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MISSION STATEMENT

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

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

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From the Desk of the Chairperson

By Robert T. Wilson

As the recently elected chairperson of the Business Law Section of the State Bar of Michigan, it is my privilege to welcome you to a new year for the Section. Before proceeding any further, I'd like to thank immediate past Chair Dee Dee Fuller for her extraordinary service to the Section over the past year, including her role in revising the Section's Strategic Plan. Thanks also go to past Secretary Ed Lukas and past Treasurer Marguerite Donahue for their efforts on behalf of the Section. We're fortunate indeed to have such able and dedicated leaders. Finally, I'd also like to recognize another past chair, Alex DeYonker, who received the Section's Stephen H. Schulman Outstanding Business Lawyer Award following our Annual Meeting on September 23. This is a singular honor and a well-deserved one.

Incoming chairs traditionally propose certain initiatives for the forthcoming year. At the ground level of Section governance, I think we need to revisit our Bylaws. A number of our council members have been looking, for example, at the question of how committee and directorship succession occurs. I will be putting together a committee to formally address these issues and submit amended and restated Bylaws to the council and ultimately to the members for approval. I welcome any volunteers.

In terms of broader tasks, I have been giving some consideration to the state of our State. I think we would all agree that we continue to struggle in the throes of the worst economic downturn since the 1930s. Our largest city has a declining population and faces other extraordinary challenges. The pain is not limited to our large cities, however, or a particular region. I had occasion to visit a small city in northeast Michigan several weeks ago, and the signs of economic distress were everywhere: shuttered factories, abandoned homes, and a recently built recreational complex where one of the two ice rinks had no ice on it because there are not enough teams who can afford to buy the ice. I was told the local unemployment rate was in the range of 30 percent.

Remarkably, in spite of the dire economy of our state, the Business Law Section remains a vital organization, financially strong, with a large group of dedicated volunteers engaged in a wide range of activities in support of our profession. I think we need to ask ourselves, however, whether we are doing enough, given the hardships our fellow citizens and Michigan businesses are facing?

The Section's mission statement defines our mission as:

> fostering the highest quality of professionalism and practice in business law and enhancing the legislative and regulatory environment for conducting business in Michigan.

We do these things, and I would argue we do them well. Now, however, more than at any time in the history of the Section, I believe it is incumbent on us to use every resource we have to promote and enhance the environment for doing business in Michigan. I would ask each of our members—some of the best and brightest minds in Michigan—to consider and share with the leadership of our Section, what we as individual attorneys, members of law firms and as an organization can do, consistent with our mission, to help improve the climate for businesses in Michigan, and thereby shore up our economy, create jobs, and leave, as a legacy to our children and grandchildren, a state of Michigan where they can live and work in reasonable prosperity.

At the end of the day, what am I asking? I am challenging each committee and each directorship of our Section, under the leadership of the committee chairs and directors, to formulate and present to the Section Council, specific proposals for activities tied to your goals as defined in the Section's Strategic Plan that have the potential to be of tangible benefit to businesses in the state of Michigan, bearing in mind especially the particular challenges they face. It may be a new event or program, a legislative or pro bono initiative, an article, or other activity outside the scope of what the Section has traditionally done, or a shift in emphasis or modification of an existing activity, but the emphasis should be on benefitting Michigan businesses in these troubled times. I know the heavy demands on your time as well as the dangers of trying to do too much—it may be that not all of the proposals would go forward or come to fruition within the next year, but I have great confidence that if we put our heads together, good work can be achieved. Please look at what you're already doing or charged with doing and consider how it can be adapted to the current circumstances of our economy and business climate. Thank you in advance for your support of this initiative.

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Homeowners Construction Lien Recovery Fund

Public Act 147 of 2010,[1] effective August 23, 2010, amends the Construction Lien Act to eliminate the Homeowner Construction Lien Recovery Fund. Companion legislation eliminates the requirement for electrical, plumbing, and mechanical contractors and residential builders and maintenance and alteration contractors to pay into the fund.[2] Laborers and suppliers were permitted to become members of the fund by payment of an initial fee and payment of a renewal fee every three years. The revenue to the Fund lagged far below expenditures.

Public Act 147 retains a mechanism for a homeowner to prevent a construction lien from attaching to a structure. Section 118a of the act, MCL 570.1118a, provides that a claim of construction lien does not attach, to the extent payments have been made, if the owner or lessee files an affidavit with the court stating that the owner or lessee has paid the contractor for the improvement to the residential structure according to the contract and the amount of the payment. Copies of the contract, any change orders, and any evidence of payment are to be attached to the affidavit. Instead of seeking payment from the Homeowner Construction Lien Recovery Fund, subcontractors and suppliers who were not properly paid by the contractor or builder will have to file an action in circuit court against the nonpayer.

Proposed Amendments to the Michigan Limited Liability Company Act

SB 1455 was introduced on August 17, 2010.[3] The bill allows for conversions of limited liability companies and will provide greater flexibility for business planning. The conversion provisions are substantially similar to the conversion provision in the Business Corporation Act. The bill includes some new provisions regarding indemnification, insurance, and transactions in which a member or agent has an interest; amends section 501 regarding how a person may be admitted as a member of a limited liability company; and adds new provisions regarding charging orders.

Physician's Assistants

Public Act 124 amended section 17048 of the Public Health Code to permit supervising physicians to organize a professional corporation or professional limited liability company with physician's assistants. Public Act 124 requires the Michigan Department of Community Health to include on the license renewal form a space for physician's assistants to disclose whether they were a shareholder in a professional corporation or member of a PLLC organized before the act took effect. Physician's assistants are required to disclose on the license renewal form the name and license number of the supervising physician and whether the physician was a shareholder or member in the same professional corporation or PLLC as the physician's assistant.

Public Acts 125 and 126 amend sections 2 and 4 of the Professional Service Corporation Act and section 902 and 904 of the Michigan Limited Liability Company Act. The amendments include services rendered by a physician's assistant in the definition of "professional service" and permit physicians to organize a professional corporation or PLLC with physician's assistants. The amendments prohibit physician's assistants from organizing a professional corporation or PLLC that will have only physician's assistants as shareholders or members, respectively. Public Acts 124-126 were effective on July 19, 2010.

Medical Marihuana

The Michigan Medical Marihuana Act[4] permits a patient with a debilitating medical condition to register as a medical marihuana patient. In addition, it permits an individual who is at least twenty-one years old, who has agreed to assist with a patient's medical use of marihuana, and who has never been convicted of a felony involving illegal drugs to register as a primary caregiver. For each registered qualifying patient to which the caregiver is connected through the Michigan Department of Community Health's registration process, the caregiver may possess twelve marihuana plants kept in an enclosed, locked facility.

The Michigan Medical Marihuana Act appears to have generated a rash of creativity. Recent news stories have pointed out how some creative efforts have resulted in new "businesses" involving the sale of marihuana. There is no place in the state, however, to legally purchase medical marihuana. The Corporation Division routinely rejects articles of incorporation, articles of organization, and assumed names that indicate the entity is being formed for an unlawful purpose.

HB 6394, introduced on August 24, 2010, specifically prohibits a person from organizing or operating a marihuana club or knowingly allowing land or a structure on land owned by or in the possession of the person to be used as a marihuana bar. "Marihuana club" is defined as "an association of individuals with membership restricted to those who pay money or any other thing of value to become member, the purpose of which is to allow more than 1 individual to use marihuana under the Michigan Medical Marihuana Act." "Marihuana bar" is defined as "land or a structure on land where an individual is allowed to use marihuana under the Michigan Medical Marihuana Act…if the use of marihuana on the property is conditioned on the payment of a fee."[5]

Research tools

The International Association of Commercial Administrators (IACA) Web site provides links to most jurisdictions in the United States and Canada. www.iaca.org. In addition, the IACA Directory (http://www.iaca.org/downloads/Directory/2010_IACA_Directory.pdf) contains contact information for the filing offices for secured transactions and for filing offices for formation and qualification of business entities.

Public Access to Court Electronic Records (PACER) provides public access to case and docket information for federal appellate, district, and bankruptcy courts at http://www.pacer.gov/. The cost is $.08 a page, and for documents the fee is capped at $2.40. Users will not be charged more than $2.40 for accessing a document that is more than thirty pages. Frequently asked questions about PACER are available at http://www.pacer.gov/psc/faq.html. Municode.com provides access to municipal codes and ordinances at http://www.municode.com/. Public Record Center.com provides access to conduct public record searches at http://www.publicrecordcenter.com/.

When you are looking to find old, changed, or deleted web pages the Internet Archive Wayback Machine can often find them. Since 1996, the Internet Archive Wayback Machine has collected and stored web pages on the Internet Archive servers located at http://www.archive.org/.

World Bank[6]

Legally valid methods for business registration give businesses formal status and provide the public with accurate information regarding the existence of a particular entity. Throughout the world, the use of information technology has improved record keeping and allowed for the development and expansion of business registries.

The International Finance Corporation (IFC)[7] of the World Bank Group is working with more than forty jurisdictions to improve and simplify business registrations.[8] The IFC works with public authorities to identify an appropriate reform solution. They have several case studies that describe the impact and lessons learned from business registration reform programs. In Columbia [9] and Bolivia,[10] the process for registering a business was substantially improved, and more businesses followed the formal process.

Several jurisdictions have used outsourcing to improve service. The World Bank, through the World Bank Group's Investment Climate Advisory Services, helps governments of developing and transitioning countries to improve business regulations.[11]

Background on the World Bank Group from the 2009 International Association of Commercial Administrators may be found at www.iaca.org under "conferences."[12]

Incorporation Transparency and Law Enforcement Assistance Act

On August 10, 2010, Representative Carolyn Maloney, senior member of the United States House of Representatives' Financial Services Committee and Chairman Barney Frank introduced the Incorporation Transparency and Law Enforcement Assistance Act, H.R. 6098.[13] The bill amends the Bank Secrecy Act and would require information about the owners of a corporation or limited liability company to be identified when a document is filed with the state. Supporters of the bill contend that the bill is necessary to stop abusive practices and prevent the use of shell companies to engage in illegal activities.

The bill amends the Bank Secrecy Act's definition of "financial institution," section 5312, subsection (a)(2),[14] to include anyone involved in forming a corporation or LLC, and it requires the United States Department of the Treasury to develop rules requiring these individuals to establish an anti-money laundering program under section 5318, subsection (h).[15] Section 5333(b) of the bill defines what each state program must contain in order to be considered an "incorporation system" under the bill.

The bill is similar to SB 569, which was introduced in the United States Senate by Senators Carl Levin, Chuck Grassley, and Clair McCaskill last year. The House bill authorizes the United States Department of the Treasury, rather than the United States Department of Homeland Security, to issue regulations to implement the bill and authorizes use of the Treasury Forfeiture Fund to pay for the bill as needed. The beneficial owner definition is revised to clarify that it applies only to natural persons who exercise substantial control over or have a substantial interest in the assets of the company. In the House bill, beneficial ownership information must be provided to the state if the state has a system for collecting the information, otherwise the information must be provided to the United States Department of the Treasury.

HR 6098 has been referred to the House Financial Services Committee. SB 569 has been referred to the Senate Homeland Security and Governmental Affairs Committee. Changes to SB 569 during markup are expected.

NOTES

1. http://legislature.mi.gov/doc.aspx?2010-HB-5830
2. Public Acts 148-151
3. http://legislature.mi.gov/doc.aspx?2010-SB-1455
4. 2008 IL 1, MCL 333.26421-333.26430
5. http://legislature.mi.gov/doc.aspx?2010-HB-6394
6. http://www.worldbank.org/
7. http://www.ifc.org/
8. http://www.fias.net/ifcext/fias.nsf/Content/AdvisoryServicesProducts_Business+Entry
9. http://www.ifc.org/ifcext/lac.nsf/AttachmentsByTitle/AS_IC_CAEColombia_EN/$FILE/IC_PC_Colombia_SEP08_EN.pdf
10. http://www.ifc.org/ifcext/media.nsf/Content/Bolivia_Business_Registration
11. http://www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/BusRegCaseStudiesIreland/$FILE/Business+RegCase+StudiesIrelandfinal.pdf
12. http://www.iaca.org/downloads/2009Conference/JointSession/WB_ST_Program_Consolidated.pdf
13. http://maloney.house.gov/index.php?option=content&task=view&id=2174&Itemid=61 and http://thomas.loc.gov/cgi-bin/bdquery/z?d111:h.r.06098:
14. http://www.law.cornell.edu/uscode/31/usc_sec_31_00005312----000-.html
15. http://www.law.cornell.edu/uscode/31/usc_sec_31_00005318----000-.html

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By Paul L.B. McKenney

IRS Requires Corporate Taxpayers to Disclose the Needles in the Haystack

Introduction

On September 24, 2010, at a speech to the ABA Taxation Section, IRS Commissioner Shulman unveiled the most important IRS compliance initiative in years—required disclosure of uncertain tax positions, or UTPs. He released the eagerly awaited final reporting form, somewhat kinder, gentler directives to the IRS, and instructions regarding UTPs. UTPs and two other factors discussed below will impact corporate planning and contemplated transactions for years. The second factor is heightened preparer reporting standards backed by harsh, realistic and credible penalty threats on return preparers taking "aggressive" positions. The third factor is the codification of the economic substance doctrine by Congress in March as a "pay for" health care legislation.

The cumulative effect of these three fundamental changes is far greater transparency and the need to disclose certain positions to the IRS. We have already seen in discussions with other professionals that taxpayers have declined to pursue "aggressive" planning that in years past they would have done without hesitation.

Why did the Congress allow the IRS to do all this now? The answer is the massive structural deficits as well as revulsion at what was revealed in hearings over tax shelters. There is a bipartisan, hard IRS-compliance-enforcement consensus in the otherwise divided Congress.

Uncertain Tax Positions

In addition to releasing the final UTP form to be filed with corporate returns on Form 1120, the IRS also released instructions and Announcements 2010-75 and 2010-76. These follow recently proposed regulations giving a regulatory underpinning to requiring Schedule UTP.

Schedule UTP is mandatory starting with 2010 returns. There is a five-year phase-in of the reporting requirement based on a corporation's asset size. The initial requirement is for corporations that have gross assets exceeding $100 million. It will be phased-in to impact taxpayers with only $10 million of assets. Filings must also be looked at in connection with audited financial statements and tax reserves. There are numerous pro-taxpayer adjustments in final form that reflect extensive comments by the ABA Taxation Section and others. In addition to the phase-in, the prior draft requirement that the amount of an uncertain tax position be quantified by dollars has been dropped. Instead, there is only a ranking of UTPs based on the U.S. federal income tax financial statement reserve for each position. Second, the required disclosure description has been greatly reduced to a "concise description," and the corporation need not include an assessment of hazards of litigation or the support for or against the claimed tax position. Third, the IRS eliminated the requirement to report administrative practice tax positions. Fourth, to avoid redundant disclosures, if the tax position is properly disclosed with the Schedule UTP, then that will be treated as if the corporation had filed a disclosure statement on Form 8275 (or a regulation disclosure statement on Form 8275-R, as the case may be). Finally, unless the transaction is a "reportable transaction" (there are very few of those these days), the IRS will also treat a proper Schedule UTP disclosure UTP as satisfying disclosure of non-economic substance transactions to obtain the lower 20 percent penalty rather than the 40 percent penalty if not disclosed. Thus, three potential disclosures are reduced to one.

Economic Substance Codification

The economic substance doctrine is now codified at IRC 7701(o). It generally mandates a conjunctive two-prong test to determine whether a transaction has economic substance. If the transaction does not pass the economic substance criteria, then it will not be given a desired effect for federal income tax purposes. The two-prong statutory test under IRC 7701(o)(1) is:

> (A) the transaction changes in a meaningful way (apart from the Federal income tax effects) the taxpayer's economic position, and
>
> (B) the taxpayer has a substantial purpose (apart from the Federal income tax effects) for entering into such transaction.

Taxpayers will frequently rely upon profit potential. When they do so, that will satisfy economic substance "only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected." IRC 7701(o)(2). This has and will continue to result in projections before and at the time a transaction is entered into to substantiate the economic substance. Is this another "appraiser's full employment act?"

The Act makes reference to existing caselaw. People will rely upon that. However, it resolves a split in which the majority view was that economic substance had to be shown by objective analysis versus the minority view of subjective profit potential. The legislation requires that the more rigorous objective standard also be satisfied. Accordingly, self-serving testimony in the past that the taxpayer really expected to profit from a tax-benefit-rich, but economically dubious, transaction or series of transactions will be entirely disregarded.

There has been considerable concern about statutorily protected transactions, such as like-kind exchanges under IRC 1031, surviving if economic substance were in place. In a series of speeches in September, senior treasury officials stated that if the transactions were blessed by Congress and not challenged prior to the March 30, 2010 effective date, then they will not have to run the gauntlet of economic substance analysis. Also in September, the IRS released Notice 2010-62 that explains the IRS views on this complicated doctrine that are well beyond the scope of this limited article. In general, the Notice is viewed as somewhat comforting by the tax bar.

Where Are Planners Today?

The traditional planning of a contemplated transaction or series of transactions for technical compliance remains in place. However, all three legs of the IRS compliance tripod—preparer penalties, uncertain tax position reporting (at least for corporations over the threshold asset limits) and economic substance—require additional scrutiny for all transactions you are contemplating today. This is a totally different tax compliance world creating an immediate impact on planning. It simply did not exist a few years ago. Forewarned is forearmed!

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 By Michael S. Khoury and Jeremy D. Bisdorf

Technology Escrows: Are They Still Relevant?

Background

Thirty years ago, it was common for developers of software and other technologies to be small, undercapitalized, and otherwise unstable and untrustworthy. For every Bill Gates that developed Microsoft in his or her garage, 100 others were slaving away to develop new and interesting applications to make businesses operate more efficiently. However, users of the software were often dependent on these individuals and were at risk if the provider simply shut down or the key employee was hit by the proverbial bus. From that situation, a process was developed for the escrow of the source code of the software.

When a company licenses software, it expects that the vendor will be available for many years to provide support, maintenance, enhancements, and bug fixes. Problems exist when the vendor is Joe Computer Nerd who developed the program in his basement (although many users assume that the problem exists with every vendor), or the developer decides to retire, change careers, dies suddenly, simply disappears, or the company is bought or abandons the product. What is the user to do at that point? The answer has been to escrow or have other rights to the source code—the human-readable form of computer software that is needed to address bug fixes, evolve the product, and continue to maintain it. This option was expanded to include other technology information and assets, and the source code escrow industry was born.

Fast forward to 2010. Most software is developed using third-party tools that often require little ongoing support other than updates and maintenance. The days of the customer being at risk for compromising its mission-critical applications (its entire business in other words) by using technology from fly-by-night operators is generally a thing of the past. Given this, and assuming that you accept the premise that software companies are no longer fly-by-night, is the technology still relevant? Is source code something that a customer would even want? Is there sufficient value?

The Escrow Process

While early escrow arrangements often required a software company to deposit a copy of the source code in electronic or hard-copy format with a third party such as a title company or bank, over time the modern escrow process developed with technology escrow companies specializing in understanding the needs of beneficiaries and publishers of software. A software developer will typically deposit electronic copies of the code, as well as tools, compilers and other information necessary for a third party to be able to understand the software products, make changes, and recreate an operational version of the software for the beneficiary. The escrow arrangement will identify release conditions for the source code, and the business arrangement between the parties will identify the circumstances in which the beneficiary will receive the escrowed materials.[1]

There are three primary approaches for getting source code rights as part of the original license agreement. The first approach is to actually get the source code when the product is delivered. Some companies provide or license the source code with the product, and the user may have sufficient leverage with the vendor to negotiate that at the outset. (Whether the user will actually look at the media with the source code on it or be able to figure out whether they really got the source code is also not the lawyer's problem.)

A second approach is to contractually obtain the right to obtain the software from the vendor in the event of a withdrawal from maintenance or other event. These rights are usually specified in the license. The user can use the code to develop, maintain, and create derivative works within the scope of the original license. For example, the license agreement may provide:

> In the event Licensor withdraws generally from the maintenance of any of the licensed products and has not provided for continuation of such maintenance by a third party whose terms, conditions, and pricing are substantially similar to those provided by Licensor, and the licensed products have been under continuous maintenance, Customer shall have the right to obtain a license to a single copy of the then current version of the source code of the object code version of the affected licensed products supplied under this Agreement (the "Source Code"). This license is restricted to use of Source Code solely for Customer's own internal use to maintain copies of the affected Products. Customer acknowledges that the Source Code shall remain Licensor's sole and exclusive property and trade secret, and that Customer shall acquire neither title nor ownership rights in the Source Code. Customer shall protect and maintain the Source Code in confidence and shall not copy, sell, assign, or otherwise disclose the same directly or indirectly to any third party. Licensor's obligations under this paragraph shall not apply to source code for any portion of the products as to which Licensor does not have ownership rights.

This gives the customer the contractual right to obtain a copy of the source code if the specified events happen, identifies the scope of the right of the customer to use the source code, and protects the confidentiality and intellectual property rights of the vendor.

The third and most common approach is to have the source code placed in escrow with a trusted third party. The parties will either establish a one-of-three party agreement between the vendor, customer, and escrow agent, or the vendor and the escrow agent will establish a two-party master agreement so that the customer can be added as a beneficiary. In each case, the escrow agreement will specify circumstances in which the source code can be released to the customer. A typical release provision in an escrow agreement (in this case, the Escrow Associates Agreement[2]), may provide:

Release Conditions

The Deposit Materials, including any copies thereof, will be released to Beneficiary after the receipt of the written request for release only in the event that the release procedure set forth in Section 7 is followed and:

i. Depositor notifies Escrow Associates in writing to effect such release; or

ii. Beneficiary makes written request to Escrow Associates; and

a. Beneficiary asserts that Depositor has failed in a material respect under the License Agreement; or

b. Beneficiary asserts that Depositor has ceased all business operations without a successor or assign; or

c. Beneficiary asserts that Depositor has filed for bankruptcy protection; and

d. Beneficiary includes a written statement that the Deposit Materials will be used in accordance with the terms of the License Agreement; and

e. Beneficiary includes specific instructions for the delivery of the Deposit Materials.

What Happens in a Bankruptcy?

Consider the contract right to the source code and release provision above. The escrow agreement or the contractual obligation says that a release event is the bankruptcy of the licensor. That agreement can be construed as an unenforceable provision by the debtor/licensor because of the *ipso facto* clause![3] Right? Wrong? Until 1988 that was a great concern. After the passage of §365(n), however, users do have protection.

When passed, §365(n) was the only absolute exception to the automatic stay. The pertinent provisions related to source code matters are in §365(n)(1)(B) and (4), which protect the licensee's rights under the terms of the license "*or any agreement supplementary to such contract*." Subsection (4) protects the rights of the licensee prior to rejection by requiring the trustee to comply with the terms of the escrow or availability provision. Subsection (1)(B) protects the rights of the licensee after rejection, if the licensee elects to maintain the license, by preserving the same rights against the trustee.

Other Issues to Consider

The escrow agreement may contain audit rights so that the licensee can periodically audit the deposits to ensure that any updates, enhancements, or new versions are being deposited on a timely basis. Do not assume that the licensee has an audit right unless a three-party agreement has been signed between the licensor, licensee, and escrow holder specifically providing this. Additionally, if the vendor is supplying custom modifications that are not being furnished to the licensee in source code form, do not assume that the modifications will be deposited into escrow unless you have signed an agreement that specifically provides for it.

Finally, if the licensee lacks trained personnel to maintain the software, the source code may be of little use. Deal with reputable, established vendors, check the vendor's financial status, and contact the vendor's references for that product before undertaking an important license and services agreement. Even established consulting organizations may partner with lesser-known or untested software or services providers, so understand who will really be supplying the software and services. Do not assume that your prime contractor's representations and warranties will be flowed down to subcontractors, or that the subcontractors will provide warranties that flow up to you. If dealing with a less-established vendor or an untested or new product, retain trained personnel with the ability to fix the software should the vendor become unable to do so, at least until the product becomes stable. Additionally, if the software is highly customized for your organization, ensure that trained personnel are retained.

Conclusion

While there are challenges to implementing an escrow arrangement, as well as questionable benefit in the event that the escrowed materials are released, an escrow provides an important protection for a customer who believes a vendor will fail to support the application. This situation can arise in mission-critical applications as well as situations where the vendor has questionable prospects but offers a compelling solution. In the final analysis, it is a balancing between the extra effort a company wants to undertake to protect its business operations and the extra costs involved against the relative benefits of the arrangement.

NOTES

1. Denson, "*The Source Code Escrow: A Worthwhile or Worthless Investment,*" 1 Rutgers Bankr LJ 3 (2003).

2. Escrow Associates, LLC (www.escrowassocites.com).

3. 11 USC 365(b)(2).

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The Dodd-Frank Wall Street Reform and Consumer Protection Act and the Consumer Financial Protection Bureau

By Rodney D. Martin and Dean H. Zarafonetis

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act")[1] creates a new federal framework for regulating consumer financial products and services. Title X of the Act, known as the "Consumer Financial Protection Act of 2010" ("CFP Act") creates a Consumer Financial Protection Bureau ("CFPB") with wide ranging powers to regulate, supervise, and enforce federal consumer financial protection statutes. Although this article is not intended to provide a comprehensive review of the CFP Act, it provides a summary of some of the major provisions that will affect those other than "too big to fail" banks.

Although much of the Dodd-Frank Act focuses on the practices of large financial institutions, the Act applies to entities of all sizes that offer or provide financial products or services to consumers. The consumer protection provisions reach beyond banks and apply as well to many nondepository entities including, most significantly, mortgage brokers, payday lenders, and certain merchants.

The Dodd-Frank Act will usher in a new era of heightened consumer regulation and protection and signals a shift in scope for consumer financial regulation. The CFP Act gives the government a more direct role in regulating the terms of credit and other financial products. With the creation of the CFPB, the Act establishes an independent federal agency devoted exclusively to protecting consumers in financial transactions.

The Bureau of Consumer Financial Protection

Creation of the Bureau of Consumer Financial Protection

The CFPB is charged with ensuring that all consumers have access to markets for consumer financial products and services and that these markets are fair, transparent, and competitive.[2] The CFPB has exclusive authority to issue regulations, orders, and guidance implementing the CFP Act, in addition to the Truth in Lending Act, the Truth in Savings Act, the Real Estate Settlement Procedures Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, and numerous other consumer statutes.[3] The CFP Act refers to the statutes within the scope of the CFPB's authority as "Federal Consumer Financial Law."[4]

The CFP Act defines consumer financial products and services to include a financial product or service offered or provided for use by consumers primarily for personal, family, or household purposes.[5] The term "financial product or service" includes extending credit and servicing loans, extending or brokering leases of personal or real property that are the functional equivalent of a purchasing finance arrangement, providing real estate settlement services, engaging in deposit-taking activities, selling, providing, or issuing stored value or payment instruments, providing payment or other financial data processing products or services to a consumer by any technological means, providing financial advisory services, collecting, analyzing, maintaining, or providing consumer report information or other account information, collecting debt related to any consumer financial product or services, and any other product or service that the CFPB may define as a consumer financial product or service by regulation.[6]

Goals of the CFPB

The CFPB's charge is to implement and enforce Federal Consumer Financial Law consistently to ensure that all consumers have access to markets for consumer financial products and services and that the markets for consumer financial products and ser-

Although the CFPB has been established, it may yet take several months to appoint a director, and to put in place the agency's staffing and funding.

vices are fair, transparent, and competitive.[7] The CFPB is further authorized to exercise its authority under the Federal Consumer Financial Law for the purposes of ensuring that, with respect to consumer financial products and services:

- Consumers are provided with timely and understandable information to make responsible decisions about financial transactions.
- Consumers are protected from unfair, deceptive, or abusive acts or practices.
- Consumers are protected from discrimination.
- Outdated, unnecessary, or unduly burdensome regulations are regularly identified and addressed to reduce unwarranted regulatory burdens.
- Federal Consumer Financial Law is enforced consistently, without regard to the status of a person as a depository institution, to promote fair competition.
- Markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.[8]

Organization of the CFPB

The CFPB is established within the Federal Reserve System, but the CFP Act makes clear that the bureau is to be independent of the Federal Reserve's authority.[9] The CFP Act contains safeguards to prevent the Federal Reserve from interfering with the CFPB's rulemaking, examination, and enforcement actions. The Federal Reserve Board may not intervene in any matter or proceeding before the director of the CFPB. Nor may it appoint, direct, or remove any officer or employee of the CFPB or merge or consolidate the CFPB or any of its functions or responsibilities.[10] Additionally, the Federal Reserve has no authority to review or approve any rule or order of the CFPB, and the Federal Reserve Board cannot delay or prevent the issuance of any CFPB rule or order.[11] The Federal Reserve is, however, permitted to delegate its authority to examine whether certain persons are in compliance with the Federal Consumer Financial Laws to the CFPB.[12]

Supervisory authority over Federal Consumer Financial Law will pass to the CFPB on the "Designated Transfer Date."[13] The Designated Transfer Date will be defined by the Secretary of the Treasury, and is at least 180 days, but not more than 12 months after the date the President signed the bill into law, July 21, 2010.[14] The Secretary may extend the deadline by making a submission to Congress, but the Designated Transfer Date must occur within 18 months after enactment.[15]

The creation of the CFPB focuses the attention of one federal agency on consumer financial issues and regulation. Although the CFPB has been established, it may yet take several months to appoint a director, and to put in place the agency's staffing and funding. The agency will then need to begin the tedious process of drafting regulations and organizing its supervisory functions. Many people had anticipated that President Obama would appoint Elizabeth Warren as director of the CFPB. Warren is an attorney and Harvard University law professor who also led the Congressional Oversight Panel created to investigate the Troubled Assets Relief Program. She has supported having a consumer financial protection agency for several years. Many feared that Warren's appointment would lead to a contentious and lengthy confirmation process in Congress that would delay the creation of the CFPB. President Obama, however, seems to have avoided that by appointing Warren to serve as a Special Advisor to the Secretary of the Treasury on the CFPB and to "take on the job to get the new CFPB started—right now."[16] Warren will proceed to organize the CFPB while the President and the Senate go through the process of selecting a director.

Functions of the CFPB

The primary functions of the CFPB are to:

- Conduct financial education programs.
- Collect, investigate, and respond to consumer complaints.
- Collect, research, monitor, and publish information relevant to the functioning of markets for consumer financial products and services to identify risks to consumers and the proper functioning of such markets.
- Supervise covered persons for compliance with Federal Consumer Financial Law, and take appropriate enforcement action to address violations of Federal Consumer Financial Law.
- Issue rules, orders, and guidance implementing Federal Consumer Financial Law.
- Perform support activities that are necessary or useful to facilitate the other functions of the CFPB.[17]

The CFPB is required to prepare and submit a report to the President, the Committee on Banking, Housing and Urban Affairs of the Senate, and the Committee on Financial Services and the Committee on Energy and Commerce of the House of Representatives, beginning with the session after the Designated Transfer Date.[18] The report must include: (i) discussion of the significant problems faced by consumers in shopping for or obtaining consumer financial products or services; (ii) justification of the budget requests in the preceding year; (iii) a list of significant rules and orders adopted by the CFPB, as well as the CFPB's significant initiatives; (iv) analysis of complaints about consumer financial products or services that the CFPB has received and collected in its central database on complaints; (v) a list, with a brief statement of the issues, of the CFPB's public supervisory and enforcement actions; (vi) the CFPB's actions taken regarding rules, orders and supervisory and enforcement actions; (vii) an assessment of significant actions by state regulators; (viii) an analysis of the CFPB's efforts to fulfill its fair lending mission; and (ix) an analysis of the CFPB's efforts to increase workforce and contracting diversity.[19]

The CFPB's Rulemaking Authority

The CFPB is given the authority to administer, enforce, and otherwise implement the Federal Consumer Financial Law through rulemaking, orders, and other guidance.[20] To support its rulemaking authority and other functions, the CFPB must monitor the risks of consumer financial products and services to consumers, including developments in markets for such products or services.[21] The CFP Act contains a laundry list of factors that the CFPB should consider, although the list is not exclusive.[22] The Bureau must also publish significant findings of its monitoring activities each calendar year, beginning with the second year after the Designated Transfer Date.[23]

The CFPB is required to take a cost-benefit approach in its rulemaking. The CFPB must consider the potential benefits and costs of the regulations to consumers and those subject to the CFPB's authority. It must also consider the impact of the proposed rules on smaller depository institutions[24] and on consumers in rural areas.[25] The CFPB may exempt certain classes of persons from any rule, pursuant to enumerated factors in the statute.[26] Although the CFPB has exclusive authority to prescribe rules regarding the Federal Consumer Financial Law, the CFPB is required to consult with the relevant prudential regulators[27] and other federal agencies during the comment process to ensure consistency with prudential, market or systematic objectives administered by such agencies.[28] Moreover, the CFPB may issue rules with respect to registration requirements for certain persons other than depository institutions, insured credit unions, or related persons.[29]

The Act requires the CFPB to review its own regulations periodically.[30] The CFPB is required to conduct an assessment of each significant rule or order adopted by the CFPB under the Federal Consumer Financial Law within five years after the rule or order is issued.[31] In doing so, the CFPB must address, among other things, the effectiveness of the rule or order.[32] Before publishing a report with respect to its assessment, the CFPB is required to invite public comment on recommendations for modifying, expanding, or eliminating the newly adopted rule or order.[33]

Although the CFPB is insulated from the Federal Reserve, the Financial Stability Oversight Council, established in Title I of the Dodd-Frank Act (the "Council"), has the authority to override CFPB rules under extraordinary circumstances.[34] Any agency represented by a member of the Council may petition the Council, in writing, to stay the effectiveness of, or set aside, a CFPB regulation if: (i) it has in good faith attempted to work with the CFPB to resolve concerns regarding the effect of the rule on the safety and soundness of the U.S. banking system or the stability of the financial system of the United States; or (ii) it files the petition with the Council within ten days after the date on which the regulation was published in the Federal Register.[35] Upon petition, the Council may set aside a final regulation prescribed by the CFPB, if the Council determines that the regulation or provision would put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk.[36]

The CFPB is given the authority to administer, enforce, and otherwise implement the Federal Consumer Financial Law through rulemaking, orders, and other guidance.

Authority to Prohibit Unfair, Deceptive, and Abusive Practices

In addition to its rulemaking authority under Federal Consumer Financial Law, the CFPB is authorized to issue rules and take enforcement actions to prohibit unfair, deceptive, or

The Act requires the CFPB to establish a unit to receive consumer complaints and to provide a timely written response to each complaint.

abusive acts or practices in connection with the offering of a consumer financial product.[37] The CFPB may only issue such rules if it has a reasonable basis to conclude that an act or practice causes, or is likely to cause, substantial injury to consumers that cannot reasonably be avoided and the substantial injury to consumers is not outweighed by countervailing benefits to consumers or to competition.[38] In determining whether a practice is unfair, the CFPB must engage in a cost-benefit analysis, weighing the injury to consumers whom the regulation is aimed at protecting against the benefit of the practice to consumers or competition.[39]

The authority of the CFPB over unfair and deceptive practices is not unlike the authority of the Federal Trade Commission. The CFP Act, however, broadens this authority to include abusive acts. "Abusive" is defined to include, among other things, taking unreasonable advantage of the reasonable reliance by the consumer that a provider of consumer financial products or services will act in the interests of the consumer.[40] The CFPB may not declare a practice abusive unless the practice: (i) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or services or (ii) takes unreasonable advantage of a consumer's lack of understanding of the material risks, costs, or conditions of a product or service, the consumer's inability to protect his or her interests in selecting or using a consumer financial product or service, or the consumer's reasonable reliance upon the provider of the consumer financial product or service to act in the interests of the consumer.[41] Additionally, in prescribing rules regarding unfair, deceptive, or abusive practices, the CFPB must consult with the prudential regulators and other federal agencies as appropriate to ensure the proposed rules are consistent with prudential, market or systemic objectives administered by such agencies.[42] The effective date of this provision is the Designated Transfer Date.[43]

Model Forms for Federal Consumer Financial Laws

The Act authorizes the CFPB to prepare model forms for the disclosures required under Federal Consumer Financial Law.[44] Before finalizing model forms, the CFPB must validate them through consumer testing.[45] Implementing new disclosures will, at least initially, result in increased compliance costs to regulated entities. The Act creates a safe harbor for those who use the model forms.[46]

For years, the Federal Reserve Board and the Department of Housing and Urban Development ("HUD") have been trying to agree on a set of combined disclosures under the Federal Truth in Lending Act and the Real Estate Settlement Procedures Act. Perhaps out of frustration with their inability to do so, Congress has now assigned that task to the CFPB.[47] The CFPB is required to accomplish this within one year of the Designated Transfer Date.[48] If, however, the Federal Reserve Board and HUD complete or form an agreement upon a combined disclosure before the CFPB finalizes one, the CFPB will not need to complete its form.[49]

Authority to Investigate Violations and Enforce Federal Consumer Financial Law

The CFP Act provides that it is unlawful for a person subject to the CFPB's authority to act in contravention of the Federal Consumer Financial Law or to engage in unfair, deceptive, or abusive acts or practices.[50] The Act gives the CFPB broad powers to investigate violations of Federal Consumer Financial Law by depository institutions with assets over $10 billion and nondepository institutions that are subject to the CFP Act.[51] These include the power to issue subpoenas to compel testimony, to require the production of documents, and to issue cease and desist orders.[52] The CFPB may also initiate civil lawsuits to enforce Federal Consumer Financial Law.[53]

Among the remedies available to the CFPB is the power to require the rescission or reformation of contracts, the refund of moneys or return of real property, the payment of damages, and the payment of civil money penalties from $5,000 to $1,000,000 per day.[54] The CFPB does not have the authority to file criminal charges, but may make referrals to the Department of Justice.[55] In addition, the CFPB is required to make referrals to the Internal Revenue Service of potential violations of tax laws.[56] The effective date of these provisions is the Designated Transfer Date.[57]

Consumer Complaint Unit

The Act requires the CFPB to establish a unit to receive consumer complaints and to provide a timely written response to each complaint.[58] The CFPB must establish a single toll-free telephone number, a Web site, and a database to collect, monitor, and respond to consumer complaints.[59] Although this is effective as of the Designated Transfer Date,[60] implementation of these activities will take time.

Protection for Whistleblowers

The CFP Act protects employees against retaliation for providing information to any local, state, or federal authority regarding violations of any law within the jurisdiction of the CFPB.[61] The Act also protects an employee who testifies against a regulated entity or refuses to engage in activity the employee reasonably believes would violate any law within the jurisdiction of the CFPB.[62] Whistleblower complaints are investigated by the Secretary of Labor.[63] In light of the new whistleblower protections, a company may wish to examine its policies and procedures to ensure that employees have an effective means of bringing violations of law to the attention of management. This is effective on the Designated Transfer Date.[64]

Limitations on Federal Preemption

The Act limits federal preemption of state law to circumstances where the state law is inconsistent with federal law.[65] A state law that is more protective of the consumer is not inconsistent and therefore is not preempted.[66] The Act allows states to have laws that are more protective than Federal Consumer Financial Law.[67] The effective date is on the Designated Transfer Date.[68]

Who is Regulated by the CFPB?

Overview

The CFP Act applies, subject to a number of exceptions, to any person who engages in offering or providing a consumer financial product or service and any affiliate that provides a service to such a person.[69] As such, it covers a broad array of entities from large money center banks to community banks, credit unions, and, in certain circumstances, retailers. The authority of the CFPB to regulate a covered person will vary depending the size and type of business. This section will review that authority.

Very Large Depository Institutions

The CFPB has exclusive authority to supervise compliance with Federal Consumer Financial Law by insured depository institutions and insured credit unions with total assets of more than $10 billion ("Very Large Depository Institutions").[70] The CFPB has the primary, but not the exclusive, authority to enforce Federal Consumer Financial Law against Very Large Depository Institutions. Other federal agencies may recommend to the CFPB in writing that the CFPB initiate an enforcement procedure against a Very Large Depository Institution.[71] If the CFPB does not act within 120 days after it receives an enforcement recommendation, the referring agency may initiate its own enforcement proceeding.[72] The CFPB may also require reports and conduct examinations with respect to Very Large Depository Institutions; however, the CFPB must coordinate its supervisory activities with those conducted by the applicable prudential regulators and the state bank regulatory authorities.[73]

The CFP Act requires the CFPB and the prudential regulator of each Very Large Depository Institution to cooperate with each other by:

- Coordinating the scheduling of examinations.
- Conducting simultaneous examinations of each Very Large Depository Institution.
- Sharing each draft report of examination with the other agency and permitting the other agency's comment on the draft before the final report.
- Considering the concerns raised by the other agency before issuing the final report or taking supervisory action.[74]

The CFP Act further requires that the CFPB report to the IRS any report of examination or related information identifying possible tax law noncompliance.[75] These provisions are effective on the Designated Transfer Date.[76]

Smaller Depository Institutions

The CFPB has limited supervisory authority over insured depository institutions and credit unions with total assets of $10 billion or less ("Smaller Depository Institutions")[77] and their service providers.[78] The CFPB may require each Smaller Depository Institution to submit reports that support the CFPB's role in implementing Federal Consumer Financial Law, to support its examination activities, and to enable it to assess and detect risks to consumers and consumer financial markets.[79]

The CFPB's authority to examine Smaller Depository Institutions is significantly limited. The CFPB may include examiners, on a "sampling basis" only, in the examina-

The CFP Act applies, subject to a number of exceptions, to any person who engages in offering or providing a consumer financial product or service and any affiliate that provides a service to such a person.

tions performed by the prudential regulator to assess Smaller Depository Institutions' compliance with the requirements of Federal Consumer Financial Law.[80] Where the CFPB does include examiners, however, the prudential regulator must: (i) provide all reports, records, and documentation related to the examination process for any institution included in the sample; (ii) involve any CFPB examiner in the entire examination process for such Smaller Depository Institution; and (iii) consider input from the CFPB concerning the scope of the examination, conduct of the examination, the contents of the examination report, the designation of matters requiring attention, and examination ratings.[81]

The CFPB's authority to enforce Federal Consumer Financial Law against Smaller Depository Institutions is also extremely limited. The CFPB may only enforce its reporting requirements. The prudential regulators retain their authority to enforce the requirements of Federal Consumer Financial Laws with respect to Smaller Depository Institutions.[82] Although the CFPB is required to notify the prudential regulator where the CFPB has reason to believe a Smaller Depository Institution has materially violated the Federal Consumer Financial Laws, the Act does not require the prudential regulator to take action. Upon receipt of such notice, the prudential regulator only need respond in writing within sixty days of receipt. No other action is required.[83]

Nondepository Institutions

The CFP Act gives the CFPB the authority to supervise and enforce Federal Consumer Financial Laws against certain nondepository persons who offer or provide consumer financial products or services. This authority extends to any person who:

- Offers or provides origination, brokerage or servicing of residential mortgages, or residential mortgage modification or foreclosure relief services;
- The CFPB has reasonable cause to determine, by order, is engaging or has engaged in conduct that poses risk to consumers with regard to the offering or provision of consumer financial products or services;
- Offers or provides a private education loan; or
- Offers or provides to a consumer a payday loan.[84]

The CFP Act gives the CFPB the authority to supervise and enforce Federal Consumer Financial Laws against certain nondepository persons who offer or provide consumer financial products or services.

In addition, the CFP Act permits the CFPB to extend its supervisory and enforcement authority over any person that it determines, by regulation, is a larger participant in a market for other consumer financial products or services. The CFPB must consult with the FTC before it issues such a regulation. The CFP Act requires the CFPB to issue such a regulation within one year after the Designated Transfer Date.[85] A service provider to a nondepository person within the CFPB's supervisory authority is also subject to the CFPB's authority.[86]

The CFPB's authority with respect to these nondepository persons is exclusive, except where shared with the FTC.[87] The CFP Act also expressly reserves the authority of the Farm Credit Administration, providing that the Act does not modify, limit, or otherwise affect the Farm Credit Administration's authority.[88] Although the CFPB has exclusive authority to enforce the Federal Consumer Financial Law with respect to these nondepository persons, any federal agency authorized to enforce Federal Consumer Financial Law may recommend to the CFPB in writing that the CFPB initiate an enforcement proceeding.[89]

The CFPB must require reports and conduct examinations of a nondepository person under its supervision on a periodic basis to assess its compliance with the requirements of the Federal Consumer Financial Law, to obtain information about the activities and compliance systems or procedures of such person, and to detect and assess risks to consumers and to markets for consumer financial products and services.[90] The CFPB's assessment must be based on the risks posed to consumers in the relevant product markets and geographic markets, taking into consideration a list of enumerated factors, including the asset size of the covered person, the risk posed to consumers, and state regulation.[91] The CFPB is required to coordinate its supervisory activities with those conducted by prudential regulators and the state bank regulatory authorities, and must use existing reports and publicly reported information to the fullest extent possible.[92] The CFPB is again required to provide the IRS with each report of examination or related information identifying possible tax law noncompliance.[93]

The CFPB and the FTC must negotiate an agreement for coordinating enforcement actions by each agency regarding the offering or provision of consumer financial products or services by any covered nondepository person. This agreement must be completed within six months after the Designated Transfer Date.[94] The agreement must include procedures for notice to the other agency, where feasible, before initiating a civil action to enforce Federal Consumer Financial Law.[95] Although the CFPB and FTC cannot file a rival enforcement action after the other has initiated an action, the non-initiating agency may intervene as a party in the existing action.[96]

Limitations on Authority of the CFPB; Preservation of Authority

The CFP Act provides a laundry list of activities that are exempted from the CFPB's authority entirely or in part.[97] The exemptions apply to the activities, not to the entities that perform those activities.[98] An entity engaged primarily in activities that are not subject to the CFPB's authority may also be engaged in activities that subject it to the authority of CFPB.[99]

A merchant that sells nonfinancial goods or services is exempt from the coverage of the CFP Act except to the extent it offers or provides a consumer financial product or service or is otherwise subject to other consumer laws.[100] A merchant is not subject to the CFPB's supervisory and enforcement authority if it engages in any of the following activities that would otherwise be considered to be a financial good or service:

- Extending credit directly to a consumer exclusively for the purpose of engaging the consumer to purchase a nonfinancial product or service from the merchant, so long as the merchant does not sell the paper (unless the buyer is in default of the credit obligation);
- Collecting its own consumer credit receivables;
- Selling a merchant's consumer credit receivables that are delinquent or otherwise in default.

However, if the CFPB deems a merchant to be "engaged significantly" in offering or providing consumer financial products or services, this exclusion from coverage will not apply if the merchant sells consumer debt that is not in default, extends credit in an amount significantly greater than the value of the nonfinancial goods or services sold, or regularly extends credit that is subject to a finance charge.[101] The CFP Act creates an exception from coverage for a small business that extends credit to customers who purchase nonfinancial goods or services, even if the merchant charges a finance charge, so long as the merchant does not extend credit for other purposes, retains the credit for its own accounts (although it can sell debts that are delinquent or in default), and is a small business under section 3[102] of the Small Business Act.[103]

The CFP Act gives special treatment to one type of merchant, motor vehicle dealers. The Act broadly defines "motor vehicle" to include: (i) any self-propelled vehicle designed for transporting persons or property on a street, highway or other road; (ii) recreational boats and marine equipment; (iii) motorcycles; (iv) motor homes, recreational vehicle trailers, and slide-in campers; and (v) other vehicles.[104] A motor vehicle dealer is generally exempted from the Act if it is predominantly engaged in the sale and servicing of motor vehicles, the leasing and servicing of motor vehicles, or both.[105] This exception will not apply, however, if a motor vehicle dealer: (i) provides financial services related to residential or commercial mortgages; (ii) operates a line of business that involves the extension of retail motor vehicle credit or leases, provided directly to consumers and pursuant to a contract that it does not routinely assign to an unaffiliated third party; or (iii) offers or provides a consumer financial product or services unrelated to motor vehicles.[106]

In addition to the exception for merchants, the CFP Act excludes a number of other industries and activities from the CFPB's authority, including:

- Licensed or registered real estate brokers and real estate agents.
- Manufactured home retailers and modular home retailers.
- Accountants and tax preparers.
- Attorneys engaged in the practice of law.
- Persons regulated by state insurance regulators.
- Employee benefit and compensation plans and certain other arrangements under the Internal Revenue Code.
- Persons regulated by the Securities and Exchange Commission or a state securities commission.
- Persons regulated by the Commodity Futures Trading Commission.
- Persons regulated by the Farm Credit Administration.
- Activities related to the making of vol-

The CFP Act provides a laundry list of activities that are exempted from the CFPB's authority entirely or in part.

untary charitable contributions to tax-exempt organizations.

- Persons engaging in the business of insurance.[107]

The powers of the Federal Trade Commission and Federal Reserve Board remain unchanged by the CFP Act, and both are directed to coordinate with the Office of Service Member Affairs to ensure that (i) service members and their families are educated and empowered to make better informed decision with respect to consumer financial products and services offered by motor vehicle dealers, and (ii) complaints are effectively monitored and responded to.[108]

Although the CFPB may not exercise its rulemaking, supervisory, or enforcement authority with respect to any exempted persons under these exemptions, the CFP Act expressly reserves the CFPB's authority to request information from a large number of exempted persons.[109] These provisions are effective on the Designated Transfer Date, except for the provision regarding the CFPB's rulemaking authority, authority with respect to covered persons, and the provisions regarding simultaneous and coordinated supervisory actions with respect to Very Large Depository Institutions, which all became effective on the enactment date.[110]

Implementation of the Dodd-Frank Act

The consumer financial protection provisions in Title X of the Dodd-Frank Act signal a significant and unprecedented increase in consumer regulation and protection. The Act creates the CFPB for the purpose of protecting consumers in financial transactions and gives it broad rulemaking and supervisory authority. Although many of the provisions of the Act are already effective or will be effective on the Designated Transfer Date, implementation will not happen overnight. But over the next two years, we can anticipate a sweeping reform of the regulation of the consumer financial services industry.

NOTES

1. Pub L No 111-203, 124 Stat 1376. Subsequent endnotes refer to sections of this Act.
2. Section 1021(a).
3. Sections 1022(a) and (b); 1002(14).
4. Sections 1022(a) and (b); 1002(14).
5. Section 1002(5).
6. Section 1002(5).
7. Section 1021(a).
8. Section 1021(b).
9. Section 1011(a).
10. Section 1011(c)(2).
11. Section 1011(c)(3).
12. Section 1012(b).
13. Section 1029A.
14. Sections 1002(9) and 1062.
15. *Id.*
16. Elizabeth Warren, The White House Blog, *Fighting to Protect Consumers* (September 17, 2010), *available at* http://www.whitehouse.gov/blog/2010/09/17/fighting-protect-consumers.
17. Section 1021(c).
18. Section 1016(b).
19. Section 1016(c).
20. Section 1022(a)-(b).
21. Section 1022(c)(1)-(2).
22. Section 1023(c)(2).
23. Section 1022(c)(3)(A).
24. Insured depository institutions and credit unions with assets of $10 billion or less. Section 1026(a).
25. Section 1022(b)(2).
26. Section 1022(b)(3).
27. "Prudential regulator" is defined, in the case of an insured depository institution and depository institution holding company, to mean its Federal bank regulatory agency. For insured credit unions, it is the National Credit Union Administration. Section 1002(24).
28. Section 1022 (b)(2)(B).
29. Section 1022(c)(7).
30. Section 1022(d)(1).
31. Section 1022(d)(2).
32. Section 1022(d)(1).
33. Section 1022(d)(3).
34. Section 1023(a). The charge of the Council is to identify risks to the financial stability of the United States, promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties that the Government will shield them from losses in the event of failure, and respond to emerging threats to the stability of the United States financial system. Section 112(a)(1). The Council is composed of 10 voting members: (i) the Secretary of the Treasury (who will serve as Chairperson of the Council); (ii) the Chairman of the Board of Governors of the Federal Reserve; (iii) the Comptroller of the Currency; (iv) the Director of the CFPB; (v) the Chairman of the Securities and Exchange Commission; (vi) the Chairperson of the Federal Deposit Insurance Corporation; (vii) the Chairperson of the Commodity Futures Trading Commission; (viii) the Director of the Federal Housing Finance Agency; (ix) the Chairman of the National Credit Union Administration Board; and (x) an independent member appointed by the President by and with the advice and consent of the Senate. Section 111(b).
35. Section 1023(b)(1).
36. Section 1023(c).
37. Section 1031.
38. Section 1031(c)(1).
39. Section 1031(c)(2).
40. Section 1031(d)
41. *Id.*
42. Section 1031(e).
43. Section 1037.
44. Section 1032(b).
45. Section 1032(b)(3).
46. Section 1032(d).
47. 1032(f).
48. *Id.*

49. *Id.*
50. Section 1036.
51. The CFP Act gives the authority to enforce Federal Consumer Financial Law against a smaller depository institution to the institution's prudential regulator.
52. Section 1052.
53. Section 1054(a).
54. Section 1055(c).
55. Section 1056.
56. *See, e.g.,* Section 1025(b)(5).
57. Section 1058.
58. 1013(b)(3).
59. *Id.*
60. Section 1018.
61. Section 1057(a).
62. *Id.*
63. Section 1057(c)(1)(A).
64. Section 1058.
65. Section 1041(a)(1).
66. Section 1041(a)(2)
67. *Id.*
68. Section 1048.
69. Section 1002(6)
70. Section 1025(b)(1). The CFPB's authority extends to affiliates of Very Large Depository Institutions and service providers to Very Large Depository Institutions. Sections 1025(a) and (d).
71. Section 1025(c)(1)-(2).
72. Section 1025(c)(3).
73. Section 1025(b).
74. Section 1025(e).
75. Section 1025(b)(5).
76. Sections 1002(9) and 1062.
77. Section 1026.
78. Section 1026(e).
79. Section 1026(b).
80. Section 1026(c)(1).
81. Section 1026(c)(2).
82. Section 1026(d)(1).
83. Section 1025(d)(2).
84. Section 1024(a)(1).
85. Section 1024(b)
86. Section 1024(a)(2).
87. Section 1024(c)(1).
88. Section 1024(b)(5).
89. Section 1024(c)(2).
90.Section 1024(b)(1).
91. Section 1024(b)(2).
92. Section 1024(b)(3)-(4).
93. Section 1024(b)(6).
94. Section 1024(c)(3)(A).
95. *Id.*
96. Section 1024(c)(3)(B).
97. Section 1027(a).
98. *See id.*
99. *See id.*
100. Section 1027(a).
101. *See id.*
102. 15 U.S.C. § 632
103. Section 1027(a)(D)(ii)
104. Section 1029(f)(1).
105. Sections 1029.
106. Section 1029(b).
107. Sections 1027(b)-(m)
108. Section 1029(c)-(e).
109. Section 1027(n).
110. Section 1029A.

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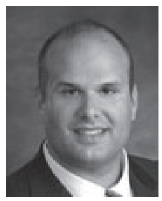

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Troubled Banks Mean Trouble for Bank Directors

By Michael A. Kus and Marsha J. Greco*

Introduction

Historically, it has been considered a great honor to be a member of the board of directors of a bank. With the ever increasing number of banks designated as being in a "troubled condition," the role of bank director has become a much more challenging job, fraught with risks of increasing scope and severity.

According to an article on CNNMoney.com dated May 20, 2010, the number of banks on the FDIC's list of troubled banks climbed to 775 during the first quarter of 2010.[1] While the economy in Michigan has been in recession for a longer period of time than experienced in most of the rest of the United States, relatively few Michigan banks have been closed and placed in receivership.

However, as the economic correction continues, banks, even those who are not in a "troubled condition," are faced with escalating challenges, and those entrusted with the responsibility to steer the banks through those challenges are under increased pressure.

Standard of Care for Directors' Duties

Under the Michigan Banking Code of 1999, a director of a bank:

> [S]hall discharge the duties of his or her position in good faith and with that degree of diligence, care, and skill that an ordinarily prudent person would exercise under similar circumstances in a like position. In discharging his or her duties, a director or an officer, when acting in good faith, may rely upon the opinion of legal counsel for the bank, upon the report of an independent appraiser selected with reasonable care by the board or by an officer of the bank, or upon financial statements of the bank certified to him or her to be correct by an officer of the bank, or as stated in a written report by an independent public or certified public accountant or firm of accountants to reflect fairly the financial condition of the bank.[2]

Under the federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), a director or officers of an insured depository institution may be held liable to the FDIC for money damages for "gross negligence, including any similar conduct that demonstrates a greater disregard for a duty of care (than gross negligence) including intentional tortuous conduct, as such terms are defined and determined under applicable State law."[3] In *Atherton v FDIC*, 519 US 213 (1997), the United States Supreme Court construed FIRREA's requirements and held that state law sets the standard of conduct to which bank directors are held "as long as the state standard (such as simple negligence) is stricter than that of the federal statute."[4] Thus, in Michigan, bank directors are held to the standards enumerated in the Michigan statute quoted above.

A director's responsibilities include:

1. The duty of loyalty and good faith to avoid putting personal interest ahead of the interests of the bank;
2. The duty of care and prudence by ensuring the bank is operating according to safety and soundness guidelines of state and federal banking regulators;
3. The duty to remain informed by monitoring and taking an active role to ensure appropriate management and operation in the affairs of the bank; and
4. The duty of inquiry, which requires a bank director to stay informed about activities of the bank.

Potential for Liability

Possibly the greatest area of concern for director liability is the need to ensure that the bank complies with all of the safety and soundness regulations and regulatory guidelines. The subject matter that is encompassed in the term "safety and soundness" is expansive.

Section 39 of the Federal Deposit Insurance Act requires each federal banking agen-

**This article was written in collaboration with Donald P. Mann, banking consultant and former Michigan banking commissioner.*

cy (collectively, the "agencies") to establish certain safety and soundness standards by regulation or by guidelines for all insured depository institutions. Under section 39, the agencies must establish three types of standards: (1) operational and managerial standards; (2) compensation standards; and (3) such standards relating to asset quality, earnings, and stock valuation as they determine to be appropriate.[5]

Appendix A to Part 364 of the Federal Deposit Insurance Corporation ("FDIC") regulations identifies the areas that the federal banking agencies consider to be within the scope of safety and soundness: 1) internal controls and information systems; 2) internal audit system; 3) loan documentation; 4) credit underwriting; 5) interest rate exposure; 6) asset growth and asset quality; 7) earnings; and 8) compensation, fees, and benefits. As with most things regulatory, while the list appears straightforward, the devil is in the details, and it is those details that can fell a bank—and its directors and officers along with it.

Both federal and state banking regulators have the power to remove "institution affiliated parties"[6] from office, impose civil money penalties for certain actions (or failures to act in some instances), and even to have criminal charges brought against a director.[7] If a bank fails and the FDIC is appointed receiver, former directors are almost always the subject of formal investigations by the FDIC and are frequently the target of civil litigation by the FDIC in an attempt to recover losses. Shareholders are also increasingly filing civil suits against former directors of failed institutions.[8]

Minimizing Liability

The potential for liability for a bank director most frequently arises from accusations that the directors or former directors failed to fulfill their duty to operate the bank in a safe and sound manner. There are a number of ways that directors can minimize the potential for personal liability for bank losses or the failure of a bank: 1) implement and monitor appropriate policies to clearly guide the operations of the bank; 2) be aware of "red flags" in management actions and in reports provided to monitor the bank's operations; and 3) obtain and understand the bank's Director's and Officer's Liability Insurance policy coverage.

Policy Implementation

To ensure the bank is operated in a safe and sound manner, directors must develop and adopt policies to guide the activities of the bank. The board is obligated to monitor the implementation and ongoing compliance with the policies once adopted. Directors are required to ensure that all significant activities of the bank are covered by clearly communicated written policies that can be readily understood by all employees to ensure the bank is operated in a safe and sound manner.[9]

Specific board policies should at a minimum cover: loans, including internal loan review procedures; investments; asset-liability and funds management; profit planning and budget; capital planning; internal controls; compliance activities; audit program; compensation; conflicts of interest; and code of ethics.[10]

Policy Monitoring

All policies should be monitored by the board to ensure that they conform to changes in laws and regulations, economic conditions, and the institution's circumstances. Monitoring is accomplished largely by reports prepared by bank management and presented to the board. Management reports to the board should include, at a minimum: income and expenses of the bank; the bank's capital position; lending and investments; past due and non-accrual loans; problem loans and workout strategies; allowances for loan and lease losses; concentrations of credit; liquidity/funding risk management; and interest rate risk management.[11] All such reports should include an analysis of the bank's current and historic performance compared to peer institutions.

In addition, the board must be extremely vigilant when considering insider transactions, compliance programs, compensation programs, and any extraordinary situation that may impact the reputation, safety, or soundness of the bank.[12]

It is the board's responsibility to ensure that bank management is operating the bank in a safe and sound manner. Directors must insist on receiving management reports from those high level managers within the bank on whose area of responsibility the report is being made. If senior management appears to be attempting to control the board's access to officers of the bank, the board must inquire and demand that those officers who

Possibly the greatest area of concern for director liability is the need to ensure that the bank complies with all of the safety and soundness regulations and regulatory guidelines.

are responsible for a particular area be present at board meetings where relevant reports are presented and discussed.[13]

Be Aware of Red Flags

Red flags are signals that the bank is headed for, or perhaps is already in, a troubled condition. A bank's board of directors needs concise, accurate and timely management information reports to help it perform its fiduciary responsibilities. Directors must review the management information reports critically and with an eye toward "red flags," which may signal existing or potential problems. Some "red flags" for directors, may include:

- Bank net worth ratios that are less than "well capitalized," and how such ratios compare with those of its peers.
- Significant concentrations of credit and inconsistent business lending practices, including a significant and increased number of loans granted on an exception basis.
- Significant upward or downward trends in the percentage of Allowances for Loan and Lease Losses ("ALLL") to total loans and leases, and ALLL averages and percentages significantly different from the peer group's.
- Downward trends in risk ratings and/or increases in special mention or classified assets.
- Any planned or anticipated growth that is inconsistent with the bank's budget, strategic plan, or with the bank's ability to properly manage, as well as growth that is significantly greater than that of peer banks, even if the growth is projected in the bank's budget or strategic plan.
- Introduction of new products or activities in which the bank has little or no expertise or for which there are inadequate risk management controls.
- Failure to revise risk management policies as changes in applicable laws and regulations occur.

A bank's board of directors needs concise, accurate and timely management information reports to help it perform its fiduciary responsibilities.

Some of the most serious red flags that require immediate action from the board of directors include:

- Signs of significant deviation by management or staff from policy or operational standards.
- Any indication that management is trying to control or inhibit communications from certain senior management or internal audit staff to the board of directors, including unexplained or unexpected changes in external auditors or the audit program.
- Inability of management to provide timely and accurate financial, operational, and regulatory reports.
- Information in management reports that is inconsistent, or reports that are untimely, incomplete, or inaccurate.

The Office of the Comptroller of the Currency has published a guide "Detecting Red Flags in Board Reports—A Guide for Directors" that contains greater details about red flags of which directors should be aware and should be prepared to take proactive steps to address.[14]

If there is any doubt about how critical it is for directors to be aware of these red flags, a quick reading of a Material Loss Review, commissioned by the FDIC Office of Inspector General after a bank failure, is very instructive in how the FDIC views action or inaction by boards of directors as contributing factors to bank failures. The content of a Material Loss Review purports to show the progression of the decline of a bank and what a bank's senior management and board did, or did not do, to correct the course of the bank. Material Loss Reviews are published by the FDIC and are available online at: www.fdicig.gov.

Directors' Liability Insurance

If red flags appear that are not being addressed by bank management despite the efforts of the board, or if a director has any reason to believe that the bank is or soon will be in a troubled condition, a director should request and retain a copy of the bank's Director and Officer Liability Insurance policy ("D&O policies.") It is critical for a director to understand what type of insurance coverage is available should claims be made against the bank losses.

A disturbing trend is for D&O policies to contain something known as a "regulatory exclusion" that precludes coverage for actions brought by the FDIC, state regulators, and other regulatory agencies. Once a bank becomes "troubled," it is more difficult to obtain D&O coverage that does not contain the regulatory exclusion.[15]

Even if the bank's D&O policy does not contain a regulatory exclusion, some insurers will attempt to deny coverage for claims brought by the FDIC as receiver under something called the "insured-versus-insured" exclusion. This exclusion basically "bars coverage for claims by one insured entity (i.e., the FDIC, which steps into the bank's shoes upon being appointed receiver) against another (i.e., the officers and directors)."[16]

Worst Case Scenario

If, despite the board's best efforts, the bank is closed and the FDIC is appointed receiver, former bank directors need to be prepared to receive a demand letter from the FDIC informing them that they may be subject to possible civil charges or that they may be the target of formal investigations via a "Notice of Investigation." This process could result in subpoenas of personal financial records and other documents.[17]

There is concern that the FDIC is targeting individual former directors of failed institutions whom the FDIC believes have the financial means for recovery, rather than focusing on those persons whom the FDIC thinks are actually responsible for a failure.[18] However, the FDIC maintains it is "looking at whether we have a meritorious and cost-effective claim…. How far we go will depend on the facts and circumstances in each case," according to Richard Osterman, Deputy General Counsel at the FDIC.[19]

Potential for Civil Suit by the FDIC

In its Financial Institutions Letter 87-92, the FDIC issued a statement of policy concerning the Responsibilities of Bank Directors and Officers. The statement also includes a discussion of the procedures followed by the FDIC to institute civil lawsuits against former directors and officers and describes the nature of suits filed. Inside directors are at a higher risk of being sued by the FDIC than outside directors.[20]

According to the policy statement, the FDIC will only institute a lawsuit against a former director after a review of factual circumstances surrounding the bank's failure by senior FDIC supervisory and legal staff, and final approval is given by the FDIC Board of Directors or its designee. The factual circumstances are developed in part based on information provided by the former director in response to a Notice of Investigation and subpoena(s). In most cases, the FDIC attempts to alert proposed defendants in advance to allow them to respond to proposed charges informally and discuss possible settlement.[21]

Cases most often result when a former director engaged in dishonest conduct or approved or condoned abusive transactions with insiders, or where a director failed to ensure the bank adhered to applicable laws and regulations, its own policies or an agreement with a supervisory authority, or otherwise engaged in an unsafe or unsound practice.[22] By far, the majority of cases involve allegations that former directors failed to establish proper loan underwriting policies and monitor adherence to those policies, approved loans they knew or had reason to know were improperly underwritten, or failed to heed warnings from regulators or professional advisors about the situation.[23] Perhaps the most troubling aspect of the current FDIC pursuit of former directors is that many allegations against former directors do not relate to activities that are unique to a particular bank. For example, the FDIC will take the position that generally poor economic conditions in a particular geographic area that contribute to a bank's decline are somehow attributable to actions, or inactions, of a bank's directors. Thus, it seems likely that some version of "guilt by association" (e.g., that a bank happens to be located in a geographic area that is economically stressed—a condition for which an individual director cannot personally be responsible) may cause even the most diligent bank directors to find themselves defending against claims by both regulators and shareholders.[24]

As an example, the Material Loss Review of Citizens State Bank, New Baltimore, Michigan states: "[t]he bank's financial deterioration was exacerbated by the depressed economic conditions, deteriorating automobile industry, and high unemployment rates prevalent in the Detroit metropolitan area."[25] While seemingly aware of the role extraordinary economic conditions played in the bank's failure, conditions that are clearly beyond the control of a bank's directors, the MLR nevertheless placed the cause of the bank's failure squarely on the board and management of the bank.[26]

Defenses to Civil Suits; Business Judgment Rule

In the face of a formidable opponent such as the FDIC, what defenses are available to directors who find themselves under investigation or a defendant in a civil suit brought by the FDIC? The "business judgment rule"

It is critical for a director to understand what type of insurance coverage is available should claims be made against the bank losses.

is the first and foremost legal argument as a defense to such a suit.

A former director who is being targeted by the FDIC is entitled to rely on the "business judgment rule" to protect himself or herself from personal liability, assuming the director acted prudently and impartially under the circumstances.[27]

The United States District Court for the Western District of Michigan had the occasion to review the current state of the business judgment rule in the 2008 unreported case, *Virginia M Damon Trust v Mackinaw Fin Corp*. In its discussion of the business judgment rule, the court noted that:

> The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis and in the honest belief that the action was taken in the best interests of the company." *Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 747 (Del. Ch. 2005) (internal ellipses and quotations omitted). Where, however, the directors' "methodologies and procedures are restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or a sham, then inquiry into their acts is not shielded by the business judgment rule." *Resolution Trust Co. v. Rahn,* 854 F.Supp. 480, 489 (W.D. Mich. 1994). Moreover, "[g]ood faith alone will not excuse [directors] when there is a lack of the proper care, attention, and circumspection in the affairs of the corporation, which is exacted of them as trustees." *City of Grand Rapids v. F & M Foods, Inc.,* No. 271773, 2007 Mich. App. LEXIS 926, 2007 WL 914667, at *4 (Mich. App. Mar. 27, 2007).[28]

If a bank director stays informed and acts under a good-faith belief that the decision is in the best interests of the bank, the business judgment rule may provide a substantial basis of a defense to claims of negligence.

The Best Defense is A Good Offense

As strong a defense as the business judgment rule is, the best defense is a good offense. Taking certain actions at the first sign of red flags is the best way a director can protect himself or herself from personal liability. Directors should consider consulting competent counsel of their own when red flags begin to appear. While the bank may have competent counsel who gives sound legal advice to the bank and the board of directors during difficult times and prior to a bank failure, it is important for directors to be sure they take appropriate steps to protect themselves from liability in the event the bank fails. Directors need to know the scope and coverage of the D&O policy. Directors also need to organize business records with an eye toward establishing a defense to potential litigation. Directors should also understand what the requirements are for the particular D&O policy applicable to their role as a bank director. Failure to follow the required notice procedures and other directives contained in the D&O policy may result in a director being denied coverage.

Copies of the board minutes, loan committee minutes, board reports, resolutions, or corrective action plans are extremely useful as evidence that a director acted according to the required standard of care. It is critical to obtain the advice of counsel in the organizing of business records because these documents are highly sensitive and subject to confidential or restricted treatment under federal and state law. Extreme care must be taken when dealing with such records so as to avoid any allegation that a director improperly removed official bank records from bank property.

Conclusion

Implementing appropriate policies, monitoring adherence to those policies, being aware of red flags, and taking appropriate action to address those red flags are all important steps to minimizing director liability. Understanding the type and extent of any insurance coverage for actions taken as a director is also an important element in managing director liability.

For current and former bank directors, the risk of personal liability for losses incurred by a failed bank is very real. While there is no way to eliminate the risk of being targeted by regulators or shareholders for such losses, there are several effective steps directors can take to minimize that risk.

NOTES

1. http://money.cnn.com/2010/05/20/news/companies/fdic_list/index.htm.
2. MCL 487.13504(1).
3. 12 USC 1821(k).
4. *Atherton v FDIC*, 519 U.S. 213, 216 (1997).
5. Appendix A to 12 CFR Part 364 is available at: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=f

f956618654606baae12cdc005d99835&rgn=div9&view=text&node=12:4.0.1.2.48.0.3.3.32&idno=12?

6. "Institution affiliated parties" include 1) any director, officer, employee, or controlling stockholder (other than a bank holding company) of, or agent for, an insured depository institution; (2) any other person who has filed or is required to file a change-in-control notice with the appropriate Federal banking agency; (3) any shareholder (other than a bank holding company), consultant, joint venture partner, and any other person as determined by the appropriate Federal banking agency (by regulation or case-by-case) who participates in the conduct of the affairs of an insured depository institution . . . which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution. 12 USC 1813(u).

7. 12 USC 1818(e) – (i).

8.. "Distressed Debt and other Woes: What Bank Directors Should be Doing…Now", Bank Director Magazine – 4th Quarter 2008 available at www.bankdirector.com.

9. FDIC Pocket Guide for Directors, available at: http://www.fdic.gov/regulations/resources/directors/index.html.

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

14. The guide is available online at: http://www.occ.treas.gov/RF_Book.pdf.

15. Chris Rafferty, "How Changes in Community Banking are Affecting Directors and Officers Liability Insurance", Smart Business Indianapolis, June 2010, available at: http://www.sbnonline.com/Local/Article/19879/74/228/How_changes_in_community_banking_are_affecting_directors_and_officers_liability_insurance.aspx. Mr. Rafferty is Vice President of the Financial Services Group at Aon Risk Services.

16. "FDIC Poised to Sue Former Directors and Officers of Failed Banks." GreenbertTraurig Financial Institutions/ D&O Litigation update, January 5, 2010, available at: www.gtlaw.com. See also William G. Passannante and Raymond A. Mascia Jr, "When the FDIC Comes Calling: Protecting D&O Coverage for a Failed Bank's Directors And Officers," ., *AKO Financial Services Alert*, December, 2009, and "D&O Liability Policies – Regulatory Exclusion," , Latham & Watkins, LLP Client Alert, July 21, 2008.

17. Joe Adler, "First the Failures, Then the Lawsuits," *American Banker*, Tuesday, July 13, 2010.

18. *Id.*

19. *Id.*

20. FDIC Statement Concerning the Responsibilities of Bank Directors and Officers, FDIC Financial Institution Letter (FIL-87-92) December 3, 1992.

21. *Id.*

22. *Id.*

23. *Id.*

24. Posting of Kevin M. LaCroix to "The D &O Diary," www.dandodiary.com. Mr. LaCroix is an attorney and a partner with OakBridge Insurance Services, in Beachwood, Ohio. OakBridge is an insurance intermediary focused exclusively on management liability issues.

25. Office of Material Loss Reviews Report No. MLR-10-042, July 2010.

26. *Id.*

27. Thomas P. Vartanian, "The Retribution Phase of the Financial Meltdown", *American Banker,* June 1, 2010.

28. No. 2:03-CV-135, 2008 US Dist LEXIS 23 at *28 (WD Mich Jan 2, 2008).

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Reclassification of Property by the State Tax Commission Threatens Loss of Tax Incentives

By Kasturi Bagchi and Michael K. Hauser

Owners of industrial property and their advisers need to be aware of a current campaign by the state of Michigan to reclassify parcels of real property. In June 2010, approximately 10,000 owners of "industrial" real property or "industrial" personal property received a notice from the State Tax Commission ("STC") to reclassify real property and/or personal property from "industrial" to "commercial" status for property tax purposes.[1] The notices typically state that, if the property owner chooses to object to the new classification, the owner can submit written information within a limited time period to support an "industrial" classification.

Many real property owners have been caught off guard by the notices, having no idea whether they will be negatively impacted by the loss of "industrial" status, and whether they should file an objection. Interestingly, a classification change for real property tax purposes will not ostensibly have a negative effect—in fact, both industrial and commercial real properties are taxed at the same tax rate, and the valuation of both types of properties is determined by the "true cash value" (which should not change based merely on a reclassification).[2] Professionals have speculated on whether assessors may change their determination of true cash value based on the classification of real property as commercial or industrial, but there does not appear to be a clear basis for doing so.[3]

The question, then, is why is the state of Michigan attempting to change the classification of real property for property tax purposes? The answer appears to be that the state is taking an indirect approach to "take a bite" out of certain tax benefits provided to payers of personal property tax, rather than real property tax. As background, during 2007, the Michigan Legislature passed three new laws intended to confer significant tax benefits to owners of industrial personal property.

- First, personal property taxes levied on industrial personal property entitle the owner to a 35 percent tax credit against the owner's Michigan Business Tax ("MBT").[4] This benefit does not apply to commercial personal property.
- Second, industrial personal property is exempted from up to 18 mills of personal property tax levied by a local school district (commercial personal property is exempted from only 12 mills of personal property).[5]
- Third, industrial personal property is exempted from 6 mills of state education tax (commercial personal property does not qualify for this exemption).[6]

Clearly, the state of Michigan has a pecuniary interest in preventing owners of personal property from receiving an "industrial" classification.

But then why is the state sending notices to real property owners? The STC's own viewpoint is that the determination of whether personal property should be classified as industrial or commercial does not depend on how the real property is classified. In a February 18, 2010 memorandum, the STC clearly stated that personal property can be classified as industrial even though the real property on which the personal property is located has been classified as commercial. As the STC points out, if the classification of personal property is dictated by the classification of the real property that it is on, then such "classification of personal property can be changed at the will of the taxpayer, simply by moving it onto a parcel of real property that is classified as industrial…. This…simply allows manipulation of the credit and exemption." Thus, the STC has officially agreed that even if real property owners succumb to a commercial classification status for real property purposes, the owner of the personal property situated thereon can still qualify for the industrial personal property classification and the related tax benefits.[7] However, the STC is concerned that the classification of real property on the assessment rolls will continue to influence the classification status of personal property located thereon, thereby paving the way for owners of personal property to qualify more easily for industrial status. This explains the statement by the State Tax Commission that it has "weeded out what it determined to be commercial, residential or other parcels that do not house any industrial activities."[8] "We want people who are entitled to the tax credit to get it," stated Kelli Sobel, the executive director of the STC.[9]

The link between real property classification and personal property classification is a legitimate concern for the STC because: (a) the statutory definition of industrial personal property refers to the property being located on "industrial parcels"[10] and arguably the classification of the real property as industrial automatically requires the personal property located thereon to be deemed industrial, although the STC has rejected this viewpoint;[11] and (b) even if a classification of the real property as industrial does not automatically lead to a personal property classification as industrial, nevertheless the STC has acknowledged that the classification of real property as industrial may be one factor favoring industrial classification of the personal property.[12]

So what property is deemed to be "industrial"? MCL 211.34c(2)(d) defines industrial real property as:

(i) Platted or unplatted parcels used for manufacturing and processing purposes, with or without buildings.

(ii) Parcels used for utilities sites for generating plants, pumping stations, switches, substations, compressing stations, warehouses, rights-of-way, flowage land and storage areas.

(iii) Parcels used for removal or processing of gravel, stone, or mineral ores, whether valued by the local assessor or by the state geologist.

(iv) For taxes levied after December 31, 2002, buildings on leased land used for industrial purposes.[13]

MCL 211.34c(3)(c) defines industrial personal property as:

(i) All machinery and equipment, furniture and fixtures, and dies on industrial parcels, and inventories exempt by law.

(ii) Personal property of mining companies.[14]

As noted above, arguably the term "industrial parcels" means real property parcels that are classified as industrial; however, the State Tax Commission has rejected this interpretation.[15] Instead, the STC takes the position that personal property is located on an industrial parcel if industrial activity is conducted on the parcel, which it primarily defines as follows:

> For purposes of MCL 211.34c, industrial activity is the manufacturing of parts, components and subassemblies used to make finished goods; or manufacturing of finished goods, including the assembly of finished goods and the processing of food, when the activity produces goods for sale to those engaged on wholesale or retail trade; or conduct of research and development activity…by the taxpayer for the purpose of developing improvements to existing designs, or developing new designs…or other products …which will be manufactured by that taxpayer or its affiliate; or extraction of raw materials and minerals from the ground; or processing or refinement of substances to be used as raw materials in later industrial or commercial processes or for the sale to those engaged in wholesale or retail trade of such substances; or generation of electricity for the taxpayer's own use in engaging in industrial activity or for sale to the public or to public utilities…[16]

Conversely, the following are not industrial activities in the STC's view:

> the breakdown of larger shipments or lots into customer orders;… wholesale or retail trade; or…the measurement, cutting, fitting, mixing, combination or assembly of ingredients, materials or other commodities that are manufactured or extracted elsewhere, to the specific order and/or specifications or needs of an end-user…;or…the production of a[n] artistic or graphic design applied to a commercial product…; or…research and development, engineering or testing that is performed by an independent contractor, or as a speculative research that is not associated with product development by a manufacturer; or…the repair or

The link between real property classification and personal property classification is a legitimate concern for the STC.

> rebuilding of existing personal property, even if significant replacement parts are installed; or…construction of real property structures…or … public or private infrastructure.[17]

If there are both industrial and commercial components to a taxpayer's personal property, then the classification of personal property at a given location follows the activity and usage of such property, "which provides the largest net revenue."[18]

Depending on the procedural background of the case, an objection to an attempted reclassification could either be filed directly to the STC, or to the local board of review (with appeals going to the STC). Notably, the classification decision is made on an annual basis—and thus, even if a protest is not made (or is not made successfully) in one year, the owner could make a protest the following year (to the board of review and the STC). Finally, it should be noted that disputes over classification could also involve a number of related issues, for example, the issue of whether property should be considered real property or personal property (for example, "fixtures" that are attached to real estate may be classified as real property or personal property, which could be important in that tax benefits could arise from the ownership of industrial personal property). Similarly, the issue of whether personal property is leased or owned by a manufacturer may be of critical importance, as the STC regards leased personal property as generally ineligible for industrial status:

> [I]f the property is being [leased]…by a tenant engaged in industrial activity, the landlord is implicitly renting the equipment to the tenant rather than engaging an industrial activity itself…The Landlord is not engaged in manufacturing at a location simply arising from the fact that the location is being used by someone for industrial activities, or from the fact that landlord's personal property is being used by someone to carry on industrial activities….The landlord is not bearing the risk associated with conducting an industrial activity. Instead, the risk it bears is that the tenant will not pay it's [sic] rent or will cause damage to the property, a commercial activity risk.[19]

While the foregoing passage was lifted out of a memorandum written by the STC for the purpose of providing guidelines in the classification of personal property, it could be used by assessors to conclude that the mere leasing of real property to a tenant for an industrial operation is also a commercial activity. Moreoever, the recommendations of the STC as to leased personal property conflict with the plain statutory language of MCL 211.34c:

> [The statute] provides that real property "used for manufacturing and processing purposes" is industrial real property and that industrial personal property includes "all machinery and equipment, furniture and fixtures, and dies on industrial parcels." Thus, if a manufacturer buys some machines and leases some others and uses all of them in its industrial real property to manufacture products, they would all appear to be equally entitled to the credit, because they would all be equal machinery used on a parcel used for manufacturing. The State Tax Commission [disagrees]…and has advised that all leased property should be classified as commercial…. Thus, …two identical forklifts or machines used identically in a factory to make products will be taxed differently if one is owned and the other is leased.[20]

To conclude: for real property owners that use the property to conduct a manufacturing business, it appears wise for such owners to object to a classification of the real property as commercial because being passive could make it easier for the state to disallow the owner's personal property from being classified as industrial (causing the owner a direct, negative tax impact). However, for real property owners that are landlords, the tax benefits of the industrial property classification would only be felt by the tenant, not the landlord. Still, the landlord will likely have an interest in seeing a tenant succeed and ensuring a tenant (or potential tenant) will not abandon the premises to obtain better tax treatment elsewhere. Therefore, even though a landlord may have no *direct* benefit to securing industrial classification of its real property, it may be *indirectly* in the landlord's interest to appeal the real property classification, as a means of satisfying and/or attracting tenants. Still, as noted above, arguing about the real property classification may be a moot point as the personal property located thereon could attain industrial status in any event.

NOTES

1. See Melissa Domsic, *Mid-Michigan Industrial Properties Come Under Scrutiny, Lansing State Journal,* June 13, 2010

2. MCL 211.27-27a. Note that all discussion herein of classification refers only to an assessor's classification of a property's status for tax purposes, regardless of how the property is zoned under local law.

3. Notably the City of Livonia has sent notices to those property owners who have received the petition advising that such reclassification would not raise taxes.

4. MCL 208.1413(1)(a).

5. MCL 380.1211 and 211.9k.

6. MCL 211.903 and 211.9k.

7. Memorandum dated August 13, 2008 from T.J. Schnelle, manager of the Commercial/Industrial/Utility Valuations Section, Assessment and Certification Division, of the STC.

8. *See* Domsic, *Mid-Michigan*.

9. *See Id.*

10. MCL 211.34c(3).

11. The State Tax Commission finds that "industrial real property" is not synonymous with "industrial parcel" because the term "parcel" is often used in the General Property Tax Act to refer to real property and personal property. See above-cited Memoranda dated February 18, 2010 and August 13, 2008.

12. See STC Bulletin 2007-7.

13. Commercial real property is defined under MCL 211.34c(2)(b) as follows:

> (i) Platted or unplatted parcels used for commercial purposes, whether wholesale, retail, or service, with or without uildings.
>
> (ii) Parcels used by fraternal societies.
>
> (iii) Parcels used as golf courses, boat clubs, ski areas, apartment buildings with more than 4 units.
>
> (iv) For taxes levied after December 31, 2002, buildings on leased land used for commercial purposes.

14. Commercial personal property is defined under MCL 211.34c(3)(b) as follows:

> (i) All equipment, furniture, and fixtures on commercial parcels, and inventories not exempt by law.
>
> (ii) All outdoor advertising signs and billboards.
>
> (iii) Well drilling rigs and other equipment attached to a transporting vehicle but not designed for operation while the vehicle is moving on the highway.
>
> (iv) Unlicensed commercial vehicles or commercial vehicles licensed as special mobile equipment or by temporary permits.

15. See Memorandum dated August 13, 2008.

16. *Id.*

17. *Id.*

18. *Id.* See also MCL 211.34c(5) (providing that the activity which has the greatest influence on valuation of the parcel should govern the classification).

19. Memorandum dated August 13, 2008.

20. Robert F. Rhoades, *Michigan Business Tax Credits For Personal Property Taxes, Related Property Tax Exemptions and the Classification of Property as Commercial, Industrial, Real or Personal Property*, 53 Wayne L Rev 1527 at 1539 (2007).

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Should Short Selling Be Regulated as a Consequence of Wall Street's Failures? Exploring the New Alternative Uptick Rule

By Helena Stigmark

Introduction

Short selling has always been a topic of debate. It is especially controversial today because of the ongoing financial crisis. This is largely because short sellers are viewed as speculators with the ability to drive the price of stocks down below their fundamental value.

The sharp rise in volatility in 2007, emerging almost simultaneously with the repeal of the "uptick" rule,[1] certainly made short sellers an easy target for public blame. Some people have blamed short sellers for contributing to, or even causing, the current financial crisis. The chief executives of Wall Street firms complained that short sellers were spreading false rumors and driving down the price of their shares.[2] They begged the United States Congress for help, thereby deflecting attention from their own poor management decisions. The U.S. market's watchdog, the Securities and Exchange Commission ("SEC"), acted at the populist will and attacked short sellers with additional regulations.[3]

Now, as the financial markets are trying to recover and the panic has subsided, it is time to go back to the basic problem and ask the fundamental question: how should short selling be regulated in the U.S. equity market?

The SEC has alleged that short selling was *not* the root, nor even contributed to, the current financial crisis.[4] Despite this conclusion, the SEC recently decided to restrict market participants' ability to engage in short selling by adopting an alternative uptick rule, which employs a circuit breaker feature.[5]

This article discusses the new SEC alternative uptick rule and advances the argument that a price restriction rule is not justified because it is likely to do more harm than good.

What is Short Selling?

The SEC defines a short sale as "any sale of a security which the seller does not own, or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller."[6] Simply put, the short seller will sell a security it does not own, borrows the security from a broker to make the delivery to the purchaser, and later purchases an equivalent security on the market to return to the lender.[7] This practice is known as covered short selling,[8] which is a legal market tool in the U.S., provided it is not used to manipulate the price of stock.

Short selling allows traders to profit in falling markets.[9] A short seller's profit is limited: the return can never be greater than 100 percent minus fees, which only happens in the event that the market price falls to zero.[10] The potential loss, however, can be infinite should the assets gain.[11] Short sellers are exposed to great risks because theoretically the market price of the security or asset sold short can rise without limit.[12]

Market Participants

There are three main categories of market participants who employ short selling. Each type uses short selling for different reasons.

The first category consists of market makers,[13] dealers that buy or sell stock consistently to ensure that there is always a buyer or seller for a particular stock.[14] They need to sell securities short to maintain customer liquidity and price stability.[15]

The second category consists of traders that take short positions to hedge the risk of a long position in the same security or in another related security.[16] Short selling is a favored hedging strategy; many hedge funds would find it too risky to invest in a long position were they not allowed to simultaneously short another security.[17]

The last category consists of speculators that deem a specific stock or market index overvalued and want to profit directly from the decline in stock price.[18]

Speculation activity is often criticized and generates most attention in the media and in the regulatory debate.[19] A common assumption is that short sellers only want to profit directly from price decline in stock. To a certain extent this is true. However, short selling as part of legitimate market making activities and hedging strategies do not anticipate future price declines.[20] Instead they try to profit from relative price changes and facilitate trading transactions that otherwise may not be completed.[21] It is worth noting that the overwhelming majority of short selling activity today is market neutral, and has no speculative purpose.[22]

The Impact of Short Selling

In General

Even though the SEC recognizes that short sellers play an important role in the market,[23] the actions taken in response to the financial crisis demonstrate that the SEC does not appreciate the magnitude and unique nature of short selling. To provide a sense of scale, it is worth noting that short sales represented 31 percent of share volume for NASDAQ-listed stock and 24 percent of share volume for NYSE-listed stock in 2005.[24] Thus, in the U.S., short sellers represent a relatively high level of market participation in the equity market. Therefore understanding the effects of regulating short selling is very important. The pros and cons are summarized below.

Pros

The main arguments in favor of allowing short selling are that short selling contributes to efficient price discovery by disclosing information of over-valued securities, enhances market liquidity thereby making trades more likely to be materialized, and facilitates hedging and risk management activities.[25]

Cons

While allowing short selling offers substantial benefits, short selling is also associated with a number of potential risks. There are three main regulatory concerns.

Recognizing that short selling facilitates efficient price discovery, regulators are concerned that the process of decline may be disorderly due to the extent and speed of the price correction mechanism, e.g. intensifying market anxiety about a security can cause potential buyers to step back.[26] Also, this may cause an "overshoot."[27] Thus, the first regulatory concern is market disorder.[28] Most empirical studies, however, support the notion that short selling contributes to efficient share prices.[29]

A second concern is that short selling may be used to illegally manipulate stock prices downwards.[30] A typical manipulative activity is to sell the shares of a company short and simultaneously spread false rumors to encourage others to sell.[31] After the 1929 market crash, the SEC was concerned about so-called "bear raids."[32] It was argued that a group of traders colluded and sold short in an effort to drive down the price of securities by creating a sell-side interest.[33]

The third alleged con arises from the concern that short selling can cause settlement disruption, i.e. that the seller fails to deliver within the settlement period.[34] This concern is especially prominent if the seller has not arranged to borrow the asset, which is the case with illegal naked short selling.[35]

It is important to note that none of the risks mentioned above are specific to short selling. During the financial crisis much focus was on the downside of short selling[36] while the benefits were often ignored.

The Former Uptick Rule

The SEC has the authority to regulate short selling of securities registered on a national securities exchange under Section 10(a) of the Securities Exchange Act of 1934 ("Exchange Act").[37] Historically, short selling has been restricted by the former Rule 10a-1 under the Exchange Act, commonly known as the "uptick" rule. The uptick rule provided that a seller could only short sell a listed security at a price higher than the price of the sale proceeding the last sale price, known as a plus tick; or a seller could short sell a security at the last sale price, provided that it was higher than the last different price of the security, known as a zero plus tick.[38] In other words, before a stock could be shorted the price had to rise, indicating that there were active buyers in the market. The uptick rule was implemented in 1938 by the SEC to restrict short selling in a declining market.[39] In brief, the SEC described the purpose of the uptick rule as the prevention of manipulative sales of a security for the purpose of accelerating a decline in the price of such security.[40]

Even though the SEC recognizes that short sellers play an important role in the market, the actions taken in response to the financial crisis demonstrate that the SEC does not appreciate the magnitude and unique nature of short selling.

For almost seventy years, the central provisions of the former uptick rule remained largely unchanged.[41] Nevertheless, its desirability and effectiveness was frequently questioned. Over the years and in response to changes in the securities market and trading strategies, the SEC added exceptions and granted relief from the uptick rule's restrictions.[42] One change that occurred in the market was the conversion to the decimal pricing increments, which means that stocks began trading in penny increments instead of one eighth dollar increments.[43] This change made it much easier to get around the uptick rule.[44] A bearish trader could, in practice, just push a stock a penny higher and then come back with a big short sale.[45] Moreover, in 1938 there was no electronic trading of stocks as trades took place on the exchanges and at a slower pace, whereas, in today's market the stock prices change more rapidly.[46]

To assess whether short selling needs further regulation, it is necessary to have an understanding of the short selling activity during Wall Street's recent panic.

In 2004, the SEC created a pilot program that temporarily suspended the uptick rule for short sales of certain securities to study the effectiveness of a short sale price test.[47] In sum, the pilot study found that the uptick rule did not have a significant impact on daily volatility, limited evidence existed that the restrictions altered a security's price, and removal of the price restriction did not affect liquidity.[48] It also concluded that removing the uptick rule resulted in an increase of short selling volume and price tests indeed operated as a constraint on short selling activity.[49] Overall, it found little empirical justification for sustaining the uptick rule.[50]

After a careful and deliberate process including numerous studies, a pilot program and many opportunities for public comments, the SEC concluded that the uptick rule did not effectively serve its purpose but instead imposed costs to the market.[51] The SEC continues to stand by this and has reiterated that "none of the empirical studies…have given us reason to question the rigor or validity of the Pilot results."[52]

The SEC eliminated all price restrictions on short selling, effective July 3, 2007. In addition to removing the uptick rule, the SEC added a rule to forbid any self-regulatory organizations ("SROs") from creating its own price test with respect to short sales.[53]

Then the financial panic descended. The removal of the uptick rule has been criticized in light of the turbulent market conditions associated with the financial crisis that started in the middle of 2007.

The Short Game and the Recent Panic

Was the fact that the market crashed after the SEC eliminated the uptick rule just a coincidence or is regulation needed? To assess whether short selling needs further regulation, it is necessary to have an understanding of the short selling activity during Wall Street's recent panic.

Even though a detailed discussion about the causes of the financial crisis is outside the scope of this article, a few general points must be made as to the origins. One root of the financial chaos was the subprime mortgage crisis of 2007, which was caused by excessive borrowing and lending practices, particularly in the United States.[54] The banks made "teaser" loans to people with no proof that the borrower could repay it.[55] The loans were then sold to big Wall Street investment firms.[56] They, in turn, repackaged them into complex mortgage securities, such as synthetic collateralized debt obligations ("CDOs") and sold them to investors throughout the world who often had no understanding of the underlying assets.[57] When the housing market collapsed, the banks were forced to write down the underlying assets, and the complex mortgage securities were downgraded.[58] When the banks could no longer sell the leveraged loans, the crisis was evident.[59] Therefore, the financial institutions' excessive leverage and risk taking in collateralized debt instruments was a major cause of the recent financial crisis.[60]

There were a handful of investors who foresaw the collapse and had the nerve to bet on their vision.[61] They made early and large bets against the U.S. home mortgage market.[62] To bet against the subprime mortgage bonds, they used derivative instruments such as a credit default swap ("CDS"), which essentially is an insurance contract that covers losses in the event of counterparty default.[63] When the housing market crashed, a few hedge funds managers made a fortune while the majority were decimated.[64]

The repeal of the uptick rule could not have caused the financial crisis. The reason is fairly simple: short sellers were primarily active on the bond market.[65] Thus, neither the uptick rule nor any other regulation on the equity market would have prevented their bearish bets.

The SEC itself has confirmed that there is no causation between short selling and the recent financial crisis.[66] This was based on the fact that the SEC found no empirical evidence that the elimination of price tests had contributed to the increased volatility and the steep decline in the stock market.[67]

It is also worth mentioning that SEC economists conducted a study of the selling pressure in September 2008, before the emergency order implemented a temporary short sale ban. It suggests that the volume of short selling was a small percentage of overall trading and that the price pressure on financial stocks mainly came from long sellers.[68] Generally, short sellers tend to be contrarians, i.e. active in a rising, rather than a declining, market.[69]

The Alternative Uptick Rule

In General

On February 24, 2010, in a three-to-two vote, the SEC adopted the alternative uptick rule (Rule 201), which became effective in May 2010, with a compliance date of November 10, 2010.[70] Under the alternative uptick rule, a circuit breaker will be triggered if the stock has declined at least ten percent during a day's session.[71] After that, short selling will be permitted in that security only if the price is above the current national best bid.[72] Once the circuit breaker is triggered, the rule would apply to short sale orders in that security for the remainder of the day and the following trading day.[73] The alternative uptick rule applies to all equity securities that are listed on a national securities exchange or in the over-the-counter market.[74]

In a speech, SEC Chairman Mary Schapiro explained that the rule is designed to restore investor's confidence and promote market efficiency.[75] She declared that the rule makes sense because it recognizes that short selling can have both beneficial and harmful impact on the markets, and her belief was that the alternative uptick rule "strikes the right balance."[76]

However, there are several reasons why the SEC should not have reinstated a price test restriction rule. Generally, the argument centers around two related themes.

First and foremost, a price test restriction rule should not be adopted because the market has changed considerably. Regulation could be justified if the SEC provided evidence that short selling caused, or contributed to, the current financial crisis. This was a fundamental question that the SEC answered in the negative.[77] As described above, short selling was not the root of, nor did it contribute to, the financial crisis because short sellers were chiefly active on the bond market.

Second, the vast majority of research suggests that a price test restriction is ineffective, and/or has a harmful effect on the market, and the SEC has not provided any new evidence to the contrary.[78] As stated above, the pilot study found little empirical justification for sustaining the uptick rule, and the SEC has confirmed that the pilot study still is valid.[79] Nevertheless, by adopting an alternative uptick rule, the SEC seems to ignore the prevailing evidence and economic data that would argue against its adoption.

The Goals

A few additional points need to be made regarding the objectives of an alternative uptick rule with a circuit breaker. What is the SEC trying to accomplish and are the goals attainable?

The SEC stated that a goal is to "prevent short selling from being used as a tool to exacerbate a declining market in a security."[80] Apparently, the SEC wants to limit potentially manipulative or abusive short selling from further driving down the price. Thus, the goal seems to be the same as the former uptick rule. A circuit breaker, if successful, seems to achieve the goal of stopping abusive short selling in declining markets, but not hindering the price discovery process under normal circumstances. However, the alternative uptick rule also effectively constraints legitimate short selling, which does not benefit from the limited exceptions.[81] Moreover, it is questionable whether the circuit breaker of a ten percent decline reflects a situation of severe deterioration.[82]

Critics argue that there can be manipulation with short selling. This is true. However, short selling *per se* is not manipulative. Any market manipulation—either upward or downward—is prohibited by federal securities law, such as Rule 10b-5.[83] The existing market abuse rules of securities laws should be sufficient, if strictly enforced. Further, the alternative uptick rule provides no protection against upward stock manipulation.

A potential advantage with a circuit breaker, also stated by the SEC, is that it gives market participants some time to reassess the circumstances and react to volatility.[84] But there is no evidence that this will actually occur, as the academic research on circuit breakers effectiveness is divergent.[85]

Apparently, the SEC wants to limit potentially manipulative or abusive short selling from further driving down the price.

In addition, the SEC has cited increasing investor confidence as an objective.[86] The overall argument seems to be that since the alternative uptick rule would allow long sellers to sell first, it would signal to the market that the security's price decline is due to long sellers and thus it would boost investors' confidence.[87] Indeed, investors' confidence in the financial market is crucial. However, the SEC fails to provide any evidence to support this notion. The goal to restore investors' confidence is speculative because there is no objective way to prove effectiveness. As the dissenters note, it might have the exact opposite effect, i.e. hampering investors confidence in the market.[88] Providing information to the market—not removing it—is more likely to boost investor confidence.

Relying on the alternative uptick rule to effectively curb abusive short selling and boost investor's confidence is a questionable strategy.

In short, it is doubtful whether the SEC's goals are achievable by regulating short selling. Many have requested reimplementation of a price restriction rule, but the broad evidence does not support regulatory action. Relying on the alternative uptick rule to effectively curb abusive short selling and boost investor's confidence is a questionable strategy.

The Costs

As summarized below, the alternative uptick rule is likely to impose substantial costs to the financial market.

First, to the extent the circuit breaker is triggered and prevents short selling for a certain time period, this will have a potentially negative impact on market quality. There is considerable risk that the alternative uptick rule will impede price discovery, reduce liquidity, and hedging activity. If investors find it more costly to hedge the risk, they might be forced to pull out of their long positions, which can frustrate capital formation. The SEC seems to downplay the negative impact with reference to the pilot study of the uptick rule.[89] The drawbacks may be smaller than an uptick rule because it restricts short selling only when a specific stock has experienced a certain decline, but the potential risks are nonetheless significant.

As outlined above, short sales that are used to facilitate market making and hedging activities do not anticipate price decline. Notably, the SEC has not provided any exemption for market makers.[90] At the very minimum, the SEC should have provided a market-maker exception and a more expansive hedging exception.

Another concern that has been raised is that it could create unintended consequences such as a "magnet effect."[91] A "magnet effect" can result in short sellers driving down the price of an equity security in a rush to sell when they realize that the trigger level is imminent, which would prevent trading.[92] However, academic research has not found any evidence of a magnet effect, and the SEC dismissed the concern.[93]

Besides the potential negative impact on the market, what seems clear is that the alternative uptick will be expensive to implement and monitor.[94] The trading centers, among other things, need to establish written policies and procedures and carry out ongoing monitoring.[95] The SEC estimates that the initial cost will be nearly $29 million, and $50.6 million every year thereafter, to comply with the regulation.[96]

Finally, the alternative uptick rule does not apply to derivative securities.[97] This could undermine some of the goals of the alternative uptick rule and create additional incentives to structure transactions by the use of derivatives.[98] As highlighted already, the short positions, before the financial crisis hit Wall Street and the rest of the world, were primarily taken on the bond market through the use of derivative products.

Misguided Rule

Indeed, the alternative uptick rule with a circuit break feature is a less radical restriction on short selling than an uptick rule since the application is contingent and limited to particular market conditions in specific stocks. However, just because the circuit breaker approach mitigates the negative effects does not make it more desirable. To adopt the alternative uptick rule, the benefits should justify the costs. For all the reasons outlined above, in this author's view, it is apparent that the alternative uptick rule is misguided and will likely do more harm than good.

Conclusion

Short sellers did not cause the demise of banks or the current financial crisis. As explained above, it appears that the stock prices of important financial institutions plummeted largely because of long sellers. More fundamentally, the financial panic was due to broader problems in the banking sector.

The SEC's main regulatory concern seems to be that speculators might use short selling to illegally manipulate stock downwards. But existing antifraud rules should be sufficient, provided they are strictly enforced.

Most importantly, the SEC must be aware of the new short game. Short positions can today be accomplished in many different forms, such as options, swaps, and other derivatives, which likely will undermine most attempts to regulate short selling on the equity market.

Furthermore, there is empirical evidence to support the conclusion that short selling is essential for efficient markets. Apart from price efficiency, short selling contributes positively to liquidity and facilitates buying by allowing investors going long to hedge their risk. Any regulation that limits short selling will reduce those benefits, and there is a considerable risk that market quality will deteriorate. The focus of the SEC should be on rulemaking that furthers efficient orderly markets and promotes capital formation. However, the alternative uptick rule runs to the contrary and may hinder investor's confidence.

The SEC's main regulatory concern seems to be that speculators might use short selling to illegally manipulate stock downwards. But existing antifraud rules should be sufficient, provided they are strictly enforced.

NOTES

1. The former uptick rule stipulated that traders only could short a stock if the price was above the last traded price of the security, or at the last traded price provided that the price was higher than the price in the previous trade.

See, Exchange Act Release No. 34-55245 (Feb. 5, 2007), 72 FR 6635 (Feb 12, 2007) [hereinafter 2007 Price Test Elimination Release].

2. *See, e.g.,* Statement of Richard S. Fuld, Jr before United States House of Representatives Committee on Oversight and Government Reform, Oct. 6, 2008 (the former Chairman and CEO of Lehman Brothers believed that short selling had contributed to the collapse of Lehman Brother and Bear Stearns. More specifically, he claimed that naked short selling followed by false rumors had contributed to the collapses of the firms). *Available at* http://online.wsj.com/public/resources/documents/fuldtestimony20081006.pdf.

3. The SEC issued several temporary emergency orders in the summer and fall of 2008. The most draconian was when SEC on September 18, 2008, following Lehman Brother's bankruptcy, banned short selling of shares in almost 1,000 financial issuers, including banks, insurance companies and securities firms. *See* Exchange Act Release No 34-58592 (Sept. 18, 2008), 73 FR 55169 (Sept. 24, 2008).

4. Exchange Act Release No. 34-61595 (Feb. 26, 2010), 75 FR at 11243 (March 10, 2010) (SEC states: "We are not aware…of any empirical studies that the elimination of short sale price test restriction contributed to the increase volatility in the U.S. market.") [hereinafter Alternative Uptick Rule Release].

5. *Id.* 75 FR at 11232–11325.

6. 17 CFR 242.200 (a).

7. Alternative Uptick Rule Release, *supra* note 4, 75 FR at 11235. For a more detailed explanation of short selling, see Tom Taulli, What Is Short Selling? 3–4 (McGraw Hill 2004) (explains a short selling transaction in six steps).

8. Traditionally there are two types of short selling: covered short selling and naked short selling. Naked short selling occurs when a trader short securities without borrowing, and without an intention to borrow, the security for delivery on the settlement date. Naked short selling has always been illegal in the US but many on Wall Street seem to agree that naked short selling happens nonetheless. The SEC has taken several actions against naked short selling as a response to the financial crisis. For example, on September 17, 2008, the SEC adopted temporary Rule 204T to curtail failures to deliver and to address potentially abusive naked short selling of securities. The SEC made the requirements of temporary Rule 204T, slightly modified, permanent with the adoption of Rule 204 on July 27, 2009, *see* Exchange Act Release No 34-60388 (July 27, 2009), 74 FR 38266 (July 31, 2009). Naked short selling has been a popular scapegoat for banks' demises but is outside the purview of this article.

9. *See, e.g.,* Manuel P. Asensio & Jack Barth, Sold Short, Uncovering Deception In The Markets 240 (John Wiley & Sons Inc 2001); Deutsche Bank Research, Steffen Kern, *Short Selling: Important Business In Need For Globally Consistent Rules*, 1–2, March 17, 2010, *available at* http://www.dbresearch.com/PROD/DBR_INTERNET_DE-PROD/PROD0000000000255171.pdf .

10. *Id.*

11. *Id.*

12. *Id.*

13. For legal definition of market makers, see 15 USC 78c(a)(38).

14. Alternative Uptick Rule Release, *supra* note 4, 75 FR at 11235.

15. *Id. See, e.g.,* David P. McCaffrey, *Review of The Policy Debate Over Short Sale Regulation During The Market Crisis*, 73 ALB L REV 483, 483 (2010).

16. *Id.*

17. The importance of hedge funds on the market became apparent when short selling was banned in the US on selected financial stock during 14 days the fall of 2008. A significant amount of studies concluded that the temporary ban in the U.S. had significant unintended consequences, including a steep rise in trading cost. This was because the trading volume plunged, not only in restricted stocks, but across the broader market. Hedge funds were forced to pull out of their long positions since they could not hedge with short positions in other stocks. Apparently, the SEC did not understand the connectivity of short sellers to the rest of the market because the ban was total at first and did not exempt short positions hedging against convertible bonds or convertible preferred stock. The ban effectively pushed the hedge funds in the red and shut down the convertible market. This demonstrates how important it is to provide for certain investment strategies so the hedging activity is not adversely affected and the market can continue to function optimally. *See,* Credit Suisse, *What Happened When Traders' Shorts Were Pulled Down* (2008), *available at* https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=11181&m=-1730413896 [hereinafter Credit Suisse, *Traders' Shorts*]; see James Mackintosh, *Short Shrift,* FIN. TIMES, Oct. 5, 2008.

18. McCaffrey, *supra* note 15.

19. *See, e.g.,* Statement of James Chanos, President, Kynikos Associates, SEC Roundtable on Hedge Funds (May 15, 2003), *available at* http://www.sec.gov/spotlight/hedgefunds/hedge-chanos.htm.

20. McCaffrey, *supra* note 15.

21. *Id.*

22. *Id. See also* Robert Sloan, Don't Blame The Shorts: Why Short Sellers Are Always Blamed For Market Crashes And How History Repeats Itself, at xii (stat-

ing that most short selling activity occur to offset risk of holding a convertible bond, of betting on the spread of a merger arbitrage, or of isolating the interest rate risk in index arbitrage) (McGraw Hill 2010); Credit Suisse, *Traders' Shorts, supra* note 17, at 5 (according to Credit Suisse less than one percent of hedge funds are dedicated to short only trade. Most hedge funds are using short selling as part of their investment strategy, i.e. to match short selling with a long position).

23. Alternative Uptick Rule Release, *supra* note 4, 75 at 11241.

24. Karl B. Diether, Kuan-Hui Lee & Ingrid M. Werner, Short-Sale Strategies and Return Predictability, 22 *Rev Fin Stud* 575, 581 (2009).

25. *See, e.g.,* Alternative Uptick Rule Release, *supra* note 4, 75 FR at 11235.

26. Technical Comm. of the Int'l Org. of Sec. Comm'ns, Regulation of Short Selling 21–22 (2009), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD292.pdf [hereinafter IOSCO Report].

27. *Id.*

28. *Id.*

29. *See, e.g.,* McCaffrey, *supra* note 15, at 191(noting that only a small number of studies suggest that short selling can destabilize prices and lead stock to be undervalued under certain circumstances).

30. *See, e.g.,* Alternative Uptick Rule Release, *supra* note 4, 75 FR at 11235; IOSCO Report, *supra* note 26, at 22.

31. *Id.*

32. Alternative Uptick Rule Release, *supra* note 4, 75 FR at 11235.

33. *Id.*

34. IOSCO Report, *supra* note 26, at 22.

35. *Id.*

36. *See* Mackintosh, *supra* note 15, at 8.

37. 15 USC 78j(a).

38. Exchange Act Release No. 1548 (Jan. 24, 1938), 3 FR 213 (Jan. 26, 1938).

39. *Id.*

40. Exchange Act Release No. 13091 (Dec. 21, 1976), 41 FR 56530 (Dec. 28, 1976).

41. Alternative Uptick Rule Release, *supra* note 4, at 11235.

42. Exchange Act Release No. 34-54891 (Dec. 7, 2006), 71 FR at 75071–75072 (Dec. 13, 2006) (discussing exceptions and relief granted by the SEC from the rule in recent years).

43. 2007 Price Test Elimination Release, *supra* note 1, 72 FR at 36348.

44. *Id.*

45. *See* Gregor Zuckerman, *Blame Game: The "Uptick" Rule Debate*: Wall St. J., April 1, 2008, at C1–C2

46. 2007 Price Test Elimination Release, *supra* note 35, 72 FR at 36348; Speech by SEC Chairman: Opening Statement on Eliminating the Short Sale 'Tick Test' (Dec. 4, 2006), *available at* http://www.sec.gov/news/speech/2006/spch120406ccc-10a.htm (In December 2006, the SEC issued a formal statement declaring that decimalization and changes in trading strategies over the years have undermined the effectiveness of the price tests).

47. Exchange Act Release No. 34-50103 (July 28, 2004), 69 FR 48008 (Aug 6, 2004).

48. *See* SEC Office of Econ. Analysis, *Economic Analysis of the Short Sale Price Restrictions Under The Regulation SHO Pilot*, Feb. 6, 2007, *available at* http://www.sec.gov/news/studies/2007/regshopilot020607.pdf; *See also* Exchange Act Release 34-54891 (Dec. 7, 2006), 71 FR at 75072–75075 (Dec. 13, 2006) (discussing the pilot result).

49. *Id.*

50. *Id.*

51. 2007 Price Test Elimination Release, *supra* note 1, 72 FR at 36352–36353.

52. Alternative Uptick Rule Release, *supra* note 4, 75 FR at 11241. However, it should be noted that there is criticism of the SEC's pilot program, see Ruth A. Hargens Horvatich, *The Long And Short Of It: The Securities and Exchange Commission Should Reinstate a Price Restriction Test To Regulate Short Selling,* 43 Creighton L. Rev. 593, 598–600 (2010).

53. 2007 Price Test Elimination Release, *supra* note 1, 72 FR 36348.

54. Lisa Sutton, *The Roots of The Credit Crunch of 2008,* 28 Rev. Banking & Fin. L. 3, 5–8 (2008).

55. *Id*

56. *Id.*

57. *Id.* The CDOs have been under SEC scrutiny and generated a great deal of attention in media due to the Goldman fraud case, which focused on broker disclosure. Goldman Sachs was one of the many firms at Wall Street that had created the CDOs. On April 16, 2010, the SEC filed a lawsuit against Goldman Sachs and its vice president for securities fraud. The suit charged that Goldman Sachs had failed to disclose material information about the CDOs (the so called Abacus investments), which the firm had sold to investors from 2005-2007. On July 15, 2010, Goldman Sachs agreed to pay $ 550 million to settle the case. Goldman Sachs acknowledged that the marketing material for the Abacus "contained incomplete information" and that it was "a mistake" not to have disclosed John Paulson's, a prominent hedge fund manager's, role. It was the first action SEC has taken against a Wall Street deal that helped investors make a fortune on the downturn in the housing market. *See* SEC complaint, *available at http://www.sec.gov/litigation/complaints/comp18116.htm; See* Consent of Defendant Goldman, Sachs & Co, *available at http://www.sec.gov/litigation/litreleases/2010/consent-pr2010-123.pdf*; Final Judgment as to Defendant Goldman, Sachs & Co, available at http://www.sec.gov/litigation/litreleases/2010/judgment-pr2010-123.pdf.

58. Sutton, *supra* note 54, at 5–8.

59. *Id.*

60. *Id. See also* Juscelino F. Colares, *Global Imbalances and Liquidity-Induced Bubbles; Reflection on The Great Recession and The Need For International Monetary Reform,* 60 Syracuse L Rev 603, 603–604 (2010).

61. For an entertaining account of short sellers who made a fortune by predicting the meltdown, *see* Michael Lewis, *The Big Short: Inside the Doomsday Machine* (W.W. Norton & Company, Inc 2010).

62. *Id.*

63. Colares, *supra* note 60, at 605.

64. Lewis, *supra* note 61.

65. *Id.*

66. Alternative Uptick Rule Release, *supra* note 4, 75 FR at 11235.

67. *Id.*

68. *See* Office of Economic Analysis: *Analysis of Short Selling Activity during the First Weeks of September 2008*, *available at* http://www.sec.gov/comments/s7-08-09/s70809-369.pdf.

69. *Id.*

70. Alternative Uptick Rule Release, *supra* note 4, 75 FR 11232.

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.* 75 FR at 11245.

75. Speech by SEC Chairman: *Statement at SEC Open Meeting – Short Sale Restrictions*, *available at*

http://www.sec.gov/news/speech/2010/spch022410mls-shortsales.htm.

76. *Id.*

77. Alternative Uptick Rule Release, *supra* note 4, 75 FR at 11243.

78. For a summary of the academic research s*ee, e.g.,* McCaffrey, *supra* note 15, at 516.

79. Alternative Uptick Rule Release, *supra* note 4, 75 at 11241.

80. *Id.* 75 FR at 11247.

81. The limited exceptions include seller's delay in delivery, certain odd-lot transactions, certain domestic and international arbitrage transactions, over-allotments and lay-off sales, riskless principal transactions, transactions on a "value-weighted average price" basis, see *id.* 75 FR at 11262–11275.

82. Troy A. Paredes Comm'r, U.S. Sec & Exch. Comm'n, *Statement at SEC Open Meeting: Adoption of Amendment to Regulation SHO (the "Alternative Uptick Rule")* (Feb 24, 2010), *available at* http://www.sec.gov/news/speech/2010/spch022410tap-shortsales.htm#P47_9332 [hereinafter Statement by Commissioner Paredes].

83. Rule 10b-5 under Securities Exchange Act of 1934 is a general antifraud provision, which broadly regulates manipulation and deception. Rule 10b-5 punishes fraud or misrepresentation in connection with purchase or sale of any security. 17 CFR 240.10b-5 (2009).

84. Alternative Uptick Rule Release, *supra* note 4, 75 FR 11234.

85. For a summary of empirical studies of mixed data, *see*, e.g., John W. Galbraith, *Circuit Breaker And The Tail Index of Equity Returns,* J. Fin. Econometrics, 109, 110-112. (2004) (stating that while "[t]here have been several previous empirical studies of the effects of circuit breakers . . . [t]hese results are mixed").

86. Alternative Uptick Rule Release, *supra* note 4, 75 FR 11233.

87. *Id.*

88. *See* Kathleen L. Casey, Comm'r, US Sec. & Exch. Comm'n Statement at SEC Open Meeting: Short Sales (Feb. 24. 2010), *available at* http://www.sec.gov/news/speech/2010/spch022410klc-shortsales.htm; Statement by Commissioner Paredes, *supra* note 82.

89. Alternative Uptick Rule Release, *supra* note 4, 75 FR at 11292–11293.

90. *Id.* 75 FR at 11262–11275.

91. *Id.* 75 FR at 11253.

92. *Id.*

93. *Id.* For a summary of academic studies see Credit Suisse, Ticking Off the Shorts 10 (2009), *available at https://tradeview.csfb.com/public/bulletin/ServeFile.aspx?FileID=12012&m=-409136585*.

94. Alternative Uptick Rule Release, *supra* note 4, at 11297–11302.

95. *Id.* 75 FR at 11297.

96. *Id.* 75 FR 11302.

97. *Id* .75 FR at 11246.

98. *Id.*

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The Enforceability of International Forum Selection Clauses

By Ryan S. Bewersdorf and Chao (Charley) Meng

Introduction

In today's proverbial global economy, it is quite probable that parties to a contract, for example for goods or services or for the sale of assets or shares, will be from different countries. Often in the sale of goods context, a company based in the United States transacts business with a foreign entity, or initially negotiates with another U.S. company, but the actual contract party turns out to be the company's foreign subsidiary. The forum selection clause is an often overlooked issue, but this material contractual term may have great importance when a dispute between contracting parties arises. The forum selection clause may be the first item litigated as it sets the stage for where the litigation will take place. This article addresses specifically the enforceability of international forum selection clauses.

In many cases, the parties' contract will set forth the exclusive forum to bring a lawsuit in the event a dispute arises. Frequently, the forum will not be in the United States, but in a foreign country. For example, if the buyer is a foreign subsidiary of a U.S. corporation, the forum selection clause may expressly state that all lawsuits must be brought in the foreign jurisdiction. The forum selection clause may also be less specific, but no less vague, such as describing the forum as the place of the "buyer's headquarters." Again, if the buyer is a foreign subsidiary, then the buyer's headquarters in the foreign country would be the appropriate forum. The forum selection clause should be read in conjunction with other defined terms in the contract.

This article sets forth the law, both Michigan state law and federal law, regarding international forum selection clauses. In short, international forum selection clauses are enforceable, and contracting parties must be prepared to be bound by any international forum selection clause in their contract, even if it requires that suit be brought or defended in a foreign country. If a company first files a lawsuit in the United States and the contract contains an international forum selection clause, the filing party should be prepared to respond to a motion to dismiss filed by the opposing party, seeking dismissal based on the agreement to litigate in another forum.

Essentials of Forum Selection Clauses

A forum selection clause is a contract clause that designates, by agreement, a specific forum for litigation. Generally, this is accomplished by providing a particular location and a particular court in that location. A typical forum selection clause may read:

> Venue for all disputes arising out of any Purchase Order between Buyer and Seller or in connection with any other contractual relationship of Buyer and Seller shall be the Courts competent at Buyer's respective headquarters.

In *M/S Bremen v Zapata Off-Shore Co,*[1] a seminal case that marks the beginning of the enforceability of international forum selection clauses, the United States Supreme Court held that a "forum [selection] clause should control absent a strong showing that it should be set aside."[2] The Supreme Court reasoned, "We cannot have trade and commerce in world markets and international waters exclusively on our terms, governed by our laws and resolved in our courts."[3]

In enforcing international forum selection clauses, courts usually will differentiate between permissive forum clauses and mandatory forum clauses.[4] A permissive forum clause merely confers jurisdiction in the specified forum and does not deny a party the right to litigate in another appropriate forum.[5] However, mandatory forum clauses, such as that in *Bremen*, specify where all of the disputes must be brought. In addition to the type of clause, courts may also look at contract terms designating which specific courts may hear a claim and the types of claims that may be heard.

Michigan State Law

Lawsuits regarding international forum selection clauses may be properly brought before state courts. In Michigan, circuit courts have jurisdiction to determine whether a forum selection clause is enforceable. MCL 600.605 provides the circuit courts with original jurisdiction over "all civil claims and remedies" except where some specific statutory or constitutional provision states otherwise. Furthermore, "a valid forum-selection clause does not divest the Michigan courts of personal jurisdiction over the parties."[6] In Michigan, forum selection clauses, including those specifying an international forum, are enforceable under MCL 600.745(3), unless one of the enumerated statutory exceptions apply. MCL 600.745(3), provides as follows:

> If the parties agreed in writing that an action or controversy shall be brought only in another state and it is brought in a court of this state, the court shall dismiss or stay the action, as appropriate, unless any of the following occur:
>
> (a) The court is required by statute to entertain the action.
>
> (b) The plaintiff cannot secure effective relief in the other state for reasons other than delay in bringing the action.
>
> (c) The other state would be a substantially less convenient place for the trial of the action than this state.
>
> (d) The agreement as to the place of the action is obtained by misrepresentation, duress, the abuse of economic power, or other unconscionable means.
>
> (e) It would for some other reason be unfair or unreasonable to enforce the agreement.

Under this statute, "state" is defined as "any foreign nation, and any state, district, commonwealth, territory, or insular possession of the United States."[7] Following this statute, Michigan courts have determined that "Michigan's public policy favors the enforcement of contractual forum-selection clauses and choice-of-law provisions."[8] Interestingly, although it would appear relatively easy for a party seeking to avoid a contractual forum-selection clause to qualify under subparagraph (c), Michigan courts have restricted its application in Michigan cases.[9] In *Hansen Family Trust v FGH Indus, LLC*, the court noted the mere fact that plaintiff had no presence in the jurisdiction designated by the forum selection clause did not make such jurisdiction "substantially less convenient" than Michigan, so as to avoid enforcement of the forum selection clause.[10] Inconvenience, insofar as it is within the contemplation of the parties at the time of contracting, does not render a forum selection clause unenforceable.[11] "Where the inconvenience of litigating in another forum is apparent at the time of contracting, that inconvenience is part of the bargain negotiated by the parties."[12] Thus, a party seeking to avoid a contractual forum-selection clause bears a heavy burden of showing that the clause should not be enforced; accordingly, the party seeking to avoid the forum-selection clause must prove that one of the statutory exceptions to enforceability applies under MCL 600.745(3).[13] Procedurally, a motion to dismiss a complaint on the basis of a valid forum selection clause is properly brought pursuant to MCR 2.116(C)(8), on the grounds that the complaint fails to state a claim on which relief can be granted.[14]

Federal Law

When contracting parties satisfy the requirements for federal jurisdiction, such as in the case of diversity jurisdiction, disputes regarding international forum selection clauses will most often be litigated in federal court. There, one party will probably move for dismissal pursuant to either or both of Fed R Civ P 12(b)(3) for "improper venue" and Fed R Civ P 12(b)(6) for "failure to state a claim upon which relief can be granted."[15] In deciding whether to grant the motion for dismissal, the court will need to determine whether the forum selection clause is enforceable.

The federal precedent regarding the enforceability of international forum selection clauses is well settled. A forum selection clause in an international agreement "should control absent a strong showing that it should be set aside."[16] "The correct approach [is] to enforce the forum clause specifically unless" plaintiff "[can] clearly show that enforcement would be unreasonable and unjust, or that the clause was invalid for such reasons as fraud or overreaching."[17] The presumptive validity of the forum selection clause may also be set aside if plaintiff can show "enforcement would contravene a strong public policy of the forum in which suit is brought."[18]

In *GE v G Siempelkamp GmbH & Co*,[19] the Sixth Circuit Court enforced a forum selection clause requiring resolution of disputes be brought in Germany. In that case, a German supplier of machinery was sued in the U.S. by the buyer. The parties' contract con-

The forum selection clause is an often overlooked issue, but this material contractual term may have great importance when a dispute between contracting parties arises.

tained a forum selection clause that stated: "Place of jurisdiction for all disputes arising in connection with the contract shall be at the principal place of business of the supplier."[20] Because the clause stated that "all" disputes "shall" be at the suppliers principal place of business, the Sixth Circuit held that German jurisdiction was exclusive and mandatory.[21]

Likewise, in *Interamerican Trade Corp v Companhia Fabricadora de Pecas*,[22] the Sixth Circuit enforced a forum selection clause requiring resolution of disputes be brought in Brazil and affirmed the trial court's decision to dismiss the plaintiff's complaint. In that case, a Brazilian automotive parts supplier was sued by a company that acted as the defendant's exclusive sales representative in the United States. The parties' contract contained a Brazilian forum selection clause.[23] Plaintiff brought suit in state court and the action was removed to federal court. The district court dismissed the plaintiff's complaint holding that because of the forum selection clause, the lawsuit could only be brought in Brazil.[24]

On appeal, the Sixth Circuit first discussed whether federal or state law applies regarding the enforceability of forum selection clauses where a federal court is sitting in diversity jurisdiction. The Sixth Circuit decided this issue relying on federal precedent that applies a similar test as, for example, the Michigan statute. However, the court left open the option for a federal court sitting in diversity to also apply state law. Ultimately, the Sixth Circuit affirmed the district court's decision.[25] In short, the precedent is clear that exclusive contractual international forum selection clauses will be enforced despite the uncertainty over whether federal courts rely on federal or state law.

Consistent with Sixth Circuit precedent, Michigan federal district courts have recently granted motions to dismiss based on international forum selection clauses. *Eberspaecher North America, Inc v CAMI Auto, Inc*, involved a dispute regarding an automotive parts supply contract where the plaintiff, seller, was based in the United States, and the defendant, buyer, was based in Canada.[26] The court granted the motion and dismissed the case.[27] In *Global Link, LLC v Karamtech Co, Ltd*,[28] another international forum selection case, the court granted the motion to dismiss the plaintiff's complaint where the parties' contractual forum selection clause required resolution of disputes be brought in Korea. Quoting the Tenth Circuit in another case, the *Global Link* court reasoned that there was "no particular reason, at least in the international context, why a forum-selection clause, among the multitude of provisions in a contract, should be singled out as a provision not to be interpreted in accordance with the law chosen by the contracting parties."[29]

Conclusion

The U.S. economy has seen a tremendous transformation in the last few decades, primarily in the form of globalization. Now, more than ever, there is a likelihood that parties to a contract will be from different countries. Often, these contracts involving international entities will contain a forum selection clause that designates a specific location, or court in the event that a dispute arises. A forum selection clause is likely enforceable absent a strong showing that it should be set aside. Given the track record of federal courts and Michigan state courts upholding international forum selection clauses, contracting parties must be ready to be bound by such clauses in their contracts. It is important that attorneys and their clients not overlook such forum selection clauses when entering into contracts because these clauses will have an impact once a dispute arises. When drafting such clauses, it is also important to take into account whether the intent is to draft a forum selection clause that is mandatory or merely permissive. For some companies, the costs of prosecuting or defending a case in an international location will have an impact on their litigation strategy.

NOTES

1. 407 US 1 (1972).
2. *Id.* at 15.
3. *Id.* at 9.
4. *See, e.g., Phillips v Audio Active Ltd*, 494 F3d 378, 386-87 (2d Cir 2007) (discussing forum selection clauses that determine whether parties are "required to bring any dispute to the designated forum or simply permitted to do so.").
5. *See Id.* at 386.
6. *Turcheck v Amerifund Fin, Inc*, 272 Mich App 341, 344, 725 NW2d 684 (2006).
7. MCL 600.745(1).
8. *Hansen Family Trust v FGH Indus, LLC*, 279 Mich App 468, 476, 760 NW2d 526 (2008).
9. *Id.*
10. *Id.* at 482.
11. *Id.*

12. *Id.*
13. *Turcheck*, 272 Mich App at 348.
14. *Hansen*, 760 NW2d at 477 n.6.
15. *See Shell v RW Sturge, Ltd*, 55 F3d 1227, 1229 (6th Cir 1995) (affirming 12(b)(3) dismissal of action based upon international forum selection clause).
16. *M/S Bremen v Zapata Off-Shore Co*, 407 US 1 (1972); *Interamerican Trade Corp v Companhia Fabricadora de Pecas*, 973 F2d 487, 489 (6th Cir 1995).
17. *Bremen*, 407 US at 15.
18. *Id.*
19. 29 F3d 1095 (6th Cir 1994).
20. *Id.* at 1097.
21. *Id.* at 1099.
22. 973 F2d 487 (6th Cir 1992).
23. *Id.* at 488.
24. *Id.*
25. *Id.* at 490.
26. No 09-12193, 2009 US Dist LEXIS 120839 (ED Mich Dec 29, 2009).
27. *Id.* at *3.
28. No 06-CV-14938, 2007 US Dist LEXIS 33570 (ED Mich May 8, 2007).
29. *Id.* citing *Yavuz v 61 MM, Ltd*, 465 F3d 418, 427-28 (10th Cir 2006).

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Case Digests

Employment—Venue under Michigan Civil Rights Act

Brightwell v Fifth Third Bank, No 138920, 138921, 2010 Mich LEXIS 1652 (July 30, 2010). Plaintiffs worked for the defendant at banking centers in Wayne County. In May 2007, defendant terminated their employment for alleged misconduct. One plaintiff learned of her dismissal through a telephone call from the defendant's office in Oakland County to her home in Wayne County, while the parties disputed where the other plaintiff received notice of his dismissal. Plaintiffs filed suits in Wayne County, alleging that the defendant terminated their employment in violation of the Michigan Civil Rights Act. The court of appeals concluded that venue was proper only in Oakland County, where defendant made the decisions to terminate plaintiffs' employment, and reversed the trial courts' orders denying defendant's motions to change venue to Oakland County.

Under MCL 37.2801(2), a violation of the Civil Rights Act occurs when the alleged discriminatory decision is made and the allegedly adverse employment actions are implemented. The discriminatory violation in a case alleging discharge from employment is the severance of the employment relationship. The decisions and actions constituting that violation are implemented, and therefore occur, when the employee is no longer entitled to enter the workplace and perform the responsibilities of employment. Venue does not depend solely on where the employer made its decision, and "it defies common sense to conclude that the county in which the employee actually worked for the employer would be an inconvenient forum for either party." In the cases involved in this appeal, each plaintiff's employment relationship with the defendant was based and severed in Wayne County. Thus, the defendant's alleged violations occurred in Wayne County, and the court remanded these cases to the Wayne Circuit Court for further proceedings on plaintiffs' claims.

Employee Right to Know Act—Exclusion of Grievance Records from Disclosure

Wright v Kellogg Co, No 290130, 2010 Mich App LEXIS 1138 (June 22, 2010). Plaintiff was an employee with defendant for 35 years before retiring in 2005. In November 2002, plaintiff received a disciplinary action that included a 34-day suspension. After the suspension, plaintiff filed a grievance concerning the disciplinary action. On March 21, 2007, plaintiff's then-attorney wrote a letter, requesting his employment file. Counsel for the employer responded in an e-mail dated March 28, 2007, stating that the employer previously sent the plaintiff's personnel record to another attorney and that a follow-up request asked for notes from grievance meetings or other notes that management kept. According to the employer's counsel, the Employee Right to Know Act does not require such notes to be included with the personnel record and, therefore, the employer did not release them. Plaintiff then filed an action claiming that the employer's refusal to release those notes with his personnel record was a violation of the act. The court of appeals disagreed, holding that notes from a grievance investigation of a disciplinary action are not part of the personnel record and fall within an exclusion from disclosure under MCL 423.501(2)(c)(vi).

Single Business Tax—Industrial Personal Property Classification

Walter Toebe Constr Co v Department of Treasury, No 291764, 2010 Mich App LEXIS 1455 (July 27, 2010). Petitioner is a Michigan corporation engaged in the construction business. The local tax assessor classified a portion of petitioner's property as commercial personal property for tax year 2006, which the parties agreed should have been classified as industrial personal property. In filing its 2006 single business tax return, petitioner claimed a tax credit of $17,810 for $118,731 it claimed to have paid on industrial personal property. The Department of Treasury sent a notice of adjustment, informing petitioner that it was disallowing the credit because petitioner had not attached any statement that the taxes had been levied and paid, or that the property was classified as industrial personal property. Petitioner responded that it had paid property taxes on the property at issue, and that the property fit the definition of industrial personal property found in the General Property Tax Act (GPTA). Because the property fit the definition in the GPTA, the referee recommended allowing the credit, despite the assessor's classification. The Department rejected the hearing referee's recommendation, arguing that the definition in the GPTA was inapplicable, and that the appropriate definition was that found in the Single Business Tax Act (SBTA). Regarding petitioner's argument that the SBTA definition had simply imported the GPTA definition, the Department noted that the SBTA definition requires the property to be "classified industrial personal property" under the GPTA. Because the property in question had never been classified industrial personal property, it did not meet the SBTA definition, and the petitioner was ineligible for the credit. The Department petitioned the Tax Tribunal for a redetermination of the decision. The Tax Tribunal agreed with the Department's argument and affirmed its decision.

The court of appeals affirmed. Because it is clear that the legislature's intent in the former Single Business Tax Act was to make the definition of industrial personal property dependent on the assessor's classification, and because the property at issue in this case was never classified as industrial personal property by the assessor, the Tax Tribunal properly disallowed the taxpayer's tax credit for the commercial personal property in question.

Use Tax—Exemption; Retroactive Amendment

GMC v Department of Treasury, No 291947, 2020 Mich App LEXIS 2050 (Oct 28, 2010). Although GMC alleged that the use of program vehicles by its employees was exempt from taxation because the vehicles were "purchased for resale, demonstration purposes" under MCL 205.94(1)(c), as interpreted by *Betten Auto Center, Inc v Dept of Treasury*, 272 Mich App 14, 723 NW2d 914 (2006), *aff'd in part and vacated in part*, 478 Mich 864, 731 NW2d 424 (2007), the court of appeals held that 2007 PA 103, which amended the Use Tax Act to obviate the earlier holding, was not improperly enacted "special" legislation and, if applied retroactively, did not violate GMC's constitutional right to due process. The court further rejected GMC's contention that its employees' use of program vehicles was exempt from taxation under the Use Tax Act, even as amended, as well as GMC's arguments that retroactive application of the 2007 amendment violated the takings clause or the state constitution's title-object clause.

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