that a tax *incurred before* but *assessed after* the petition date may be entitled to priority treatment.[63]

4. Refunds

The Act permits the government to set off an income tax refund for a year that ended before the entry of an order for relief against an income tax liability for the same period. Moreover, if the setoff is prohibited by applicable non-bankruptcy law because of a pending action to determine amount or legality of the liability, the taxing authority may hold the refund pending resolution of the action.

Notice

The Act amends Section 342 to provide additional notice requirements for notice to be deemed effective. For example, if a debtor is required to give notice, that notice must contain the name, address, and last four digits of the debtor's taxpayer identification number.[64] If the notice relates to an amendment that adds a creditor to the schedules, the debtor's full taxpayer identification number must be included in the notice provided to the creditor.[65] In addition, if, during the 90 days before the petition date of a voluntary case, a creditor supplies the debtor (in at least two communications) with the debtor's account number and the creditor's mailing address, then the debtor is required to send any notice to that address and include the account number in the notice.[66]

A notice that does not conform to amended Section 342 will not be deemed effective until it is "brought to the attention of such creditor."[67] If a creditor has established "reasonable" internal procedures for dealing with bankruptcy-related notices, notice will not be considered to have been "brought to the attention of such creditor" until it is actually received by the person or subdivision designated in those procedures to receive notice.[68]

Professional Compensation: Board Certification

Under the Act, Section 330 has been amended to allow the Bankruptcy Court to consider whether a professional is board certified, or has otherwise demonstrated skill and expertise in the bankruptcy field, when determining the appropriate rate of compensation awarded to the professional.[69]

Involuntary Cases

The Bankruptcy Code before the Act required that a petitioning creditor in an involuntary case hold a claim that was not subject to a bona fide dispute.[70] The Act now clarifies that a petitioning creditor must hold a claim that is not subject to a bona fide dispute as to liability or amount.[71] This amendment became effective April 20, 2005, and applies to all cases, whether pending or commenced on or after that date.

Meeting of the Creditors

The Act modifies Section 341(c) to provide that a creditor holding a consumer debt, or any representative of the creditor, is permitted to participate in the meeting of the creditors in both Chapter 7 and Chapter 13 cases.[72] The Act clarifies that attorneys are not required to represent a creditor at any meeting of the creditors.[73]

The Act amends Section 342 to provide additional notice requirements for notice to be deemed effective.

Chapter 11 Amendments and Revisions

Committees of Creditors and Equity Security Holders

1. Composition

Under the Act, the formation process for, and responsibilities of, statutory committees have changed. Section 1102(a) of the current Bankruptcy Code mandates that the UST appoint a committee of unsecured creditors as soon as "practicable" after the order for relief has been entered in a Chapter 11 case.[74] The UST has the discretion to appoint a committee that is representative of the unsecured creditor (or equity security-holder) constituency.[75]

The Act, however, provides the bankruptcy court with the authority to order the

UST to change the composition of a committee if the court determines that such change "is necessary to ensure adequate representation" of the constituency.[76] The bankruptcy court may order the trustee to change the number of committee members, for example, to include a creditor that is a small business if (1) the creditor holds the type of claim represented by the committee, and (2) the aggregate amount of the creditor's claim is disproportionately large in comparison to the creditor's annual gross revenue.[77]

2. Information and Comment

The Act requires that committees cooperate with the constituencies they represent. Furthermore, Section 1102(b)(3) states that a committee must provide its constituency with access to any information the committee receives.[78] If the committee does not comply with a request for information, the bankruptcy court may compel a report or disclosure to the committee's constituency, or at least to the inquiring creditor.[79] Finally, a committee is now required to solicit and receive comments from its constituency.[80] While the Act is not clear as to whether confidential or privileged information is subject to this requirement, it is likely that, initially, this provision will have a chilling effect on a debtor's willingness to share information with a committee.

3. Compensation for Professionals

The Act denies compensation for services rendered by an individual committee member's professional for the benefit of the committee.[81] Although an administrative expense for a creditor's or committee's professionals is allowed in some circumstances,[82] Section 503(b)(4) omits reference to professional services incurred by a member of a committee, even if such services were incurred in the performance of the committee member's duties.[83]

The UST must seek appointment of a Chapter 11 trustee if there are grounds to suspect that the debtor's CEO or CFO participated in actual fraud, dishonesty, or criminal conduct.

Appointment of Chapter 11 Trustee or Examiner

Section 1104 of the Bankruptcy Code before the Act provided that the bankruptcy court has the authority to appoint a Chapter 11 trustee or, alternatively, an examiner for cause, including fraud, dishonesty, incompetence, or gross mismanagement.[84] Similarly, the Act permits the court to order the appointment of a trustee or examiner as an alternative to conversion or dismissal where such appointment is in the best interests of the creditors and the estate.[85]

Additionally, under the Act, the UST must seek appointment of a Chapter 11 trustee if there are reasonable grounds to suspect that (1) the members of the debtor's governing body, (2) the debtor's chief executive officer or chief financial officer, or (3) the members of a governing body who selected the CEO or CFO participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.[86] This requirement likely reflects Congress' recognition of gross mismanagement of companies like *Enron Corp.* and *WorldCom, Inc*. This change became effective on April 20, 2005.

Section 1104 also provides that after a Chapter 11 trustee is elected at a meeting of creditors, the UST must file a report certifying the election.[87] On the filing of such certification by the UST, the trustee is deemed appointed as of the date of the report, and any prior trustee's appointment is considered terminated.[88] If a dispute arises as a result of a Chapter 11 trustee's election, the bankruptcy court is now vested, under the Act, with the authority to resolve such a dispute.[89]

Status Conferences

Before the Act, Section 105(d) provided that the bankruptcy court had the discretion to hold status conferences. The Act, however, now *requires* the bankruptcy court to hold status conferences necessary "to further the expeditious and economical resolution of the case."[90]

Conversion or Dismissal

The Act enumerates additional examples of "cause" for dismissal or conversion of a Chapter 11 case.[91] "Cause" now includes the following non-exhaustive factors: (1) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation; (2) gross mismanagement of the estate; (3) failure to maintain appropriate insurance; (4) unauthorized use of cash collateral; (5) failure to comply with an order of the court; (6) unexcused failure to comply with reporting or filing requirements; (7) failure to attend a meeting of the creditors or examination pursuant to Bankruptcy Rule 2004; (8) failure to attend a meeting scheduled by the UST or to provide information requested by the UST; (9) failure to pay taxes or file tax returns; (10) failure to pay fees or charges required by Chapter 123 of Title 11; (11) revocation of a confirmation order; (12) inability to consummate a plan; (13) material default under a plan; (14) termi-

nation of a plan due to occurrence of a condition specified in the plan; (15) failure to pay domestic child support arising post-petition; (16) failure to file a disclosure statement or to file or confirm a plan within the time prescribed by the court or the Bankruptcy Code.

If cause is established, the court may deny the motion for conversion or dismissal only if a party objects and demonstrates (1) a reasonable likelihood that a plan will be confirmed within the prescribed time, (2) a justification exists for the act(s) constituting cause, and (3) such act(s) will be cured, and conversion or dismissal is not in the best interests of the creditors and the estate.[92]

The Act imposes a time period for hearings on conversion or dismissal.[93] The bankruptcy court must commence such a hearing no later than 30 days after the motion is filed, and the court must come to a decision 15 days after that, unless the movant consents to a continuance for a specific time or compelling circumstances prevent the court from meeting the time limits.[94]

Exclusivity

Before the Act, the debtor was granted the exclusive right to file a plan of reorganization and had 60 days to gain approval of it.[95] The bankruptcy court had the discretion to grant extensions of the exclusivity periods for an undetermined amount of time if the debtor could demonstrate cause.[96] The Act maintains the debtor's exclusivity periods, but Section 1121 now provides that the exclusivity period may not be extended beyond 18 months after the order for relief has been entered.[97] In addition, the debtor's exclusivity to gain approval of a plan cannot be extended past 20 months after the order for relief has been entered. Therefore, under the Act, the bankruptcy court can grant to the debtor the exclusive right to file a plan for, at most, 18 months and, at most, an additional 2 months to gain approval of such plan.[98]

Small-Business Filings

1. Definition

Under prior law, a debtor could elect to be categorized as a small-business debtor. Under the Act, this designation is automatic. The Act provides that a "small business debtor" is a person engaged in commercial or business activities, but not a person whose primary activity is owning or operating real property.[99] As of the petition date or the date of the order for relief, a small-business debtor cannot have aggregate non-contingent liquidated secured and unsecured debts of more than $2 million.[100] Finally, in order for a debtor to qualify as a small-business debtor, the UST must not have appointed a committee of unsecured creditors or the court must have determined that any such committee is inactive.[101] Therefore, where an unsecured creditors' committee has been appointed by the UST, a debtor must show inactivity of the committee to gain small-business debtor status.[102]

2. Duties of the Debtor or Chapter 11 Trustee

The Act requires that a debtor (or Chapter 11 trustee) file with its petition in a voluntary case, or within seven days of the order for relief in an involuntary case, its most recent (1) balance sheet, (2) statement of operations, (3) cash-flow statement, and (4) federal income tax return.[103] Alternatively, the debtor may make a statement under penalty of perjury that no such documents have been prepared or filed.[104]

Small-business debtors also are required to attend any meetings scheduled by the bankruptcy court or the UST, including the initial debtor interview, the meeting of the creditors, and any scheduling conferences.[105] The court may waive such requirements upon a finding of "extraordinary and compelling circumstances."[106]

The schedules and the statement of financial affairs must, as with non-small business debtors, be timely filed. However, the bankruptcy court is not permitted under the Act to grant an extension more than 30 days after the date of the order for relief unless the small-business debtor can show "extraordinary and compelling circumstances."[107] In addition, the Act states that a small-business debtor must file all post-petition financial reports required by the Bankruptcy Rules or the local rules.[108]

A small-business debtor must maintain the insurance customary to its industry and must timely submit all tax returns and other government filings.[109] The small-business debtor also must timely pay any taxes entitled to an administrative expense priority.[110]

In addition, a small-business debtor must file periodic financial reports concerning profitability, projected cash receipts and disbursements, and comparisons of the actual receipts and disbursements with the previous projections.[111] These reports must make an affirmative statement about compliance with the Bankruptcy Code provisions, including the payment of administrative expenses and taxes

Under prior law, a debtor could elect to be categorized as a small-business debtor. Under the Act, this designation is automatic.

when due. The reports also must contain an affirmative statement about compliance with all government filings, including tax filings.[112]

Finally, a small-business debtor under the Act must permit the UST or a designated representative of the UST to inspect the debtor's business premises and books and records with reasonable prior written notice.[113]

3. Plan and Disclosure Statement

The Act provides some specific provisions regarding the plan and disclosure statement that may be filed by a small-business debtor. Under the Act, the bankruptcy court now has the authority to dispense with the disclosure statement requirement arising under Section 1125 if the debtor is (1) classified as a small-business debtor, and (2) the debtor's plan provides "adequate information" as defined by Section 1125(a)(1).[114] The bankruptcy court also may conditionally approve a small-business debtor's disclosure statement,[115] and acceptances and rejections of a small-business debtor's plan may be solicited based on such a statement, provided the debtor furnishes adequate information.[116] However, a conditionally approved disclosure statement must be mailed at least twenty-five days before the confirmation hearing.[117]

The expanded duties and obligations described in Sections 308 and 1116 seem counterproductive, as they amount to additional burdens on the small-business debtor.

The changes to the plan and disclosure statement requirements, coupled with Congress' directive that the Judicial Conference of the United States create proposed plan and disclosure statement forms, seem to reflect the government's awareness of the cost of the Chapter 11 process for small-business debtors. However, the expanded duties and obligations described in Sections 308 and 1116 seem counterproductive, as they amount to additional burdens on the small-business debtor.

4. Plan Filing and Confirmation Deadlines

The Bankruptcy Code before the Act provided that only the small-business debtor could file a plan for the first 100 days and that all plans had to be filed within the first 160 days after the entry of the order for relief.[118] Both periods could be reduced, for cause, on request of a party, but only the 100-day period could be extended for circumstances for which the small-business debtor should not have been held accountable.[119]

As noted above, Section 1121 provides that a non-small business debtor has an exclusive right to file a plan within the first 120 days after the order for relief is entered. Under the Act, small-business debtors are granted the exclusive right to file a plan for a period of 180 days.[120] The 180-day exclusivity period may be extended if (1) the debtor demonstrates, by a preponderance of the evidence, that a court is likely to confirm a plan within a reasonable period of time; (2) a new deadline is imposed at the time the extension is granted; and (3) the order extending the time is entered before the expiration of the existing deadline.[121]

However, a small-business debtor must file its plan and disclosure statement within the first "300 days" after the order for relief is entered or the debtor will lose its exclusive right to file a plan; the bankruptcy court may not extend the exclusivity period beyond 300 days.[122] Accordingly, the inability to satisfy these deadlines would apparently result in a debtor's inability to confirm a plan and would be grounds for conversion or dismissal.

The Bankruptcy Code before the Act imposed no deadline on the bankruptcy court for plan confirmation. However, the Act provides that the bankruptcy court must confirm a plan that complies with confirmation requirements no later than 45 days after the plan is filed, unless the time period is extended pursuant to Section 1121(e)(3)(A)–(C).

5. Serial Filings

The Act includes an exception to the automatic stay directly applicable to small-business debtors. Section 362(n) under the Act provides that the automatic stay does not apply in a case in which the debtor (1) is a small-business debtor in a case pending at the time the new case is filed, (2) was a small-business debtor in a case that was dismissed by an order that became a final order within two years of the current case's petition date, (3) was a small business debtor in a case in which a plan was confirmed within two years of the current case's petition date, or (4) is an entity that acquired substantially all of the assets of a small-business debtor, unless such entity can establish that it required such assets in good faith.[123]

It should be noted, though, that new subsection (n) does not apply to an involuntary case where no collusion occurred between the debtor and the petitioning creditors or where the small-business debtor can prove that (1) the filing resulted from unforeseeable circumstances beyond the debtor's control, or (2) the bankruptcy court will more likely than not confirm a plan of *reorganization* within a reasonable period of time.[124]

Key Employee-Retention Programs

As interpreted by the majority of bankruptcy courts, Section 503 of the Bankruptcy Code before the Act allowed payments or administrative claims to insiders under key employee-retention programs. Under Section 101, an "insider" includes, among other things, a debtor's officers, directors, and general partners.[125]

Under the Act, Section 503 now strictly limits allowance of claims or payments to insiders under key employee-retention programs. Any payments made to an insider for the purpose of inducing the insider to remain employed with the debtor will be prohibited unless the court finds that (1) the payment is essential to the retention of the insider because the insider has a bona fide job offer at an equal or greater rate of compensation, (2) the services provided by the insider are essential to the survival of the business, and (3) the amount of payment does not exceed certain limits that are calculated by reference to similar payments recently made to insiders.[126]

Severance payments to insiders also are not allowed under the Act unless they are part of a program applicable to all of the debtor's employees and do not exceed ten times the average amount of severance pay given to non-management employees during the calendar year in which the payment is made.[127]

Finally, Section 503(c) prohibits transfers or payments of obligations that are outside of the ordinary course of business and not justified by the facts or circumstances of the case, including any transfers or payments made to or for the benefit of officers, managers or consultants hired post-petition.[128]

Investment Bankers

Under Section 327(a) before the Act, a debtor could retain an investment banker as a professional to be paid by the estate, provided the investment banker qualified as a "disinterested person," which was defined in part as "not an investment banker for any outstanding security of the debtor."[129] The effect of this portion of the definition was to preclude the debtor from retaining an investment banker who was an underwriter for securities issued by the debtor before the bankruptcy case.

Under the Act, the debtor is permitted to hire an investment banker that, pre-petition, underwrote securities issued by the debtor.[130] Despite the deletion of part of the definition, a potential investment banker still must satisfy the other requirements of a "disinterested person."[131]

Health Care

The Act contains several provisions that are intended to apply to bankruptcies involving health care providers. "Health care business," a newly-defined term in the Act, includes hospitals, treatment facilities, hospices, and home health agencies, as well as "similar" institutions and long-term care facilities.[132]

Section 351 under the Act obligates the debtor (or trustee) to publish a notice giving patients and insurance providers 1 year to assert a claim to patient records.[133] If no claim is made to such records within the 1-year period, Section 351 authorizes the debtor to destroy the patient records.[134] During the first 180 days of this 1-year notice period, Section 351 places an affirmative duty on the debtor to promptly contact patients and insurance companies regarding patient records.[135]

The debtor also is obligated to "use all reasonable and best efforts to transfer patients from a health care business that is in the process of being closed to an appropriate health care business" within the vicinity of the closing health care business.[136] The health care business to which patients are transferred must provide similar services and provide a reasonable quality of care.[137]

The Act creates a new estate-compensated professional by providing for a "patient care ombudsman." The court must order the appointment of an ombudsman no more than thirty days after the commencement of a case where the debtor is a health care business.[138] The ombudsman is charged with monitoring the quality of patient care and representing the interests of patients until the court finds that an ombudsman is no longer necessary.[139] In addition, the ombudsman has a duty to interview patients and physicians in the execution of his or her duties.[140] Sixty days after the commencement of the case, and at subsequent sixty-day intervals, the ombudsman must file a report with the court regarding the quality of patient care.[141] If the ombudsman determines that patient care is in significant decline or otherwise being materially compromised, the ombudsman must file a report or motion with the court.[142]

Notably, the Act contains a health-care related exception to the automatic stay, allowing the secretary of health and human services to exclude the debtor from participation in Medicare or any other federal health care program.[143]

Under the Act, Section 503 now strictly limits allowance of claims or payments to insiders under key employee-retention programs.

Finally, Section 503(b) allows an administrative expense claim for "actual necessary costs and expenses" associated with the closing of a health care business, including the costs for disposal of records and the transfer of patients.[144]

The Bankruptcy Code formerly treated consumer debtors no differently than any other debtor under Chapter 11. However, the Act contains specific provisions that apply only to a Chapter 11 case filed by a consumer debtor.

Consumer Cases

For the most part, the Bankruptcy Code formerly treated consumer debtors no differently than any other debtor under Chapter 11. However, the Act contains specific provisions that apply only to a Chapter 11 case filed by a consumer debtor. The Act states that all property, including post-petition earnings, acquired by the consumer debtor in a Chapter 11 case after the case is commenced but before it is closed, dismissed, or converted must be included in the property of the estate.[145] As noted above, in order for a Chapter 11 individual debtor's plan to be confirmed, the debtor must be up-to-date on all post-petition domestic support obligations.[146] Moreover, the plan must provide that the debtor's disposable income received during the five-year period after payments under the plan commence must be made available to creditors.

Retiree Health Plans

Section 1114 of the Bankruptcy Code formerly provided that a debtor filing under Chapter 11 may not unilaterally terminate or modify a retiree health plan without first negotiating with a representative for the retirees. Upon the filing of a Chapter 11 petition, retiree benefits covered by Section 1114 must continue unchanged until a modification or termination is agreed to by the debtor and the representative or ordered by the bankruptcy court.[147] Under the Act, Section 1114 permits a bankruptcy court to set aside modifications to retiree benefits made within the 180 days before the petition date while the debtor was insolvent, unless the court finds that such modification is favored by a balancing of the equities.[148]

Chapter 15

The Act deletes Section 304 of the Bankruptcy Code, which governed cases ancillary to any foreign proceedings. As a substitute, the Act adds Chapter 15, which is devoted to cross-border insolvencies. Chapter 15 incorporates the Model Law on Cross-Border Insolvency promulgated by the United Nations.

According to Chapter 15, a case is commenced by the filing of a petition by a foreign representative seeking "recognition" of a foreign insolvency proceeding. On "recognition," the automatic stay and other protections of the Bankruptcy Code apply. Chapter 15 encourages comity and cooperation among courts and estate representatives in different countries.

NOTES

1. Unless otherwise noted, all changes became effective on October 17, 2005.
2. For a more comprehensive discussion, please see Kevin C. Driscoll, Jr., *Bankruptcy 2005: New Landscape for Preference Proceedings*, 24-5 Am Bankr Inst J 1 (June 2005).
3. 11 USC 547(b).
4. 11 USC 547(b)(4)(B).
5. *Levit v Ingersoll Rand Fin Corp (In re Deprizio)*, 874 F2d 1186 (7th Cir 1989).
6. 11 USC 547(i).
7. 11 USC 547(c)(2).
8. *Id.*
9. 11 USC 547(c)(2)(A) and (B).
10. 11 USC 547(c)(1).
11. 11 USC 547(e)(2). This amendment should substantially restrict bankruptcy trustees' attempts to avoid tardily recorded real estate mortgages in connection with refinancings. See *Gold v Interstate Fin Corp (In re Schmiel)*, 319 BR 520 (Bankr ED Mich 2005), for an example of this type of preference attack.
12. 11 USC 547(c)(3)(B).
13. The consumer threshold remains at $600. 11 USC 547(c)(8).
14. 28 USC 1409(b).
15. 11 USC 549(c).
16. *Id.*; 11 USC 101(54).
17. 11 USC 548(a).
18. *Id.*
19. 11 USC 548(a)(1)(B)(ii)(IV).
20. Compare *id.* with 548(a)(1)(B)(ii)(I)–(III).
21. For a more comprehensive discussion, please see Deborah L. Thorne, *New Law Gives Trade Creditors Help*, 24-4 Am Bankr Inst J 1 (May 2005).
22. 11 USC 546.
23. UCC 1-201(32) and (33), 2-702(3); *see, e.g.*, *Yenkin-Majestic Paint Corp v Wheeling-Pittsburgh Steel Corp (In re Pittsburgh-Canfield Corp)*, 309 BR 277 (6th Cir BAP 2004).
24. 11 USC 546(c)(1).
25. 11 USC 503(b)(9) and 546(c)(2).
26. 11 USC 507(a)(3) and (4) (under the former Bankruptcy Code).
27. *See* 11 USC 507(a)(4) and (5) (under the Act).
28. 11 USC 507(a)(4).
29. 11 USC 507(a)(4) and (5).
30. 11 USC 1141(d)(6).
31. 11 USC 1125(g).
32. 11 USC 341(e).
33. 11 USC 363(b)(1).
34. 11 USC 363(b)(1)(B).
35. *See* 11 USC 366.
36. *See id.*
37. 11 USC 366(c)(2). Subsection (b) requires adequate assurance within 20 days, while subsection (c)(2) requires adequate assurance within 30 days. Such discrepancy will ultimately be decided by the courts or by further amendment.
38. 11 USC 366(c)(3)(B)(i)–(iii).
39. 11 USC 366(c)(1)(A).
40. 11 USC 366(c)(1)(B).
41. 11 USC 366(c)(4).

42. 11 USC 101(51B).
43. 11 USC 362(d)(3).
44. *Id.*
45. 11 USC 362(d)(3)(B).
46. 11 USC 365(p)(1).
47. 11 USC 365(d)(4).
48. *Id.*
49. *Id.*
50. 11 USC 365(b)(1)(A).
51. *Id.*
52. 11 USC 503(b)(7).
53. 11 USC 503(f)(1).
54. 11 USC 365(l); *see* 11 USC 362(c)(4)(D).
55. 11 USC 362(j).
56. 11 USC 1129(a)(9)(C).
57. *Id.*
58. *Id.*
59. *Id.*
60. The Act does not specify whether this rate of interest will be the default rate.
61. 11 USC 511.
62. 11 USC 507(a)(8).
63. *Id.*
64. 11 USC 342.
65. *Id.*
66. 11 USC 342(c)(2)(A) and (B).
67. 11 USC 342(g)(1).
68. *Id.*
69. 11 USC 330(a)(3)(E).
70. 11 USC 303(b)(1).
71. *Id.*
72. 11 USC 341(c).
73. *See id.*
74. 11 USC 1102(a)(1).
75. *Id.; see* 11 USC 1102(a)(2) (court may order appointment by UST of additional committees).
76. 11 USC 1102(a)(4).
77. *Id.*
78. 11 USC 1102(b)(3)(A).
79. 11 USC 1102(b)(3)(C).
80. 11 USC 1102(b)(3)(B).
81. *See* 11 USC 503(b)(4).
82. *Id.*
83. 11 USC 503(b)(4) (excluding reference to section 503(b)(3)(F)).
84. 11 USC 1104(a)(1) and (c).
85. 11 USC 1104(a)(3).
86. 11 USC 1104(e).
87. 11 USC 1104(b)(2)(A).
88. 11 USC 1104(b)(2)(B).
89. 11 USC 1104(b)(2)(C).
90. 11 USC 105(d).
91. 11 USC 1112(b)(4).
92. 11 USC 1112(b)(2); *see also* 11 USC 1104(a)(3) (court may appoint trustee or examiner if grounds for dismissal exist but court determines appointment is in best interests of creditors and estate).
93. 11 USC 1112(b)(3).
94. *Id.*
95. 11 USC 1121(b) and (c).
96. 11 USC 1121(d)(1).
97. 11 USC 1121(d)(2)(A).
98. 11 USC 1121(d)(2)(A) and (B).
99. 11 USC 101(51D).
100. *Id.*
101. *Id*
102. *See id.*
103. 11 USC 1116(1)(A).
104. 11 USC 1116(1)(B).
105. 11 USC 1116(2).
106. *Id.*
107. 11 USC 1116(3).
108. 11 USC 1116(4).
109. 11 USC 1116(6)(A).
110. 11 USC 1116(6)(B).
111. 11 USC 308.
112. *Id.*
113. 11 USC 1116(7).
114. 11 USC 1125(f)(1).
115. 11 USC 1125(f)(3)(A).
116. 11 USC 1125(f)(3)(B).
117. *Id.*
118. 11 USC 1121(e).
119. 11 USC 1121(e)(3).
120. 11 USC 1121(e)(1).
121. 11 USC 1121(e)(3)(A)–(C).
122. 11 USC 1121(e)(2); *cf.* 11 USC 1121(d)(2)(B) ("20 months").
123. 11 USC 362(n).
124. 11 USC 362(n)(2).
125. *See* 11 USC 101(31).
126. 11 USC 503(c)(1).
127. 11 USC 503(c)(2).
128. 11 USC 503(c)(3).
129. 11 USC 101(14).
130. *Id.*
131. *Id.*
132. 11 USC 101(27A).
133. 11 USC 351(1)(A).
134. *Id.*
135. 11 USC 351(1)(B).
136. 11 USC 704(a)(12); *see* 11 USC 1106(a)(1), which makes Section 704(a)(12) applicable to Chapter 11 cases.
137. 11 USC 704(a)(12)(B) and (C).
138. 11 USC 333(a)(1).
139. 11 USC 333(b)(1).
140. *Id.; see* 11 USC 333(a)(1).
141. 11 USC 333(b)(2).
142. 11 USC 333(b)(3).
143. *See* 11 USC 362(b)(28).
144. 11 USC 503(b).
145. 11 USC 1115(a)(1) and (2).
146. 11 USC 1112(b)(4)(P).
147. 11 USC 1114(e)(1)(A) and (B).
148. 11 USC 1114(1) and (2).

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The Judicial Dissolution of a Michigan Limited Liability Company When Members Deadlock

By James R. Cambridge

Introduction

Some Michigan limited liability companies are set up with two members having equal membership interests and rights. These LLCs often are organized this way because of a sense that one member is no more important than the other. Other LLCs are formed this way to keep both members in check and to force them to work together. Such a structure is fine as long as they can work together and make the decisions that need to be made to operate the business of the LLC. There may come a time, however, when the two members are deadlocked and cannot agree, leaving the LLC paralyzed. The situation may become so bad that one member may want to shut down the LLC, or, for that matter, both members may want to shut down the company but cannot agree on the terms of the dissolution. The members will turn to the operating agreement for guidance. The agreement may provide a way out through withdrawal, expulsion, a buy out, or some other dissolution mechanism—but what if it does not? The members and their lawyers will likely turn in that case to the Michigan Limited Liability Company Act (Michigan LLCA),[1] which permits a member to petition for the judicial dissolution of the corporation. However, obtaining an order from a court dissolving the LLC may be easier said than done. This article discusses how Michigan courts may consider a petition to dissolve a Michigan LLC when there is a deadlock among the members.

The Judicial Dissolution of a Michigan LLC

On application by or for a member of a Michigan LLC, the circuit court for the county in which the registered office of the LLC is located may decree the dissolution of the company whenever it is unable to carry on business in conformity with its articles of organization or operating agreement.[2] On the entry of a decree of judicial dissolution, the LLC will be automatically dissolved, and its affairs must be wound up.[3] The court, however, may order the dissolution of an LLC only if the company is unable to carry on business in conformity with its articles of organization or operating agreement. This requires more than the members finding it difficult to carry on the business. It is a very high standard to meet, and it reflects the intent of the Michigan LLCA that the judicial dissolution of an LLC when the members deadlock should be an extraordinary event.

Comparison to Michigan Corporation and Partnership Law

An LLC resembles a partnership in some ways and a corporation in others. No Michigan court has yet considered, in any published decision, the judicial dissolution of a Michigan LLC in a deadlock. The courts have considered, however, the judicial dissolution of a Michigan partnership and the judicial dissolution of a Michigan corporation when there is a deadlock among corporate shareholders, as discussed below. In evaluating a petition to dissolve an LLC, a Michigan court might consider both partnership and corporate law.

Under the Michigan Business Corporation Act (Michigan BCA),[4] a Michigan corporation may be dissolved by a court in certain circumstances. Section 823 of the Michigan BCA[5] provides that, when a deadlock prevents a corporation from functioning effectively in the best interests of its creditors and shareholders, one or more of its directors, or one or more of its shareholders entitled to vote in an election of directors of the corporation, may bring an action in the circuit court for the county in which the principal place of business or registered office of the corporation is located; the court may then enter a judgment to dissolve the LLC.

Although a Michigan court might look to Michigan corporation law for guidance in considering whether an LLC should be judicially dissolved upon a deadlock, Section 823 of the Michigan BCA differs from Section 802 of the Michigan LLCA in some important respects. Under Section 823 of the Michigan BCA, a corporation may be dissolved by a judgment entered in an action brought in

a circuit court in which either the principal place of business or registered office of the corporation is located. Under Section 802 of the Michigan LLCA, on the other hand, a dissolution action must be brought in the circuit court for the county in which the registered office of the LLC is located. Furthermore, a Michigan corporation may be judicially dissolved if it is proven that the corporation's directors are unable to agree on material matters regarding management of corporate affairs or if the corporation's shareholders are so divided in voting that they have failed to elect successors to any director whose term is expired or would have expired upon the election and qualification of such director's successor. There is no similar provision in the Michigan LLCA. However, under Section 802 of the Michigan LLCA, a deadlock among the members may be a basis for the judicial dissolution of the LLC if, because of the deadlock, the LLC is unable to carry on business in conformity with its articles of organization or operating agreement. Although the Michigan BCA stipulates that a certain type of deadlock must exist before a Michigan corporation's judicial dissolution, the Michigan LLCA merely implies that a deadlock may be a basis for seeking the judicial dissolution of an LLC. Under both statutes, there must be a showing of an inability to function effectively and carry on the company's business. The statutory provisions seemingly differ, however, on the extent of the inability to carry on and the dysfunction that is required for judicial dissolution.

Section 823 of the Michigan BCA requires that the deadlock result in the corporation's inability to function effectively in the best interests of its creditors and shareholders. This is different from the standard contained in Section 802 of the Michigan LLCA, which requires a showing that the LLC be unable to carry on business in conformity with the articles of organization or operating agreement. Time will tell whether this difference will make it easier or more difficult to judicially dissolve a Michigan LLC upon a deadlock. The requirement of Section 802 of the Michigan LLCA may, in fact, make this more difficult.

In *Barnett v International Tennis Corp,*[6] the Michigan Court of Appeals noted that the dissolution of a business is a very drastic measure that is only to be considered as a remedy of last resort.[7] Although the issue in *Barnett* was not a deadlock but the oppression of a corporation's minority shareholder, the court indicated that it is necessary to demonstrate exceptional circumstances, and that a showing of corporate paralysis must exist, before dissolution will be ordered. Citing *Stott Realty Co v Orloff,*[8] the court stated that "[t]he ultimate test is whether corporate ruin will inevitably follow continuance of present management."[9]

In evaluating a petition to dissolve a Michigan LLC, a court might also consider Michigan partnership law. Under Section 32 of the Michigan Uniform Partnership Act (Michigan UPA),[10] a circuit court may dissolve a Michigan partnership in certain circumstances. On application by or for a partner, the court may decree a dissolution of a partnership whenever, among other circumstances, a partner has been guilty of such conduct as tends to affect prejudicially the continuance of the partnership's business[11] or when it is "not reasonably practicable" to carry on the partnership business.[12] A court also may order the dissolution of the partnership if the business of partnership can only be carried on at a loss[13] or if other circumstances render a dissolution equitable.[14] It seems likely that a deadlock between two fifty-fifty partners could provide a basis for the judicial dissolution of a partnership.

In *Sami Taki & Showbiz Video Corp v Ghassan Hami & Taki-Hami P'ship,*[15] the Michigan Court of Appeals determined that it was not possible to complete the business of this partnership in a logical, reasonable, and feasible manner because of acrimony and dissension between the two fifty-fifty partners. The court found that, given the nature of the partners' relationship, the equitable dissolution of the partnership was appropriate under Section 32(1)(d)[16] because the conduct of one partner in particular made it "not reasonably practicable" to carry on the business in partnership.[17]

Although Section 32 of the Michigan UPA authorizes the judicial dissolution of a Michigan partnership in certain circumstances on request, it is clear that the application for dissolution must come from a partner. In *Eastland Partners Ltd Partners v Village Green Mgmt Co (In re Brown),*[18] the Sixth Circuit held that only a partner may petition a court for the judicial dissolution of a partnership. A court does not have the authority to decree this dissolution on the request of the partnership itself; the request must come from a partner.[19] The same is true for an LLC, for which a dissolution request must be made by or for a member and not by the LLC itself.

The Michigan Court of Appeals noted that the dissolution of a business is a very drastic measure that is only to be considered as a remedy of last resort.

Prototype and Uniform LLC Acts

When considering a request to dissolve a Michigan LLC, a court also might look at the provisions of other limited liability company acts.

The Michigan LLCA is based largely on a draft of the American Bar Association's Prototype Limited Liability Company Act (Prototype LLCA).[20] Section 902 of the Prototype LLCA and Section 802 of the Michigan LLCA are similar in the general sense that both sections provide for the dissolution of an LLC when, because of a deadlock, the business of the LLC is frustrated. The Michigan standard, however, is tougher. Under Section 802 of the Michigan LLCA, a court may decree dissolution of the LLC whenever the company is unable to carry on business in conformity with its articles of organization or operating agreement. The Prototype LLCA is not as stringent. The commentary to its Section 902 indicates that dissolution by court decree is available mainly when the parties' agreement limits a member's power to dissolve the LLC at will. This is an expression of the drafting committee's view that if a member's ability to cause dissolution is limited by the contract of the operating agreement (or, for that matter, a member does not have a means to withdraw), then a court could order judicial dissolution. However, a showing that it is "not reasonably practicable" to carry on the business of the LLC in conformity with the operating agreement is still required under the Prototype LLCA. But the commentary to Section 902 of the Prototype LLCA does not really shed any light on what it means by "not reasonably practicable," except to say that this standard probably includes at least some of the causes of dissolution provided for in partnership law and, in particular, partner misconduct. The commentary says nothing specific about a deadlock.

A member seeking judicial dissolution under the Uniform LLCA may point to a poor company financial record, making dissolution an alternative to placing the LLC in bankruptcy court.

Since the Prototype LLCA's publication, the Uniform Limited Liability Company Act (Uniform LLCA)[21] has been written. Although not adopted by the state of Michigan, the Uniform LLCA illustrates yet another perspective on the judicial dissolution of an LLC in the case of a deadlock. Its Section 801 provides that a court may order an LLC's dissolution if the company's economic purpose is likely to be unreasonably frustrated or if it is not otherwise reasonably practicable to carry on the company's business in conformity with its articles of organization and operating agreement. Either of these events could occur in connection with a deadlock. The commentary to Section 801 indicates that it is the LLC member seeking judicial dissolution who has the burden of proving the existence of these circumstances, and that, even where the burden of proof is met, the court has the discretion to order a form of relief other than dissolution, e.g., the appointment of a receiver.

In showing that the economic purpose of the LLC is likely to be unreasonably frustrated, a member seeking the judicial dissolution of the LLC under the Uniform LLCA may point to a company financial record that is poor and unlikely to improve, making dissolution an alternative to placing the LLC in bankruptcy court. The Section 801 commentary also indicates that, when a court determines whether to order relief and the type of relief to order in an involuntary dissolution action, it should take into account the other rights and remedies of the applicant. The commentary suggests, for example, that a court should not grant involuntary dissolution of an at-will LLC, even though the applicant-member has the power to cause the dissolution of the LLC at will, if the applicant-member has the right to disassociate and force the LLC to purchase that member's interest; in that case, it would not be appropriate to order the involuntary judicial dissolution of the LLC. The commentary further suggests that if a member has the right to be brought out of the LLC, this might satisfy the member and should not require the judicial dissolution of the entire LLC.

Delaware Law

In evaluating a petition for the dissolution of an LLC, a Michigan court might also look at Delaware law. Under the Delaware Corporation Act,[22] the Delaware Court of Chancery may order the judicial dissolution of a corporation with only two shareholders, each of whom owns 50 percent of the stock. Under Section 273 of the Act,[23] if these equal stockholders are engaged in a joint venture and are unable to agree on the desirability of discontinuing the joint venture and disposing the assets used in the venture, either one may petition the chancery court to order the dissolution if they cannot otherwise agree on a discontinuance plan. Interestingly enough, in Delaware the only requirement for a court to consider the judicial dissolution of a corporation is this disagreement between equal stockholders over the desirability of discontinuing the corporation. In

other words, Delaware does not require a showing of an inability to carry on the business of the company or proof that it is not reasonably practicable to carry on the business. This provision affords relief where the corporation's two equal shareholders are deadlocked and cannot agree on whether the joint venture should be continued or on how the corporation's assets should be disposed.[24]

In *Haley v Talcott*,[25] the Delaware Chancery Court considered whether a deadlock between two fifty-fifty members of a Delaware LLC made it "not reasonably practicable" to continue the business in conformity with the operating agreement. In *Haley*, one member served as the manager, while the other was merely an investor; each member owned 50 percent of the LLC.[26] After the members had a falling out, the manager-member alleged that it was "not reasonably practicable" to continue the business of the company in conformity with the operating agreement. The investor-member responded that the manager-member was limited in the operating agreement to a contractually-provided exit mechanism by which he could buy out the manager-member. The court found that it was "not reasonably practicable" for the LLC to carry on business in conformity with the operating agreement.[27] Further, the exit mechanism was not a reasonable alternative: it would not provide adequate remedy when it left the manager-member with personal liability for the LLC's debt under a bank guaranty. Therefore, the court concluded that the manager-member was entitled to a judicial dissolution of the corporation.[28] The court noted that the Delaware Limited Liability Company Act[29] (Delaware LLCA) is based on the principles of freedom of contract and that the presence of a reasonable exit mechanism in an operating agreement thus bears on the propriety of ordering dissolution.[30] The court further stated that "[w]hen the agreement itself provides a fair opportunity for the dissenting member who disfavors the inertial status quo to exit and receive the fair value of her interest, it is at least arguable the LLC may still proceed to operate practicably under its contractual charter because the charter itself provides an equitable weight to break the impasse."[31] Citing *In re Arthur Treacher's Fish & Chips, Inc*,[32] the court observed that the limitations on judicial discretion to dissolve a joint venture corporation under Section 273 of the Delaware Corporation Act are, perhaps, less compelling when considering an LLC under Section 18-802 of the Delaware LLCA because of the contractual focus of the Delaware LLCA.[33]

Survey of State Law

Finally, a Michigan court might look to the laws of states other than Michigan and Delaware when considering whether a Michigan LLC should be dissolved, as courts in other states have been asked to consider the judicial dissolution of an LLC.

In *Spires v Casterline*,[34] a New York court determined that it was not reasonably practicable for the business of a New York LLC to continue, and that, because there was no provision or mechanism in the operating agreement for a member to withdraw or be removed from the business, the LLC had to be judicially dissolved. However, in *Schindler v Niche Media Holdings, LLC*,[35] a different New York court determined that the judicial dissolution of another New York LLC was unwarranted because the company had conformed to its articles of organization and, in fact, had flourished. The *Schindler* court stated that the judicial dissolution of a limited liability company under the New York Limited Liability Company Law[36] is only warranted when, as the statute provides, it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement.[37] This means that judicial dissolution will be ordered only when a complaining member can show that the company is unable to function as intended or that it is failing financially.

Well-drafted articles of organization and operating agreements should provide for the times or events of dissolution.

In *Dunbar Group, LLC v Titnor*,[38] the Virginia Supreme Court considered on appeal an order of a trial court ordering the expulsion of a member and the dissolution of a Virginia LLC. The court found that, although the expulsion of the member was proper, the dissolution of the LLC was not, because the record did not show that it was "not reasonably practicable" to carry on the LLC's business. In *Dunbar*, defendant filed a separate application for judicial dissolution under the Virginia Limited Liability Company Act[39] on the grounds that it was "not reasonably practicable" to carry on the business of the company in conformity with the articles of organization and operating agreement. Defendant alleged that serious differences of opinion about company management had arisen between LLC members and managers and that the corporation was deadlocked in its ability to conduct its business, including contracting with customers and receiving

and disbursing assets and company funds. Ultimately, the trial court determined that defendant had commingled company funds with his own and ordered that he be expelled as an LLC member. Plaintiff, being the sole remaining member of the LLC, argued on appeal to the Virginia Supreme Court that, even though the other member had been expelled, it was not, in fact, impracticable for the LLC to continue. The supreme court agreed and reversed the lower court's decision to dissolve the LLC because the evidence was insufficient to support a judicial dissolution.[40]

In *McConnell v Hunt Sports Enters*,[41] the Ohio Court of Appeals found that it was not "feasible, profitable, advantageous and reasonably practicable" to operate the business of an Ohio LLC that had been formed to run a National Hockey League franchise in Columbus.[42] The Ohio court noted that Ohio law does not require a finding of any wrongful conduct to dissolve an LLC;[43] all that is necessary to order judicial dissolution is a determination that it is "not reasonably practicable" for the Ohio LLC to carry on business in conformity with its articles or operating agreement.[44]

A Michigan court might look to the laws of states other than Michigan and Delaware, as courts in other states have been asked to consider the judicial dissolution of an LLC.

Conclusion

The judicial dissolution of a Michigan LLC should not be easy to accomplish—but it should not be impossible either.

While the LLC is being planned, the members of a Michigan LLC are free to decide when it should be dissolved. The members may designate the time for dissolution in the articles of organization,[45] or they may designate the events of dissolution in either the articles or operating agreement.[46] Otherwise, the members may unanimously vote to dissolve the LLC.[47] This is the general rule. Well-drafted articles of organization and operating agreements should provide for the times or events of dissolution, including a deadlock among the members. However, this ignores the reality that these provisions sometimes do not exist or that, if they do, they are inadequate. What then? A member should be able to turn to the courts and ask for an order decreeing the dissolution of the LLC.

Judicial dissolution is an extraordinary event and, in the case of a deadlock, should be ordered only if the LLC is unable to carry on business in conformity with its articles of organization or operating agreement. But this should only be considered as a last resort, and Michigan courts should grant this relief sparingly. Judicial dissolution was not meant to be easy—if it were, a disgruntled member might use this process to take advantage of the LLC and its other members. Such abuse should not be permitted.

What evidence should be required to show that an LLC is unable to carry on business in conformity with the articles or operating agreement? Section 802 of the Michigan LLCA[48] indicates that something more is required than mere difficulty in carrying on business. A literal reading of the section might require absolute impossibility rather than just difficulty. Some will read the section this way and argue that the deadlock must make it impossible to carry on business. Others will argue that absolute impossibility is not required but that there must be a more general showing that the deadlock makes it impossible, as a practical matter, to carry on business in the manner the members had originally intended. This may be the more reasoned view. Absolute impossibility should not be required for judicial dissolution, but neither should mere difficulty in carrying on business be a basis for dissolution.

NOTES

1. MCL 450.4101 et seq.
2. MCL 450.4802.
3. MCL 450.4801.
4. MCL 450.1101 et seq.
5. MCL 450.1823.
6. 80 Mich App 396, 263 NW2d 908 (1978).
7. *Id.* at 417.
8. 262 Mich 375, 247 NW 698 (1933).
9. *Barnett*, 80 Mich App at 417.
10. MCL 449.32.
11. MCL 449.32(1)(c).
12. MCL 449.32(1)(d).
13. MCL 449.32(1)(e).
14. MCL 449.32(1)(f).
15. No 219307, 2001 Mich App LEXIS 777 (May 4, 2001) (unpublished).
16. MCL 449.32(1)(d).
17. When, as in *Taki*, one partner begins carrying a concealed firearm to meetings in order to intimidate or threaten the other partner, it may be fair to say that it is no longer reasonably practicable to carry on the business as a partnership. *Taki* at *8-9.
18. 342 F3d 620 (6th Cir 2003).
19. *Id.* at 634.
20. Prototype Limited Liability Company Act Draft (Nov 19, 1992), Working Group of the Prototype Limited Liability Company Act Subcommittee on Limited Liability Companies, Committee on Partnerships and Unincorporated Business Organizations, Section of Business Law, American Bar Association (on file with author).
21. Uniform Limited Liability Company Act (1996), drafted by the National Conference of Commissioners on Uniform State Laws, available at www.nccusl.org (click on "Final Acts & Legislation" and select "Limited Liability Company Act" from the "Act Title" menu).

22. Del Code Ann tit 8, § 101 et seq. (1953).
23. Del Code Ann tit 8, § 273 (1953).
24. *See also In re Coffee Assocs, Inc*, No 12950, 1993 Del Ch LEXIS 263 (Del Ch Dec 3, 1993) (unpublished).
25. 864 A2d 86 (Del Ch 2004).
26. *Id.* at 87.
27. *Id.* at 98.
28. *Id.*
29. *Id.* at 96.
30. *Id.*
31. *Id.*
32. 386 A2d 1162, 1167 (Del Ch 1978).
33. *Haley,* 864 A2d at 97 n31.
34. 4 Misc 3d 428, 778 NYS2d 259 (2004) (unpublished).
35. 1 Misc 3d 713, 772 NYS2d 781 (2003) (unpublished).
36. NY (LLC) Law § 101 et seq. (Consol 1994).
37. NY (LLC) Law § 702 (Consol 1994).
38. 267 Va 361, 593 SE2d 216 (2004).
39. Va Code Ann § 13.1-1000 et seq.
40. 267 Va at 368.
41. 132 Ohio App 3d 657, 693, 725 NE2d 1193 (Ohio Ct App 1999).
42. *Id.* at 693.
43. *Id.* at 694.
44. *Id.*
45. MCL 450.4801(a).
46. MCL 450.4801(b).
47. MCL 450.4801(c).
48. MCL 450.4802.

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Letters of Intent – Best Practices

By Kevin M. DiDio

"A letter of intent is customarily employed to reduce to writing a preliminary understanding of parties who intend to enter into contract, or who intend to take some other action such as merger of companies."[1]

Introduction

The written letter of intent is an essential tool regularly used by parties to commercial transactions. "Letter of intent" is a generic term for a preliminary document negotiated in anticipation of executing more definitive agreements that will ultimately supersede the letter. The term "letter of intent" may be used synonymously with "memorandum of understanding," "agreement in principle," or "heads of agreement." This article will focus on the written letters of intent used in negotiated mergers and acquisitions (M&A), provide a basic understanding of the applicable law, and recommend best practices for negotiating and drafting letters of intent.

Should a Letter of Intent Be Used?

The suggestion to use a letter of intent will elicit a variety of reactions from M&A counsel. Many lawyers will strenuously advise that any preliminary agreement will only create exposure; they may cite *Texaco, Inc v Pennzoil Co*[2] to prove their point. The prudent lawyer, however, should not be dissuaded from using a letter of intent, although he or she must approach the exercise with caution.

While most M&A transactions take familiar forms (i.e., a merger, asset sale, or stock sale) and require that the parties to the transaction resolve familiar issues, no two transactions are consummated in the same manner. Accordingly, a letter of intent should be used to identify the unique, essential terms of the transaction. The letter also should define for the practitioner the basis of the transaction going forward and allow the parties to the transaction to narrow their focus when structuring the deal. Ultimately, the well-drafted letter of intent will help facilitate the preparation of the definitive transaction agreements.

Negotiating and drafting a letter of intent can sometimes be a timely and costly endeavor, but the relative value of the end product should not be discounted. Practitioners are frequently pressured by clients or opposing counsel to avoid using a letter of intent for fear of wasting valuable time or resources. Experience, however, suggests that practitioners should be encouraged to educate their clients about the ultimate savings—in both time and money—usually realized by all parties to the transaction when using a letter of intent, especially if the transaction is a complex one. Having a road map to follow will make the parties, their attorneys and investment bankers, and all of the other professionals advising on the deal more efficient and productive.

The letter of intent also serves other practical purposes. The buyer may need a letter of intent to pursue financing, to prove the worth of a deal before banks and equity investors will commit resources to the proposed transaction. In certain large transactions, a letter of intent allows the process of obtaining government approvals or clearances to begin; a premerger notification report, for example, may be filed under the Hart-Scott-Rodino Antitrust Improvements Act of 1976[3] once the parties have entered into a letter of intent, thereby starting the clock on the applicable waiting period. Additionally, by addressing the essential terms of the M&A transaction early in negotiations, parties often will find themselves in a better negotiating position. This is especially true for the seller, who has the most leverage before signing a letter of intent.

The Letter of Intent as an Enforceable Contract

The *Black's* definition of letter of intent is indicative of the confusion that sometimes surrounds such a letter's enforceability. Is a "preliminary understanding" a contract? The answer is yes—sometimes.[4] In Michigan, letters of intent are interpreted no differently than any other contract, as the following statements by Michigan courts demonstrate:

- "A contract to make a subsequent contract is not per se unenforceable; in fact, it may be just as valid as any other contract."[5]
- "Like any other contract, a contract to make a contract can fail for indefiniteness if the trier of fact finds that it does not

include an essential term to be incorporated into the final contract."[6]

- "It is well recognized that it is possible for parties to make an enforceable contract binding them to prepare and execute a subsequent agreement. In such a case, where agreement is expressed on all essential terms, the instrument is considered a contract, and is considered a mere memorial of the agreement already reached."[7]
- "If the document or contract that the parties agree to make is to contain any material term that is not already agreed on, no contract has yet been made; and the so-called 'contract to make a contract' is not a contract at all."[8]

In *Heritage Broadcasting Co v Wilson Communications, Inc,*[9] defendants unsuccessfully argued that not all material and essential terms had been agreed on. The court found that the parties had agreed on "the assets to be sold, the consideration, the schedule for payment, the handling of the accounts receivable, the rights and remedies of each party upon breach, and mutual termination rights if the closing did not occur within 360 days of the definitive agreement. The definitive agreement would have added only the mechanics necessary to accomplish the conveyance."[10] The U.S. District Court for the Eastern District of Michigan, Southern Division, recently decided a high-profile "essential term" case between Ford Motor Company and a prominent race car driver, Kasey Kahne. The court found that the "clear and unambiguous language of the contract shows that the parties intentionally left [certain material terms] for future negotiation and mutual agreement or joint determination."[11] Accordingly, the personal services agreement between the parties was held not enforceable under Michigan law.[12]

Citing *Teachers Insurance & Annuity Ass'n of America v Tribune Co,*[13] the Sixth Circuit in *Giverny Gardens, Ltd Partnership v Columbia Housing Partners Ltd Partnership* stated that it is the "modern trend" for courts to analyze the following factors to help determine whether a preliminary agreement is binding: "(1) the language of the agreement; (2) the existence of open terms; (3) the context of negotiations; (4) whether there was partial performance; and (5) the custom of such transactions."[14] The court's decision in *Busch v Dyno Nobel, Inc*[15] to uphold a letter of intent was based, at least in part, on the fact that the parties to the letter had performed their obligations under the letter for several years.

Certain letters of intent may not be held enforceable if they are "conditional" letters of intent. In *Kelley v Thompson-McCully Co, LLC,*[16] the Michigan Court of Appeals declined to enforce a letter of intent drafted for the purpose of acquiring the shares of a Michigan corporation. The court explained that because the letter of intent expressly stated that implementation of the letter was predicated in part on board approval, "the letter did not create in plaintiff the power to enter into a contract by accepting the terms set forth."[17]

The issue of "intent" may not in itself be determinative as to the binding nature of an otherwise-enforceable letter of intent. It is well-established law that, if two parties go through a process of offer and acceptance, they need not also manifest an intent to be bound or to invoke legal sanctions in order to have mutual assent.[18] As Judge Learned Hand stated, "A contract has, strictly speaking, nothing to do with the personal or individual intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties."[19] This is still the prevailing doctrine in Michigan. In *Opdyke*, the Michigan Supreme Court opined that intent to contract is a question of fact that should be left to the jury. Justice Ryan eschewed the approach taken by the trial court and the Michigan Court of Appeals in having "carefully scrutinized [the letter of intent] in order to ascertain the parties' intent," and found that the letter of intent at issue ultimately amounted to a binding obligation.[20] Thus, a letter of intent may be enforceable even if the parties are not aware of its legal consequences.

In most jurisdictions, however, no contract will result if it unequivocally appears from the parties' statements or conduct, or from the surrounding circumstances, that the parties did not intend to be bound or did not intend legal consequences.[21] See *Ashdown Group, Ltd v Prestige Pattern & Model, Inc* for a court's discussion of explicit and unambiguous language in a nonbinding letter of intent used in an M&A transaction.[22]

Is a "preliminary understanding" a contract? The answer is yes—sometimes.

What is the True Function of Your Letter of Intent?

This is the question each attorney (and opposing counsel) must first ask before drafting the letter of intent for an M&A transaction. Letters of intent can have dif-

ferent functions and generally fall into one of three categories. The key difference between them is the binding or nonbinding nature of the letter's terms and conditions.

The first type is an entirely nonbinding letter, often simply called a "term sheet"[23] or "gentleman's agreement."[24] The function of this type of document is merely to get the proverbial ball rolling and encourage the parties to loosely share ideas, thoughts, concerns, and opinions. A term sheet can prove to be an effective alternative to a comprehensive letter of intent if the parties find themselves getting bogged down with too many difficult issues too early in the negotiation process. If the deal begins to lose its momentum but the parties still wish to proceed with negotiations, it may be a good idea to use a term sheet.

Letters of intent generally fall into one of three categories. The key difference between them is the binding or nonbinding nature of the letter's terms and conditions.

The second category is limited in scope and merely establishes the ground rules for negotiation of the M&A transaction. For example, some parties will expressly agree to certain standards of good faith, fair dealing, and commercial reasonableness.

The third type of letter is unique in that it is a contract that is partly binding and partly nonbinding. When properly drafted, this type of letter will have two separate sections: one to expressly contain binding terms and conditions and the other to expressly contain nonbinding terms and conditions. The language used by the drafter in these sections can be helpful in determining the intent of parties. The use of subjective or hypothetical terms (i.e., "would") rather than indicative terms (i.e., "will" or "shall") is an indication that the parties do not intend to be bound.[25] Use of the verb "contemplates" indicates an expectation or intention rather than a promise or an undertaking.[26]

What may be considered a fourth type is in reality not a letter of intent at all. Despite the parties' best intentions, they sometimes will draft a "letter of intent" that is entirely binding. Here the parties have not entered into a "contract to make a contract" but, rather, a definitive agreement that acts to consummate the transaction. Parties do sometimes purposefully enter into these entirely binding letters if, for example, the deal is so economically or strategically attractive that the parties are willing to make the business decision to be bound at an early stage of the negotiating process.

There is no right kind of letter of intent—the form and substance should be determined by the parties after taking into consideration all of the factors of the contemplated transaction. Most importantly, the lawyers must understand what function the parties to the transaction intend the letter of intent to serve. The practitioner must not allow a client to sign a letter of intent that has binding provisions when in fact the client had wanted to sign only a nonbinding term sheet. The client will typically use the expression "letter of intent" colloquially—do not misinterpret this as an invitation to assume that the client expects the signed letter to be binding in some respect. Prior to a contemplated letter's execution, the practitioner must sufficiently and accurately explain its contractual implications.

Binding and Nonbinding Terms and Conditions

When carefully drafting a letter of intent of the third type, i.e., a letter that contains both binding and nonbinding terms, the following provisions are typically made binding:

- *Deposit.* The seller in an M&A transaction may demand an earnest money deposit that usually will be applied to the purchase price if the contemplated transaction closes. The buyer and the seller also will agree to what happens to the deposit should the contemplated transaction fail to close.
- *Access and Disclosure.* For a stated period of time following the execution of the letter of intent, the seller will grant the buyer (and the buyer's professional advisers) access to the seller's books and records, assets, material contracts, and other seller-related items that are germane to the contemplated transaction.
- *Exclusivity.* For a stated period of time following the execution of the letter of intent, the seller will agree to a "no shop" covenant. During this stated period, the seller will be proscribed from entering into an M&A transaction with any other party and will not be allowed, directly or indirectly, to solicit, initiate, or encourage submission of proposals or offers from any other party.
- *Conduct of Business.* The seller will agree, usually until the closing, to continue to conduct business in the ordinary course and to refrain from entering into any extraordinary transactions.
- *Best Efforts.* For a stated period of time following the execution of the letter of

intent, both the seller and the buyer will agree to negotiate in good faith and to use their best efforts (or, alternatively, their commercially reasonable efforts) to arrive at a mutually acceptable definitive agreement for approval and execution.

- *Costs.* Regardless of whether the proposed transaction closes, the buyer and seller will agree on how certain deal-related costs and fees will be allocated and paid. The costs and fees typically include those of attorneys, accountants, bankers, auditors, consultants, and brokers.
- *Termination ("Breakup") Fee.* If the seller breaches one or more of the binding covenants in the letter of intent, the parties can agree that the seller will pay to the buyer a sum certain. This penalty is meant not only to encourage the seller to perform its obligations under the binding covenants but also to quantify damages when the buyer may otherwise have difficulty in proving its damages should the seller breach the letter of intent. Courts consistently have mandated that any breakup fee be reasonable under the circumstances. In *Frazier Industries, LLC v General Fasteners Co*, the Sixth Circuit enforced a letter of intent but failed to award a $475,000 breakup fee to plaintiff because there had been no breach of any of the agreed-upon covenants (including an access covenant, an exclusivity covenant, and a best-efforts covenant) that would have triggered this payment.[27]
- *Fiduciary Out Qualification.* In conjunction with the exclusivity or "no shop" clause, the seller likely will want to draft a "fiduciary out" provision to state that the seller will not actively solicit other offers or negotiate with third parties unless some event occurs that would make proceeding with discussions illegal, invalid, or contrary to the fiduciary duty of the directors. The buyer's counsel should attempt to narrow the scope of the fiduciary out provision by mandating that a competing offer, without more, is not sufficient to trigger the "out," and that any claim of a fiduciary out must be subject to applicable law, as advised in writing by an opinion of counsel.
- *Confidentiality.* The parties should agree on a definition of "confidential information," the restrictions placed on the disclosure of confidential information, and the parties' obligations with respect to the return of confidential information. Note that the existence of and the terms and conditions of the letter of intent itself typically are included in the definition of "confidential information." The parties must be careful to coordinate this provision with any confidentiality agreement already signed by the parties.
- *Announcements.* The parties typically will agree that no party may make public announcements concerning the contemplated transaction without the prior written consent of all other parties.
- *Dispute Resolution.* The parties should identify the law that will govern the terms and conditions of the letter of intent and agree on a jurisdiction (and perhaps venue) if any proceeding arises. In lieu of litigating a claim in a stated jurisdiction, parties may wish to establish rules for binding arbitration or some other form of alternative dispute resolution. Some letters of intent also will identify service-of-process issues.
- *Language.* If the contemplated M&A transaction involves parties that have different native languages, the parties should agree on what language will control the interpretation of the letter of intent. With cross-border transactions becoming more common, this term should not be overlooked.
- *Binding Nature.* Even if the parties sign a letter of intent or term sheet that is entirely intended to be nonbinding, the parties must ensure that one provision is expressly binding: the provision whereby the parties disclaim the contractual effect. The parties must carefully identify all the parties that need to sign the letter of intent. In addition to the buying and selling parties, other candidates include the guarantors for either party's obligations and the target. An unsigned letter of intent and an alleged oral agreement that there was a "deal" for the sale of a building were held unenforceable under the Michigan Statute of Frauds.[28]

All other terms and conditions of the letter of intent typically are nonbinding. As the parties have usually only conducted limited due diligence at the time of the letter's execution, the final terms regarding deal structure, purchase price, payment terms, ancillary agreements, representations and warranties, covenants, closing conditions,

Note that the existence of and the terms and conditions of the letter of intent itself typically are included in the definition of "confidential information."

and survival and indemnification should be subject to continuing due-diligence investigations and management approval. These nonbinding terms and conditions will be ultimately negotiated and agreed upon in the final definitive agreements.

Consequences of Entering into a Letter of Intent

Parties should be aware of the following unintended adverse consequences that a letter of intent may have:

- *Tax Consequences.* Before signing, the parties must consider the tax implications of the letter of intent and the agreed-upon deal. For example, where substantial deviations from the terms set out in the letter are agreed on for tax reasons, there is a risk that the letter of intent might provide grounds for tax authorities to argue that the final structure is a device for tax avoidance. Practitioners should work with tax counsel and the client's tax advisers to understand any tax consequences of any preliminary agreement.
- *Mandatory Disclosure.* Under certain securities laws or listing agreements, parties entering into letters of intent may be obligated to disclose the letter.
- *Decreased Leverage in the Negotiating Process.* Parties frequently find themselves at a disadvantage in later stages of a deal if they seek to depart from any term of the letter of intent, even if the contemplated term is nonbinding. Do not discount the moral force that a piece of writing can have.

Parties should be aware of the unintended adverse consequences that a letter of intent may have.

Conclusion

By most accounts, M&A activity is projected to be on the rise in the upcoming year. When the next deal comes across your desk, do not make the mistake of discounting the importance of starting the deal off on the right foot. Understand the expectations and needs of your client and proceed to draft the best letter of intent that you can.

NOTES

1. *Black's Law Dictionary* (6th ed 1990).

2. 729 SW2d 768 (Tex App 1987). In one of the most well-known letter-of-intent cases in the United States, Texaco and Pennzoil were each suitors of a controlling interest in Getty Oil. As a result of a binding "Memorandum of Agreement" between Pennzoil and Getty Oil, Texaco was ordered to pay Pennzoil $7.53 billion in contract damages and $3 billion in punitive damages (subsequently lowered).

3. 15 USC 18a.

4. For a more comprehensive analysis of the contractual nature of letters of intent, see Frank Stellingwerf & Gerard Mantese, *Letters of Intent,* 79 Mich BJ 1512 (2000).

5. *Opdyke Inv Co v Norris Grain Co,* 413 Mich 354, 359, 320 NW2d 836 (1982), *citing* 1 Corbin, *Contracts,* § 29, at 84.

6. *Opdyke,* 413 Mich at 359.

7. *Hansen v Catsman,* 371 Mich 79, 82, 123 NW2d 265 (1963), *quoting* Corbin, § 29, at 68.

8. *Id.*

9. 170 Mich App 812, 819, 428 NW2d 784 (1988).

10. *Id.*

11. *Ford Motor Co v Kahne,* 379 F Supp 2d 857, 869 (ED Mich 2005).

12. *Id.*

13. 670 F Supp 491 (SDNY 1987).

14. No 04-5339, 2005 US App LEXIS 9236 at *9 (6th Cir May 16, 2005).

15. No 00-1808, 2005 US App LEXIS 14724 (6th Cir July 18, 2002).

16. No 236229, 2004 Mich App LEXIS 2016 (July 27, 2004) (unpublished).

17. *Id.* at 26, *citing Eerdmans v Maki,* 226 Mich App 360, 365, 573 NW2d 329 (1997).

18. *See* John D. Calamari & Joseph M. Perillo, *The Law of Contracts,* §§ 2-4 (3d ed 1987).

19. 1 *Williston on Contracts,* § 3.5 (4th ed 1990).

20. *Opdyke,* 413 Mich at 362.

21. Calamari & Perillo.

22. No 208742, 1999 Mich App LEXIS 1233 (July 6, 1999) (unpublished).

23. The ABA Business Law Section, Committee on Negotiated Acquisitions, defines "term sheet" as "[a] recital of general terms of a proposed transaction, typically intended to be nonbinding. Term sheets are usually unsigned, in contrast to letters of intent." The M&A Process (2005).

24. *See* Herbert Bernstein & Joachim Zekoll, *The Gentleman's Agreement in Legal Theory and in Modern Practice: United States,* 46 Am J Comp L 87 (1998).

25. *Texaco,* 729 SW2d at 790.

26. *Hansen,* 371 Mich at 83.

27. Nos 03-1385, 03-1395, 2005 US App LEXIS 8158 (6th Cir May 10, 2005).

28. 912 F2d 104, 108-109 (6th Cir 1990).

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Case Digests

*Prepared by Elizabeth M. Rucker**

Labor and Employment—Sexual Harassment

In *McClements v Ford Motor Co*, 473 Mich 373, 702 NW2d 166 (2005), plaintiff was hired by AVI Food Systems as a cashier at Ford Motor Company's Wixom plant cafeteria. She alleged that a superintendent in the plant's pre-delivery department sexually harassed her in 1998. In 2000, a female Ford employee approached plaintiff, claiming that the superintendent also had sexually harassed her in 1998. The Ford employee reported the incidents to her uncle, a production manager at Wixom, and to a former Ford superintendent temporarily assigned to her union. The latter informed Wixom's director of labor relations of the alleged incidents, but the director took no further action. Plaintiff did not come forward with her allegations until 2001, when the Ford employee informed her that the superintendent in question had been convicted of indecent exposure in 1995. Plaintiff then filed suit, claiming that defendant Ford Motor Company had (1) negligently retained the superintendent, whom it knew had a propensity to sexually harass women; and (2) breached its obligation under the Elliott-Larsen Civil Rights Act (ELCRA), MCL 37.2101 et seq., to prevent the superintendent from sexually harassing her. The trial court granted defendant's motion for summary disposition on both counts. Defendant did not have sufficient notice of the superintendent's sexually harassing behavior, as the Ford employee's reports were not enough to constitute notice, and the single 1995 conviction did not establish a propensity for sexually harassing behavior. Thus, plaintiff could not rely on the negligent retention theory. As for the discrimination claim, defendant was not liable to a non-employee plaintiff, and, even if it were, defendant's higher management was not aware of the alleged sexually harassing behavior. Thus, defendant could not be held liable under ELCRA. The court of appeals affirmed the judgment under ELCRA but reversed the negligent-retention judgment, finding a genuine issue of material fact whether defendant knew or should have known of the superintendent's behavior.

The Michigan Supreme Court reinstated the trial court's judgment. Plaintiff was limited to remedies under ELCRA because a common-law claim for negligent retention may not be based on workplace sexual harassment. An inquiry into defendant's notice of the superintendent's alleged behavior was thus unnecessary. Plaintiff could not bring a claim under ELCRA because she failed to establish that defendant affected or controlled the terms, conditions, or privileges of her employment as a cashier in a cafeteria run by another company in one of defendant's assembly plants.

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General Sales Tax Act and Motor Fuel Tax Act—Constitutionality

In *By Lo Oil Co v Department of Treasury*, 267 Mich App 19, 703 NW2d 822 (2005), plaintiff distributed and sold gasoline and diesel fuel. Its records were audited by the Treasury Department. The department finalized a deficiency assessment for diesel motor fuel tax and an adjusted deficiency assessment for general sales tax. Following the audit, plaintiff filed a complaint in the circuit court, seeking damages and equitable relief in connection with the assessment of taxes under the Motor Fuel Tax Act, MCL 207.1001 et seq. (repealed in 2001), and the General Sales Tax Act, MCL 205.51 et seq. Plaintiff subsequently filed suit in the court of claims, seeking a refund of taxes, interest, and penalties paid under protest. The circuit court granted the department summary disposition, while the court of claims ruled that plaintiff had failed to state a valid claim. On appeal, the court of appeals ruled that plaintiff failed to state an actionable claim for a violation of a federal right under 42 USC 1983, failed to allege a violation of either procedural or substantive due process, and also failed to state an actionable claim under the "fair and just treatment" clause of Mich Const 1963, art I, § 17. Thus, the court of appeals affirmed the decisions of the circuit court and the court of claims.

Michigan Minimum Wage Law—Motor Carrier Exemption

In *Alexander v Perfection Bakeries, Inc,* 267 Mich App 161, 705 NW2d 31 (2005), plaintiffs delivered baked goods to retail stores and placed the goods on the shelves. They regularly worked more than 40 hours a week but only received their base pay of minimum wage plus commissions, never any overtime pay. Plaintiffs contended that the Michigan Minimum Wage Law of 1964 (MWL), MCL 408.381 et seq., applied to the defendant, who should therefore pay them overtime. The trial court granted defendant summary disposition, holding that plaintiffs had failed to state a cause of action under the MWL. The court of appeals affirmed.

Minimum wage is governed by two statutes, the MWL and the Fair Labor Standards Act (FLSA), 29 USC 201 et seq. The FLSA exempts motor carriers from overtime compensation requirements. Thus, the court of appeals held defendant was exempt from paying overtime wages to plaintiffs because they qualified as motor carriers. Plaintiffs argued against the exemption, contending that if they were not entitled to overtime pay under the MWL, the application of the FLSA would result in a lower overtime pay rate than they would receive under the MWL while in violation of the MWL. The court of appeals held that the term "minimum wage" is unambiguous and does not include overtime pay. Plaintiffs therefore would receive the same minimum wage under both the state and federal statutes. Thus, there was no violation of the MWL.

Single Business Tax Act—Capital-Acquisition Deduction

In *Dana Corp v Department of Treasury*, No 255984, 2005 Mich App LEXIS 2020 (Aug 18, 2005), plaintiff was a Virginia corporation that sold goods produced outside of Michigan and that sought a refund of taxes paid between 1997 and 1999. Plaintiff alleged that the site-specific and apportioned capital-acquisition deduction (CAD) under the Michigan Single Business Tax, codified at MCL 208.23(e), was not fairly apportioned under the Commerce Clause, US Const, art I, § 8. The court of claims ordered a refund, agreeing with plaintiff that the CAD was unconstitutional because it was not internally consistent. However, the court of appeals reversed, concluding that the CAD is fairly apportioned, does not discriminate against interstate commerce, and is constitutional. It applies equally to all Michigan taxpayers who locate new property in Michigan.

Single Business Tax Act—Nexus with Michigan

In *JW Hobbs Corp v Department of Treasury*, No 254069, 2005 Mich App LEXIS 2157 (Sept 1, 2005), the department claimed that plaintiff, an Illinois-based company that had contracted with a Wisconsin-based company to sell goods in Michigan, was subject to the Michigan Single Business Tax (SBT) from 1989 to 2000. Plaintiff argued that it did not have a sufficient nexus with Michigan and did not pay the tax in reliance on two Revenue Administrative Bulletins published by defendant describing the nexus standard (RAB 1989-46 and SBT Bulletin 1980-1). The department promulgated a more-expansive nexus standard in RAB 1998-1, establishing that the presence of a nonresident employee or independent contractor soliciting sales in Michigan for two or more days each year provided a presumption of sufficient nexus. The trial court held that plaintiff was entitled to a refund of the SBT and any penalties paid for the years 1989 through 1997, finding the earlier RABs binding until replaced by RAB 1998-1. However, plaintiff was not entitled to a refund for years 1997-2000.

On appeal, the court of appeals held that RABs are not binding and that "defendant [was] not estopped from retroactively applying the new rule created by case law simply because it had issued revenue administrative bulletins advising taxpayers of what the then-applicable rule was." *Hobbs* at *13. The case was remanded to determine whether, using the appropriate nexus standard, minimum contacts with Michigan had been established. The trial court's ruling on penalties was affirmed because changes in the nexus standard over the course of several years did not present a reasonable cause for the failure to pay.

Use Tax Act—Out of State Promotional Activity

In *Brunswick Bowling & Billiards Corp v Department of Treasury*, No 261682, 2005 Mich App LEXIS 2019 (Aug 18, 2005), plaintiff, a Delaware corporation with its principal office in Muskegon, Michigan, contested defendant's imposition of a use tax for items withdrawn from plaintiff's Michigan inventory and given away to professional bowlers and customers for promotional purposes outside the state. The court of claims granted plaintiff's motion for summary disposition, concluding that if such an imposition of the use tax were authorized by law, plaintiff could potentially be liable for taxes on the same transaction in multiple states. Such an interpretation would violate the Commerce Clause, US Const, art I, § 8. The court of appeals affirmed, noting that these activities do not constitute a taxable "use" in Michigan since plaintiff clearly maintained a "right or power" over the items as they were transferred out of state. Thus, the "use" of these items did not occur in Michigan.

Bankruptcy—Lien Priority

In *United States v Crestmark Bank (In re Spearing Tool & Mfg Co)*, 412 F3d 653 (6th Cir 2005), the federal government challenged the district court's judgment granting appellee Crestmark Bank lien priority over a federal tax lien. Crestmark and Spearing entered into a lending agreement in April 1998, and Crestmark perfected its security interest by filing a financing statement under the Uniform Commercial Code. The statement precisely identified Spearing as "Spearing Tool and Manufacturing Co.," its name registered with the Michigan Secretary of State. In April 2001, Crestmark and Spearing entered into a secured financing arrangement, and again Crestmark perfected its interest using Spearing's precise name. Meanwhile, Spearing fell behind in its employment-tax payments. The IRS filed two notices of federal tax lien with the Michigan Secretary of State against Spearing, identifying the latter as "Spearing Tool & Mfg Company Inc," thus varying from Spearing's registered name. Crestmark was unaware of these tax liens, as the Michigan electronic lien search only returns liens matching the exact name queried. During its periodic checks for liens, Crestmark only searched for Spearing's registered name, even after receiving a handwritten note from the secretary of state's office suggesting a search under "Spearing Tool & Mfg Company Inc." Thus, Crestmark advanced more funds to Spearing between October 2001 and April 2002. Only after Spearing filed a Chapter 11 bankruptcy petition on April 16, 2002, did Crestmark search for the alternative name and discover the tax liens. Crestmark argued that Michigan law should control the identification of the taxpayer, thus holding the government to the same precise identification standards used by Crestmark.

The bankruptcy court granted the government priority, but the district court reversed. The Sixth Circuit affirmed the judgment of the bankruptcy court, holding that federal law controlled the form and content of taxpayer identification for tax liens and that a tax lien does not need to precisely identify the taxpayer. A reasonable and diligent search by Crestmark would have revealed the tax liens. The abbreviations used by the government were common and reasonable, and, in addition, such an alternate search had been suggested by the secretary of state. Policy considerations supported the IRS' position.

Precise identification would be unreasonably burdensome on the IRS, as "[t]he overriding purpose of the tax lien statute obviously is to ensure prompt revenue collection." *Id.* at 656. The government's interest in effective tax collection supersedes the bank's convenience in loan collection.

Labor and Employment—Employee Retirement Income Security Act

In *Gismondi v United Techs Corp*, 408 F3d 295 (6th Cir 2005), plaintiffs sought early-retirement benefits from defendant after its automotive division was sold to Lear Corporation. Under the United Technologies Employee Retirement Plan, participants could receive early-retirement benefits if (1) the severance date occurred at or after the participant's 50th birthday, and (2) the sum of years of the participant's age and continuous years of service equaled or exceeded 65. The retirement plan defined "severance date" in section 2.59(a) as the earliest of three different possibilities, with only two of these possibilities at issue in this case: "(i) the date the employee 'quits, retires, is discharged or dies,' [or] (ii) the first anniversary of the first date that the employee is absent from work 'for any other reason.'" *Id.* at 297. Defendant calculated plaintiffs' severance dates under section 2.59(a)(i), contending that plaintiffs were "discharged" when transferred to Lear. Plaintiffs were 49 at the time of the automotive division's sale. They argued that their severance dates should be calculated under section 2.59(a)(ii). Thus, they would have attained 50 years of age one year after the sale. The district court applied an arbitrary and capricious standard of review and found defendant's interpretation rational. The Sixth Circuit affirmed the judgment of the district court, agreeing that the defendant's interpretation of section 2.59(a)(i) to include "the transfer of employees upon sale of a company division [was] rational." *Id.* at 300.

Labor and Employment—Employee Retirement Income Security Act, Labor Management Relations Act, and Worker Adjustment and Retraining Notification Act

In *UAW v Aguirre*, 410 F3d 297 (6th Cir 2005), plaintiffs sought unpaid vacation time, medical and vision benefits, union dues, and other amounts from defendants, who were shareholders of Mexican Industries in Michigan, Inc. Mexican Industries was an S corporation that suffered financial downturns after the death of its founder, Hank Aguirre. The company maintained its subchapter-S status after Aguirre's death by establishing four qualified subchapter-S trusts, one for each defendant (Aguirre's heirs). Amid declining fortunes, Mexican Industries entered into a collective-bargaining agreement with the UAW in 2000. The company began laying off employees and closing plants in April 2001; individual plaintiffs were laid off in June. The company filed a Chapter 11 bankruptcy petition on June 25, 2001, with the Chapter 11 bankruptcy proceeding later converted to a Chapter 7 liquidation proceeding. Plaintiffs claimed that the company violated the Employee Retirement Income Security Act (ERISA), 29 USC 1001 et seq.; the Labor Management Relations Act, 29 USC 141 et seq; and the Worker Adjustment and Retraining Notification Act, 29 USC 2101 et seq. Plaintiffs further claimed that defendants were personally liable for the damages caused by those violations. However, plaintiffs did not sue the company directly because the filing of a bankruptcy petition stays commencement or continuation of judicial proceedings against a debtor. The district court granted defendants summary judgment.

The Sixth Circuit affirmed the district court's judgment, holding that defendants could not be held individually liable for the company's alleged violations. There is no legal support for plaintiffs' theory of "a veil piercing version of the alter ego doctrine," as the two concepts are distinct. Separating the two concepts, the alter ego doctrine was inapplicable, and plaintiffs "failed to show a genuine issue of material fact as to any of the three veil-piercing factors." *Id.* at 303. The court also upheld the district court's grant of Rance Aguirre's motion for Rule 11 sanctions, as it should have been clear by the close of discovery that plaintiffs had no support for a claim against Rance Aguirre. Finally, the court affirmed the district court's grant of Rance Aguirre's motion to strike the affidavit of plaintiffs' purported expert witness, as admission of the affidavit would not have changed the court's conclusions. At worst, striking the affidavit was harmless error.

Securities—Disclosure in Prospectuses

In *Benzon v Morgan Stanley Distribs*, 420 F3d 598 (6th Cir 2005), plaintiffs, investors in Class B shares of Morgan Stanley mutual funds, appealed the district court's order of dismissal of their claims that defendants violated federal securities law. Plaintiffs claimed that defendants failed to disclose the relative value of the Class B shares in their prospectuses in violation of 15 USC 771, 15 USC 78j, and SEC Rule 10b-5(b); that they sold Class B shares that assessed unnecessary fees in violation of SEC Rules 10b-5(a) and (c); and that they failed to disclose a broker-compensation scheme that involved a conflict of interest in violation of 15 USC 77l(a)(2) and SEC Rule 10b-5(b). Plaintiffs alleged that Class B shares were inferior to other classes of shares offered by the mutual fund and that the prospectuses were misleading in suggesting that Class B shares were valuable to a certain type of investor. The Sixth Circuit affirmed the trial court's dismissal for failure to state a claim upon which relief can be granted. The prospectuses contained all relevant information necessary to conclude that Class B shares were inferior to other classes of shares offered by Morgan Stanley. Thus, the prospectuses were not misleading. Any alleged omissions were not material, as the prospectuses contained information sufficient to compare the classes of shares. Federal regulations do not require disclosure of broker compensation, and, regardless, such disclosure was not necessary to make the prospectuses not misleading. It is not fraudulent to offer different classes of securities that have different values. Thus, the offering of various securities was not actionable under SEC Rules 10b-5(a) and (c).

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