



The Michigan Business Law

JOURNAL

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

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

Issue	Primary Theme/Committee	Article Deadline
Summer 2016	LLC & Partnership Committee	March 31, 2016
Fall 2016	Financial Institutions Committee	July 31, 2016
Spring 2017	Regulation of Securities Committee	November 30, 2016
Summer 2017	In-House Counsel Committee	March 31, 2017

ADVERTISING

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

MISSION STATEMENT

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

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

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From the Desk of the Chairperson

By Douglas L. Toering



The Business Law Section: Extend Our Reach—and Yours

Where did 2015 go? If I could answer that question...

By now, most of 2015 is in the rearview mirror. Thank you to our past chair, Jim Carey. It was my privilege to have worked with him (and learned from him), not only during his tenure as Chair of the Business Law Section, but also during his term as Treasurer. Jim is one of those rare attorneys who can navigate back and forth between his private law practice and academia. Perhaps it is because Jim is such an excellent teacher that he has been so patient with me as I learn from him. Thank you, Jim.

And thank you, also, to our Vice Chair, Judy Calton, and to our Treasurer, Mark Peters, for all their service to the section during the past year. It has been a pleasure working with them. I look forward to serving with them and with our new Secretary, Kevin Block, during the upcoming year. It will be my privilege and honor to work with them as I serve you, our members.

Space would fail me to thank our council members, committee and directorship chairs, section administrator, and other section members who are dedicated to excellence in the practice of business law, whether it be transactional matters or litigation. Specifically, please allow me to recognize Laurence S. Schultz of Driggers, Schultz & Herbst, PC in Troy. A former BLS chair, Larry was honored at the BLS annual meeting in September with the Steven H. Schulman Outstanding Business Lawyer Award. Congratulations, Larry! And thank you to previous BLS chairs, Eric Lark and Hugh Makens, who presented the award. One more thank you—this goes to everyone who helped make the annual meeting and the Business Law Institute a success.

With that, what might 2016 bring? Our theme for 2016 is *"Extending Our Reach—And Yours."* By that, I mean that as the BLS extends its reach, your practice can grow, too. How? Here are some ways:

1. Outreach to Newer Attorneys. New attorneys are the future of our section and, in many ways, our state as well. They want to make a difference. That's good. Let's show them how they can do so through the Business Law Section. If you have ideas, please contact Kevin Block, whose committee is spearheading this effort, or me.
2. Outreach to Other State Bar Sections: Joint Programming. No SBM section is an island. The practice of business law affects many other practice areas. Through cross-programming be-

tween the BLS and other state bar sections, we can learn from them and they can learn from us. Plans are already in the works for joint seminars with other sections.

3. Outreach to Others: Joint Programming Elsewhere. Whether it be the Michigan Association of Certified Public Accountants or the state of Michigan through the Department of Licensing and Regulatory Affairs, the section has worked with a variety of other groups. Let's continue that.
4. Outreach to Judiciary and Legislature. The BLS works with the state business court judges and the federal bankruptcy judges on local practice in those courts. (The BLS offers free section membership to those judges.) And when it comes to legislative changes that affect business in Michigan, the Business Law Section is there. Indeed, over the past few years, the BLS has been instrumental in advancing legislation in Michigan, such as the business court statute and amendments to the business corporation act, the limited liability company act, and the non-profit corporation act.
5. Outreach to Former BLS Chairpersons. What a wealth of wisdom and experience our former chairs possess. How can we tap into that?
6. Outreach to In-House Counsel. For years, the BLS has helped sponsor the Crain's General and In-House Counsel Summit. Any other ideas?
7. Outreach to You. How does this sound to you? Check out the new BLS website (<http://connect.michbar.org/businesslaw/home>). What committees interest you? How can you contribute to the professionalism of the practice of business law in Michigan? How can you help the BLS extend our reach while you extend yours?

Whatever the section does, of course, is built on the foundation of the excellent, hard work done by so many people—past chairs, past and present council members, past and present committee and directorship chairs, and the many other BLS members who have combined to make this section what it is today.

Will you roll up your sleeves with us? If so, the Business Law Section can extend its outreach while you extend yours. Help us make a difference.

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Postsecondary Distance Education and SARA

What is SARA and Why Does It Matter?

The State Authorization Reciprocity Agreement¹ (SARA) represents a voluntary approach to state oversight of distance education. The purpose is to facilitate access to distance education courses to students across state lines by easing the regulatory process on colleges and universities through uniform requirements while reducing the cost of regulation, therefore increasing institutional compliance. Prior to this, colleges and universities were required to seek out and comply with requirements state-by-state.

"The State of Michigan is pleased to join the SARA initiative as it will expand and enhance educational opportunities for our citizens," said Michigan Department of Licensing and Regulatory Affairs (LARA) Chief Deputy Director Shelly Edgerton. "It will enable all of our postsecondary institutions to focus on providing quality and affordable educational opportunities." Prior to joining M-SARA, LARA had received more than 1,100 inquiries from out-of-state institutions requesting approval or exemption to offer distance education to Michigan residents.

The National Council for State Authorization Reciprocity Agreements (NC-SARA) is the national organization responsible for coordinating the efforts of the four regional education compacts. Administration of SARA occurs via "the four regional education compacts (Midwestern Higher Education Compact, New England Board of Higher Education, Southern Regional Education Board, and the Western Interstate Commission for Higher Education), which are now accepting applications for participation from states in their regions."²

States that have obtained SARA membership (by joining their regional compact) allow approved postsecondary institutions to "apply for blanket approval to offer distance education to students in the other member states or continue to handle

state authorization on their own."³ Centralizing the authorization process allows an institution to obtain approval in their "home state," provided the home state is a SARA state, and then offer distance education in any other SARA member state.⁴

A survey conducted in early 2014 (through a partnership between the University Professional & Continuing Education Association; Cooperative for Education Technologies, a division of the Western Interstate Commission for Higher Education, and the Midwestern State Authorization Reciprocity Agreement) highlights the significance of SARA in promoting both the availability and accessibility of postsecondary education. The survey focused on the progress colleges had made in obtaining authorization in other states.⁵ This survey had been conducted biannually in 2011 and 2013. Of the survey respondents, 36 percent represented public, 4-year institutions; 30 percent represented private, nonprofit 4-years institutions; and, 25 percent represented community colleges. The remaining groups were combined into "other." The results of the survey revealed the following:

- 31 percent of responding colleges have yet to apply to a single state.
- Approximately 72 percent of respondents decided not to admit students in some states.
- Approximately 25 percent of institutions have applied and/or received approval from all states of interest, up from 5 percent in 2011 and 15 percent in 2013.
- Of the institutions that have not applied to one or more state, 55 percent indicate that it is due to the high cost and 50 percent are waiting to hear about the reciprocity agreement.
- About 40 percent of schools had to turn away students

last year due to authorization issues.

- Colleges that operate in multiple jurisdictions typically serve students in about 30 states.
- The average compliance costs were \$7,750 (median) and \$28,833 (mean).
- The range of compliance costs is vast—the minimum cost incurred was \$10 for a small community college and the maximum was \$400,000 for a large, public, 4-year institution.
- A total of 193 respondents provided the names of one or more states in which they will not serve students.
- Due to compliance hurdles, the states from which the greatest number of institutions will not accept students are Arkansas, Minnesota, Massachusetts, Alabama, and Maryland, all named by at least one-third of respondents.⁶

A system in which each state continues to maintain their own requirements and approval process for distance education impacts not only the institutions but the students as well. As noted in the above survey results, the differences in requirements, fees, and approval processes pose a significant obstacle to compliance and the availability of educational programs.

Michigan: The Tenth M-SARA State

The Higher Education Authorization and Distance Education Reciprocal Exchange Act (2015 PA 45) was signed by Gov. Snyder on June 8, 2015, and became effective June 9, 2015.⁷ Upon application, Michigan was approved as the 10th M-SARA state on August 30, 2015, joining the ranks of the following jurisdictions:

1. Indiana approved on February 2, 2014;
2. North Dakota approved on

- April 3, 2014;
3. Nebraska approved on August 9, 2014;
 4. Kansas approved on November 16, 2014;
 5. Missouri approved on November 16, 2014;
 6. Minnesota approved on January 26, 2015;
 7. Ohio approved on March 2, 2015;
 8. Iowa approved on June 1, 2015; and
 9. Illinois approved on July 31, 2015.

The Higher Education Authorization and Distance Education Reciprocal Exchange Act authorizes LARA to enter into reciprocal distance learning compacts; ensure that distance learning providers meet standards of practice; promulgate rules necessary to implement, administer, and enforce the act; set annual fees; protect student records; and, establish a student complaint system.⁸ In-state schools that choose to participate as part of a national reciprocity agreement are authorized to provide distance education in other member states. Out-of-state schools located in states that are not a member of a national reciprocity agreement may seek authorization under this act to provide distance education to Michigan residents. To be eligible to apply and participate, a school must be degree-granting and accredited. Michigan institutions offering distance education to residents of other states are no longer faced with the challenges of gaining approval or registering in those other SARA member states. A reduction in the number of independent approvals a Michigan institution must seek will have a positive impact on the amount of fees incurred and staff resources expended.

The Michigan Department of Licensing and Regulatory Affairs (LARA) has statutory powers, duties, functions, and responsibilities regarding the establishment and approval of non-public institutions incorporating private colleges and universities. Within LARA, the Corporations, Securities & Commercial

Licensing Bureau (CSCL) is responsible for administering the act, which includes responding to formal complaints against authorized public, independent nonprofit, and proprietary institutions of higher education providing distance education from Michigan, or out-of-state institutions of higher education providing distance education in Michigan, pursuant to 2015 PA 45. The Bureau also investigates complaints against any other licensed or authorized postsecondary school that it regulates.

NC-SARA has established a clear and simple institutional participation process. Once a jurisdiction has been approved as a SARA member, the identified portal agency then notifies institutions of the member status. In Michigan, both the in-state application and approval form for institutional participation in SARA and the out-of-state institution Distance Education Authorization forms are currently available online at the CSCL website. On submission, the in-state application must be accompanied by a \$2,000 application fee and a \$2,000 annual authorization fee. The out-of-state application fees are slightly higher with a \$5,000 application fee and a \$5,000 annual authorization fee.⁹ CSCL staff reviews the application and notifies NC-SARA when approved and provides the institution with the link to pay the filing fee to WICHE/NC-SARA. The fees are as follows:

- \$2,000/year for institutions with fewer than 2,500 full time enrolled (FTE) students
- \$4,000/year for institutions with fewer than 2,500–9,999 FTE students
- \$6,000/year for institutions with 10,000 or more FTE students¹⁰

After NC-SARA confirms payment, welcome materials are sent to the institution, and the institution is listed on the NC-SARA website. The institution is responsible for renewing annually to maintain their participation status.¹¹ Within days of receiving M-SARA approval, Michigan received its first in-state applications,

which were received and processed the same day.

Out-of-state schools that are not SARA members do not need to be sent to NC-SARA and are authorized by CSCL to provide distance education to Michigan residents.

If a student has a complaint regarding a participating institution, those complaints should be first routed through the institution's existing student grievance process. If a student is not satisfied at the conclusion of that process, they may then bring a complaint to the portal agency in the institution's home state; however, this does not preclude the student's state of residence from participating in the resolution process. The portal agency is ultimately responsible for conducting the investigation and resolution process.¹²

Important Reminders and Other News

- Following a Request for Proposal, the LARA, Corporations Division engaged the services of CW Professional Services LLC (Lochbridge) to implement the new Corporations Online Filing System. At this time the Division anticipates launching the new system in Spring 2016.
- The 2015 Annual Reports for nonprofit corporations were due to the Corporations Division by October 1, 2015.
- For assumed names that expire on December 31, 2015, a Certificate of Renewal of Assumed name must be received by the Corporations Division by December 31, 2015.
- For name registrations that expire on December 31, 2015, a Certificate of Renewal of Name Registration and Certificate of Good Standing from its jurisdiction of incorporation must be received by the Corporations Division by December 31, 2015.

NOTES

1. SARA was developed with input from a broad array of associations, state administrators, the U.S. Department of Education and institutional leaders from all areas of higher education. It became operational in January 2014.

2. SHEEO.org, Projects, <http://www.sheeo.org/projects/state-authorization-postsecondary-education> (last visited September 17, 2015).

3. Carl Straumsheim, *Sustaining SARA, Inside Higher Ed* (Dec 18, 2014), <https://www.insidehighered.com/news/2014/12/18/state-authorization-reciprocity-effort-passes-tipping-point-supporters-say>.

4. NC-SARA.org, Documents, SARA Policies and Standards, State Authorization Reciprocity Agreements Policies and Standards printable pdf file, <http://nc-sara.org/files/docs/SARA-FAQs.pdf>.

5. “The sample was created by combining membership and email lists from WCET and UPCEA institutions and removing duplicate responses, as well as using a list from the Higher Education Directory. Overall, 577 individuals started and 498 qualified. The qualifier question: Does your institution currently offer online or correspondence courses to students in other U.S. states? Of those responding institutions, 86% replied “Yes”, 13% replied “No”, and 1% did not respond. The number of qualified respondents was more that double the number from the 2011 survey.” WCET.EICHE.edu, *What are Institutions Doing (or Not Doing) About State Authorization?* (May 2014), <http://wcet.wiche.edu/wcet/docs/stateapproval/titutionsDoingAboutStateAuthorization2014.pdf>.

6. *Id.*

7. The Act would sunset and be repealed on September 30, 2017.

8. MCL 390.1693 (3)-(6).

9. MCL 390.1694 4(1)(d) and 4(3)(c).

10. NC-SARA.org, Documents, SARA Policies and Standards, State Authorization Reciprocity Agreements Policies and Standards printable pdf file, (July 10, 2015), <http://nc-sara.org/content/sara-policies-and-standards>.

11. MCL 390.1964 4(2) and 4(4).

12. *Id.*



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Tidbits and Food for Thought – New Filing Dates, Statutes of Limitations and Maybe a Second Bite at the Apple?

In early October, the Michigan Department of Treasury officials told lawmakers that refunds for taxes improperly collected on more than 76,000 accounts due to a “computer glitch” would take at least 12 more weeks to process, depending on other priorities.

In a recent notice, the Michigan Department of Treasury (“Department”) issued an important announcement. If a taxpayer had filed a written request with the Department that all copies of all letters and notices regarding a dispute be sent to the taxpayer’s representative, the Department must send a copy of all letters or notices sent to the taxpayer regarding that specific dispute. See MCL 205.8.

The Department did not always honor that request, resulting in the taxpayer thinking the representative had a time-sensitive correspondence when, in fact, the representative did not have the correspondence. The result is predictable—some deadlines to the Court of Claims or the Tax Tribunal for requesting an informal conference or appeal submission were missed.

The Department now takes the position that the time period to request an informal conference begins when the Department (or IRS) furnishes the taxpayer’s representative, by certified mail or personal service, a copy of the Bill for Taxes Due (Intent to Assess). The time period to file an appeal in the Court of Claims or the Tax Tribunal begins when the Department furnishes the taxpayer’s representative, by certified mail or personal service, a copy of the Final Bill for Taxes Due (Final Assessment).

If you have a client that you believe may have missed one of these deadlines, and the representative at the time did not receive notice as outlined above, such a taxpayer can have his or her appeal rights reinstated by requesting an informal conference and providing the Department with the taxpayer’s name, identification

number, and assessment number (if applicable).

Practitioner’s Note: It is still advisable to remind clients, in writing, to forward any and all notices that they may receive from the Department to their representative. When reviewing previous matters where an appeal may be appropriate, confirm with the representative whether they got the communication from the Department. A new appellate opportunity may present itself.

Michigan’s Offer in Compromise Program is up and running. Long-overdue taxpayers that settle tax debts with the IRS or otherwise have unpaid state tax liabilities may qualify for relief. The Department website¹ presents the program in a simple manner, including criteria, required forms, attachments, and a checklist. The three criteria for relief are:

1. Doubt as to liability;
2. Doubt as to collectability;
3. A Federal compromise has been given for the same tax year(s).

The program is available to individuals and businesses.

As referenced in an earlier column, the Surface Transportation and Veterans Care Choice Improvement Act of 2015² (the “Act”) contained important practical tax and informational reporting changes effective for tax years *starting after* December 31, 2015.

The highlights:

- Partnership tax returns will be due March 15 for calendar year partnerships;
- S corporations remain due March 15;
- C corporations will be due April 15;
- FBAR due dates change from June 30 to April 15.³

Another important change contained in the Act concerns statute of limitations (“SOL”). The SOL is generally three years from the due date or filing date, whichever is later. Two important exceptions are a finding of

civil fraud, and thus *no* SOL, or six years for a 25 percent or more omission of income.

The Act legislatively overrules the U.S. Supreme Court decision in *United States v Home Concrete & Supply, LLC*,⁴ wherein the Supreme Court ruled that overstating basis (a common tax shelter ploy) was not the same as omitting income. The Act provides for a six year SOL for tax returns filed after July 31, 2015 and previously filed tax returns with open SOL.⁵ It is also important to note that unfiled tax returns have no SOL.

Check the signature line before filing your tax return. The US Tax Court in *Reifler v Commissioner*⁶ recently held that a timely filed joint tax return inadvertently not signed by a taxpayer wife was not a valid tax return and imposed the failure-to-file penalty. The court specifically rejected the tacit consent and substantial compliance arguments of the petitioners.

The IRS has started sharing individual financial account information with certain foreign countries. The automatic digital sharing was developed under the Foreign Account Tax Compliance Act or FATCA. Since other countries are sharing information with the United States, turnabout is fair play. The agreements to share data is authorized under bilateral agreements.

NOTES

1. <http://michigan.gov/taxes/0,4676,7-238-68920---,00.html>

2. Pub L No. 114-41, 129 Stat 443.

3. Id. at 2006.

4. 200 US 321 (2012).

5. IRC 6501(e)(1)(B).

6. TC Memo 2015-199.



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The Internet of Things

A popular buzz phrase in the business and technology world is “The Internet of Things,” generally known as IoT. Is this phrase really just a tech fad or is it something that business lawyers should care about because of its effect on us or our clients? While the impact will certainly not be universal, the term IoT will be fairly widespread and is worth taking some time to understand.

What is IoT?

Let’s start with my working definition of IoT:

The internet of things can be described as a system where physical objects are interconnected or connected to communications systems or the Internet to collect and share information. These devices may be able to take actions independently or with an interface with external sources. The vision of IoT is that interconnected objects, often with actuators or sensors, will have the ability to communicate information about the local environment, which information will improve business operations and the lives of users.

A couple of key concepts of IoT are the use of sensors and interconnected systems.

Sensor technology, you will correctly note, has been used in business for decades. What is different now? There are a few technological advances that have really changed the business model and driven the development of IoT. The dramatic improvements in battery, wireless, and communication technologies, not just the Internet, have enabled physically independent but virtually interconnected systems to monitor and report information to the business user. The key benefits businesses will see are the ability to obtain real-time information from disparate locations and the ability to exchange such information, as well as the potential to enable

autonomous actions for rapid decision making.

What are IoT Trends?

IoT may be better understood in the context of some specific applications. Many of us are familiar with radio frequency identification chip (RFID) technology, which has been used in logistics, inventory control, and reporting for years. RFID technology, however, is a passive technology, requiring the user to activate a scanner near an RFID chip to access the information stored on the chip. In other words, it is a “pull” technology that allows the user to go get the necessary information.

The big difference with IoT is an ability of these sensors and devices to “push” information to a user or other interconnected devices. A good example is in the consumer context involving electronics and appliances in our homes. IoT-enabled devices can include kitchen appliances, televisions, electronics, HVAC equipment, and communication devices. In the future, everyone may have a refrigerator that displays a panel allowing the user to control televisions, keep track of shopping lists and recipes, connect to the Internet, and make and answer telephone calls with an interconnected mobile phone or other device. This connectivity brings all of these devices together into a single system that the owner of the house can use.

On a much more advanced scale, the automobile industry is looking at IoT and the entire issue of connectivity for a variety of purposes. A number of current technologies are being deployed on automobiles that will dramatically improve the safety of the vehicles. These technologies include lane departure warnings, an automatic braking system, and other alerts that warn drivers. These current technologies are self-contained; the vehicle possesses systems that can search out information from the environment through the use of cameras

and other devices and then report information back to the driver.

The next generation will likely involve connectivity among vehicles and other networks. For example, if vehicles can communicate with each other and understand locations of other vehicles, the autonomous systems in those vehicles can identify a collision that is about to happen and warn the drivers in time to avoid the collision. The system may also automatically engage braking systems independent of the actions of the drivers so that each of the vehicles may begin to slow down or stop to avoid accidents. In addition to point-to-point connectivity, vehicles may also communicate with other systems, such as one that monitors public safety and traffic control. These systems are of critical importance to the development of autonomous vehicle technologies. The car of the future that drives itself may not be that far off if the onboard and infrastructure technologies are deployed.

The value proposition goes beyond consumer convenience and vehicle safety. Interconnected systems that automate functions or even decision making may provide much greater potential for business. For example, a system may monitor multiple activities on an assembly line and among robotic devices to identify and avoid problems before they become serious. One of the “low hanging fruit” areas identified as a prime area for IoT involves energy efficiency.

What are the Legal Issues?

Developing technologies have raised a number of issues that impact consumers, businesses, and governmental players. These issues primarily involve privacy and security. Effective deployment of IoT requires a substantial amount of effort to collect the useful data. The warning from your refrigerator that the temperature has risen above normal parameters resulting in a text to your cell phone is only possible if the information about the

appliance and owner can be collected and available for dissemination. Current expectations are that everything from your food preferences, television viewing, driving habits, etc. can be collected from these interconnected devices. The questions being asked, therefore, involve the extent to which data can be collected, how that data will be used, who may use it, and what consent is required. Also, many people are concerned about the tracking of their automobile usage and the collection of data involving driving habits and destinations. Who will be authorized to collect that data, how will the data be stored, and who may use it are all serious questions that need to be answered.

A second and closely related area involves security. If your information is being collected, stored, and transmitted among appliances, vehicles, or systems that may exist in the cloud, how secure will that information be? Will it be difficult (preferably impossible) for a perpetrator to hack into that system and steal or manipulate the data? In two recent events, hackers have proven that they were able to hack into moving vehicles through cellular telephones of drivers and take control of the vehicles' systems. In one case, the hacker was able to turn off the engine and in another to break and stop the vehicle. Significant safety issues as well as protection of personal information are of utmost concern.

Regulatory and legislative actions have been fairly minimal to date. Legislation exists that states information stored on a vehicle belongs to the owner of that vehicle and cannot be accessed without permission or a court order. That will not necessarily help an owner if an external party can hack into their vehicle systems. To address this, Congress has recently introduced the Security and Privacy in Your (SPY) Car Act,¹ which directs the Federal Trade Commission and the National Highway Traffic Safety Administration to study the issue and establish standards for the security of onboard systems.

The Federal Trade Commission has also issued guidance for IoT, predicting that there will be nearly 50 billion interconnected devices by the year 2020.

Why Should I Care?

Based on the sheer number of expected devices that will interconnect in our world, the impact on our clients, our practices, and our personal lives could be substantial. From the client's standpoint, companies certainly need to consider how to protect their information. The privacy and security concerns also extend to employees, customers, and business partners. Many businesses will seek to participate in IoT by deploying devices to capitalize on IoT technologies. The best advice we can give those companies or any inventor or entrepreneur considering participating in this space is that the security and privacy concerns will continue to grow. Building security protocols into devices upfront and establishing mechanisms by which privacy can be protected (or consent obtained) will address issues before they become a problem. This is certainly another example of "living in interesting times."



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NOTES

1. S.1806 — 114th Congress (2015-2016).

The Jump From Law School to In-House Counsel

In law school, you learn how to think like a lawyer. You do not, however, learn how to actually *be* a lawyer. Rather, learning how to be a lawyer comes with experience, usually by way of your first job out of law school.

The transition from law school to the practice of law is challenging. Regardless of the setting—whether it is in a firm, government position, in-house, or otherwise, new lawyers must learn how to be a lawyer and to do so within their new environments.

As a young attorney who went in-house immediately following the bar exam, I have noticed my experiences in learning how to be a lawyer differ from those of my peers who started out in other positions, primarily as new associates in firms. Here are some of my key observations about beginning a legal career in-house, made as I head into my third year of practice.

It's All About the Business

To effectively provide legal advice, I live and breathe the business. As my job is to help advance business objectives while minimizing legal risk, I spend a lot of time learning and understanding the business and how my company operates. Understanding the ins and outs of the business helps me apply the law to relevant facts to competently advise my clients.

Client Interaction Is Critical

New attorneys starting out in firms may not have their own clients for a few years and will likely have little client interaction early in their careers. Contrast that to my experience beginning as an in-house attorney, where I was given responsibility for supporting different client groups during my first year on the job. Not only do I have my own clients, but I am also integrated into their work groups to provide ongoing legal support. My clients, who include business personnel in various departments, and I work as a team to deliver results for one overall client—the company for

which we work. Strong relationships are critical so that together we can focus to drive success for our business and do so in a legally compliant, ethical, and efficient manner.

Communication and Prioritization Help Balance a Heavy Workload

Unlike at a firm, where a new associate may have to actively seek out work from other attorneys, there is no shortage of work in-house. My workload is always heavy, with a wide variety of requests for legal advice, legal approval, and legal work from my several clients. As my to-do list can be daunting, I prioritize (and reprioritize) often. When doing so, I make sure to communicate frequently with my clients to understand their needs, as it is their work that drives the business. Keeping open lines of communication with my clients helps manage their expectations as well as my own.

In-House Attorneys Add Perspective

I am often included on cross-functional projects that involve several different business departments. As a result, I have line of sight to various business processes and can leverage that broad understanding to add value. Being able to provide enterprise-level knowledge of the business together with legal advice can help bring various stakeholders to consensus and advance business objectives.

Having Independence Also Means Taking Responsibility

Though it may vary in different in-house settings, the level of independence and decision making I have as a young in-house attorney is likely much greater than that of my peers at a firm, and it is both a privilege and a source of stress. The frequent and varied legal guidance I provide to my clients is vital to their decision making and ranges from answers to one-issue questions to advice on complex

strategies and processes. The legal office plays an integral role in the collaborative environment within which multidisciplinary teams often work, and, as the attorney for my clients, it is my job to provide competent legal advice and direction within the larger group. While I regularly seek counsel from more seasoned attorneys, I am ultimately responsible for providing legal guidance in a way that supports and furthers the success of our company.

Beginning a legal career is tough. No matter the chosen career path, new lawyers must learn to apply the knowledge and tools developed in law school in a way that works for them. Starting out in-house makes for a unique experience, as new in-house attorneys must learn how to be lawyers as well as members of a broader corporate team.

As part of the learning experience, new lawyers should also make the most of available resources and opportunities for development within the legal community. I certainly value the opportunities that the In-House Counsel Committee provides for me to learn from others and to share my journey so it may benefit others.



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Why Would I Want to Go to Mars? UCC Filings and the Model Administrative Rules

By Darrell W. Pierce

Like the Red Planet, Uniform Commercial Code (“UCC”) filing office operations are an important part of our universe but not something we need to visit or think about very often. UCC financing statements are, after all, relatively simple forms that contain basic identifying information and are indexed in a very simple system—essentially alphabetical order by debtor name. If one understands the Article 9 rules regarding debtor names and collateral descriptions, and is capable of avoiding typographical errors, the system works well and is relatively easy to use. But when things do not go according to plan or the facts are inconsistent with customary expectations, one may find devils (or angels) in the details of filing office operations. Information regarding those details are often found in the filing office’s administrative rules which, as discussed below, are to be adopted after the filing office “consults” with the Model Administrative Rules (the “MARs”) promulgated by the International Association of Commercial Administrators (“IACA”), a trade association (if you will) of filing officers primarily from the United States and Canada.¹ While each filing office has unique features in its own rules, 38 state UCC filing offices, including the Secretary of State of Michigan, have adopted rules that are based on MARs. Four state UCC filing offices (Kansas, Maryland, Nevada, and West Virginia) and the District of Columbia have adopted rules with elements of MARs but with some significant changes, four state UCC filing offices (Alaska, Hawaii, Montana, and Virginia) have adopted rules that do not appear to be substantially based on MARs, and four states (Arizona, Florida, Pennsylvania, and South Carolina) do not have administrative rules.²

The UCC Filing System

Seasoned commercial lawyers understand the importance of UCC financing statements. They provide a ready means for a secured party to cause its security interest to be

enforceable against, and to establish its priority with respect to, other creditors. With limited exceptions (e.g., timber to be cut, as-extracted collateral, and deposit accounts³), the secured party is able to accomplish these objectives by filing a single financing statement in the central state filing office in the state where the debtor is “located” under Article 9.⁴ Filed financing statements are a matter of public record, so potential creditors are able to search, by debtor name, to determine what, if any, security interests may be ahead of them before they extend credit. Indeed, the primary rule of priority under Article 9, “first to file or perfect,”⁵ was specifically designed to permit potential secured parties to establish their priority by filing, and confirm it by searching, all prior to closing and advancing funds.

The filing system has been described as the heart of Article 9⁶ and rightfully so. It is a system that provides notice of the existence of a secured party, an address to which notices or inquiries to the secured party may be sent, and an indication of the collateral potentially claimed by the secured party with respect to the named debtor. For the most part, the system works well. Collateral is readily described by “type” using terms defined in the UCC (like inventory, accounts, and general intangibles)⁷ and for financing statements in appropriate cases, a simple description of “all assets” or “all personal property” now owned or hereafter acquired is sufficient.⁸ But there have been some issues with debtor names.

Article 9 provides that a financing statement is not legally sufficient if it does not provide the precise debtor name or if the name provided does not appear in a search conducted under the actual debtor name using the relevant filing office’s “standard search logic, if any.”⁹ A filing office’s search logic is found in its administrative rules, not in Article 9 itself. Model standard search logic is found in the MARs, and it is intentionally “strict,” putting the burden on the filer

The filing system has been described as the heart of Article 9 and rightfully so.

to get the debtor name right in order to minimize transaction costs by minimizing search “hits” that require additional diligence by the searcher. Some cases challenged Article 9’s strict debtor name requirements,¹⁰ but most of the early debtor name cases under the 2001 version of Article 9 involved individual debtor names, primarily nicknames.¹¹ This issue was addressed in the 2010 amendments to Article 9¹² by either requiring the use of the individual debtor’s name as it appears on their driver’s license (or other state-approved identification) or permitting the use of that name (but still allowing for the “individual name” of the debtor to be used, which may not be identical to the driver’s license name).¹³ For organization names, Article 9 has been clear in requiring the filer to use the precise name of the organization as found in its organic records, and, for “registered organizations” (which include corporations and limited liability companies), the “public organic record” is used, so filers and searchers will be able to file and search under the same publically available name.¹⁴ There have been transaction-specific issues that get litigated, but for those who can properly ascertain the objectively verifiable debtor name, describe collateral, and fill out the UCC1 form in accordance with its instructions, the system is working pretty well.

So why would one want to take a deep dive into the minutiae of filing operations and examine a filing office’s administrative rules? What is in there, and how would that be of interest to a practicing attorney? The answer is based on the unfortunate but unavoidable fact that sometimes things do not work out as planned—mistakes get made, even by competent attorneys and filing officers, and there are cases (though relatively rare) of races to the filing office and fraudulent (unauthorized) filings. One might also have to render a legal opinion to the effect that the filing office will accept a particular proposed UCC filing in advance of tendering the filing to the filing office. With respect to mistakes and opinions, the rules can help determine (1) whether or not the filing office will accept a filing (even if a mistake were made), (2) whether or not a debtor name error is “fatal” to the filing, and (3) whether or not the filing office improperly refused or improperly indexed a filing. If one is in a race to the filing office, it can be determined from the rules the best means to communicate with the filing office so that the filing can be made as soon as possible. And if

you have a client who is victim of a fraudulent filing, the rules will tell you whether or not the filing office has a procedure (judicial or non-judicial) to handle the situation. After reviewing the contents of the MARs and noting some recent changes, this article will address ten specific situations where a consultation of filing office rules should prove useful.

Contents of MARs

IACA just adopted a revised version of the MARs at their 2015 annual conference in May. Michigan has not yet revised its own rules, adopted in 2002, which reflect an earlier version of the MARs.¹⁵ Like other administrative rules, one purpose of the MARs is to supplement the UCC to fill gaps in the statute. For example, the MARs provide a rule for calculating lapse dates (fifth anniversary of filing date) for filings made on February 29 during leap years (March 1 becomes the lapse date).¹⁶ The MARs also provides a definition of “address,” which has to be provided for the debtor and secured party for a financing statement to be acceptable for filing.¹⁷ The definition has proved to be somewhat controversial. Because the address is not required for legal sufficiency, most filing offices have adopted a rule that has minimal requirements, i.e. the address must include only a city and a state or foreign country. Other filing offices took the position that the addresses provided should meet postal requirements (street address or PO box, city, state, and zip code, or an indication that the address is foreign).¹⁸ Michigan’s response, interestingly, was to not include a definition of address in its rules.

The MARs also address some important technical issues for the filing office. For example, the filing office treats every secured party ever named on a financing statement as a secured party of record, even though they may no longer be or never were a secured party or a secured party of record, because the filing office cannot know for a fact whether a particular UCC financing statement amendment was actually authorized by the party named as having authorized it.¹⁹ More important, the MARs articulate the design of the filing office’s information management system and the mission-critical rules of the filing office’s data entry procedures.²⁰ The fundamental rule in this regard is that information provided by a filer is entered exactly as it is received. It is not the job of the filing

office to attempt to discern errors or correct them.²¹

An interesting issue addressed in the new MARs is the recognition that filing offices do not know when to remove a filing against a transmitting utility from the searchable index. Filings against debtors other than transmitting utilities all have lapse dates, when they cease to be legally effective if not continued. In the absence of timely action by a person purporting to be a secured party of record, the filing lapses, ceases to be effective, and is removed from the searchable index at a time selected by the filing office but no earlier than a year after lapse.²² Filings that are identified as having a transmitting utility debtor, however, do not lapse and may be removed from the searchable index only a year after all secured parties of record have filed termination statements.²³ The problem is that the filing office does not know with certainty if a termination statement is in fact being filed by the proper party, so the filing officers are reluctant to remove what might be a legally effective filing from the searchable index. The MARs still state the rule that a transmitting utility financing statement may be removed from the searchable index a year after it is terminated by all secured parties of record, but the comments state that most filing officers opt to leave these filings in place, unless a special request for removal is made and the filing officer is convinced it is legitimate.

The MARs also provide a place for the filing office to provide information about itself and its services to filers, searchers, and service companies. Some versions of the MARs indicate the filing office's location, address, electronic address, and hours of operation, though the current version assumes this information is otherwise readily available to filers and searchers. The MARs identify which forms the filing office will accept and set forth filing fees (or where to find them, as some filing offices want to be able to adjust fees without amending formal rules) and the means of acceptable payment.²⁴ The MARs allow filing offices to explain any expedited services they might offer and the fees for such services, and they provide a place for one to find out about the filing offices archive procedures if one needs to find information regarding old UCC filings that have lapsed and are no longer indexed in the filing offices primary searchable index.²⁵

The MARs also identify the means of communication that the filing office permits for filing, search requests, and the time of filing a filer can expect by using a particular means of communication. This kind of information can be important if one is in a race to the filing office and needs to file quickly, with the proper fee so as to avoid rejection.

The issue of means of communication and time of filing was one of the most controversial issues for the filing officers to address. Some felt that a filer who paid extra money to send a courier to file in person or to submit a filing by overnight courier should have priority. Others felt strongly that filings submitted by mail should not be penalized because it takes time to get through the weekend's mail. Even with the advent of electronic filing, most filing offices take two or three business days to clear the weekend mail delivery. So, should a financing statement submitted by courier in person on Tuesday afternoon have priority over a financing statement that arrived in the U.S. mail the previous Saturday? Michigan and the new MARs adopt a hybrid approach, with in-person filings getting the time of delivery (if ultimately accepted for filing), and mail and courier filings getting the earlier of the time the filing is "received" (i.e., time-stamped) or the close of business next following delivery to the filing office.²⁶ Interestingly, Michigan gives electronic filings a file time that is the time Michigan's system accepts the filing, while the MARs rule preserves the "time first examined or next close of business" rule even for electronic filings.²⁷ This is because filing offices want (or need) to review electronic filings to assure they are not "bogus" filings filed for inappropriate reasons (see the discussion below).

The new MARs reinforce the statutory rule that the filing office is required to accept a UCC filing unless there is a statutory reason to reject the filing by not listing grounds for refusal and simply referring to the relevant statute.²⁸ The MARs rule does have a blank for the filing office to add any other grounds for refusal set forth in non-uniform amendments to Article 9 that are found in a number of states, including Michigan, to address bogus filings. Bogus filings fall mainly into two types of filing. One type is a "harassment" filing made against someone the filer does not like (such as a government official, judge, arresting officer, banker, etc.) and where the filer is not a legitimate secured party. The

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second type is a “redemptionist” or “straw-man” filing where the filer files (more or less) against himself in connection with some meritless scheme under which they believe they can obtain debt relief or draw funds on the government. Silly as they may appear on their face, the redemptionist filings are troubling because many redemptionist filers will use the filing as a basis for further criminal activity.²⁹ Michigan has a number of non-uniform provisions in its version of Article 9 to address bogus filings, including a provision that requires the filing office to notify each individual debtor against whom a financing statement is filed, an expedited judicial action to order the removal of bogus filings from the filing office, an affidavit-based procedure for debtors to challenge bogus filings, and non-uniform grounds for rejection based on filing office determination that a proposed filing is bogus.³⁰ Interestingly, none of these statutory rules have been added to the “sole grounds” for rejection found in Michigan’s existing rules—undoubtedly because the statutory changes came after the current rules were adopted in 2002. It is hoped that with the new MARs, Michigan will update its own rules.³¹

If a filing is refused, the MARs provide details as to the process the filing office must undertake to notify the filer of the refusal as required by statute.³² The MARs generally provide that the means of communication should be the same as that used by the filer; that is, an in-person filing should be accepted or rejected on the spot, electronic communications should be responded to electronically, and mailings would be responded to by mail, etc.³³ The MARs also address the procedure to be followed if a filer wants to challenge a rejection by the filing office, and they make it clear that if a rejected filing is ultimately accepted, it gets its initial filing date as if it had been accepted in the first place, as it was deemed filed under the statute when it was improperly rejected.³⁴

The most important information found in a filing office’s rules is its “standard search logic, if any” that drives the test for adequacy of a debtor name and the legal effectiveness of a financing statement. There are two ways a filer can satisfy Article 9’s debtor name requirement. The first is to provide the debtor name precisely as it is, as set forth in an individual debtor’s driver’s license, on a registered organization’s public organic record, or another organization’s organic documents.³⁵

If the first test is failed because the designated name is not precisely provided, Article 9 provides an important, and importantly limited, fallback—if a search, using the correct debtor name and the filing office’s “standard search logic, if any” nevertheless finds the relevant financing statement, the imprecisely provided name is nevertheless sufficient.³⁶ This rule is very important to searchers, who now are assured that if they conduct a standard search logic search under the correct debtor name, they will find every potentially legally effective financing statement, and those financing statements that are not found by such a search cannot be effective. Article 9 does not specify what “standard search logic” is or should be. The issue is left to the filing offices and their respective rules. However, the basic contours of standard search logic as set forth in MARs were well-known to the drafting committees responsible for the 2001 version of Article 9 and its 2010 amendments.

So, how much “wobble room” does standard search logic afford a filer? The answer is “not much” as the standard search logic is intentionally “strict” to limit “hits” to help reduce transaction costs. It imposes a cost on filers to be accurate, but it saves searchers the cost of confirming filings that do not in fact relate to the debtor in question.³⁷ Under the MARs, search logic for individual names is (1) a case is disregarded (usually by converting all letters to upper case), (2) exact match for surname, and (3) for first and middle names, it is exact match, plus initials are treated as the logical equivalent of names that begin with that initial (so searching “J” gets “John” and every other name that begins with “J” and searching “John” gets “John” and “J”).³⁸ For organization names, (1) the character “&” is deleted each time it appears (if any) and replaced with “and;” (2) all characters other than numerals and English letters (of both cases) are “disregarded” (usually by being stripped from the name); (3) a table of “ending noise words” that usually indicate the nature of the organization like “Inc.” and “PLLC” are disregarded (programming creates differences here: some filing offices strip only the last ending noise word, others keep stripping them until there is no ending noise word at the end of the name anymore); (4) if the word “the” appears at the beginning of the name, it is disregarded; (5) all spaces are disregarded; (6) case is disregarded; and (7) after these procedures are applied to the name in question and to the names in the

searchable database, the search “finds” only exact matches.³⁹ As one can see, the search logic is indeed strict, and a filer must be very careful to avoid typographical errors when submitting debtor names.

Even though Michigan’s standard search logic is from an older version of the MARs, it is almost identical in its outcomes to the current MARs version. This is not surprising because it is important for filing offices to maintain a stable search logic. The search logic can change legal outcomes, with unpredictable results. Would an expanded search logic cause a previously ineffective financings statement to become effective, or would a contraction in search logic cause a previously effective financing statement to become ineffective? The answers are not known, and an analysis is beyond the scope of this article, but suffice it to say that the filing officers are aware of the potential issues and are accordingly and appropriately reluctant to change search logic outcomes. The Michigan rule lays out the search logic using different language, but the only difference between the Michigan rules and the MARs is that Michigan does not convert “&” to “and” — it treats the “&” as a character that is not disregarded as punctuation.⁴⁰ This is not an important difference. It is more important that Michigan maintain the consistency of its search outcomes.

There is a problem with strict search logic in finding other liens (like federal tax liens) that might also be filed in the UCC filing office. Other lien holders, like the IRS, do not have to adhere to Article 9’s strict debtor name standards, so some filing offices offer alternative search logics (like keyword searches), and there is a placeholder in the MARs for those alternative search options to be revealed.⁴¹ Note that the alternative search logics are not used under the UCC 9-506 test for debtor name sufficiency.

One of the more controversial reasons for rejection is the failure to communicate information to the filing office using characters the filing office’s system can store and read. The requirement for “legible” communication is not itself controversial, and it is understood that, as a practical matter, computerized information systems handle certain character sets and not others. For the most part, the filing office in the United States can index and store only those characters found on the American standard keyboard. They cannot handle accented characters and char-

acters that do not appear in American English. But there are business organizations with odd characters in their names, individuals with names that reflect their heritage (and some issuers of driver’s licenses that accept characters that the UCC filing office does not accept), and foreign debtors with collateral in UCC jurisdictions. How does one submit their names to the UCC filing office? The MARs reflect two alternatives.⁴² The first reflects the practice of most filing offices today, including the District of Columbia that is likely to be handling foreign debtor names, and it requires a filer or searcher to re-submit the debtor name using characters the filing office can handle. This prevents the filer from submitting the debtor name as it actually is, so the filer cannot meet the UCC 9-503 test, which requires the filer to get the debtor’s name correct. It also prevents a search under the actual debtor name that could determine if the re-submitted name is “close enough” under the UCC 9-506 test. Accordingly, IACA has offered a second alternative rule, under which the filing office would substitute a neutral character (a universal character or an item of punctuation such as an asterisk) for the characters it cannot handle. The second alternative permits filers and searchers to submit debtor names as they are, making it possible to apply the UCC 9-503 and 9-506 tests. The filing officers understand the issue, but they will have to overcome their reluctance to “tamper” with submissions by filers and searchers.

So, why does all this detail regarding filing office operations and search logic matter? Here the author’s ten best practical reasons to understand what is in the MARs:

Top Ten Reasons to Care About MARs

1. A client wants to purchase filing office records in bulk. How is that done? Article 9 mandates public sale of filing office records in bulk, but leaves it to the filing office to figure out how that is to be done and to determine pricing.⁴³ The MARs address these matters in MARs Rules 108 and 109. Because administrative rules can be hard to amend, the MARs provide for mandatory periodic non-discriminatory sale of data, but with prices as determined from time to time. Michigan does not address bulk sales in its rules.
2. For litigation, we need to prove a cli-

Even though Michigan’s standard search logic is from an older version of the MARs, it is almost identical in its outcomes to the current MARs version.

ent was perfected in the past. Can the filing office provide historical records?

As indicated above, the MARs provide information about what the filing office archives and for how long. Michigan retains data for five years after lapse or termination.⁴⁴

3. A secured party client has changed its name or address. Can it amend its financing statements without having to prepare and file an amendment for each one?

The MARs have a placeholder for so-called “master amendments” but does not take a position as to whether they should be offered or on what terms.⁴⁵ Michigan may take “global filing” to amend secured party name and/or secured party address (only).⁴⁶ Pricing is determined on a case-by-case basis.

4. A debtor name has accents or foreign characters. Can the client file under the debtor name or, if not, how should one file?

As noted above, most filing offices will not accept non-standard characters, although some are considering the better approach of providing substitute characters. There is an argument based on Michigan’s explanation of its search logic that Michigan might simply “strip” non-standard characters as part of its search logic, but that is not the case. If one is forced to alter a debtor name so the filing office can take it, one should provide the name in American standard characters, using “best fit” substitutes, as best as one can. This may require alternative debtor names to be submitted. With accents, the substitute (unaccented same letter) may be obvious, but other foreign characters will be more difficult. Note that a searcher will have the same problem. In any event, the actual name (using non-standard characters) should be provided somewhere on the financing statement (in the collateral box or the miscellaneous box). This may require the filing to be submitted in a paper format and not electronically.

5. A client is in a race to the filing office. What’s the fastest way to file?

As noted above, the MARs and Michi-

gan rules identify how one can file and how the filing office will assign a file date and time. You can pick your best alternative. If it is possible, in-person filing is usually the fastest means.

6. A client’s filed financing statement is not appearing in search results. Can the problem be corrected?

If the debtor name is correct on the financing statement and the search request, there is likely a filing office error, and a review of the rules should indicate who could be contacted to address the error and whether the filing of an information statement will trigger filing office action. Michigan does not take action based on an information statement,⁴⁷ but it does have a procedure to address filing office error.⁴⁸ The MARs provide the same rules.⁴⁹

7. A transaction requires multiple financing statements or amendments to be filed promptly and in a particular order (with no one able to file in the “gaps.”) Can this be accomplished with certainty and, if so, how?

This is somewhat of a trick question because neither the MARs nor the Michigan rules specifically instruct filers how to handle this situation. However, an overall reading of intake procedures and the time of filing rules indicate that mail and other deliveries are accepted in bulk, processed over time, and not in any particular order. Accordingly, this problem requires filing in-person over the counter.

8. A client needs a legal opinion that a financing statement is in acceptable form and will be filed. Can the opinion be rendered, and should it be qualified to account for filing officer discretion?

The opinion can be rendered because, between Article 9 and the relevant filing office’s rules, you should be able to determine exactly when and why a financing statement would be accepted for filing or rejected. This analysis cannot prevent an appropriate rejection, but it will provide a sound basis for the opinion. We prefer to opine on filed financing statements or to provide a “when filed” opinion because of the possibility of wrongful rejection, but

understand that the opinion is sometimes very important.

9. A client's financing statement has been rejected. Was the rejection proper, and, if not, is there a means to quickly correct the problem?

As discussed, the rules identify the only grounds for rejection and provide a procedure for correcting the error and getting the original filing date.⁵⁰

10. An error in a debtor name on a filed financing statement has been discovered. Is the error fatal to legal effectiveness?

The rules will contain the standard search logic that you can apply to determine if your financing statement will nevertheless be found. This may be faster and more cost-effective than running searches. While the best practice is to correct errors and to verify effectiveness through post-filing searches, that is not always a cost the client is willing to bear, and there are cases where secured parties have determined to rely on adequate but not precise debtor names.

As stated above, the UCC filing system is working pretty well, and most of the time it is not necessary for practicing attorneys to immerse themselves in the details of filing office operations. But when those special circumstances arise that present a potential problem, filing office rules might provide the best means to make a legal determination or to make a practical decision as to how to proceed with the filing office.

NOTES

1. See, MCL 440.9526. IACA was formerly known as the International Association of Corporate Administrators and some versions of the UCC have not caught up with their name change.

2. See State UCC Administrative Rules as compiled by Paul Hodnefield of Corporation Service Company, updated March 6, 2015, available at http://http://csctransactionwatch.com/wp-content/uploads/2013/06/State_Admin_Rules_03022015.pdf. Paul is the other Co-Chair of the American Bar Association's Task Force on Filing Office Operations and Search Logic.

3. See MCL 440.9310 and 440.9501.

4. MCL 440.9307. "Registered organizations" (generally, corporations, limited liability companies and limited partnerships) are located in the state where they are organized, other organizations are located in the state where their chief executive office is located and individuals are located where they have their principal residence.

5. MCL 440.9322.

6. Reporter's Prefatory Comment for Part 5 of revised Article 9, May, 1997 draft.

7. MCL 440.9108.

8. MCL 440.9504.

9. MCL 440.9503 and MCL 440.9506(3).

10. Adding additional descriptive information in the debtor name box or field (such as "a Michigan corporation" or "d/b/a _____") renders the financing statement ineffective. See, *In re EDM Corp.*, 431 BR 459 (BAP 8th Cir 2010). Typographical errors are also "fatal" flaws. *In re PTM Techs, Inc.*, 452 BR 165 (Bankr MDNC 2011), held a missing "h" in the debtor name made the financing statement ineffective.

11. *Clark v Deere & Co (In re Kinderknecht)*, 308 BR 71 (10th Cir BAP 2004).

12. Adopted in all states.

13. Forty-two states, including Michigan, require the driver's license name, leaving only seven states where a common law debtor name that differs from the driver's license name could be sufficient. For the purposes of this article, "driver's license name" refers to the name on a driver's license or other state-issued identification.

14. MCL 440.9102 includes the definition of public organic record. It is the publicly available record filed or issued to organize an organization and amendments and restatements of that record.

15. The IACA MARs are available at <http://www.icaa.org/secured-transactions/model-administrative-rules/>. Michigan's rules can be found at http://www.michigan.gov/sos/0,1607,7-127-1631_8851--,00.html.

16. MARs Rule 306.3.

17. MARs Rule 100.1. Such addresses are not required for legal sufficiency under MCL 440.9502, but if they are not provided, the filing office is supposed to refuse to file the financing statement under MCL 440.9516. Secured parties should also note that the address they provide for themselves may be effectively used by others who are required to search and notify secured parties of record (of purchase-money security interests in inventory or of foreclosure action, for example), so secured parties will want to provide addresses where such notices can be received and properly handled.

18. MARs Rule 100.1 and Alternative Language.

19. See Mars Rule 100.10.

20. MARS Section 3 and 4.

21. Michigan Rule 206 provides that "[t]he responsibility for the legal effectiveness of filing rests with filers and remitters and the filing office bears no responsibility for legal effectiveness." Michigan Rules 302 and 303 provide that data is entered as presented and as designated (e.g. organization or individual name, or, first name, middle name or surname).

22. MCL 440.9515 and 440.9519.

23. MCL 440.9515.

24. MARs Rule 104. Michigan Rule 440.106. Michigan fees are set forth in the statute. MCL 440.9525.

25. MARs Rule 105. See, e.g. Michigan Rules 440.503-440.506. With respect to archives, see MARs Rule 314 and Michigan Rules 440.414 and 440.415.

26. Michigan Rule 440.403. MARs Rule 101.

27. Michigan Rule 440.403. MARs Rule 101.4.

28. MCL 440.9520 and MCL 440.9516. MARs Rule 202.

29. The issue of bogus filing is a serious one, addressed by the National Association of Secretaries of State in its *Report: State Strategies to Subvert Fraudulent Uniform Commercial Code Filings*, updated April, 2014, available at <http://www.nass.org/reports/surveys-a-reports/>.

30. MCL 440.9501(4), MCL 440.9501a and MCL 440.9520(5).

31. There are some other issues in the Michigan rules that could be updated. For example, the Michigan rules include an old (and lengthy) MARs rule (440.408) that determined whether a debtor name was an individual or organization name if the filer did not clearly designate the nature of the debtor. It was possible that a filing of this nature, though it should have been rejected, might nevertheless be accepted by mistake, whereupon it would be deemed filed. This cannot happen on the new UCC forms or in electronic filing protocols, so the rule has been deleted from the MARs.

32. MCL 440.9520(3).

33. MARs Rule 203. Michigan Rule 440.204.

34. MARs Rule 204. Michigan Rule 440.207. MCL440.9516(4).

35. MCL 440.9503. There are also name rules for other debtors like estates and trustees found in UCC 9-503.

36. MCL 440.9506.

37. This can be hard to do. A secured party of record has no duty to communicate with a prospective competing secured party. Only the debtor has rights to compel an accounting or list of collateral. MCL 440.9210.

38. MARs Rules 503.1.2 and 503.1.4. The filing office may “strip” punctuation and spacing prior to applying the “exact match” test.

39. MARS Rules 503.1.2 and 503.1.3.

40. Michigan Rule 440.510.

41. Mars Rule 503.2. Michigan’s rules do not identify an alternative search logic option.

42. MARs Rule 401. Under Michigan’s older version of the rules, the issue of non-standard characters is not explicitly addressed. Michigan may refuse non-standard characters on the somewhat suspect ground that they are “illegible.”

43. MCL 440.9523.

44. Michigan Rules 440.414 and 440.415.

45. MARs Rule 405.

46. Michigan Rule 440.413.

47. Michigan Rule 440.311.

48. Michigan Rule 440.405.

49. MARs Rules 310 and 405.

50. MARs Rules 203 and 204, and Michigan Rule 440.207.



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Business Courts, Arbitration, and Pre-Suit Mediation: A Modest Proposal for the Strategic Resolution of Business Disputes

By Hon. John C. Foster, Richard L. Hurford & Douglas L. Toering

Introduction

Binding arbitration holds a well-deserved and respected position in the dispute resolution tradition of the United States. No less a historical figure than George Washington embraced the wisdom of arbitration to resolve disputes involving the interpretation of his will. He directed that “all disputes (if unhappily any should arise) shall be decided by three impartial and intelligent men, known for their probity and good understanding...” Those three, “unfettered by Law, or legal constructions,” would declare “their sense of the Testators intention,” and their decision would be binding.¹

Our first president has not been alone in embracing the many benefits of arbitration. Indeed, arbitration has often been the default dispute resolution provision in many commercial contracts, especially buy-sell (shareholder) agreements. For a number of reasons, however, the perceived advantages of arbitration—cost savings, efficiency, and fairness—have lost some of their luster over the past 20 years.²

For example, the latest edition of the American Institute of Architects (AIA) construction forms, the nation’s most widely-used template for building contracts, has eliminated a binding arbitration provision from its standard contract form; arbitration is now solely an option the parties must consciously select.³ Indeed, the concerns about the cost and delay of arbitration in business disputes have been the subject of numerous articles and studies.⁴ This perception led in significant part to the recent passage of the Delaware Rapid Arbitration Act (DRAA).⁵

Under the DRAA, the dispute must be resolved within 120 days of the arbitrator’s acceptance of the appointment;⁶ all issues of substantive and procedural arbitrability are reserved to the arbitrator; the arbitrator has broad authority in granting interim and final relief, whether legal or equitable; and, any

challenge to the arbitrator’s decision must be filed within 15 days. To avail themselves of the DRAA, one of the parties to the agreement must be a Delaware-based business or have Delaware as its place of incorporation.⁷

Regardless of any perceived deficiencies, arbitration will (and should) remain in every lawyer’s dispute resolution toolbox. Nonetheless, given the track record of Michigan’s business courts in efficiently resolving business litigation, arbitration should no longer be the default. Rather, the choice of forum is a strategic decision requiring consideration in each commercial contract. When that occurs, the business courts will often emerge as a strong option in those Michigan counties with business courts.

In any event, drafters of business contracts should seriously consider a progressive dispute resolution process. This requires, among other steps, mediation before a party sues or demands arbitration.⁸ A combination of pre-suit mediation and, failing that, litigating in the business courts may prove an attractive option. But if the parties prefer arbitration, mediation followed by arbitration is another option.

This article will briefly review the business court statute, the rationale for the business courts, and whether the data demonstrate the objectives of the business courts are being achieved; compare how arbitration and business courts resolve business disputes; encourage pre-suit mediation when appropriate; and offer a protocol for pre-litigation mediation.

The Objectives of the Business Court Legislation

The purpose of the business courts is to resolve business and commercial disputes efficiently and to “enhance the accuracy, consistency, and predictability” of decisions in business disputes.⁹ Generally, every “business or commercial dispute” (as broadly

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defined) is assigned to a specialized docket.¹⁰ To implement this statutory mandate, the business courts are encouraged to adopt “evidence-based practices”¹¹ that reduce litigation waste and inefficiencies. Those practices can also serve as a model to all trial courts.¹²

Practice, Procedure, and Expertise in the Business Courts

Under Administrative Order 2013-6, those circuits with business courts “shall establish specific case management practices for business court matters. These practices should reflect the specialized pretrial requirements for business court cases, and they will typically include provisions relating to scheduling conferences, alternative dispute resolution (with an emphasis on mediation scheduled early in the proceeding), discovery cutoff dates, case evaluation, and final settlement conferences.”¹³

Also, since January 2014, opinions from the business court judges have been available to the public on an indexed website.¹⁴ Those online opinions (albeit non-binding on anyone but the litigants) will help foster consistency among the business court judges. Likewise, if a particular judge has addressed a similar issue in the past, this will provide guidance to counsel and the parties in their particular case.

Attorneys filing a business court case must verify on the face of the complaint that the case “meets the statutory requirements to be assigned to the business court.”¹⁵ Also, all business cases must bear a “CB” case code.¹⁶

The Michigan Judicial Institute has provided comprehensive training opportunities for business court judges. On October 22-25, 2013, the National Judicial College and the Michigan Judicial Institute held a conference for business court judges.¹⁷ Attended by 31 judges from five Midwestern states, the seminar addressed both procedural and substantive matters including case management techniques, early use of various alternative dispute resolution processes, interpretation of financial statements, and numerous substantive law issues. The last emphasized bankruptcy, dissolution, and receivership; commercial loans; shareholder and operating agreements; and shareholder disputes.

The Michigan State Court Administrative Office (“SCAO”) has also been instrumental in exploring evidence-based practices to assist the business courts. For example, in Sep-

tember 2013, SCAO convened an early ADR summit attended by experienced business litigators, ADR experts, and business court judges. The summit recommended, among other things, that the following become standard operating procedures in the business courts:

1. **Early Scheduling Conferences.** Judges should personally meet lawyers, clients, and *pro se* litigants in an early scheduling conference. Early judicial involvement helps identify issues.
2. **Scheduling Orders and Differentiated Case Management.** This recognizes a “number of tracks for various kinds of cases....”
3. **ADR.** Judges, lawyers, and parties should consider using a broader array of ADR procedures, not just the more familiar “standby” options such as case evaluation and mediation.¹⁸
4. **Discovery.** Judges should be more actively involved in determining the scope and amount of discovery. This can include staged or proportional discovery.
5. **Case Evaluation.** If case evaluation is ordered at all, it should take place *after* mediation. In fact, in many business courts, case evaluation is the exception rather than the rule.¹⁹
6. **Early Neutral Involvement.** Parties should engage a “knowledgeable neutral third-party” early in the case to help resolve contested issues throughout the litigation.²⁰

In fact, much of this is already occurring as reflected by the recently implemented Case Management Protocol in the Oakland County Business Court²¹ and the requirements contained in the Notice and Order to Appear issued in all Macomb County Business Court cases. Virtually every evidence-based practice identified during the Early ADR Summit is incorporated into the practices of the Oakland and Macomb County Business Courts.²² In particular, early and active judicial involvement and early ADR are two of the key factors in the expedited case processing times in the business courts. In the authors’ opinion, the majority of business court cases can be effectively mediated after 90-120 days of discovery.²³

Business Court Processing Times

Although the business court statute was passed in October 2012, Macomb County and Kent County began their specialized business dockets on November 1, 2011 and March 1, 2012, respectively. In June and July 2013, Oakland and Wayne Counties began their business courts under the new business court statute. The results for those four courts have been impressive. Through June 30, 2015, the average time to close a business court case in those counties ranges from

about five months (148 days) to seven months (210 days).²⁴ Moreover, over two-thirds (68 percent) of the respondents to a Macomb County survey preferred the business court process over the ordinary civil case process, and 62 percent reported the process shortened the time to resolution.

To promote efficiency, SCAO has suggested that business court judges consider serving as both dispute resolution advisors and, of course, as traditional trial court judges. SCAO summarized those two roles:²⁵

Traditional Trial Judge	Trial Judge and Dispute Resolution Advisor
Short-term and long-term goals: Focuses the parties on a trial date and prepares the parties for a trial (but 98.6% of the civil cases do not go to verdict).	Short-term and long-term goals: Assists the parties in resolving their dispute, if possible (short-term), and prepares for trial as necessary (long-term).
Typically relies on a computer-generated scheduling order.	Conducts an early case conference with counsel to establish a differentiated case management plan and triages cases for effective ADR strategies.
Presides over discovery disputes and motion practice.	Stages proportional discovery and motion practice to support the agreed upon ADR strategies.
Orders case evaluation just prior to the trial date as the first ADR activity in the case (with mediation to follow in some cases.)	Explores multiple and early ADR strategies throughout the life of the case and conducts periodic, moderated settlement conferences to determine the impediments to a voluntary resolution.
Determining legal rights and remedies of the parties is the sole focus.	In addition to determining legal rights and remedies, judges (and neutrals) explore the parties' interests and needs-based solutions.
Result: The vast majority of cases resolve later in the litigation.	Result: The vast majority of cases resolve earlier in the litigation.

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Business Courts or Arbitration?

Below is a comparison of some of the perceived advantages of arbitration versus what can be achieved in the business courts.

*Arbitration Is
Traditionally Viewed
As:
Quicker*

But Business Courts Have Many of the Same Advantages and More

Arbitration has been traditionally viewed as quicker and cheaper than litigation in the courts. In reality, that may not always be the case.²⁶ Indeed, the average times to close cases in the business courts in Kent, Macomb, Oakland, and Wayne Counties are impressive. Evidence-based practices are a key reason.²⁷ Another advantage of the business courts (and other courts, as well) is the “black robe effect:” sometimes parties (or counsel, for that matter) will listen to a judge when they will not listen to anyone else. That, in itself, often fosters an earlier resolution. Moreover, a ruling on a threshold issue of law, which arbitrators may be reluctant to decide, can help the parties resolve the case quickly.²⁸

Less expensive

The parties must pay the fees of the arbitrator(s). For cases involving an arbitration agency, the fees can also include administrative expenses. By contrast, there is no charge for the business courts (except for nominal filing and motion fees). To the degree that arbitrators limit discovery, and to the degree that an arbitration hearing can be shorter than a trial, arbitration can save legal fees. But the recently adopted pilot project for summary jury trials provides an additional option for a shortened trial.²⁹ In addition, the proportionate discovery practices in the business courts can rival the discovery cost savings in arbitration. Moreover, some individual business courts are developing their own evidence-based practices.³⁰ After evaluating the success of those practices, the Michigan Supreme Court or SCAO can take the very best and commend their use in all the business courts.

More informal

The arbitration hearing is more informal than a trial court proceeding. However, business court judges become personally involved in the case, often informally in an early court conference or during telephone conferences. This can help resolve discovery problems and other issues far more quickly than traditional motion practice.

More restricted in discovery

Discovery can be more limited in arbitration. But that can depend on the terms of the arbitration agreement, the practices of the individual arbitrator(s), and any third-party administrative protocols incorporated in the arbitration agreement.³¹ With mandatory early disclosures as part of the local administrative orders for some of the business courts, limited discovery may no longer be an advantage to arbitration.³² Also, one of the typical agenda items for early court conferences in the business courts is tailoring the amount and timing of discovery to the needs of the specific case. That has not generally been a practice of most arbitrators, although they possess that power.³³

More reliable; fairer

Except for Wayne and Oakland Counties (which have more than one business court judge), the parties know who the judge will be. Depending on the arbitration agreement, the parties may or may not know the designated arbitrators. The indexed decisions of business court judges also provide the parties and counsel with valuable insight into how a particular judge might rule on a specific issue.

But what about experience and fairness? Parties in the business courts need not be concerned that the judge will be unschooled in, or indifferent to, business issues. Each business judge has received training sponsored by the Michigan Judicial Institute. The judges also attend ongoing conferences sponsored by MJJ and SCAO.³⁴

Finality

Arbitration is more “final” than the business courts, in that it is difficult to vacate or modify an arbitration award.³⁵ That is an advantage if you win, of course, but not if you lose. So should the parties limit their appeal rights in advance by selecting arbitration? Maybe yes, maybe no; it depends on the circumstances. Indeed, many parties see the limited review of arbitration awards as a significant disadvantage. Thus, some parties have (with mixed results) attempted by agreement to expand the bases for the review of arbitration awards.³⁶ Also, if the parties agree and for an additional fee, certain arbitration providers offer supplemental appellate procedure options.³⁷

More efficient, in that it allows the arbitration hearing on a date certain

Business courts may or may not be able to set a date certain for trial, although it is the practice of most business court judges to set a date certain once it appears the case will proceed to a trial. That said, very few business cases (or other civil cases, for that matter) actually go to verdict.³⁸

More flexible, in that the parties may craft their own arbitration agreement

This is an advantage to arbitration. For example, the parties may decide to submit only certain disputes to arbitration. The parties can also choose whether to apply the Federal Arbitration Act or the state arbitration procedure.³⁹ Still, arbitrators might not always explore “off ramps” from the arbitration process through the staged use of ADR. By contrast, a business court judge, when acting in the role of a dispute resolution advisor, can help the parties explore meaningful opportunities for resolution (traditional financial settlement, business solution, ADR) throughout the litigation.

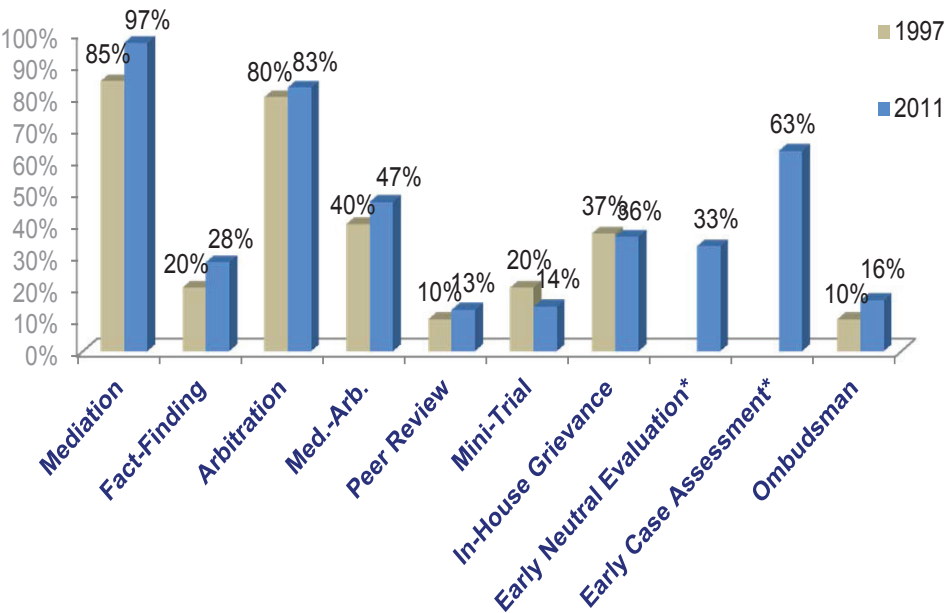
Confidentiality

One major plus of arbitration is confidentiality. This may be an advantage for family-owned business, high-tech companies, or businesses that may lose customers or suppliers simply because their competitors or suppliers become aware of the lawsuit. If a party has to file suit to confirm an arbitration award, then the dispute can become public knowledge anyway (if that has not already happened during the arbitration process).

Pre-Litigation Mediation

Businesses Are Embracing Pre-Litigation ADR

Businesses are increasingly using an array of ADR techniques. A study by Thomas Stipanowich summarized this clear trend by Fortune 1000 companies.⁴⁰



If business clients have already decided to use various forms of ADR, their lawyers would be well advised to adapt.

When one compares the ADR practices of companies between 1997 and 2011 in resolving disputes, it is clear that sophisticated businesses are increasingly using a wide variety of ADR processes. Why? Primarily, to save time and money.⁴¹ If business clients have already decided to use various forms of ADR, their lawyers would be well advised to adapt. Indeed, counsel can recommend whatever ADR strategies are appropriate, including pre-litigation mediation.

Pre-Litigation Mediation: An Option with Either Business Courts or Arbitration

Mediation Generally

Mediation offers many advantages:

1. Mediation is informal, confidential, creative, and non-binding.
2. As the dispute lingers, the parties become entrenched in “positions.” Thus, fewer and less creative business solutions (along with less money) may be available to resolve the dispute. Money is fungible, and whatever money the parties spend in litigation is unavailable to settle the case.
3. Mediation is well-suited to address underlying personal or family dynamics that are sometimes at the core of disputes involving small businesses. If the problem is money (e.g., issues involving owner compensation, perks, debt, and the like), the mediator can recommend an outside expert or use competing expert witness vetting techniques to help the parties agree on how to manage their financial affairs.
4. The parties choose the mediator and the process; the process can be designed to meet the needs of the parties in their particular dispute.
5. Mediation (as well as court or arbitration) gives the parties the opportunity “to be heard.”
6. Mediation allows a party to acknowledge regret without fear it will be admitted as evidence. How often does a sincere statement of regret—“I’m sorry; I didn’t mean to hurt you”—help settle a case in mediation?
7. If the case is filed in the business court, it will eventually go to media-

tion anyway (probably sooner rather than later).

8. Even if the mediation does not resolve the entire dispute, the parties can use mediation to narrow the dispute and construct an effective litigation plan. That, in turn, can lead to further settlement discussions.

When Is Pre-Litigation Mediation a Realistic Option?

Given that only 1.4 percent of all civil cases in Michigan in 2014 went to verdict, the parties should consider pre-litigation mediation. But is pre-suit or pre-arbitration mediation a realistic alternative?

Yes, if:

- a. The parties want to continue to work together or wish to assure that the matter is resolved amicably.
- b. The dispute involves a closely held business, particularly a family business.
- c. Publicity about the dispute could harm relations with customers (or clients or patients), with vendors, or with employees.
- d. The parties are loathe to involve customers and current employees in the resolution of the dispute.
- e. Counsel (perhaps with the mediator’s assistance) are able to work together.

No, if:

- a. The parties cannot trust each other. Yet, a skilled mediator can often help to bridge the trust gap.
- b. One party needs a temporary restraining order or preliminary injunction. That said, mediation remains an option after the business court awards or denies such relief.
- c. The other party will use mediation solely as a delaying tactic.
- d. One party needs discovery, which the other party refuses to provide. Still, a mediator can help the parties resolve the discovery issue so the parties can proceed to a meaningful mediation.
- e. A party will not take mediation seriously unless suit or arbitration is filed.
- f. The parties cannot agree on satisfactory mediation, tolling, and standstill agreements. See below.

Because the business court judges often encourage (or require) early mediation, some attorneys and judges (the authors included) recommend pre-suit mediation in appropriate cases.

Recommended Protocol for Pre-Litigation Mediation

In General

Because the business court judges often encourage (or require) early mediation, some attorneys and judges (the authors included) recommend pre-suit mediation in appropriate cases. As long as the client's interests are not prejudiced by the delay, why not mediate the dispute before filing suit? To protect the parties, counsel should consider the various agreements described below. In the case of a closely held business, the principals of the company should also be parties to these agreements.

Tolling Agreement

The parties should enter into a tolling agreement.⁴² In it, the parties agree that the statutes of limitations, or other defenses based on the passage of time, are tolled for a given period to allow the parties time to mediate the dispute.

Mediation Agreement

The parties should enter into a written mediation agreement. But in pre-suit mediation, there is obviously no judge to enforce the agreement. Thus, the parties should consider additional issues for their mediation agreement. Those include:

1. The right, if any, of the mediator to call additional mediation sessions.
2. Document production (what and from whom). For example, should a party be able to obtain records from the company's accountant, tax advisors, etc.?
3. Confidentiality of proceedings under MRE 408 and MCR 2.412.
4. Confidentiality of documents produced (non-disclosure agreement that may become a stipulated protective order should the matter not resolve).
5. Attendees. This is particularly important in shareholder (business breakup) litigation. Should the company's professional advisors (corporate counsel, corporate accountant, banker, financial and insurance advisor) attend? What about spouses of the business owners? And should adult children, who are already involved in the business, participate?

6. Consequence if a party is not cooperative or has otherwise acted in "bad faith." How will that consequence be enforced? What happens if a party simply fails to show for mediation (or "walks out" early in the mediation) or fails to produce documents?
7. Whether to involve early neutral experts (and who decides, and who pays). For example, if one party believes there are bookkeeping irregularities, it might be helpful to retain an independent auditor to examine the documents and issue a non-binding report.

Standstill (Status Quo) Agreement

In cases involving small businesses (particularly shareholder disputes), the parties should know how the business will be operated during the mediation process. Hence, the need for a standstill (or status quo) agreement. Some of the provisions of a standstill agreement may, depending on the nature of the dispute and on the pre-existing agreements among the parties, include:

1. No changes to:
 - a. Compensation for parties
 - b. How monies are disbursed or invested
 - c. Methods of accounting and bookkeeping
 - d. Methods of payment to vendors and payment on other accounts payable
 - e. Those approved to sign checks at given amounts
 - f. Professional advisors
 - g. Location of main and branch offices
 - h. Pricing to customers or clients; methods of bidding projects
 - i. Line of business
 - j. Clients and customers
 - k. Suppliers
 - l. Vendors
2. No transactions outside the ordinary course of business, including:
 - a. Borrowing
 - b. Transfers of money or other property between affiliated companies
 - c. Purchasing, selling, or mortgaging assets
 - d. Hiring or firing (or promotion or demotion) of employees

Regardless of whether the parties opt for arbitration or the business court, they should seriously consider including pre-litigation mediation in the dispute resolution clause.

- e. Removal of officers, directors, or managers
- f. Future distributions or bonuses
- g. Issuance, redemption, or cross-purchase of shares or membership interests
3. Reinstatement of a party to position as officer, director, manager, or employee
4. Management decisions outside the ordinary course of business to be conducted in the presence of all parties
5. Agreed access by shareholders or members to company books and records
6. Agreement on how shareholder or member loans will be repaid
7. Restoring distributions that were not proportionate to equity interests or that were not otherwise permitted by agreement
8. Notice before any party files suit or demands arbitration
9. Retention of all documents (whether hard-copy or electronic) by the company and by the principals themselves
10. Confidentiality. Unless required by existing agreements, the parties will not disclose even existence of the dispute to customers, clients, vendors, lenders, etc.
11. Accounting for disputed transactions
12. Modification. Any of the above may be modified only by unanimous (or agreed supermajority), written consent.

Recommended Pre-Litigation Mediation Clause

Regardless of whether the parties opt for arbitration or the business court, they should seriously consider including pre-litigation mediation in the dispute resolution clause. A brief example follows:

As a condition precedent to the filing of [a lawsuit/demand for arbitration], except when a party seeks temporary or preliminary equitable relief or when delay will unduly prejudice a party, the parties agree to engage in a confidential [and good faith] mediation with _____ as the mediator. Unless mutually agreed to the contrary, the

parties will schedule the mediation to take place within ____ days [of the date the dispute arises / of the written notice of the dispute required by this agreement]. In those instances where temporary or preliminary equitable relief is sought or delay will unduly prejudice a party, the parties will engage in the confidential mediation within 30 days of the filing of the [lawsuit / demand for arbitration]. The parties will comply with all confidentiality and other agreements reasonably required by the mediator. The parties also agree to confer on the voluntary exchange of information, documents, and other data that will assist the confidential mediation process.

Conclusion

Given the success of the business courts so far, and their emphasis on early judicial involvement, it is time to rethink, just as the American Institute of Architects did, the conventional wisdom that binding arbitration should be the default.⁴³ So what is better, arbitration or business courts?

The answer is: It depends. The choice should be based on the nature of the transaction, the needs and desires of the parties, and the parties themselves. But before filing suit or demanding arbitration, should mediation be required? If so, then the parties should agree at the outset on a forum-selection clause that requires mediation before litigation, except in limited circumstances. But regardless of what the parties decide, they should make a considered decision about how (and when) their dispute will be handled.

NOTES

1. <http://www.mountvernon.org/educational-resources/primary-sources-2/article/george-washingtons-1799-will-and-testament/>

2. See, e.g., Thomas J. Stipanowich, *Arbitration: The New Litigation*, 1 U Ill L Rev (2010).

3. Am. Inst. of Architects, Contract Documents, <http://www.aia.org/aiaucmp/groups/aia/documents/pdf/aia078760.pdf>

4. See Thomas J. Stipanowich, *Arbitration: The New Litigation*, 1 U Ill L Rev (2010); Robert Gaitskell, Society of Construction Law, *Trends in Construction Dispute Resolution* (2005), <http://www.scl.org.uk/files/129-gaitskell.pdf>; Editorial, 17 Constr L J 1, 1-2 (2001); Leslie A. Gordon, *Clause for Alarm*, ABA J (Nov. 2006); Sylvia Hsieh, *Arbitration Falling out of Vogue*, Lawyers USA (Mar 10, 2008); *Knocking Heads Together*, Economist (Feb 3, 2000); Harout Jack Samra, *Is Arbitration All It's Cracked Up to Be?*, ABA Section Annual Conference (Apr

2012); http://www.americanbar.org/content/dam/aba/administrative/litigation/materials/sac_2012/3-1-arbitration.authcheckdam.pdf

5.. Gregory V. Varallo, Blake Rohrbacher, and John D. Hendershot, *The Practitioner's Guide to the Delaware Rapid Arbitration Act*, http://www.rlf.com/Files/11206_DRAA%20Book%20Final.pdf at 9-10.

6. An arbitrator who fails to comply with the time requirements of the DRAA can face financial penalties. See Harvard Law School Forum on Corporate Governance and Financial Regulation, *Delaware Enacts New Rapid Arbitration Act* (Apr 15, 2015), <http://corpgov.law.harvard.edu/2015/04/14/delaware-enacts-new-rapid-arbitration-act/>

7. Under Michigan's Uniform Arbitration Act, as long as the parties comply with the mandatory terms of that Act, they may incorporate many of the DRAA's features in their arbitration agreement.

8. See, e.g., Richard L. Hurford, *SMART Dispute Resolution Processes*, Mich Bar J (June 2010). For example, the parties might consider the use of a meet-and-confer opportunity, supplemented with "real time mediation" if appropriate; the use of a dispute resolution board to resolve issues if the contract is ongoing; and failing those efforts, arbitration or litigation. If the amount in dispute is less than \$150,000, the DRAA or summary jury trial process may be viable, cost-effective options. See generally, *A Taxonomy of ADR, A Practical Guide to ADR Practices & Processes for Counsel* (Apr 2015), <http://hurfordresolution.com/>.

9. MCL 600.8033(3).

10. A fuller summary of Michigan's business court legislation appeared in Toering, *The New Michigan Business Court Legislation: Twelve Years in the Making*, Bus L Today (Jan 2013), http://www.americanbar.org/publications/blt/2013/01/03_toering.html; and in Diane L. Akers, *Michigan's New Business Court Act Presents Opportunities and Challenges*, 33 Mich Bus L J no. 2, 11 (Summer 2013). See also the ABA's *Annual Review of Developments in Business and Corporate Litigation* 201-203 (by Douglas L. Toering) (2013).

11. "Evidence-based practices" have become increasingly important to all courts, not just the business courts. In fact, the judicial dashboard developed by SCAO incentivizes the use of "evidence-based practices" (<http://courts.mi.gov/education/stats/dashboards/Pages/default.aspx>). Also, the Michigan Supreme Court has called on all courts to become laboratories in developing such practices that will increase efficiency. In the 2015 budget for the judiciary, Chief Justice Robert P. Young, Jr. stated:

Every trial court in this state can be a little laboratory of new ideas—a fertile ground for discovering new and better ways of doing things. (<http://courts.mi.gov/News-Events/Newsummary/Documents/ChiefJusticeYoungFY2015BudgetRemarks.pdf>).

12. Hon. Christopher P. Yates, *Specialized Business Dockets: An Experiment in Efficiency* https://www.accesskent.com/Courts/17thcc/pdfs/Experiment_Efficiency.pdf

13. <http://courts.mi.gov/courts/michigansupremecourt/rules/documents/administrative%20orders.pdf>. The local administrative order of each business court can be accessed at <http://courts.mi.gov/administration/admin/op/business-courts/pages/business-courts.aspx>

14. http://courts.mi.gov/opinions_orders/businesscourtssearch/Pages/default.aspx

15. MCR 2.112(O). Kent County has a practice of reviewing all filed cases to assure that business and commercial cases are assigned to the business court. Elsewhere, Wayne County may impose a fine of \$100 if the appropriate designation assigning a matter to the business court is not used.

16. [http://courts.mi.gov/Administration/SCAO/OfficesPrograms/TCS/Documents/TCS%20Memoranda/TCS-2015-16.pdf#search=Case code Business court](http://courts.mi.gov/Administration/SCAO/OfficesPrograms/TCS/Documents/TCS%20Memoranda/TCS-2015-16.pdf#search=Case%20code%20Business%20court)

17. Retired Judge William Dressel, President of the National Judicial Institute, and Dawn McCarty, Director of the Michigan Judicial Institute, coordinated this four-day seminar.

18. An incredibly valuable tool for all trial courts is a publication by the Supreme Court Administrative Office entitled the Caseflow Management Guide. (<http://courts.mi.gov/Administration/SCAO/Resources/Documents/Publications/Manuals/cfmng.pdf>). The purpose of the Guide is to provide judges with case flow management techniques and suggestions and explores a number of "evidence based practices" that can be employed throughout the life of the litigation. One such practice discussed in the Guide is "proportionate" or "staged" discovery:

Each of the following approaches is aimed at minimizing the time and expense devoted to discovery while promoting nontrial dispositions at the earliest point in the process...(d) Developing a process where initial discovery focuses on the information needed for settlement with discovery for trial provided only in cases that are likely to be tried.

In sum, it will not be surprising for the Business Courts to ask the parties to identify that discovery essential to engage in a meaningful ADR event and to focus on completing that discovery as soon as possible. An ADR event would then be scheduled before all discovery is completed and in advance of the discovery cut-off date. The parties could then pursue whatever additional discovery that many be necessary to prepare for a trial in the event the ADR event was not successful in resolving the dispute.

19. SCAO commissioned a comprehensive study on the effectiveness of case evaluation and mediation. *The Effectiveness of Case Evaluation and Mediation in Michigan Circuit Courts*. <http://courts.mi.gov/Administration/SCAO/Resources/Documents/Publications/Reports/The%20Effectiveness%20of%20Case%20Evaluation%20and%20Mediation%20in%20MI%20Circuit%20Courts.pdf>. The study seriously questioned the cost-benefit of case evaluation.

20. <http://courts.mi.gov/Administration/SCAO/Resources/Documents/standards/odr/ADR%20Summit%20Report%20September%204,%202013.pdf>.

21. <https://www.oakgov.com/courts/businesscourt/Documents/ocbc-pro-case-management.pdf>.

22. The reliance on evidence-based practices is certainly not unique to the Macomb and Oakland County Business Courts. See, e.g., Hon. John C. Foster and Richard L. Hurford, *ADR Within ADR: The Business Courts—a Laboratory for Litigation Process Improvement*, Mich Bar J 20 (Jan 2015).

23. <http://courts.mi.gov/Administration/SCAO/Resources/Documents/standards/odr/ADR%20Summit%20Report%20September%204,%202013.pdf>

24. Closed cases include cases that were settled, dismissed, removed, or stayed by bankruptcy.

25. <http://courts.mi.gov/Administration/SCAO/OfficesPrograms/ODR/Documents/ADR%20Guide%2004092015.pdf>. See also, *A Taxonomy of ADR: A Guide to ADR Practices & Procedures for Counsel*, supra.

26. For an older study of the cost and length of arbitration in large, complex commercial cases, see American Arbitration Association, *By the Numbers*, Commercial Bulletin (Issue 7, 2007), https://www.adr.org/aaa/ShowPDF?doc=ADRSTG_003921. See also Special Focus: Time & Cost 2012, *Dispute Resolution Journal* (American Arbitration Association).

27. Hon. John C. Foster and Richard L. Hurford, *ADR Within ADR: The Business Courts—a Laboratory for Litigation Process Improvement*, Mich Bar J 20 (Jan 2015).

28. See Diane L. Akers, *Michigan's New Business Court Act Presents Opportunities and Challenges*, 33 Mich. Bus L J no. 2, 11, 14 (Summer 2013). See also MCL 691.1695(2) (allowing summary disposition proceedings in arbitration).

29. On March 25, 2015, the Michigan Supreme Court approved Administrative Order 2015-1 authorizing summary jury trials. This provides litigants with yet another option for the efficient and fair resolution of disputes. See http://courts.mi.gov/Courts/MichiganSupremeCourt/rules/court-rules-admin-matters/Court%20Rules/2014-24_2015-03-25_formatted%20order_AO%202015-1_Summary%20Jury%20Trial.pdf. This pilot project was the culmination of the efforts of a working committee consisting of judges, representatives of the plaintiffs' and defense bars, and neutrals to evaluate the wisdom of establishing a summary jury trial process in Michigan. See Richard L. Hurford, *The Summary Jury Trial Pilot Has Landed*, ADR Quarterly (June 2015).

30. For example Oakland County has adopted a form model protective order, https://www.oakgov.com/courts/businesscourt/Documents/mod-bc-pro_ord.pdf. In January 2013, Macomb County established "Initial Discovery Protocols" for disputes involving business contracts, business organizations, employment, and non-competes. <http://circuitcourt.macombgov.org/CircuitCourt-BusinessDocket>

31. See, e.g., MCL 691.1697. Of course, limited discovery can be a double-edged sword: one party may not need the discovery, because that party has better access to relevant information and documents. That poses a disadvantage to the party (a minority shareholder, perhaps) that may not have the same access.

32. See, e.g., local administrative orders for Genesee County (¶5) and Macomb County (¶5).

33. MCL 691.1697(3).

34. Of course, business court juries will not have had that training. Still, most business court actions are not jury cases.

35. MCR 3.602(J), (K); MCL 691.1700, .1702, .1703, .1704.

36. See *Hall St Assocs, LLC v Mattel, Inc*, 552 US 576, 128 S Ct 1396, 1404 (2008). See also, Phillip DeRosier, *Judicial Review of Arbitration Awards Under Federal and Michigan Law*, Michigan B J 34 (February 2013); Brian T. Burns, *Freedom, Finality, and Federal Preemption: Seeking Expanded Judicial Review of Arbitration Awards Under State Law After Hall Street*, 78 Fordham L Rev 1813 (2010).

37. AAA, <http://go.adr.org/AppellateRules>; JAMS, <http://www.jamsadr.com/appeal/>

38. In Wayne, Oakland, Macomb, and Kent Counties, the cases where a party demands a jury in the business courts range from 10% to 29%.

39. See, e.g., Federal Arbitration Act, 9 USC 1 *et seq*; Michigan Uniform Arbitration Act, MCL 691.1681 *et seq*. and MCR 3.602.

40. Thomas J. Stipanowich, *Living with ADR: Evolving Perception and Use of Mediation, Arbitration and Conflict Management in Fortune 1,000 Companies* (2013), <http://www.mdcourts.gov/macro/pdfs/reports/cornellstudy2013.pdf>.

41. *Id.*

42. A sample agreement for an early mediation is included as Exhibit 7 to the *Taxonomy of ADR*, *supra*.

43. Akers, 33 Mich Bus L J at 14-15.



Judge John C. Foster retired from the Macomb County Circuit Court bench April 30, 2015. Judge Foster served as the Chief Judge for the Macomb County Circuit Court, Macomb County Probate Court, and the 42nd District Court, Divisions I and II. He was also the appointed business court judge for the Macomb County Circuit Court, which was the first court in Michigan to create a business docket. Judge Foster is currently providing mediation and arbitration services.



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*In Need of Repair: Secret Personal Property Liens in Michigan**

By Thomas R. Morris

Introduction

An 1876 admiralty case observed that “[s]ecret liens injure commerce, for reasons apparent to every one, and our policy has been to fetter navigation and trade as little as possible.”¹ No case has praised the secret lien.

Article 9 of the UCC provides a uniform system for the registration of security interests, yet secret liens persist. This article identifies both the numerous “non-Article 9” liens and the smaller subset of secret, obsolete, or otherwise problematic remedies, property interests, and personal property liens under Michigan and federal law. The article also suggests the elimination or correction of several secret liens.

Why do Secret Liens Exist?

Personal property liens exist outside of the Article 9 system for several reasons.

First, possessory liens have existed for hundreds of years. Many of these liens, such as the artisan’s or mechanic’s lien, and the innkeeper’s, warehouseman’s, carrier’s, and self-storage lien, continue to be useful because retention of possession facilitates short-term credit for simple services. Possessory liens are explicitly recognized by Article 9.²

Second, liens serve many purposes other than to secure loans, such as (i) to secure payment for services that improve or preserve the property itself, (ii) to secure payment of taxes and other governmental obligations, and (iii) to enable recovery by judgment creditors.

Third, courts have equitable powers that result in the imposition of liens or the creation of property interests. Although court orders are usually³ in writing, they can be difficult to discover because they are not indexed in a central filing office.

Fourth, property may be subject to laws that are not consistent with the UCC. Property that is subject to the jurisdiction of a Native-American tribe may preclude the application of the UCC.⁴ Copyrights, patents,

and trademarks are subject to federal registration.⁵ Article 9 does not govern the perfection or priority of a lien on goods that are covered by a certificate of title (typically motor vehicles and trailers). A lien on a vehicle is not “secret” because the lien must be noted on the certificate of title.⁶

Fifth, legislatures enact laws to regulate specific industries. These industry-specific liens (or statutory trusts) include (i) the Michigan Building Contract Fund Act (MBCFA);⁷ (ii) the Perishable Agricultural Commodities Act, 1930 (PACA)⁸ and the Packers and Stockyards Act, 1921 (PSA);⁹ (iii) labor obligations owing by mining operations;¹⁰ and (iv) labor and materials for oil and gas wells and pipelines.¹¹ These create systems of debtor-creditor relations unique to particular industries.

While most of the secret liens identified below are relatively harmless, several have the potential to cause an unexpected loss to a lender relying on a borrower’s collateral. A lien is problematic if it is both economically significant and secret or not readily discoverable. Those liens should be eliminated or modified.

A List of Secret and Problematic Liens

Non-Article-9 liens and other similar interests under Michigan and federal¹² law are categorized below according to the legal source of the lien or property interest. Legislation has given rise to many types of liens, so the *statutory lien* is the first category. Next are *judicial or common-law liens and judicial remedies*, some of which are based on statutes. Third are *statutory trusts*. These use a different terminology and do not by their wording create liens, but their effect can be similar. Fourth are *retention of title and other remedies*. Some of these remedies are not called liens but, since they are property interests that secure payment or performance, they function as liens. In this list the true secret liens are identified, and there are suggestions as to how to deal with several of them.

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Statutory Liens

In Rem Tax Liens

These are secret in the sense that they are not found in a registry like the secretary of state's UCC office. The personal property tax lien under the General Property Tax Act¹³ is the prime example. The industrial facility tax¹⁴ is secured by a lien against personal property only in the event of a jeopardy assessment, and in that event is evidenced by a filing with the register of deeds.¹⁵ The industrial facility tax obligation applicable to personal property is, like an obligation for personal property taxes, enforceable directly (without a judgment) against any personal property of the taxpayer located within the state.¹⁶ Because personal property is by definition moveable, the presence of a personal property tax lien is not always determinable by researching a local governmental database or by inquiring locally. A prospective lender or buyer would need to know where the property has been located to determine whether any personal property tax liens exist.

A more elusive *in rem* tax lien secures federal estate and gift taxes.¹⁷ This lien is problematic because it initially attaches to property included in the gross estate. However, if property is transferred by the decedent's successor (i.e. spouse, transferee, trustee, surviving tenant, person in possession, or beneficiary) to a purchaser or holder of a security interest, the transferred property becomes free of the lien. Instead, the lien will transfer and attach to "all of the property of" the successor, except any part transferred to a purchaser or holder of a security interest.¹⁸ This type of lien is in practice a floating lien against the assets of the family member who fails to pay the estate or gift tax. It is not intended to ensnare a legitimate purchaser or secured creditor.¹⁹

Other Federal Liens

Liability for federal taxes gives rise to a statutory lien against the assets of the taxpayer. As with the federal estate tax lien, there are protections for purchasers and lenders.²⁰ Because tax liens are perfected by the filing of a notice, and because there are numerous research materials on tax liens, this article does not discuss them in detail.²¹

If a company owes unpaid benefits or other pension-related liabilities, the Employment Retirement Income Security Act (ERISA)²² provides for a lien in favor of the Pension Benefits Guaranty Corporation

(PBGC) similar to a tax lien with the same requirements for the filing of notice of the lien.²³

The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)²⁴ provides for a lien to secure cleanup costs.²⁵ The "primary CERCLA lien" is against real property only.²⁶ This secures removal, remediation, and other such costs.²⁷ A "windfall" CERCLA lien, which secures unrecovered response costs to the extent of the enhancement of the value of property subject to the "response action" (i.e. cleanup), attaches to personal property such as equipment as well as real property.²⁸ The perfection requirements applicable to the "windfall" lien, however, do not provide for the filing of a notice with the secretary of state UCC office. Instead, "if the State has not by law designated one office for the receipt of such notices of liens" (and Michigan has not) "the notice shall be filed" with the clerk of the U.S. district court where the real property is located.²⁹ This leaves open the possibility of a CERCLA lien against personal property being evidenced only by a filing with a federal court. Prior-perfected liens are protected,³⁰ but a CERCLA "windfall" lien could be a secret lien to anyone relying on a UCC search.

A lien on *future* imports of pesticides and devices of an owner or consignee is granted in favor of the United States Department of Treasury to secure any unpaid charges for storage, cartage, and labor on imported pesticides and devices that are refused admission or delivery.³¹

Possessory Liens

These are sometimes called "secret" because no recordation is required.³² If a lender or purchaser can determine who is in possession of the collateral, or if the collateral or lien rights are not consequential, then a possessory lien poses little threat to commercial financing.

Possessory Liens Recognized by Article 9. The simplest and least objectionable possessory liens come within the Article 9 definition of "possessory lien."³³ In this category are liens to secure debts owing to a garage keeper,³⁴ hotel keeper,³⁵ campground operator,³⁶ self-service storage facility,³⁷ or a mechanic, artisan, or tradesman for the manufacture or repair of goods or the keeping of animals.³⁸ These liens depend on possession and secure payment for services or materials furnished with respect to goods in the ordinary course

Article 9 of the UCC provides a uniform system for the registration of security interests, yet secret liens persist.

of business.³⁹ Bank,⁴⁰ warehouse,⁴¹ and carrier liens⁴² are also provided for in the UCC.

Industrial Liens. These liens are provided by various modern statutes to secure payment rights for certain segments of manufacturing. The plastic mold act⁴³ provides for a possessory lien in favor of a molder, i.e. a manufacturer of plastic parts. The Special Tools Lien Act⁴⁴ provides for a possessory lien in favor of an end-user of special tooling. A molder and end-user have a lien on the mold or tool to secure payment for their services. The non-possessory liens provided for by these statutes protect the moldbuilder or special-tool maker and are discussed below.

Floating Logs Lien. Several Michigan statutes still address a nineteenth-century industrial practice that no longer exists—floating logs downstream to the saw mill.⁴⁵ These statutes are unlikely to cause a conflict with commercial financing or other property rights, but they should be repealed because they are obsolete.

Distraint Liens. Beasts can be distrained for “going at large contrary to law” or for damaging property.⁴⁶ If you do not pay a bridge toll, the bridge authority has a lien on, and may take and retain possession of, your automobile until you do.⁴⁷ This is similar to a lien on a vehicle impounded for certain violations.⁴⁸ A buyer of goods on a home solicitation sale may keep the goods to secure a refund.⁴⁹ Although not all of these possessory liens qualify as a “possessory lien” under Article 9, none poses a significant risk to commerce.

*Aircraft Garage Keeper Lien.*⁵⁰ An aircraft garage keeper who furnishes fuel, labor, or materials has a lien on the aircraft to secure the unpaid sums due. “The garage keeper may detain the aircraft at any time it is in his or her possession within 90 days after performing the last labor or furnishing the last supplies for which the lien is claimed.”⁵¹ Therefore, even if the aircraft has flown, the garage keeper can ground it if it lands again in the garage keeper’s possession within 90 days. The lien has priority over all other liens.⁵² Enforcement of the lien is by means of a sale and requires that notice be recorded with the Federal Aviation Administration aircraft registry.⁵³

Boat Storage Lien. The Michigan Marina and Boatyard Storage Lien Act⁵⁴ grants a lien to a storage facility owner on a boat “stored” at a particular facility.⁵⁵ The lien secures unpaid charges for storage, rent, labor, materi-

als, and supplies. The lien may take priority over prior liens, depending on when certain notices are provided.⁵⁶ Because a boat owner might cause a hiatus in the marina’s possession by using the boat, it is not clear whether the lien is always possessory, but a marina would probably deny the use of a boat to an owner who is seriously delinquent.

Michigan’s Non-Possessory Statutory Liens: Pitfalls for the Unwary

Worker’s Disability Compensation. The first (and possibly most notable) secret lien in this category is the lien for worker’s disability compensation that in “the case of the insolvency of an employer...shall constitute a first lien upon all the property of the employer...paramount to all other claims or liens, except for wages and taxes...”⁵⁷ No notice of the lien is required to be filed.

Medicaid and Other Health-Care Overpayments. Under the Social Welfare Act,⁵⁸ the Michigan Department of Community Health “shall have a priority lien on any assets of a provider for any overpayment, as a consequence of fraud or abuse, that is not reimbursed to the department of community health.”⁵⁹ The term “priority” is not defined. The term “abuse” implies a lower and less defined standard than “fraud,” potentially extending the remedy to any instance of overpayment not caused by a unilateral mistake by the government. There is no requirement that notice of the lien be filed. Like the worker’s compensation lien, this lien is doubly offensive to commercial financing because it is both secret and priming.

False claims under Michigan NREPA. A person who makes a false claim for payment or indemnification under the underground-storage-tank-corrective-action-funding provisions of the Natural Resources and Environmental Protection Act⁶⁰ is subject to unique penalties and procedures. “Money owed pursuant to this section constitutes a claim and lien...upon any real or personal property owned *either directly or indirectly* by the person...[and] has the force and effect of a first in time and right judgment lien.”⁶¹ (emphasis added). Thus, assets of the offender’s closely held corporation (being indirectly owned) might be subject to the lien. Because it is treated as a judgment lien, although it is subordinate to a prior-perfected lien, it is not subject to perfection by notice filing. This lien may be rare, but it is a priority dispute wait-

A lien is problematic if it is both economically significant and secret or not readily discoverable. Those liens should be eliminated or modified.

Michigan statutes are peppered with provisions for liens that lack a coherent scheme.

ing to happen. Other liens under the Michigan NREPA are discussed below.

Agricultural Services. Michigan law provides for liens to secure payment for the following two types of agricultural services:

- *Pressing, threshing, or hulling.*⁶² The lien secures charges for the mechanical processing of certain crops.⁶³ Notice is to be filed with the county register of deeds.⁶⁴ The lien does not attach to product that passes “into the hands of an innocent purchaser or dealer in the usual course of trade.”⁶⁵
- *Service by stallion.*⁶⁶ This lien attaches to both the mare who was serviced and the foal. Notice is to be filed with the county register of deeds. The lien is valid for one year and has priority over all other liens on the offspring.⁶⁷ Horses in this instance are treated like growing crops, a security interest in that is also perfected with a county filing.

*Animals Transported by Rail.*⁶⁸ A lien is granted to secure the payment of any food, water, or shelter provided by the railroad company to the animals.⁶⁹ It is not clear whether the lien terminates on surrender of possession and, given the obsolescence of the statute, we may never know.

*Oil or Gas Well or Pipeline.*⁷⁰ This lien secures labor and materials, and it attaches not only to real property but also to equipment and to the oil or gas produced by the well. The statute provides a unique set of rules for perfection and enforcement of the lien. Notice is to be filed with the register of deeds, which is problematic as to personal property. Further complicating matters for this industry is a specific forfeiture statute that provides that “illegal oil or gas, products derived from illegal oil or gas, conveyances used in the transportation of illegal oil or gas or oil or gas products, and containers used in their storage, except railroad tank cars and pipelines, are subject to confiscation” and seizure by the Michigan Department of Environmental Quality.⁷¹

Michigan Railroad Companies. This lien secures payment of a judgment against a street railway or railroad company for personal injury or death.⁷² This law appears to be redundant because a judgment creditor of a railroad company could execute against the company’s assets.⁷³

*Watercraft.*⁷⁴ This lien secures debts for supplies, provisions, labor, and other expenses relating to the maintenance and docking of a boat. The lien arises after the supplier or laborer provides notice of its claim to the owner/master of the craft.⁷⁵ To enforce the lien, the sheriff will seize and hold the watercraft pending the litigation and any sale.⁷⁶ This procedure may also be used to enforce a non-possessory lien of a canal or harbor company for unpaid tolls and charges.⁷⁷

Special Tools and Plastic Molds, Part Two. The Special Tools Lien Act⁷⁸ and plastic mold act⁷⁹ discussed above, each grant a lien to the makers of the special tool or mold to secure payment for the manufacture of the device. The lien becomes non-possessory on delivery to the customer or user. The requirements for perfecting a non-possessory lien of a toolmaker or moldbuilder are 1) to include the name of the toolmaker or moldbuilder on the tool or mold,⁸⁰ and 2) to file a UCC financing statement with the secretary of state.⁸¹

Corporate stock; Partnership assets. This lien secures debts owed to the corporation by the shareholder.⁸² This is no longer provided for under the Business Corporation Act,⁸³ but it still appears as a relic in the Summer Resort and Park Associations Act of 1897,⁸⁴ where it is unlikely to come into conflict with the holder of a security interest. The Uniform Partnership Act⁸⁵ provides for a lien on partnership assets to secure debt to an investor for fraud.⁸⁶ This lien is subordinate to the claims of creditors of the partnership, so it essentially adjusts the rights of a defrauded investor vis-à-vis those who defrauded him. Completing this category of uncommon liens is the statutory lien (to secure payment of certain fees) on shares of stock deposited with the Michigan Department of Treasury in connection with a “protective committee.”⁸⁷

Property of Insured. This lien secures payment of premiums to farmers’ mutual insurers or other special mutual property insurers.⁸⁸ The statute does not specify a method of perfection, the manner of enforcement, or priority. Therefore, resort to the courts would be appropriate for enforcement.⁸⁹

Liens for Which Faulty Perfection Requirements Apply

Michigan statutes are peppered with provisions for liens that lack a coherent scheme. Perhaps the starkest example is a provision whereby costs for removing a marine navigational hazard, if not paid within 30 days

of mailing of a written notice, “may become a lien against the person’s property.”⁹⁰ The statute provides no specificity as to the scope of the lien (e.g. whether it attaches to just the navigation hazard or all of the person’s property), the priority of the lien, perfection requirements, or enforcement.

Several Michigan statutes, discussed below, provide for a lien to be perfected as provided by state or federal law. Although a lien against real property is always perfected by filing with the register of deeds, neither state nor federal law provides a general rule for perfection of nonconsensual liens against personal property. Although these nonconsensual liens meet the definition of a “security interest” in that the liens are “an interest in personal property or fixtures which secures payment or performance of an obligation,”⁹¹ they are excluded from Article 9 and its filing system because they do not arise from a transaction that “creates a security interest in personal property or fixtures by contract”⁹² and do not otherwise come within Article 9.⁹³ The Michigan legislature should revise any statute that provides for a nonconsensual lien on personal property to provide that a notice is to be filed with the secretary of state, as provided in the State Tax Lien Registration Act.⁹⁴

*Natural Resources and Environmental Protection Act.*⁹⁵ In addition to the provisions of the act applicable to false leaking-underground-storage-tank claims, the Michigan NREPA provides for a lien⁹⁶ to secure the payment of civil fines resulting from a violation of the water pollution provisions of the act. “A lien under subsection (7)(b) shall take effect and have priority over all other liens and encumbrances except those filed or recorded prior to the date of judgment only if notice of the lien is filed or recorded *as required by state or federal law.*”⁹⁷ The lien under the NREPA for “cleanup costs for scrap tires accumulated after January 1, 1991”⁹⁸ may be sought by the state in a court action. The state may request a lien that attaches to certain personal property and that primes prior liens.⁹⁹ The NREPA does not specify how such a lien against personal property would be perfected. Presumably, the court that awards the lien would deal with that issue.

*Support and Parenting Time Enforcement Act; Alimony.*¹⁰⁰ This statute grants the government a lien¹⁰¹ on all assets of the debtor-parent to secure the payment of child support. An award of alimony is also secured

by this lien.¹⁰² The lien is to be perfected “in the same manner in which another lien on *property of the same type* is perfected.”¹⁰³ This language incorrectly presumes that the manner of perfection is determined by the type of property to which the lien is to attach. A consensual lien, such as a security interest, is not necessarily perfected in the same manner as a nonconsensual lien, e.g. a judgment lien. Presumably, the debtor will not authorize the filing of a financing statement (for nontitled personal property), or a notation on a vehicle or boat title, so the lien to be perfected would be a levy on execution, i.e. by seizure of property. This lien could present issues with respect to a debtor who owes child support and then incurs non-purchase-money secured debt.

*Michigan Employment Security Act*¹⁰⁴ Unpaid contributions owed to the Michigan Unemployment Agency are a lien on all property, real and personal, belonging to the obligor, which attaches when the agency files the requisite notice.¹⁰⁵ The lien pre-empts all other liens except for those recorded before the notice. Notice of the lien need only be filed with the “register of deeds of the county in which the property subject to the lien is situated.”¹⁰⁶ The statute provides that notice of the lien “*may* also be filed with the secretary of state....”¹⁰⁷ The word “shall” should be substituted for the word “may” to expand the benefits of the centrality of the Article 9 filing system.

Landlord Lien

A landlord’s lien is the right of a landlord to execute upon a tenant’s property in satisfaction of unpaid rent or property damage.¹⁰⁸ This type of lien is not recognized under Michigan law,¹⁰⁹ but it is provided for in many standard leases. Under Michigan law, if the lien is provided for in a lease, it is an Article 9 security interest and must be perfected as such.¹¹⁰

Judicial or Common-Law Liens

These liens exist in the law but are not provided for by statute. This discussion divides them between possessory and nonpossessory. Because a judgment-execution lien can be perfected by “constructive” possession, which is not actual possession, it could occur as a nonpossessory lien.

Possessory Common-Law Liens. These range from the humble artisan’s lien to the potentially problematic execution lien. Possessory

Several Michigan statutes... incorrectly presume that the manner of perfection is determined by the type of property.

Possessory
liens are less
problematic
than
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possession.

liens are less problematic than unregistered non-possessory liens because notice is provided by possession.

*Artisan's Common-Law Lien.*¹¹¹ This is a possessory lien provided under common law to secure indebtedness arising from the provision of labor, skill, and/or materials that add value to the property of another.¹¹²

Execution Lien. Although Michigan's Revised Judicature Act of 1961¹¹³ specifies that property subject to a judgment execution is "bound from the time of such levy," the lien arising from the execution of a judgment is only recognized, not provided for, by statute.¹¹⁴ This "binding" of the property constitutes a lien that arises on the taking of possession of the personal property.¹¹⁵ Possession may be actual or constructive.¹¹⁶ Constructive possession presents notice issues. An execution lien perfected by constructive possession (i.e. without possession or recorded notice) is a secret lien.

Attorney's Lien. There are two different types of attorney's liens. A possessory lien is the right of the attorney to retain possession of documents, money, and other client property until the outstanding fees due to the attorney are paid.¹¹⁷ A non-possessory or charging lien is the equitable right to have fees and costs due to the attorney secured by the fund created through the attorney's efforts.¹¹⁸

Non-Possessory Judicial Liens and Judicial Remedies

Garnishment lien. A garnishment lien is perfected on the service of a writ of garnishment.¹¹⁹ Such a lien is secret insofar as a search of the records of an indeterminate number of courts may be required to discover its existence, and the completion of service might not be evident from the court records.

Charging order. A charging order¹²⁰ against a limited liability company membership interest is issued pursuant to a court order and is a lien on the membership interest of the indebted member. However, the lien cannot be foreclosed. The charging lien is secret for the same reasons as a garnishment lien.

Other State Judicial Liens. Michigan courts have the authority to "devise and make such new orders as may be necessary to carry into effect the powers and jurisdiction possessed by them."¹²¹ The courts have used this authority to create liens outside of Article 9. For example, a landlord has an equitable lien on rent owed by a sublessee to

an insolvent lessee.¹²² Article 9 of the UCC recognizes a receiver as a lien creditor,¹²³ and the Michigan Supreme Court tacitly recognized the authority of a circuit court to grant a lien on real property to secure payment to the receiver.¹²⁴ Although the case involved real property, there is no reason to believe that the holding would not apply to personal property. A receiver's lien might be evidenced by only a court order and granted without any requirement of notice to persons not parties to the case.¹²⁵ A receiver's lien therefore poses the same potential problems as other judicial liens—it is discoverable only by happenstance or a search of an indeterminate number of court dockets.

Common-Law Assignment for the Benefit of Creditors (ABC). An ABC is filed with the circuit court where the assignor resides, or if not a resident, where the assigned assets are principally located.¹²⁶ Because an ABC transfers title to the assignee to secure payment of claims of creditors, it is in substance a lien. Because it is perfected in the same way as other judicial liens identified above, an ABC presents the same potential notice and discoverability issues.

Bankruptcy Court Orders. The property of a bankruptcy estate is under the jurisdiction of the bankruptcy court, which has the authority to authorize the trustee or debtor in possession to obtain secured credit.¹²⁷ Liens granted on property of the estate are routinely permitted to be perfected and evidenced solely by a court order, and the priority of such debt may be insulated from reversal on appeal.¹²⁸ Therefore, secured debt authorized by order of the bankruptcy court might be evidenced only in the records of the bankruptcy court.

Forfeiture. The unique and controversial powers of the state and federal governments to proceed *in rem* in forfeiture actions presents a set of controversial issues beyond the scope of this article.¹²⁹ The Racketeer Influenced and Corrupt Organizations Act (RICO)¹³⁰ contains powerful and broad forfeiture provisions.¹³¹ Title to the property forfeited vests in the United States on the commission of the act.¹³²

The Judgment-Debtor Injunction. An order for examination may contain a provision restraining the debtor from transferring his property until further order of the court.¹³³ This is not a lien, but because it is backed by contempt power, a judgment creditor can

gain leverage over the debtor as though it has a lien.

Other Federal Court Orders. The federal courts have broad authority to issue injunctions.¹³⁴ As with state-court injunctions, the use by a judgment creditor of this power can effectively put the creditor in the position of a gatekeeper for the disposition of the debtor's assets.

Constructive Trust. This *ex post facto* remedy has the potential of changing ownership of property after the fact. Because it is a remedy in favor of a creditor (or other claimant) determined to be entitled to relief, and dedicates specific property to the payment or other remedy for the creditor/claimant, it can function like a lien.¹³⁵

Alter Ego Remedies. These remedies, including successor liability, may alter title after the fact by determining that two or more entities should be considered to be one.¹³⁶

Setoff And Recoupment

Setoff is the common law right of a creditor to balance mutual debts with a debtor.¹³⁷ Recoupment is a common law right that allows a person to reduce or eliminate one obligation against another, but only to the extent that they both arise out of the same transaction.¹³⁸ Recoupment is "applied when there are countervailing claims arising from the same transaction."¹³⁹ Similar rights are also created by statute. For example, a lien is created under the Michigan Insurance Code of 1956¹⁴⁰ in favor of a limited liability pool against the insurance policy of a member to secure payment of an assessment.¹⁴¹ Sometimes the right of setoff conflicts with the rights of a secured creditor who holds a security interest in an account.¹⁴²

Statutory Trusts—Federal

PACA and PSA. Under PACA¹⁴³ and PSA,¹⁴⁴ certain participants in the food industry hold funds in trust for suppliers and sellers. The trust takes priority over pre-existing liens.

Taxes. Income taxes withheld from employee wages, i.e. "withholding taxes" and other taxes collected by a business for the government, are held in trust for the United States.¹⁴⁵

Statutory Trusts—State

Michigan Building Contract Fund Act. The MBCFA¹⁴⁶ or "builders' trust fund" provides that funds paid to a building contractor are held in trust for the benefit of subcontractors, laborers, and suppliers. This can have the

effect of a secret lien, as it is a property interest to secure payment and is not perfected by either possession or the filing of a notice. Moreover, the statute is saturated with ambiguity due in part to its nature as a criminal statute without an explicit civil remedy,¹⁴⁷ which has for decades been interpreted to provide a civil remedy.¹⁴⁸ It has been applied so as to include in the definition of "contractor" a person who did not enter into the contract.¹⁴⁹

Taxes. Withholding taxes collected by businesses, similar to tax collections for the federal government, are held in trust for the state of Michigan.¹⁵⁰

Retention of Title and Other Devices

Reclamation. A seller may reclaim goods on discovering the insolvency of a buyer. However, reclamation rights are subject to the rights of a buyer in the ordinary course and to a lien creditor.¹⁵¹ Reclamation rights are similar to a secret lien. In bankruptcy, those rights can give rise to an administrative expense claim.¹⁵²

Equitable Subrogation. Equitable subrogation is "a legal fiction through which a person who pays a debt for which another is primarily responsible is substituted or subrogated to all the rights and remedies of the other."¹⁵³ A subrogee obtains no greater rights than those possessed by the subrogor.¹⁵⁴ Subrogation rights are often exercised by a surety with respect to a principal in the construction industry.¹⁵⁵ A surety can, by contract, hold an interest in money owed to the principal, and this interest is excluded from Article 9.¹⁵⁶

Statutory Liens or Subrogation on Insurance Recoveries. Similar to equitable subrogation, some statutes grant liens to certain payors on insurance recoveries.¹⁵⁷

*Hot Goods Doctrine.*¹⁵⁸ The "hot goods" doctrine is, in effect, a secret lien for unpaid wages. The doctrine prohibits the sale of goods if certain wage-related expenses related to the production of the goods were not paid.

Consignment. A consignment transaction is one in which a person transfers goods to a merchant or factor for sale. Under common law, title remains in the consignor.¹⁵⁹ Under the UCC, a consignor who has not perfected its security interest in accordance with Article 9 loses to a creditor of the consignee if, for example, the merchant/consignee "is not generally known by its creditors to be substantially engaged in selling the goods of oth-

Many of the least problematic non-Article 9 liens are either well-known or possessory. The more problematic liens are uncommon and difficult to detect.

ers.”¹⁶⁰ The consignor who loses to a creditor of the consignee cannot be said to have had a secret lien. Rather, the consignor is the victim of a failure to protect itself from parting with title on delivery.

Unemployment Compensation Contributions. Under the Michigan Employment Security Act,¹⁶¹ a successor-employer may be liable (up to the net value of the assets acquired) for the predecessor’s liability under the act.¹⁶² The act also provides for a lien in favor of the Unemployment Insurance Agency as described above, but the successor-liability provision has the effect of a secret lien on the predecessor’s assets because successor liability is not dependent upon the filing of a notice of the lien for delinquent contributions.

Priority of Federal Government Claims. Under federal law,¹⁶³ property of a debtor under certain circumstances is to be used first to pay debts owed to the federal government. A representative of a person or an estate who instead pays other debts may be liable to the federal government. While this statute does not create a lien in favor of the United States, it is similar in effect to the creation of a lien and a penalty for disregarding the lien.

Which Liens Are Problematic?

Many of the least problematic non-Article 9 liens are either well-known or possessory. The more problematic liens are uncommon and difficult to detect. The most problematic are those likely to prime an already-existing lien or be enforceable against a bona fide purchaser. The following list does not include all liens and remedies discussed above, but it is intended to show the author’s opinion as to where selected liens fall on a spectrum from useful to problematic.

Least problematic:

- Possessory and certificate-of-title liens recognized in the UCC or Article 9
- Marina lien and other liens that may qualify as possessory liens
- Seizure of motor vehicles in small matters
- Unique types of federally-regulated property such as patents, ships and airplanes
- Agricultural liens
- Industrial liens

Firmly Implanted in the Law:

- In rem tax liens
- Other tax or government liens, including PBGC

- Hot-goods doctrine
- Judicial remedies which may create secret liens and interests.

Obsolete and Inconsistent with UCC but Rare:

- Floating log liens
- Distraint of beasts
- Animals transported by rail
- Corporate stock and insurance provisions
- Lien to secure judgment against railroad company

In Need of Clarification or Correction as to Filing:

- CERCLA
- NREPA (penalties for water pollution)
- Michigan Employment Security Act
- Alimony and child support obligations

Most Problematic:

- Industry Specific:
 - MBCFA, “Builder’s Trust Fund”
 - Oil well and pipeline lien
 - Federal PACA and PSA
- Simply Secret
 - NREPA (penalties for false claims)
- Secret and Priming:
 - Reimbursement to Michigan Department of Community Health
 - Worker’s Disability Compensation

How to Eliminate Secret Liens

Certain obsolete liens could be eliminated. It is no longer necessary to have special log laws or a chapter of the Michigan Compiled Laws devoted to railroads. The legislature should weed out these and other obsolete laws. The fairness and impact on other creditors of priming liens should also be re-examined.

The legislature should also consider using the State Tax Lien Registration Act, which utilizes the Secretary of State UCC registry for the perfection of tax liens on personal property, as a model for a lien registration act covering all non-consensual liens, including federal liens such as the CERCLA “windfall” lien. The centralized registration of nonpossessory liens on personal property would reduce, if not eliminate, the old and continuing problem of the secret lien.

NOTES

1. *The Dolphin*, 7 F Cas 866, 868 (CCED Mich 1876).
2. MCL 440.9333.
3. The Michigan Court of Appeals has held that a court order does not necessarily have to be written. *See, e.g., Arbor Farms, LLC v GeoStar Corp*, 305 Mich App 374, 387, 853 NW2d 421 (2014).
4. The National Conference of Commissioners on Uniform State Laws issued the Model Tribal Secured Transaction Act, which includes template portions of Article 9 of the UCC, with recommendations as to how the template can be modified based on tribal codified law, customs, and traditions.
5. *In re World Auxiliary Power Co.*, 303 F3d 1120, 1128 (9th Cir 2002); 17 USC 101 *et seq.*
6. MCL 440.9303; *See, e.g.,* MCL 257.238 (vehicles) and 125.2330d (mobile homes).
7. MCL 570.151 *et seq.*
8. 7 USC 499a *et seq.*
9. 7 USC 181 *et seq.*
10. MCL 570.194 (labor for mining, smelting, and manufacturing ores and minerals in the Upper Peninsula of Michigan); MCL 570.201 (labor for mining coal, shale, or clay).
11. MCL 570.251 *et seq.*
12. The UCC Committee of the Business Law Section of the State Bar of California has compiled an ambitious Hidden Liens Report that is worth consulting for the identification of federal liens and the large number of secret liens that exist under California law: <http://businesslaw.calbar.ca.gov/Publications/HiddenLiens/HiddenLiensReport.aspx>
13. In Michigan, *see* MCL 211.40.
14. MCL 207.551 *et seq.*
15. MCL 207.562; MCL 211.694.
16. MCL 207.562(1); MCL 211.47.
17. 26 USC 6324.
18. 26 USC 6324(a)(2).
19. The terms “purchaser” and “security interest” are defined in 26 USC 6323(h) so as to protect legitimate purchasers and creditors.
20. *See* 26 USC 6323.
21. *See* 26 USC 6321 *et seq.*; MCL 205.29 *et seq.*
22. 29 USC 1001 *et seq.*
23. 29 USC 1368(a), (c).
24. 42 USC 9601 *et seq.*
25. 42 USC 9607(l), (r).
26. 42 USC 9607(l)(1).
27. 42 USC 9607(l).
28. 42 USC 9607(r)(2) provides for a lien on the “facility.” CERCLA’s definition of “facility” in 42 USC 9601(9) includes equipment and other personal property.
29. 42 USC 9607(l)(3). [Note that at least one court has indicated that certain provisions of this statute violate the Fifth Amendment due process clause. *See, e.g., Van Horn v Department of Toxic Substances Control*, 231 Cal App 4th 1287, 1299, 180 Cal Rptr 3d 416, 424 (2014).]
30. *Id.*
31. 7 USC 136o(c)(1).
32. Robert Force, Admiralty and Maritime Law 1 at 164 (Federal Judicial Center, 2004) quoted in *Northland Seris, Inc v 20’ Container*, No 3:13-cv-029-JWS-JDR, 2013 US Dist LEXIS 80586 at *2 (D Alaska June 6, 2013).
33. MCL 440.9333.
34. MCL 570.303.
35. MCL 427.201.
36. MCL 554.657.
37. MCL 570.521 *et seq.*
38. MCL 570.185-186; 570.193.
39. *Id.*
40. MCL 440.4210, 440.4504 and 440.5118.
41. MCL 440.7209.
42. MCL 440.7307.
43. MCL 445.611 *et seq.*
44. MCL 570.541 *et seq.*
45. MCL 485.121-123; MCL 426.160.
46. MCL 433.101-103.
47. MCL 254.235.
48. *See, e.g.,* MCL 257.724(2) which applies to overweight vehicles, MCL 324.8905c which applies to a vehicle used in littering, and MCL 600.8733 which applies to trailway municipal infractions.
49. MCL 445.114.
50. MCL 259.205.
51. *Id.*
52. *Id.*
53. MCL 259.205b.
54. MCL 570.371 *et seq.*
55. MCL 570.373.
56. *Id.*
57. MCL 418.821(1).
58. MCL 400.1 *et seq.*
59. MCL 400.111a(7)(d).
60. MCL 324.101 *et seq.*
61. MCL 324.21548(9).
62. MCL 570.331-339.
63. MCL 570.331.
64. MCL 570.332.
65. MCL 570.331.
66. MCL 287.210.
67. MCL 287.210. The legislature used the term “colt” (a young male horse) as interchangeable with “foal” (a baby horse).
68. MCL 750.51.
69. *Id.*
70. MCL 570.251.
71. MCL 324.61523.
72. MCL 462.431.
73. This may not have been the case in 1885, for example. *See East Alabama Ry Co v Doe*, 114 US 340, 353 (1885).
74. MCL 570.402.
75. *Id.*
76. MCL 570.405; 570.430-435.
77. MCL 485.11.
78. MCL 570.541 *et seq.*
79. MCL 445.611 *et seq.*
80. MCL 570.563(1); MCL 445.619(1).
81. MCL 570.563(2); MCL 445.619(2).
82. As to summer resort and park associations, MCL 455.14.
83. MCL 450.1101 *et seq.*
84. MCL 455.1 *et seq.*
85. MCL 449.1 *et seq.*
86. MCL 449.39.
87. MCL 451.303.
88. MCL 500.6838.
89. *See, e.g., Berry v Dehnke*, 302 Mich 614, 625, 5 NW2d 505 (1942) (where lien created by statute has no adequate remedy, party may resort to court).
90. MCL 324.80163. *See also* MCL 485.12 (lien against watercraft for rule violation or damage.).
91. MCL 440.1201(2)(ii).
92. MCL 440.9109(1)(a).
93. *Id.*; *Shurlow v Bonthuis*, 456 Mich 730, 736, 576 NW2d 159 (1998).
94. MCL 211.681 *et seq.*
95. MCL 324.101 *et seq.*

96. MCL 324.3115(7)(b); MCL 324.63223(7)-(9) (civil action by Michigan attorney general).
97. MCL 324.3115(8) (emphasis added); *See also* MCL 324.63223(8).
98. MCL 324.16908b.
99. MCL 324.16908b(2)(b).
100. MCL 552.601 *et seq.*
101. MCL 552.625a and 552.625b.
102. MCL 552.27.
103. MCL 552.625b(3) (emphasis added).
104. MCL 421.1 *et seq.*
105. MCL 421.15(c).
106. *Id.*
107. *Id.* (emphasis added).
108. *Shurlow*, 456 Mich at 734.
109. *In re Kentwood Pharmacy, LLC*, 475 BR 602, 609 (Bankr WD Mich 2012).
110. *Shurlow*, 456 Mich at 738.
111. Authority for this lien is found in *Nickell v Lambrecht*, 29 Mich App 191, 196-97, 185 NW2d 155 (1970) quoting Brown, *The Law of Personal Property* (2d ed), §107, p 511.
112. 29 Mich App at 196.
113. MCL 600.6001 *et seq.*
114. MCL 600.6012.
115. *In re Obakpo*, 494 BR 269, 278-79 (Bankr ED Mich 2013).
116. *Id.*, citing *United States Leather, Inc v Mitchell Mfg Grp, Inc*, 276 F3d 782, 789 (6th Cir 2002).
117. *George v Sandor M Gelman, PC*, 201 Mich App 474, 476, 506 NW2d 583 (1993).
118. *Id.*
119. *Mary v Lewis*, 399 Mich 401, 411, 249 NW2d 102 (1976).
120. MCL 450.4507.
121. MCL 600.1455(3).
122. *SS Kresge Co v 1275 Woodward Ave Corp*, 270 Mich 218, 221, 258 NW2d 525 (1935).
123. MCL 440.9102(l)(yy).
124. *Price v Kosmalski (In re Receivership of 11910 S Francis Rd)*, 492 Mich 208, 213-14, 821 NW2d 503 (2012). Note that the receiver's lien will not pre-empt a prior recorded lien unless the lienholder explicitly agrees. *Id.*
125. MCR 2.622(A) provides that a receiver is a fiduciary for the benefit of all persons appearing in the action or proceeding. By negative implication, the receiver arguably owes no such duties to persons who are not parties to the action or proceeding, so the rule implies that notice may be limited to parties.
126. MCL 600.5201(1).
127. 11 USC 364.
128. 11 USC 364(e).
129. *See e.g.*, Anno. 1 ALR 5th 317, Effect of Forfeiture Proceedings under Uniform Controlled Substances Act or Similar Statute on Lien against Property Subject to Forfeiture.
130. 18 USC 1961 *et seq.*
131. 18 USC 1963.
132. 18 USC 1963(c).
133. MCL 600.6116.
134. Fed R Civ P 65. But a limit to that authority was recognized in *Grupo Mexicano de Desarrollo SA v Alliance Bond Fund, Inc*, 527 US 308 (1999).
135. *See, e.g.*, *Filibeck v Beal (In re Estate of Filibeck)*, 305 Mich App 550, 853 NW2d 448 (2014).
136. *See, e.g.*, *Vernor's Dollars Discount, Inc v Fremont Mut Ins Co*, No 276541, 2008 Mich App LEXIS 437 (Feb 28, 2008) (unpublished); *Florence Cement Co v Vettraino*, 292 Mich App 461, 807 NW2d 917 (2011).
137. *In re Hess*, 456 BR 309, 314 (Bankr ED Mich 2011).
138. *Flynn v Barry*, 221 Mich 422, 423-24, 191 NW 215 (1922); *In re Delicruz*, 300 BR 669, 680 (Bankr ED Mich 2003).
139. 300 BR at 680 (citation omitted).
140. MCL 500.100 *et seq.*
141. MCL 500.6540.
142. MCL 440.9404.
143. 7 USC 499e(c)(2).
144. 7 USC 196 and 197.
145. *See, e.g.*, 26 USC 7501.
146. MCL 570.151 *et seq.*
147. *DiPonio Constr Co v Rosati Masonry Co*, 246 Mich App 43, 48, 631 NW2d 59 (2001), *app den*, 465 Mich 897, 636 NW2d 141 (2001).
148. *DiPonio Constr*, 246 Mich App at 48; *In re Certified Question from United States Dist Court*, 411 Mich 727, 733, 311 NW2d 731 (1981); *National Bank of Detroit v Eames & Brown*, 396 Mich 611, 621, 242 NW2d 412 (1976).
149. *See People v Brown*, 239 Mich App 735, 610 NW2d 234 (2000).
150. *See, e.g.*, MCL 207.1141(fuel tax); MCL 205.19(4)(taxes).
151. MCL 440.2702.
152. 11 USC 503(b)(9), 546(c)(1).
153. *Hartford Accident & Indem Co v Used Car Factory, Inc*, 461 Mich 210, 215, 600 NW2d 630 (1999) (citations omitted).
154. *Id.*
155. *See, e.g.*, *Amoco v LA Davidson*, 95 Mich App 358, 360-363, 290 NW2d 144 (1980).
156. MCL 440.9109(4)(f).
157. *See, e.g.*, 45 USC 362(o) (reimbursement to Federal Railroad Retirement Board); MCL 600.6303 (collateral source benefits in personal injury actions); 42 USC 1396k (assigning payments to the state for medical care); MCL 400.106 (same).
158. 29 USC 215(a)(1).
159. *Wasey v Whitcomb*, 167 Mich 58, 72, 132 NW 572 (1911); *In re Taylor*, 46 F2d 326, 328 (ED Mich 1931).
160. MCL 440.9102(t)(i).
161. MCL 421.1, *et seq.*
162. MCL 421.15(g).
163. 31 USC 3713.



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Cybersecurity Risks, Regulation, and Resources

By Shane B. Hansen, Carly A. Zagaroli, and Paul D. Bratt

Overview

Those convenient “clouds” of electronically stored or accessed data and personal information also contain “lightning” that can strike unprepared investment firms and their clients. Criminal enterprises behind these attacks have become more sophisticated and often involve domestic or foreign organized crime syndicates, foreign nationals, and even foreign governments—no longer just techno-geeks and petty thieves.

A 2014 pilot survey by state securities regulators¹ found that 4.1 percent of state-registered investment advisers had experienced a cybersecurity incident and 1.1 percent had experienced theft, loss, or unauthorized exposure or misuse of confidential information. Cybersecurity experts (including cybersecurity consulting firms marketing their services) believe the “hit rate” is likely higher. With the U.S. government,² the Securities and Exchange Commission (SEC),³ the North American Securities Administrators Association (NASAA),⁴ the Financial Industry Regulatory Authority (FINRA),⁵ and news media sounding sirens of cyber threats, do not be caught unaware sleeping under a tree when the lightning strikes at your firm and your clients.

Connectivity Is Convenient But Risky

Today you need more than gates, guards, and guns to prevent criminals from getting away with the firm’s and clients’ identities or cash. E-mail, computers, laptops, tablets, internet-based information access or storage, smartphones, internet-connected hardware and related software, flash drives, wireless communications—all the “modern conveniences”—create ample opportunity for a tech-savvy intruder to monitor, gain access to, and misappropriate confidential information. Smartphone applications like “Swipe” and “Swift Key” include seemingly helpful features that “learn” and adapt to your (bad) typing habits by tracking your every key entry on their remote file servers—convenient, yes, but the person with access to that

remote file server can potentially see every password and ID you type. Frequently, hi-tech platforms and data aggregators gather, store, and allow access to both clients’ and the firm’s own confidential personal information. Access to client information and e-mails can later be translated into highly convincing identity theft schemes. The days of physical computer tapes, CDs, DVD, and manual data back-ups are largely gone—replaced by more reliable third-party “cloud” servers and systems. However, today’s remarkable connectivity and convenience through networks, the internet, and the digital cloud create cyber vulnerabilities.

Firms are susceptible to various kinds of cyber threats, some more serious than others. Unencrypted laptops, tablets, smart phones, and similar devices are easy targets if lost or mislaid, particularly if not password-protected. Unencrypted e-mail is easily intercepted, especially when e-mail addresses are stolen from other sources, such as “big box” retailers. How often have you forgotten your password to personally access a website and simply clicked to have it e-mailed to you—are *you* the *only* person receiving it? Many consumer-grade file-sharing websites and systems are not designed with strong cybersecurity protections. These file-sharing systems may be simple and cheap—great for personal photo sharing—but may not be suitable for the type of confidential personal, financial, and business data transmitted and stored by financial services firms.

Malware, “digital worms,” and “key-logging” software are commonly spread through e-mail, spurious applications and program updates, “Trojan horse” file attachments, and visiting infected websites. Phishing e-mails continue to be a common attack strategy. There are cyber threats to the computer operating systems you use to conduct daily business—not just your own systems, but also third-party systems and websites you rely on to serve your clients. A “bot-net”—short for robot network—is an accumulation of compromised computers (called “zombies”) manipulated by a central com-

puter or “controller.” Botnets have the ability to overload web servers, to steal data, and may be difficult to detect. Distributed denial of service (DDoS) attacks can stall business operations for hours or even longer—your website or third-party websites you rely on to monitor portfolios or enter trades. These attacks have been used to extort “ransom” from the web host in exchange for resumed operations. In the meantime, you may be unable to access or use the website.

Cyber-Related Regulations

Assessing and planning for cybersecurity risks has become a high regulatory priority among securities regulators. On September 15, 2015, the SEC Office of Compliance Inspections and Examinations (“OCIE”) issued a release, *Cybersecurity Examination Initiative*, summarizing its examination priorities, which will involve more testing to assess implementation of firm procedures and controls.⁶ OCIE’s focus will include: governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response. The release includes a sample of OCIE’s requests for information and documents.

The SEC and FINRA have brought enforcement cases against firms for cybersecurity-related compliance failures. Firms have been cited for inadequate written policies and procedures, failing to enforce such policies and procedures, failing to conduct periodic self-assessments of cybersecurity-related procedures, and failing to respond to self-identified deficiencies. For example, on September 22, 2015, the SEC issued a press release announcing the settlement of an enforcement action against R.T. Jones Capital Equities Management, Inc. The SEC alleged that the firm failed to adopt any written policies and procedures to ensure the security and confidentiality of personally identifiable information (PII) of approximately 100,000 individuals, including thousands of the firm’s clients, and protect it from anticipated threats or unauthorized access.⁷ According to the SEC’s order, the firm’s web server was attacked in July 2013 by an unknown hacker who gained access and copyrights to the data on the server. No indications of a client suffering financial harm as a result of the cyber-attack were yet reported. The SEC’s order found that R.T. Jones violated Rule 30(a) of Regulation S-P under the Securities Act of 1933. Without admitting or denying the find-

ings, the firm agreed to cease and desist from committing or causing any future violations of Rule 30(a) of Regulation S-P and agreed to be censured and pay a \$75,000 penalty. Concurrently, the SEC issued an *Investor Alert: Identity Theft, Data Breaches and Your Investment Accounts*.⁸

Privacy and Safeguarding Rules

Important privacy regulations derive from the Financial Services Modernization Act of 1999, more commonly called the Gramm-Leach-Bliley (GLB) Act.⁹ The GLB Act directed the SEC,¹⁰ the Federal Trade Commission (FTC),¹¹ and the federal bank regulatory agencies to adopt consumer privacy regulations. The FTC does not examine state-registered investment advisers, but it may respond to client complaints and referrals from state securities regulators.

SEC Regulation S-P, *Privacy of Consumer Financial Information*, applies to SEC-registered broker-dealers and investment advisers. Regulation S-P implemented sections of the GLB Act and the Fair Credit Reporting Act (FCRA) for entities registered with and regulated by the SEC. SEC Rule 30 (Safeguarding Rule) requires registrants to “adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information.”

State-registered investment advisers are covered by the FTC’s *Privacy of Consumer Financial Information* rule. The FTC’s rule is more rigorous than the SEC’s Regulation S-P. Notably, it requires state-registered firms to “develop, implement, and maintain a *comprehensive information security program* that is written in one or more readily accessible parts and contains administrative, technical, and physical safeguards that are appropriate to your size and complexity, the nature and scope of your activities, and the sensitivity of any customer information at issue.”¹²

SEC—CTFC Identity Theft “Red Flags” Rules

As the name implies, the federal identity theft rules direct covered firms to take steps to prevent losses caused by identity theft through unauthorized account orders or access, including impersonations. The SEC and the Commodities Futures Trading Commission (CFTC) jointly adopted rules implementing identity theft “red flags” and guidelines under the Fair and Accurate

Firms are susceptible to various kinds of cyber threats, some more serious than others.

Credit Transactions Act of 2003 (FACTA), which amended the Fair Credit Reporting Act (FCRA). The SEC's version is Regulation S-ID, Section 248.201, and the CFTC's version is Subpart C, Section 162.30, both titled *Duties Regarding the Detection, Prevention, and Mitigation of Identity Theft* (Red Flags Rules). The SEC-CFTC Red Flags Rules apply to SEC and CFTC registrants; the FTC's Red Flags Rule applies to state-registered investment advisers.

Generally, the Red Flags Rules require a covered financial institution to develop, implement, and administer a written identity theft prevention program. The program's purpose is to detect, prevent, and mitigate identity theft in connection with the direct or indirect opening or maintenance of a covered account.¹³

FINRA Cybersecurity Rules and Guidance

FINRA's website provides cybersecurity guidance and resources for brokerage firms.¹⁴ FINRA has provided guidance about cybersecurity issues, including risks related to wireless fidelity (Wi-Fi) and remote access networks.¹⁵ Accordingly, a broker-dealer's written supervisory and control procedures must address compliance with the SEC's Safeguarding and Red Flags Rules under FINRA Rules 3110, 3120, and 3130.

Cybersecurity and identity theft prevention measures intersect in FINRA Rule 3110(c)(2). This rule requires brokerage firms to have policies and procedures to address safeguarding customer funds and securities; transmittals of funds (e.g., wires or checks, etc.) or securities from customers to third-party accounts; from customer accounts to outside entities (e.g., banks, investment companies, etc.); from customer accounts to locations other than a customer's primary residence (e.g., post office box, "in care of" accounts, alternate address, etc.); and between customers and registered representatives, including the hand-delivery of checks. Policies and procedures must also build controls around changes of customer account information, including address and investment objectives changes and validation of such changes. These are among the leading circumstances surrounding identity theft losses.¹⁶

State Breach Notification Laws

Forty-seven states require security breach notifications.¹⁷ Firms must report identified data breaches to all affected customers and, typically, to government authorities. Requirements do vary significantly by state and are not preempted by federal law. Twenty-nine of those laws contain exceptions or safe harbors for firms that are subject to, and/or comply with federal privacy laws and related rules promulgated by their federal regulator. However, the SEC has not adopted breach notification requirements, so its rules likely do not preempt state laws. Forty-seven states have also enacted "security freeze" laws that allow customers to freeze their credit reports in the event of a security breach. The national credit reporting agencies charge for security freezes, likely an expense of the firm whose cybersecurity was breached. Firms with clients in multiple states will be subject to multiple state laws with differing reporting obligations.

Business Continuity Planning and Disaster Preparedness

Cyber-attacks on a firm or on a third-party vendor on which the firm relies can have a devastating impact on normal operations, so they should be among the risks addressed in business continuity and disaster recovery planning. For example, "ransomware" is a flavor of malware restricting access to the computer system that it infects. The "infection" is then accompanied by extortionate demands for access to be restored. Ransomware may encrypt files on the computer's hard drive, lock up the system, or simply threaten data erasure if the ransom is not promptly paid. Denial of service attacks are another form of business interruption. Cybersecurity risks intersect with recordkeeping requirements when books and records are stored or archived in the "cloud." Specifically, if records are stored in electronic form it must be protected from alteration, loss, or destruction.¹⁸

Cybersecurity Resources and Planning

Commonly cited by cyber-industry experts, the National Institute of Standards and Technology (NIST), an agency of the U.S. Department of Commerce, released the first version of the *Framework for Improving Critical Infrastructure Cybersecurity* on February 12, 2014 (Framework). The Framework con-

Assessing and planning for cybersecurity risks has become a high regulatory priority among securities regulators.

Firms with clients in multiple states will be subject to multiple state laws with differing reporting obligations.

sists of voluntary standards, guidelines, and practices to promote the protection of critical infrastructure. The Framework is industry-neutral and relevant to all types of businesses. The NIST's Computer Security Division published NISTIR 7621, *Small Business Information Security: The Fundamentals*, to help small businesses and small organizations implement the fundamental components of an effective information security program.

In addition, the Securities Industry and Financial Markets Association (SIFMA) published useful *Guidance for Small Firms*,¹⁹ including a *Small Firm Cybersecurity Checklist*. These resources are useful to all business models, not just broker-dealers. These resources will aid in your development of a firm-specific approach to cybersecurity risks as you develop policies, procedures, and a program to safeguard your clients' and firm's information.

So, how to get started? Each firm's circumstances will be different, so each cybersecurity risk assessment and each program will be different, but here are some basic suggestions:

- **Muster an internal team.** Its members should include IT, operations, compliance, and front-line and back-office representatives. Involve senior management. Identify gaps in expertise—likely technology—and engage outside support. Keep records of the team's composition, meetings, and related activities.
- **Develop written cybersecurity and identity theft game plans.** Written records are critical in demonstrating your team's efforts to regulators and courts. Set and update written priorities and progress reports.
- **The Red Flags Rules include specific guidance with helpful content.** FINRA created a template designed to help small firms develop and document their "red flags" program.
- **Start with the basics.** Identify the technology you are using to remotely connect to e-mail and client information, including technology allowing clients' remote access and assess its vulnerabilities—think about all office, home, and mobile devices. Install and update antivirus software, implement passwords and user IDs.
- **Revisit your plan when prompted**

by changes and do it periodically.

When employees, representatives, and third-party vendors change, change log-ins and user access rights. New offices, new employees and representatives, new services, new vendors, and new technologies should trigger a reassessment of related cybersecurity risks.

- **Password management.** Require and train all employees and representatives to use and periodically change passwords and user IDs on all electronic devices (e.g., computers, tablets, and other mobile devices).
- **Antivirus Software, "Patches," and Encryption.** Install and update antivirus software on all electronic devices. Check for application updates and promptly install security "patches." Install encryption software on files, e-mails, and mobile electronic devices.
- **Vendors.** Do your due diligence before contracting with "cloud" service providers. Beware of free "cloud" services for data storage, back-up, and file sharing.
- **Train and Educate.** Train employees and representatives, and educate clients, on common cybersecurity risks and defensive strategies.

NOTES

1. North American Securities Administrators Association, *Compilation of Results of a Pilot Survey of Cybersecurity Practices of Small and Mid-Sized Investment Adviser Firms*, (September 2014), <http://www.nasaa.org/wp-content/uploads/2014/09/Cybersecurity-Report.pdf> ("NASAA Survey").

2. U.S. Computer Emergency Readiness Team ("US-CERT"), National Cybersecurity and Communications Integration Center (NCCIC), Department of Homeland Security, <https://www.us-cert.gov/about-us>.

3. Cybersecurity Risk Alert, SEC, <http://www.sec.gov/ocie/announcement/Cybersecurity+Risk+Alert++%2526+Appendix+-+4.15.14.pdf>.

4. *NASAA Survey Finds Mid-Sized IAs Addressing Cybersecurity Risks*, NASAA, <http://www.nasaa.org/32570/nasaa-survey-finds-mid-sized-ias-addressing-cybersecurity-risks/>.

5. *Customer Information Protection*, FINRA, <http://www.finra.org/Industry/Issues/CustomerInformationProtection/>.

6. Available at: <http://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf>. See also FINRA Targeted Examination

Letters-Cybersecurity, <http://www.finra.org/industry/regulation/guidance/targetedexaminationletters/p443219>.

7. The SEC's press release and order are available at: <http://www.sec.gov/news/pressrelease/2015-202.html>.

8. Available on the SEC's website at: http://www.sec.gov/oiea/investor-alerts-bulletins/ia_databreaches.html.

9. Title V of the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999), 15 U.S.C. § 6801, *et seq.*

10. SEC Regulation S-P, *Privacy of Consumer Financial Information*, 17 C.F.R. § 248 (2000).

11. FTC, *Standards for Safeguarding Customer Information*, 16 C.F.R. Part 314, 67 FR 36493 (2002).

12. 16 CFR 314.3(a).

13. See also *Fighting Identity Theft with the Red Flags Rule: A How-To Guide for Business*, FTC, May 2013, <http://www.business.ftc.gov/documents/bus23-fighting-identity-theft-red-flags-rule-how-guide-business>.

14. FINRA Customer Information Protection, <http://www.finra.org/Industry/Issues/CustomerInformationProtection/>; and Firm Identity Theft, <http://www.finra.org/Industry/Issues/CustomerInformationProtection/p117442>.

15. NASD Notice to Members 05-49, *Safeguarding Confidential Customer Information* (2005), http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_014772.pdf.

16. The FINRA report is at http://www.finra.org/sites/default/files/p602363%20Report%20on%20Cybersecurity%20Practices_0.pdf.

17. See National Conference of State Legislatures website for a list of states at: <http://www.ncsl.org/research/telecommunications-and-information-technology/security-breach-notification-laws.aspx>.

18. For SEC-registered investment advisers, see Rule 204-2(g), 17 C.F.R. 275.204-3; state law imposes similar requirements on state-registered investment advisers. For broker-dealers, see SEC Rules 17a-3 and 17a-4, 17 C.F.R. 240.17a-3 *et seq.*

19. Available at <http://www.sifma.org/issues/operations-and-technology/cybersecurity/guidance-for-small-firms/>.



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Franchising and Franchise Law: An Introduction

By Howard Yale Lederman

Introduction

Franchising is a national and international strategy for growing a business. A franchise is a business and contractual relationship between a franchise owner called a franchisee and a franchise seller called a franchisor. Franchising begins with a franchisee seeking to buy a franchise from a franchisor. Franchising involves an agreement. The franchisor grants the franchisee, for a defined time period, the right to use the franchisor's business model and intellectual property, such as signs and logos, trademarks and service marks, business plans and operations manuals, necessary to operate the business. The franchisor also provides marketing and sales assistance, training, operating manuals, and other assistance to promote and grow the brand. In return, the franchisee pays an initial franchise fee, regular royalty payments on sales, and sometimes other payments, like advertising fees, to the franchisor.¹ The word "franchise" originated from the French word for freedom and involved a ruler's grant of a royal privilege to a subject "to perform public or other services in exchange for consideration."² But franchising has become synonymous with almost complete franchisor control and rigid uniformity.³ Franchisor control over the franchisee is usually almost 100 percent.

"Franchisors typically display an intense commitment to standardizing routines and services across affiliated units. McDonald's standardized every aspect of operations, including food preparation, customer service, and cost control."⁴ For example, a McDonald's franchise agreement reads:

The McDonald's System is a comprehensive restaurant system for the retailing of a limited menu of uniform and quality food products, emphasizing prompt and courteous service in a clean, wholesome atmosphere.... The foundation of the McDonald's System and the essence of this [Franchise] is adherence by [Franchisee] to standards and policies of [Franchisor] providing for the uniform operation of all McDonald's

*restaurants...including, but not limited to, serving only designated food and beverage products; the use of only prescribed equipment and building layout and designs; strict adherence to designated food and beverage specifications and to Licensor's prescribed standards of Quality, Service, and Cleanliness....*⁵

Why Franchising?

Why has franchising grown so much compared to alternatives, like company-owned outlets, independent dealerships, or independent distributorships?

Since franchisors often offer proven successful business models, many individuals interested in starting businesses choose franchising over more independent alternatives. A powerful incentive for them to do so is the high, new-small-business-failure rate—according to the U.S. Small Business Administration, only "about half of all new establishments survive five years or more[,] and about one-third survive 10 years or more."⁶ "Franchising makes the possibility of owning one's own business available to thousands of people to whom it otherwise would not have been available. For those [having] no previous business experience, franchising may offer a shortcut to ownership of a business."⁷

"For the most part, franchising substantially reduces the risk of owning and running a new business." Franchising is based on the franchisee's right to use the franchisor's intellectual property, like trademarks, service marks, signs, and logos. Since potential customers recognize the franchisor's intellectual property, they are likelier to become franchisee customers. "Because the franchisor usually has an established product or service, the franchisee runs considerably less risk of failing to launch a new product."⁸

Franchising reduces the barriers to opening a business. The franchisee does not have to create a product or service, find a location without help, or identify a market without help. Due to the franchisor's economic power, raising capital is much easier. Find-

ing a desirable location and leasing desirable building space are easier.⁹

Franchising makes running a business easier. Many franchise systems provide established suppliers, "accounting systems tailored to the business, train the franchisee in operations, and provide continuing guidance and counseling."¹⁰

The franchisee can take advantage of the franchisor's greater purchasing power and thus obtain lower supply and service prices from franchisor purchase of greater volumes of these supplies and services.¹¹

But franchising also has a downside for franchisees. "Most first-time franchisees barely survive the ordeal of opening a single unit. Getting a business off the ground can gut bank accounts, spike stress levels, and create 80-hour workweeks."¹²

For franchisors, franchising also has some big advantages over alternatives. Franchising enables the franchisor to create and "maintain a large number of consumer outlets to distribute his products without having to invest his own money in the retail end of the operation. This is perhaps the prime advantage of franchising as an alternative to company-owned sales outlets. A vast distribution system can be quickly accomplished with a relatively [low investment] in sales outlets."¹³

"Franchising is a method for spreading the capital cost of market expansion. Increasing the market for any product or service usually requires expenditures in facilities, sales outlets, personnel, inventory, and advertising. Immense effort must be put into opening a new market, and there is always a risk of failure. In franchising, the franchisee bears a considerable portion of these burdens, especially the cost of establishing new outlets and the risk of opening new markets. The franchisor is thus relieved of this cost[,] but nonetheless receives a fee for the use of its name, trademarks, and business concepts."¹⁴

Compared to alternatives, franchising often enables a franchisor to expand a product or service market more rapidly. Rapid expansion often enables a franchisor to capitalize on product or service market opportunities more rapidly and thus increase sales and even dominate a market.¹⁵

Franchising enables a franchisor to capitalize on its intellectual property to create and market related products or services. For example, a hair salon franchisor can create hair salons and market hair care products at

franchise outlets, an ice cream manufacturer can franchise ice cream shops, or a picture frame manufacturer can franchise "do-it-yourself framing" outlets.¹⁶

Franchising enables a franchisor to market complex products demanding substantial maintenance or repair. "Through franchising, the franchisor may provide for a network of franchisees...trained and qualified to service the product without incurring the cost of setting up service centers itself." The franchisor can control how the franchisee services the products,¹⁷ and the franchisor can train the franchisee's employees on how to service the products. In addition, the franchisor can require the franchisee to maintain defined maintenance and repair equipment and a defined parts inventory. For example, in the motor vehicle, bicycle, and agricultural equipment lines of business, the manufacturers require and arrange for necessary training of the franchisee's employees on how to service these complex products, necessary servicing equipment, and the necessary parts inventory.¹⁸

"Franchising has inherent efficiencies as a method of doing business....it relieves the franchisor of the burden of managing individual sales outlets and of carrying the overhead and burden associated with those businesses." Moreover, the franchisor can secure lower prices for supplies and services with its greater purchasing power arising from "having many different outlets selling identical products or services[,] thus needing the same components, ingredients, and the like. In addition, "individual franchise [owners]...tend to be more productive than employee managers of company-owned stores."¹⁹

Franchising enables franchisors to capitalize on franchisees' knowledge of local market conditions.²⁰ Finally, franchising often enables franchisors to avoid the burdens and costs of complying with federal and state labor and employment laws and to pass these burdens and costs to franchisees.

The vast majority of courts have concluded that the franchisor-franchisee relationship is not an employer-employee relationship, but an independent contractor relationship.²¹ "One of the hallmarks of franchising as a business model is that franchisors seek to ensure that their franchisees are seen and treated as independent contractors[,] rather than as employees."²² The franchisee's employees are usually not the franchisor's employees,

Since franchisors often offer proven successful business models, many individuals interested in starting businesses choose franchising over more independent alternatives.

but a joint employer situation can arise in some circumstances.

Franchising Is a Growing and Important Part of Our Economy

Since 1945, franchising has mushroomed into a large and growing part of our economy. According to International Franchising Association (IFA) estimates, despite the recent severe recession, the number of franchising establishments remained substantial. Since 2011, the number has rebounded almost to its prerecession level:

2007: 770,835
2008: 774,016
2009: 746,646
2010: 740,335
2011: 735,571
2012: 747,359
2013: 757,857
2014: 769,683

2015 (Estimated): 781,794²³

Franchise employment has remained substantial. The number of direct franchise-based employees has far surpassed its prerecession level:

2007: 7,994,000
2008: 8,028,000
2009: 7,800,000
2010: 7,786,000
2011: 7,934,000
2012: 8,127,000
2013: 8,334,000
2014: 8,569,000

2015 (Estimated): 8,816,000²⁴

Franchising's gross domestic product has also far surpassed its prerecession level:

2007: \$403 Billion
2008: \$410 Billion
2009: \$405 Billion
2010: \$414 Billion
2011: \$434 Billion
2012: 453 Billion
2013: 473 Billion
2014: 495 Billion

2015 (Estimated): 521 Billion²⁵

"Franchising is an American success story. Independently owned and operated local franchise businesses are growing faster, creating more jobs at a quicker pace and producing higher sales growth than other businesses. Franchising is an engine of economic expansion in the United States[,] and 2015 looks to be another strong year for franchise businesses[.]"²⁶

Over the last three decades, franchising has spread rapidly around the world.²⁷

Federal Pre-Franchise Agreement Disclosure Requirements

Before the parties can sign a franchise agreement, federal regulations require the franchisor to disclose extensive documents, facts, and information to the franchisee. The relevant federal rule is the FTC Disclosure Rule known as the Amended FTC Franchise Rule, the New FTC Franchise Rule, or just the FTC Franchise Rule (FTC Rule).²⁸ The Original and Amended FTC Rules have created minimum federal disclosure requirements. The FTC Rule does not preempt nonconflicting state laws requiring greater disclosure.²⁹ On December 21, 1978, the FTC issued the Original or Old FTC Rule effective October 21, 1979, mandating franchisor presale disclosure of 19 items of documents and information to potential franchisees.³⁰ On March 30, 2007, the FTC amended the Original or Old FTC Rule and issued the Amended or New FTC Franchise Rule mandating franchisor presale disclosure of 23 items and optional presale disclosure of one more important item under strict accuracy conditions.³¹ The Original and Amended FTC Rules' main purpose is to prevent franchise fraud.³² The 24 items are:

1. The Franchisor's Identity and any Parents', Predecessors', and Affiliates' Identities
2. The Franchisor's Business Experience
3. The Franchisor's Litigation History
4. The Franchisor's Bankruptcy History
5. The Franchisor's Required Initial Fees
6. The Franchisor's Required Other Fees
7. The Franchisor's Estimated Initial Franchisee Investment
8. The Franchisor's Restrictions on The Franchisee's Products and Services Sources
9. The Franchisee's Obligations to the Franchisor
10. Financing Available to the Franchisee
11. The Franchisor's Assistance, Advertising, Computer Systems, and Training Available to the Franchisee

The vast majority of courts have concluded that the franchisor-franchisee relationship is not an employer-employee relationship, but an independent contractor relationship.

12. The Franchisor's Territories Policy
13. The Franchisor's Trademarks Available to the Franchisee.
14. The Franchisor's Patents, Copyrights, and Proprietary Information Available to the Franchisee
15. The Franchisee's Obligation to Participate in the Actual Operation of the Franchise Business
16. The Franchisor's Restrictions on What the Franchisee May Sell
17. The Franchisor's Renewal, Termination, Transfer, and Dispute Resolution Policies
18. Public Figures Involved in the Franchise Marketing or Sales Program
19. The Franchisor's Financial Performance Representations to Potential Franchisees
20. The Franchisor's Company and Franchise Outlets and Franchisee Information
21. The Franchisor's Current, Audited Financial Statements
22. The Franchisor's Proposed Franchise Agreement Provisions Descriptions
23. The FDD Delivery Receipts
24. Exhibits-The Franchise Agreement³³

Regarding Item 19, Financial Performance Representations, if the franchisor discloses any such representations, they must be accurate.³⁴ The franchisor cannot disclaim or compel the potential franchisee "to waive reliance on any [FDD representation]." The FTC Rule bars the franchisor from disclaiming or compelling a prospective franchisee to waive reliance on any FDD representation, unless the disclaimer or waiver relates to contract changes resulting from franchisor-franchisee negotiations.³⁵ The franchisor must disclose the mandatory documents, facts, and information to the potential franchisee at least 14 days before the potential franchisee signs a franchise agreement or pays a payment to the franchisor or a franchisor agent or affiliate related to the proposed franchise sale.³⁶ If the potential franchisee asks the franchisor to disclose the mandatory items earlier, the franchisor must do so.³⁷ If not disclosing financial performance information, the franchisor must include a prescribed preamble warning prospective franchisees not to rely on its agents' and employees' unauthorized financial performance representations.³⁸

The franchisor must disclose the items above in a uniform format document called a Franchise Disclosure Document (FDD).³⁹ The FDD's documents, facts, and information must be current as of the close of the franchisor's fiscal year.⁴⁰ Within a reasonable time after the end of each quarter, the franchisor must prepare and furnish FDD updates to potential franchisees.⁴¹

If the franchisor changes any proposed franchise agreement provision materially and unilaterally, the franchisor must disclose any such change to the potential franchisee at least seven days before the potential franchisee signs the proposed franchise agreement. The franchisor must disclose any such changes in the form of a modified proposed franchise agreement.⁴² Otherwise, if the franchisor presents a proposed franchise agreement materially different from the FDD sample franchise agreement, the FTC may proceed against the franchisor under the FTC Act for a deceptive practice.⁴³

Before furnishing the FDD, the franchisor must notify the potential franchisee of available FDD formats and any conditions or requirements for obtaining or reviewing the FDD in any particular format.⁴⁴ The franchisor can furnish the FDD, all FDD updates, and all FDD changes in electronic formats. But the franchisor must furnish the FDD, all FDD updates, and all FDD changes to the potential franchisee in a form permitting the potential franchisee to download, store, print, or otherwise maintain them for future use.⁴⁵ Any provided electronic FDDs, FDD updates, and FDD changes cannot include audio, video, pop-up screens, or any external links. But any provided electronic FDDs, FDD updates, and FDD changes can include internal links and search features.⁴⁶

FTC Rule Exemptions

The FTC Rule has several exemptions, including:

- The Minimal Required Payment Exemption, which applies to situations in which required payments or payment commitments, until six months after the franchisee begins operating, total less than \$540.⁴⁷
- The Fractional Franchise Exemption, which applies to situations in which "the franchisee or any of its officers, directors, or [parent corporation] officers or directors, or [affiliate corporation] officers or directors has

Before the parties can sign a franchise agreement, federal regulations require the franchisor to disclose extensive documents, facts, and information to the franchisee.

Besides the FTC disclosure rule, there are three kinds of state franchise and other laws regulate franchising: registration laws, disclosure laws, and relationship laws. The first two kinds are pre-contract laws, while the last kind is a post-contract law.

more than two years of experience in the same type of business, and the parties have a reasonable basis to anticipate that the sales from the relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year of operation."⁴⁸

- The Leased Department Exemption, which applies to situations where "[t]he franchise relationship is a leased department[]" defined "as an arrangement under which a retailer licenses or permits a seller to conduct business from its premises[,] and where the seller does not purchase goods, services, or commodities from the retailer or any person with whom it requires the seller to do business." Leased departments sometimes arise "in certain department store departments."⁴⁹
- The U.S. Petroleum Marketing Practices Act Exemption, which applies to situations where the U.S. Petroleum Marketing Practices Act covers the franchise relationship.⁵⁰
- The Large Investment Exemption, which applies to situations where "[t]he franchisee's initial investment," with certain exclusion, "totals at least \$1,084,900[,] and the prospective franchisee signs an acknowledgement verifying the grounds for the exemption" in specified language.⁵¹
- The Sophisticated Investor Exemption I, which applies to situations where "[t]he franchisee (or its parent or any affiliate) has been in business for at least five years and has a net worth of at least \$5,424,500."⁵²
- The Sophisticated Investor Insider Exemption II, which applies to situations where at least one buyer "of at least a 50% ownership interest in the franchise within 60 days of the sale, has been, for at least two years, an officer, director, general partner, individual, with management responsibility for the offer and sale of the franchisor's franchises or the administrator of the franchised network; or within 60 days of the sale, has been, for at least two years, an owner of at least a 25% interest in the franchisor."⁵³

- The Oral Franchise Agreement Exemption, which applies to situations where "[t]here is no written document [describing] any material term or aspect of the relationship or arrangement."⁵⁴

Kinds of State Franchise Laws

Besides the FTC disclosure rule, there are three kinds of state franchise and other laws regulate franchising: registration laws, disclosure laws, and relationship laws. The first two kinds are pre-contract laws, while the last kind is a post-contract law. State registration laws require franchisors to register their franchise opportunities with a state agency before offering them to potential franchisees. Like the FTC Rule, state franchise disclosure laws require pre-contract franchisor disclosures regarding the franchise opportunities. State franchise relationship laws regulate post-contract franchisor-franchisee relationships. These laws cover such areas as franchise agreement terminations, franchise renewals, and franchise transfers. The Michigan Franchise Investment Law (MFIL)⁵⁵ is a combination disclosure and relationship law. In contrast, California and Wisconsin have two separate laws regulating disclosures and relationships.

The MFIL has franchise presale disclosure requirements similar to the FTC Rule. At least ten business days before the potential franchisee signs a franchise agreement or at least ten days before the franchisor receives any consideration, "whichever occurs first," the franchisor must provide an FDD or similar document to the franchisee disclosing documents and information similar to the FTC Rule's required disclosure.⁵⁶ In the franchise sale process, the franchisor's directors, officers, and salespeople must adhere to the FTC Rule and applicable state disclosure and registration laws strictly. Also, if selling franchises in more than one state, franchisors must adhere to all the relevant states' disclosure and registration laws.⁵⁷

It is important to note that only the FTC can enforce its disclosure rule, which does not include an express or implied private right of action. Instead, an aggrieved franchisee must look to its state's little FTC Rule or state franchise or similar law.⁵⁸

What Is a Franchise?

The FTC Rule and the MFIL have a similar three-part franchise definition. To be a franchise, a business relationship must meet

these three requirements: (1) a franchisee has the right to operate a business identified or associated with the franchisor's logo, sign, service mark, trademark or similar intellectual property; (2) significant franchisor control over or assistance to the franchisee; and (3) a required franchisee payment, a franchise fee, to enter the business.⁵⁹ Whether a business relationship is a franchise does not depend on which terms the parties use to describe their relationship. For example, if the parties use terms like "license," "consulting agreement," "dealer agreement," or "distributorship agreement," but if their relationship has the above three characteristics, the courts will regard their relationship as a franchise and hold applicable the FTC Rule and any related state franchise laws.⁶⁰

The key is not whether the franchisor provides a trademark or other commercial symbol, exercises significant control, or provides significant assistance. The key is whether the franchisor represents that, after the franchisee signs the franchise agreement, the franchisor provides a trademark or other commercial symbol, exercises significant control, or provides significant assistance.⁶¹ The franchisor's precontract and contemporaneous representations regarding the relationship's characteristics as of the franchise agreement date define and govern the parties' agreement and their post-agreement relationship.⁶² The FTC intended for the courts and the franchising community to read the three franchise definitional elements broadly. For example, the word "trademark" encompasses other forms of intellectual property, such as logos, service marks, symbols, trade dress, and trade names.⁶³ "Indeed the right to use the franchisor's mark [including the preceding forms of intellectual property] is an integral part of franchising."⁶⁴

To be significant, the franchisor's assistance or control "must relate to the franchisee's overall method of operation—not a small part of the franchisee's business."⁶⁵ Examples of significant control include:

- Site approval for new franchise locations
- Store or center appearance or design requirements
- Territorial or similar restrictions
- Hours of operation
- Production or service methods
- Accounting practices
- Employment policies and practices
- Marketing campaigns requiring

franchisee participation or payments

- Restrictions on kinds of clients or customers served
- Inventory controls⁶⁶

Examples of significant assistance include:

- Some kinds of marketing and sales assistance
- Employee training
- Employment policies and practices assistance
- Accounting systems assistance
- Site location assistance
- Website assistance
- Systemwide networks assistance
- Detailed operations and similar manuals⁶⁷

The following are not significant assistance or control:

- Some kinds of marketing assistance
- Trademark restrictions
- Compliance requirements with federal, state, or local laws or regulations⁶⁸

The FTC reads the minimum payment or franchise fee requirement "broadly," encompassing many kinds of payments, including:

- A mandatory initial franchise fee,
- Mandatory rental payments,
- Mandatory advertising assistance fees,
- Some mandatory equipment and supplies payments,
- Mandatory training fees,
- Mandatory security deposits,
- Mandatory escrow deposits,
- Mandatory accounting charges,
- Mandatory marketing literature charges,
- Mandatory equipment rental payments,
- Mandatory equipment purchase payments for equipment obtainable only from the franchisor,
- Mandatory continuing royalties on sales.⁶⁹

However, the minimum payment or franchise fee requirement does not encompass these kinds of payments:

- Payments for inventory or supplies at bona fide wholesale prices
- Payments to third parties for ordinary business expenses⁷⁰

The FTC Rule defines "franchise," "franchise seller," and "franchisee" broadly. The FTC Rule defines franchisee as "any person[,] who is granted a franchise."⁷¹ The FTC

The FTC intended for the courts and the franchising community to read the three franchise definitional elements broadly.

Rule defines franchisor as “any person[,] who grants a franchise and participates in the franchise relationship.”⁷² The FTC Rule defines “franchise seller” as “a person that offers for sale, sells, or arranges for the sale of a franchise[.]”⁷³

Kinds of Franchises and Kinds of Franchisee Payments

There are two kinds of franchises—a product franchise and a business format franchise.⁷⁴ A product franchise is a franchise relationship, where the franchisee sells the franchisor’s products or services, sometimes exclusively, sometimes not. While permitting the franchisee to use its trademarks and other intellectual property, the franchisor does not sell a business model or system to the franchisee. The focus is on the product or service. Examples include motor vehicle dealerships and soft drink bottlers. A business format franchise is a franchise relationship, where the franchisor sells the right to use a business model or system. The focus is on the business model or system. The franchisee operates under a 100 percent franchisor-controlled business model or system. Most restaurant, fast food, hotel/motel, and moving franchise systems are business format franchises. Franchisees can be single-unit or multi-unit franchisees.⁷⁵

The franchisor can collect revenue in several ways, such as by an initial franchise fee, wholesale price markups for inventory sold to the franchisee, ongoing royalties, advertising fees, accounting fees, management consultation fees, training fees, and location selection fees.⁷⁶

Dealerships and Distributorships

The terms “dealership” and “distributorship” are often considered the same as and used interchangeably with “franchise.” They meet most franchise definitional requirements. But they are different, sometimes far different. Although similar to a franchise, especially a product franchise, a dealership is just different enough from a franchise to trigger different legal standards. Compared to a franchisor, a manufacturer’s control over its dealer is usually less. A manufacturer’s marketing assistance is usually less comprehensive. The manufacturer does not charge the dealer an initial fee. Rather, the manufacturer makes money from selling inventory to the dealer. Examples of dealers are motor vehicle

manufacturers, agricultural equipment dealers, and office equipment dealers.⁷⁷

In contrast, a distributorship differs from a franchise greatly. The manufacturer “rarely provides a marketing system or plan[.]” The manufacturer “may, at most, provide some advertising support or assistance in promoting the product.” The distributor does not pay any initial fee for the right to sell the [manufacture’s] products or to use its trademark.” Distributorships include wholesalers and certain kinds of retailers, such as industrial chemicals, equipment, and machinery.⁷⁸

Disclosure and Registration

In twelve states, the franchisor must file its offer with a state agency. In three states, the franchisor cannot sell franchises without first furnishing a disclosure document to the franchisee, but they do not require registration. To register, the franchisor files an FDD with applicable state additions and the required fee with a state agency. The state agency reviews and approves or disapproves the disclosure document. If the state agency disapproves, the franchisor cannot offer or sell franchises in the state. Under the FTC Rule and state acts, the franchisor must update the FDD periodically for it to remain effective.⁷⁹

Franchisees’ attorneys need to ask clients whether the franchisor has furnished them with an FDD. If not, this failure or refusal is a red flag.⁸⁰

The franchisor’s attorney is involved in the main registration and disclosure steps—evaluating the particular federal and state disclosure and registration requirements, preparing the disclosure documents, and ensuring compliance with the requirements. The franchisor’s attorney resolves any doubts on whether the system is a franchise in favor of franchise. A franchisee’s attorney evaluates whether the franchisor has disclosed all the required documents and information and whether the franchisor has complied with all the rule’s form, format, and timeliness requirements.⁸¹

In registration states, franchisees’ attorneys need to check the state registration offices to make sure that the franchisor has registered, and that the registration statement is current. Franchisees’ attorneys “should review the FDD carefully to see whether it appears to be accurate and complete.” They should research the franchisor and its principals on the Internet for any relevant information. Franchisees’ attorneys should review

the franchise agreement's provisions carefully and discuss its provisions with their clients carefully. Franchisors' attorneys need to watch for possible personal liability for violating or participating in violating the disclosure rules and laws, just as in the securities law field.⁸²

NOTES

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3. See, e.g., *Husain v McDonald's Corp*, 205 Cal App 4th 860, 869, 140 Cal Rptr 3d 370 (2012); Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 Stanford L Rev 927, 932 (Apr 1990) ("the franchisor typically exercises significant [and] relatively unrestricted decisionmaking authority.") & 934 (In business format franchising, "the distinguishing characteristic is that the franchisee is under the control of the franchisor[,] and thus is instructed how to run her business as an employed manager would be.") (April 1990); Thomas McCarthy, *Trademark Franchising and Antitrust: The Trouble With Tie-Ins*, 58 Cal L Rev 1085, 1090 (1970), Donald Chisum, *State Regulation of Franchising: The Washington Experience*, 48 Wash L Rev 291, 297 (1973).
4. Arturs Kalnins & Kyle J Mayer, *Franchising, Ownership, and Experience: A Study in Pizzeria Restaurant Survival*, 50 Management Science 1716, reprinted in *The Scholarly Commons* (December 2004), available at <http://scholarship.sha.cornell.edu/cgi/viewcontent.cgi?article=1301&context=articles>.
5. *Husain*, 205 Cal App 4th 860, 869.
6. SBA Office of Advocacy, *Frequently Asked Questions* (March 2014), available at https://www.sba.gov/sites/default/files/FAQ_March_2014_0.pdf. *Accord*, Scott Shane, *Start Up Failure Rates: The Definitive Numbers*, Small Business Trends (Dec 17, 2012), available at <http://www.smallbusinesstrends.com/2012/12/start-up-failure-rates-the-definitive-numbers.html> (analyzing several studies and finding: "The typical new business started in the United States is no longer in operation five years after being founded."), Jim Clifton, *American Entrepreneurship: Dead or Alive?*, Business Journal (January 13, 2015), available at <http://www.gallup.com/businessjournal/180431/american-entrepreneurship-dead-alive.aspx> ("for the first time in 35 years, American business deaths now outnumber business births" by about 70,000 in 2009-2014). See also, Susan Ward, *Should You Buy a Franchise* (undated), available at <http://www.sbinfocanada.about.com/franchiseinfo/a/buyfranchise.htm> (in Canada, franchisees have an 80% survival rate, while nonfranchisees have a 70-80% failure rate).
7. W Michael Garner, 1 *Franchise and Distribution Law* (Thomson Reuters 2014-2015 ed) Sec 1:3.
8. *Id. Accord*, David E Holmes, *The Advantages and Disadvantages of Franchising* (2003), available at http://www.holmeslofstrom.com/z_pdf/articles/franchisors/Fran%20Advantages.pdf (customers are likelier to identify the franchisor's intellectual property with the franchisee and become the franchisee's customers).
9. W Michael Garner, 1 *Franchise and Distribution Law* (Thomson Reuters 2014-2015 ed) Sec 1:3; David E Holmes, *The Advantages and Disadvantages of Franchising* (2003), available at http://www.holmeslofstrom.com/z_pdf/articles/franchisors/Fran%20Advantages.pdf.
10. W Michael Garner, 1 *Franchise and Distribution Law* (Thomson Reuters 2014-2015 ed) Sec 1:3; Susan Ward, *Should You Buy a Franchise* (Undated), available at <http://www.sbinfocanada.about.com/franchiseinfo/a/buyfranchise.htm>.
11. Susan Ward, *Should You Buy a Franchise* (Undated), available at <http://www.sbinfocanada.about.com/franchiseinfo/a/buyfranchise.htm>.
12. Jason Daley, *The Unique Challenges and Benefits of Multi-Unit Franchising*, Entrepreneur (July 19, 2013), available at <http://www.entrepreneur.com/article/226763>.
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16. W Michael Garner, 1 *Franchise and Distribution Law* (Thomson Reuters 2014-2015 ed) Sec 1:3.
17. *Id.*
18. *Id. Accord*, David E Holmes, *The Advantages and Disadvantages of Franchising* (2003), available at http://www.holmeslofstrom.com/z_pdf/articles/franchisors/Fran%20Advantages.pdf (franchisee has more stake in the business than a company manager).
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35. 16 CFR 436.9(h); FTC, *Future Rule 16 CFR Part 436 Compliance Guide* (May 2008), p 20; CCH, *FTC Disclosure Rules for Franchising & Business Opportunities* (Walters Kluwer CCH 2007) p. 45.
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37. 16 CFR 436.9(e); FTC, *Future Rule 16 CFR Part 436 Compliance Guide* (May 2008), p 20; Robert M Barkoff & Andrew C Seldin, *Fundamentals of Franchising* (3d ed ABA 2008), p 112.
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82. *Id.*



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Case Digests

Securities—Private Right of Action

Harris v TD Ameritrade, Inc, No 15-5220, 2015 US App LEXIS 17601 (6th Cir Oct 8, 2015).

In 2005, the plaintiffs bought tens of thousands of shares in Bancorp International Group through a TD Ameritrade account. The shares were held in “street name,” meaning TD Ameritrade used another entity, Depository Trust & Clearing Corporation, to hold the securities on the plaintiffs’ behalf. Six years later, the plaintiffs sought to hold some of their Bancorp International stock registered in their name and reflected in a physical copy of a certificate signifying their ownership. TD Ameritrade refused to convert the plaintiffs’ form of ownership, explaining that Depository Trust had placed all Bancorp International stock in a global lock that prohibited activity in the stock, including changing the form of ownership. Depository Trust had imposed the lock because someone had fraudulently created hundreds of millions of invalid shares of Bancorp International stock.

Dissatisfied with this explanation, plaintiffs sued TD Ameritrade to correct the problem, alleging that TD Ameritrade had violated an SEC rule and Nebraska’s version of the Uniform Commercial Code. See SEC Rule 15c3-3, 17 CFR 240.15c3-3(b), (h), (l); Neb Rev Stat UCC 8-504, 8-506, 8-507, 8-508. They sought an injunction requiring TD Ameritrade to convert the ownership form, and they also sought punitive damages. After TD Ameritrade removed the case to federal court based on federal question jurisdiction, the district court dismissed the case under Fed R Civ P 12(b)(6). *Harris v TD Ameritrade, Inc*, No 4:14-cv-017, 2015 US Dist LEXIS 15192 (ED Tenn Feb 9, 2015).

The Sixth Circuit affirmed the district court. Although SEC Rule 15c3-3 places a number of obligations on securities brokers and dealers, neither the rule nor the Securities Exchange Act of 1934 creates a private right of action related to the plaintiffs’ claim. The court also refused to imply a private right of action under the court’s equitable powers. As for the UCC claim, the court rejected the plaintiffs’ argument that the UCC creates a private or implied right of action to vindicate the plaintiffs’ rights. The court suggested that the plaintiffs’ best remedy might be to ask the SEC or a state agency to enforce a violation of the duties of federal or state law against TD Ameritrade.

WARN Act—Unforeseeable Business Circumstances Exception

Calloway v Caraco Pharm Labs, Ltd, 800 F3d 244 (6th Cir 2015).

Defendant pharmaceutical manufacturer was subject to the regulatory authority of the Food and Drug Administration (FDA) and received several warning letters and other

notices over several years relating to production problems found during inspections. After recalls, audits, and other actions, the FDA filed a forfeiture complaint, and the company began a mass layoff a few days later. The company did not send a notice to any of the employees until the layoffs began, and eventually issued WARN Act notices 11 days after the layoff. The notices stated that they were late because the company did not “reasonably foresee that the FDA would take the action that it did.” The plaintiffs filed a complaint alleging that defendant violated the WARN Act by not providing a 60-day notice of the mass layoff. At a bench trial the district court awarded damages to the plaintiffs in the stipulated amount of \$491,723.99, as well as prejudgment interest and attorney fees.

The Sixth Circuit noted that the full 60-day notice period is not required if the closing is “caused by business circumstances that were not reasonably foreseeable as of the time that notice would have been required.” 29 USC 2102(b)(2)(A). To qualify for this exception, the defendant “must prove two elements: (A) that the circumstances complained of were unforeseeable; and (B) that the circumstances complained of actually caused the mass layoff or plant shutdown.” The Sixth Circuit held that the district court properly concluded that the defendant’s actions in the months leading up to the layoff demonstrated that the company was aware of serious deficiencies at its facilities that rendered imminent enforcement action foreseeable. The defendant could have issued notice to its employees of (or conditional notice of probable layoffs caused by) an imminent enforcement action without actually conducting the layoffs if the action never occurred. The court stated that to hold otherwise would all but do away with the WARN Act’s requirements because the exact date of a government enforcement action will rarely, if ever, be foreseeable. The district court did not engage in analysis by hindsight and did not fail to consider the circumstances that led to the mass layoff. Thus, the court held that defendant was not entitled to the unforeseeable business circumstances exception under the WARN Act.

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